

# PUBLICATION

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## Spotlight on District of Columbia: Update - Enactment of Mandatory Unitary Combined Reporting

July 19, 2011

During its 2009 legislative session, the District of Columbia Council enacted legislation that directed the Council to enact legislation in 2010 requiring unitary combined reporting for D.C. corporate taxpayers. Although enactment did not occur last year, it now appears imminent.

The D.C. "Fiscal Year 2012 Budget Support Act of 2011" contains the implementing legislation for mandatory unitary combined reporting for the District. It was enrolled and sent to the Mayor on July 8, 2011. Mayor Gray now has 10 days, excluding weekends and holidays, to act on the bill, until approximately July 22. If approved, the bill is still subject to a 30 day Congressional review period (a "day" is counted only when both the House and Senate are in session.) The bill becomes D.C. law after the Congressional review period ends.

### Specifics of D.C.'s Mandatory Unitary Combined Reporting Legislation

Unitary combined reporting requires a corporate taxpayer who is a member of an affiliated group of corporations to determine its state taxable income by reference to its and the business income and apportionment factors of its affiliates with which the taxpayer is engaged in a unitary business. The combined income is apportioned to the taxing state using the combined apportionment factors.

Any corporation, including an S corporation and an entity that elects to be taxed as a corporation for federal income tax purposes, that does business in D.C. or has an affiliate doing business in D.C. (and corporate investors, partners or members of a flow-through entity doing business in D.C.) will be affected by D.C.'s new tax legislation.

Some of the specifics of the legislation include:

- Mandatory unitary combined reporting will be effective for tax years beginning "on or after December 31, 2010."
- A "unitary business" is defined as "a commonly controlled group of business entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts."
- The legislation requires the filing of a "water's edge" combined report. A "water's edge" group generally means commonly controlled and unitary corporations that are (a) incorporated in the United States or in any of its territories or possessions; (b) foreign corporations having 20 percent or more of their apportionment factors (property, payroll and sales) within the U.S.; (c) foreign corporations with income effectively connected with the conduct of a trade or business in the U.S.; (d) any "controlled foreign corporation" that has "Subpart F income," as defined for federal income tax purposes; (e) a foreign corporation that is a resident of a foreign country that is not a party to a tax treaty with the U.S. and that earns 20 percent or more of its income from intangible property licensed to or services provided to members of the water's edge group; or (d) a foreign corporation that is doing business in a foreign "tax haven" jurisdiction.

- A "worldwide unitary combined reporting" election is provided in which all commonly controlled and unitary corporations wherever organized and doing business may be included in the D.C. combined report. The election is effective for 10 years and generally cannot be withdrawn during that 10 year period.
- If the "taxpayer member" of the D.C. combined reporting group has a net operating loss (NOL), the NOL can be carried back or forward to offset only that member's net income for a prior or future tax year, not the combined income of the unitary group.
- Similarly, any tax credit of a taxpayer member not fully utilized in one tax year is only allowed to that member in future carry forward years and not to any other taxpayer member of the group.
- A member or corporate partner's distributive share of partnership/LLC income and apportionment factors flow through and into the partner's/member's combined report of income.
- If the partnership or LLC is subject to the D.C. unincorporated business franchise tax, the unincorporated entity's income or loss is separately apportioned to D.C. and the unincorporated entity is taxed on that income. However, the post-apportioned income or loss of the unincorporated entity is then included in the member or corporate partner's D.C. combined report of income.
- Dividends paid by one member of the unitary group to another member "to the extent those dividends are paid out of the earnings and profits of the unitary business included in the combined report, in the current or an earlier year" are eliminated from the income of the dividend recipient. This provision is borrowed from California, but is a trap for the unwary, as it presents a potential "Willamette situation" for unitary groups with respect to dividend distributions of pre-unitary earnings. (*Willamette Industries, Inc. v. Franchise Tax Board*, decided in 1995.) As a result, distributions of earnings from newly acquired corporations may not qualify for dividend elimination for the recipient. And, D.C.'s dividends received deduction may be unavailable, as it is limited to only dividends received from wholly owned subsidiaries.
- For publicly traded corporations, if the legislation results in an increase to net deferred tax liabilities, the combined group is entitled to a tax deduction over a seven year period beginning with the fifth year of combined filing in an amount equal to 1/7th of the increase in taxable temporary differences that caused the increase in the net deferred tax liability.

## What the Legislation Does not Address

Of equal significance are other questions that could perplex corporate taxpayers but are not addressed by the legislation, including:

- Significantly, the legislation fails to address whether the so-called "Joyce rule" or "Finnigan rule" applies to determine the sales factor of the combined group. D.C. applies the sales factor "throwback rule." For example, the gross receipts from a sale of tangible personal property that is shipped from D.C. to a location where the seller is not taxable are assigned to or "thrown back" to the seller's D.C. sales factor numerator. Under the "Joyce rule", the seller must be separately taxable in the sales destination state to avoid throwback, regardless of whether another member of the unitary group is taxable in the destination state or foreign jurisdiction. Conversely, under the "Finnigan rule" approach, the seller avoids throwback if any other member of the unitary group is taxable in the destination jurisdiction. These rules are also applied to inbound sales. It is unclear whether D.C. will follow the Joyce approach or the Finnigan approach.
- The legislation does not define when a group of business entities are "commonly controlled." While other unitary states require ownership of greater than 50 percent of the voting stock or voting power of one or more corporations by another, the D.C. legislation is silent in this regard. Will D.C. require greater than 50 percent ownership or 80 percent ownership? What about indirect ownership and control or attributed ownership?

- By its terms the legislation does not require a unitary relationship to exist between a corporate partner/member and a partnership/LLC before the corporate partner's/member's distributive share of income and apportionment factors are included in the D.C. combined report. This is constitutionally suspect. In addition, the legislation does not address how transactions between corporate partners/members and their partnerships/LLCs are reflected for purposes of the combined report (i.e., eliminated from income and factors, or included).
- Although the deferred intercompany transaction rules of the federal consolidated return regulations are made applicable to transactions among and between members of the D.C. combined group, the legislation is silent with respect to stock basis adjustments of the members, earnings and profits calculations, and other combined report mechanics.

Presumably, these yet-addressed areas may be dealt with in regulations when or if issued by the D.C. Office of Tax and Revenue.

If you are interested in discussing how this District of Columbia corporate income tax development may affect your company or affiliates that touch D.C., please contact any the attorneys in the Firm's Tax Department.