Report

Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes

Pursuant to House Joint Resolution 563 of the 2021 Special Session I of the Virginia General Assembly

2021 Interim

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INTRODUCTION

Large multistate and multinational corporations present unique challenges to individual states in administering their corporate income tax. Such businesses often feature dozens or hundreds of affiliated entities operating as constituent parts of an overarching business. Within such a group, in a given state some affiliates may conduct extensive operations, some may have only limited contact, and others may conduct no business at all. State taxation authorities therefore have to make complex judgments about which activities of a corporation outside of the state are subject to that state's corporate income tax.

The results can vary widely, depending on the exact rules adopted and on corporate tax planning decisions. No uniform set of rules has taken hold, resulting in a patchwork of different approaches taken by various states across the country. Some states treat each corporation within an affiliated group as a separate individual entity, each of which would file its own corporate income tax return. Another approach is to treat the group's members as a combined business and tax the group as if it were a single corporation. Virginia has adopted a hybrid approach, in which an affiliated group may make an election, irrevocable for 20 years, to be treated on a separate basis or to file a single return on a consolidated or Virginia combined basis.

Other states have adopted a mandatory unitary combined reporting policy that requires an affiliated group of corporations having Virginia taxable income to file a single unitary return, combining their income, expenses, gains, losses, and apportionment factors of all related corporations operating in any state. Proponents of such an approach believe that the resulting tax imposed on the unitary group would be comparable to that imposed if all members of the group were merged into a single corporation. Generally speaking, the unitary combined approach would extend to a greater expanse of nationwide corporate activity, but would also add administrative complexity, both for the impacted businesses and for the Department of Taxation.

The Work Group recommended against the adoption of mandatory unitary combined reporting. As will be discussed below, the concerns of the Work Group centered on the additional complexity of combined filing compared with Virginia's current system, the uneven impact the transition may have on certain taxpayers, and the potential damage to Virginia's business climate. Additionally, Work Group members argued that current provisions in Virginia law such as its add-back statute already address the common tax shifting strategies that combined reporting is intended to remedy. The Work Group recommended codifying budget language related to the add-back statute.

The Work Group also evaluated aspects of Virginia's corporate income tax system unrelated to unitary combined reporting. There was discussion of a wide range of proposals, including the adoption of market-based sourcing and expanded single sales factor apportionment. The Work Group also discussed and requested draft legislation regarding adjustments to Virginia's filing election and intercompany interest deduction rules.

1. Roadmap

Part I of this report will begin with a discussion of current Virginia corporate income tax policy. It will then provide an overview of mandatory unitary combined reporting, the policy choices that must be made in any transition to combined reporting, and present the rationales offered for and against making such a transition. It will conclude by presenting the other corporate income tax reform proposal discussed by the Work Group.

Part II of the report will present data from the Department of Taxation regarding the costs and benefits of making this transition. Next will be a discussion of the findings of the Work Group regarding both unitary combined reporting as well as other adjustments to corporate income tax policy that were suggested by Work Group members. Part II will conclude with presenting the Work Group's recommendations and conclusions, as well as requested draft legislation.

2. House Joint Resolution 563 (2021 Special Session I)

House Joint Resolution Number 563 of the 2021 Special Session I[1] directed the Division of Legislative Services, in conjunction with the Department of Taxation, to establish a Work Group assessing the feasibility of transitioning to unitary combined reporting for corporate income tax purposes in the Commonwealth. The resolution introduced by Delegate Watts assigned to the Work Group the following tasks:

- Assess the administrative feasibility of such a transition;
- Ascertain impacts on major classifications of corporations operating in Virginia and on corporate expansion within and into the Commonwealth;
- Project the fiscal impact if corporate income tax unitary combined reporting were to be adopted;
- Identify and make recommendations on any legislation necessary should Virginia transition to unitary combined reporting, including the repeal of obsolete provisions and amendments to the existing provisions in the Code of Virginia; and
- Identify different legal authorities and requirements that would apply to corporations under a unitary combined reporting system and solicit input from those corporations that may be affected by a transition to unitary combined reporting.

The resolution set a deadline of November 1, 2021, for the Work Group to submit a summary report with its findings and recommendations to the General Assembly.

3. Work Group Participants

The Work Group included the following executive and legislative officials, who participated in in selecting the Work Group stakeholder membership:

- Chair of the House Committee on Finance (Delegate Vivian E. Watts);
- A member of the Senate Committee on Finance and Appropriations (Senator David W. Marsden);
- Secretary of Finance (Secretary Joseph Flores);
- Deputy Secretary of Finance, June Jennings;
- Secretary of Commerce and Trade (Secretary Brian Ball);
- Deputy Secretary of Commerce and Trade, Cassidy Rasnick;
- Tax Commissioner, Craig Burns; and

[1] See Attachment 2, HJR 563 (2021 Special Session I, Watts).

- Assistant Tax Commissioner William White.

The executive and legislative officials appointed the following nonlegislative citizen corporate tax professionals for participation in the Work Group:

- Tyler Henderson, Sr., Manager, State and Local Tax at Amazon;
- Gary Tappana, Vice President of Tax Policy at Anheuser-Busch;
- Mike Carchia, Head of State Tax Planning at Capital One;
- Tammy Herrin, In-house Tax Counsel at ExxonMobil;
- Jon Elder, Vice President of Taxes at Dollar Tree;
- Tim Winks, Sr., Manager, Indirect Tax at Ferguson Enterprises;
- Glen Page, Sr., Manager, State Income & Franchise Tax at HCA Healthcare;
- Tom Powers, Executive Director, Corporate Tax Department at JP Morgan Chase;
- Karen Lint, Corporate Tax Director at Huntington Ingalls Industries;
- Lori Nieto, Corporate Tax Director at Northrop Grumman;
- Ken Wright, Sr., Manager, State Tax at Smithfield Foods;
- Alison Malloy, Sr., Director of Tax at Verisign;
- Kathleen Kittrick, Director, State Tax Policy at Verizon;
- David Brunori, Senior Director at RSM LLP and Research Professor of Public Policy at The George Washington University;
- Greg Matson, Executive Director of the Multistate Tax Commission;
- William L.S. "Sandy" Rowe, Of Counsel at HuntonAndrewsKurth; and
- Ellen Berenholz, Executive Director, Tax Policy at Comcast.

PART I: CORPORATE INCOME TAX POLICY IN VIRGINIA, UNITARY COMBINED REPORTING, AND ADDITIONAL CORPORATE TAX REFORM PROPOSALS

1. Overview of Current Virginia Law

The corporate income tax is the Commonwealth's third largest source of general fund revenues. Collections in Fiscal Year 2020 totaled just over $1 billion, or roughly five percent of general fund revenues.[2] The corporate income tax can be volatile, typically fluctuating with the health of the state, regional, and national economies.[3] Most corporate income taxes are paid by a small number of very large and profitable taxpayers.

There were 68,343 corporate returns filed in Taxable Year 2018. However, among those returns, the 250 that reported taxable income of $10 million or more were responsible for 69.3% of all taxes assessed. The rate of the tax is six percent of a corporation's Virginia taxable income.

a. Nexus

In order to be subject to corporate income tax, a corporation must have "nexus" with the taxing state. Nexus occurs when a corporation has sufficient contacts with the taxing jurisdiction, defined by the Supreme Court as occurring when a corporation "avails itself of the substantial privilege of carrying on business" in the state.[4] Historically, nexus required more than just making sales; nexus also required the corporation to have a physical presence of property or personnel in the state. This was mandated by Public Law 86-272, a 1959 federal law that prohibited a state from imposing income tax on an entity whose only business activity in the state is soliciting orders for the sale of tangible personal property.[5] However, based on the *Wayfair* decision, a corporation can have nexus, as a matter of federal constitutional law, in a state based solely on its electronic sales; nevertheless, as a matter of federal statutory law, P.L. 86-272 continues to protect corporations from state income taxation if their only connection to the state is by soliciting orders.[6]

b. Apportioning Income to Virginia

Once nexus is established, a corporation must determine how much of their income is attributable to the taxing state in a process known as apportionment. States use a system known as formulary apportionment to determine how of a corporation's income is earned in their state. In Virginia, the default apportionment method is a three-factor formula that looks to the proportion of a corporation's sales, payroll, and property that are located or sourced in Virginia relative to the corporation's sales, payroll, and property everywhere. The current formula is the following:[7]

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[2] Department of Taxation Annual Report, FY 2020. The two larger sources of revenue are the individual income tax and the retail sales and use tax, 70% and 17%, respectively.

[3] Id. Collections totaled $859 million in FY 2012, $757 million in 2014, and $943 million in 2019. See Table 2.1 (26).

[4] *South Dakota v. Wayfair, Inc.*, 585 U. S. ____ (2018).

[5] P.L. 86-272.

[6] See *Wayfair*, 585 U.S. at 18. ("It is not clear why a single employee or a single warehouse should create a substantial nexus while 'physical' aspects of pervasive modern technology should not. For example, a company with a website accessible in South Dakota may be said to have a physical presence in the State via the customers' computers.").

[7] Va. Code §§ 58.1-408, 58.1-409, 58.1-412, and 58.1-414.

Apportioned Income = Everywhere Income * [((property factor + payroll factor + (two times the sales factor))/4]

The "factors" in the equation above include the proportion of a corporation's property, payroll, and sales in Virginia divided by its total property, payroll, and sales everywhere.

Special apportionment formulas apply to certain industries, for example, manufacturers and retailers.[8] Retailers are required to apportion their income using a "single sales factor" method, meaning that their apportionment is based only on the proportion of the corporation's total sales that are sourced to Virginia. Manufacturers are given the option of using the single sales factor method or the standard apportionment formula. For unitary groups, some entities may be eligible for single sales factor apportionment, while others are required to use the three-factor method.

For a corporation whose entire business is conducted in Virginia, no apportionment is required.

c. Reporting in Virginia

Generally, every corporation that is incorporated in Virginia, registered with the State Corporation Commission, or receiving income from Virginia sources must file a corporate income tax return. Large, multi-entity businesses are treated as an "affiliated group," defined as a group of two or more corporations (i) one of which owns 80 percent of the voting stock of the other or others or (ii) 80 percent of the voting stock of which is owned by the same interests.[9]

Virginia allows an affiliated group to make a filing election from three different options: separate, consolidated, and "Virginia combined."[10] Separate filing is the default option, in which each corporation in an affiliated group with nexus to Virginia is required to file its own return, reporting only its income, expenses, gains, losses and allocation and apportionment factors on such return. This approach treats each corporation in an affiliated group as distinct and separate from the others in determining the tax liability of each individual entity.

Consolidated filing is the current option most similar to unitary combined reporting. Under consolidated filing, all corporations in an affiliated group that have nexus to Virginia file as if the group were a single corporation. The corporate income tax liability of the affiliated group is computed in the aggregate, and the entire affiliated group files one corporate income tax return.

Under the "Virginia combined" method, each corporation in an affiliated group determines its income, expenses, gains, losses, and allocation and apportionment factors separately and determines its own tax liability. The final corporate income tax liability of each corporation is then combined with that of all other corporations in the affiliated group and included on one corporate income tax return.

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[8] *See generally* Va. Code §§ 58.1-417 through 58.1-422.3. In addition to retailers and manufacturers, motor carriers, financial corporations, construction companies, railway companies, and debt buyers have alternative methods of apportionment.

[9] Va. Code § 58.1-302.

[10] Va. Code § 58.1-442. "Virginia combined" is referred to in quotes to distinguish it from unitary combined reporting, which is an entirely different concept.

Whichever method a corporation chooses, its filing election applies to all group members and is made in the first year when a group of affiliated corporations is eligible to file a Virginia consolidated or combined return. The filing election may be altered, but only under stringent circumstances: Once made, the election cannot be modified for 20 years and only if (a) for the most recent taxable year there would have been no decrease in tax liability if the proposed filing method had been in effect and (b) the affiliated group agrees to file under both the new and former filing method and pay the greater of the two amounts for the taxable year in which the new election is effective and for the prior taxable year.[11]

Affiliated groups do not include foreign corporations because in 1981 the General Assembly prohibited "worldwide reporting" and the inclusion of those entities whose income is derived from sources outside the United States.

2. Overview and Some Considerations of Mandatory Unitary Combined Reporting

An alternative to separate reporting or Virginia's elective system is mandatory unitary combined reporting (MUCR). Under MUCR, a group of related corporations is required to combine the income, expenses, gains, losses, and allocation and apportionment factors of all related corporations on a single combined return. The intent is to tax the corporate group as though it were a single unified entity. This approach is somewhat similar to the consolidated return option available under current Virginia law, but MUCR features several important differences.

First, states that require unitary combined reporting generally do not allow alternative reporting options, and filing a unitary combined return is mandatory.

Second, under MUCR, a corporate group must include on its return all related corporations engaged in a unitary business, regardless of the state's nexus with or the location of the corporations in the unitary group. This results in a much higher number of corporations ultimately being included in the return. It also requires the taxpayers and regulators to make complex determinations of which entities must be included in the unitary group.

Third, unitary combined reporting looks to both the ownership and business relationships of related corporations to determine the extent of the group. For ownership, two or more corporations are treated as belonging to a group if they share common ownership of at least 50 percent. For the business relationship aspect, the group includes those firms whose business activities are sufficiently interdependent, interrelated, and integrated.[12] More detailed explanation of the extent of the business relationship required, and the difficulty in making that determination, is provided below.

In requiring unitary combined reporting, a state must make several policy choices, including but not limited to (i) defining the unitary group, (ii) the treatment of unitary group members without nexus, (iii) the treatment of international corporations in a unitary group, and (iv) how to manage the transition to the new reporting regime.

a. Defining the Unitary Group

The definition of a unitary group is a key part of any unitary combined reporting legislation. The Supreme Court has provided that two or more entities are engaged in a "unitary business" if they have functional integration, have centralized management, and benefit from shared economies of

[11] Id.
[12] *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438.

scale.[13] This test is subjective, and is specific to the related corporate entities, but requires a level of interconnectedness between the entities, going beyond just a passive investment relationship. The Multistate Tax Commission in its model legislation has used the following definition for a unitary business:

> "Unitary business" means a single economic enterprise that is made up either of separate parts of a single business entity or of 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.[14]

However, providing a definition for a unitary business in the Virginia Code does not resolve all ambiguity on the bounds of the unitary group. The limits of a unitary business are the creation of case law. Because those limits depend on subjective criteria, they remain ambiguous no matter how specific the state statute is. Even in states where the statutory definition of a unitary business is the same as the language in federal case law, differences in regulatory administration and court rulings can result in vastly different treatments of a unitary group.

b. Treatment of Group Members without Nexus

Related to the question of defining the unitary group is determining how to treat unitary group members who lack nexus with the taxing jurisdiction. As noted above, a business must have nexus with a state in order to be subject to its corporate income tax. However, the Supreme Court has ruled that when a group of entities is engaged in a unitary business, and one of the entities has nexus with the taxing state, the whole unitary group may be taxed by that state.[15]

This ambiguity of taxing corporations without formal nexus to the state raises the question of whether unitary combined reporting violates Public Law 86-272, the prohibition on states from taxing a company whose only activity within the state is the solicitation of sales of tangible personal property. As a result, states have become split between two approaches to MUCR, known as *Joyce* and *Finnigan*, the names being derived from two California Board of Equalization cases.

Under *Joyce*, the determination of whether a group member has nexus to a state is made at the level of each individual entity. Each individual entity is considered the taxpayer. Each group member that has nexus must apportion its income to the taxing state relative to the total everywhere income of the group. The unitary group includes those entities without nexus to the taxing state, but those entities are not required to apportion their income.

Under *Finnigan*, apportionment is done at the group level. The entire unitary group is considered the taxpayer for apportionment purposes, and the determination of nexus is made for the group as a whole. The whole group apportions its income to the taxing state based upon its

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[13] Id.
[14] See Attachment 4c - Multistate Tax Commission Proposed Model Statute for Combined Reporting. 2006 draft, amended 2011.
[15] *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438 (1980) ("The argument that the source of the income precludes its taxability runs contrary to precedent. In the past, apportionability often has been challenged by the contention that income earned in one State may not be taxed in another if the source of the income may be ascertained by separate geographical accounting. The Court has rejected that contention so long as the intrastate and extrastate activities formed part of a single unitary business.").

total income for the unitary business. *Finnigan* therefore makes a greater number of corporations subject to taxation.

Overall, the difference between the *Joyce* and Finnigan approaches are as follows:

- *Joyce*: Taxable Income = (Sum of state-sourced income for each entity with nexus) / (Total income for the entire unitary business, including non-nexus entities)
- *Finnigan*: Taxable Income = (State-sourced income for the entire unitary group, including non-nexus entities) / (Total income for the entire unitary business, including non-nexus entities)

The following example summarizes the distinction:

> By way of example, imagine three companies, each with a million dollars in sales into a given state—and nowhere else. The three companies are all members of the same unitary group, but only Company A has taxable nexus in the state, whereas the others only sell into the state, with operations located elsewhere. Under *Finnigan* rules, all $3 million of the company's sales are apportioned to the state, since the nexus established by Company A gives the state the authority to tax Companies B and C as well. Under *Joyce* rules, however, only the $1 million from Company A is included in a sales factor in the state.[16]

Historically, states tended to adopt the *Joyce* approach out of concerns that *Finnigan* would violate P.L. 86-272. However, the *Finnigan* approach has never been ruled to be in violation of federal law. Based on the decision in *Wayfair*, a business is now seen as having a meaningful presence in a state through electronic sales. Based on *Wayfair* and the fact that statutes using the *Finnigan* method have survived legal challenges, the nexus concerns about *Finnigan* have receded, and states that adopt MUCR have tended to choose that model in recent years.[17]

c. Treatment of International Corporations

Another decision a state must make when adopting MUCR is whether to include foreign entities in the taxpayer's income and apportionment calculation. Three different approaches have been taken by the states on this issue: domestic combination, water's edge combination, and worldwide combination.

The domestic combination approach includes only those entities that are incorporated in the United States. Under water's edge, foreign entities are included in the unitary group only if they conduct business in the United States. Typically, there is a requirement that at least 20 percent of a foreign entity's business be in the United States in order to be included in the unitary group. The worldwide combination includes all entities regardless of their location. As noted

[16] Jared Walczak, Throwback and Throwout Rules: A Primer, Tax Foundation (2019).

[17] The Multistate Tax Commission has published model legislation based on both the *Joyce* and *Finnigan* models. See Attachments 4c and 4d. In 2006, legislation following *Joyce* was published, and in 2021 the *Finnigan* legislation followed. Mr. Gregory Matson in his presentation at the August 16 Work Group meeting did not endorse either model but noted the MTC wanted to provide states with models of both given the trend toward *Finnigan*. He also mentioned that when the *Joyce* draft was published in 2006, 12 of the 17 MUCR states used *Joyce*, while today the numbers are closer to even.

previously, the General Assembly excluded foreign entities from the definition of an affiliated group in 1981.[18]

Combined reporting states have overwhelmingly opted for the water's edge model; in fact, all states have done so with the exception of Alaska's rules for oil and gas companies.[19] The MTC model legislation opts for worldwide, but with a water's edge election.

d. Transitional Issues

In a transition to unitary reporting, states must address certain incentives and credits that accrued to taxpayers under their old system. For example, taxpayers with net operating losses (NOLs) often are able to carry over those losses to offset against profits in subsequent years. A state must determine whether NOLs of a corporation that filed separately can be carried over to the combined return and to what extent. Similar issues are present for tax credits and deductions. Depending on the accumulated volume of such incentives from years of filing separately, the state may see revenue losses or taxpayers may not be able to make advantageous use of incentives they had expected to use.

NOLs and credits are typically treated differently under *Joyce* and *Finnigan*. Under *Joyce*, they are tracked by each individual company. Under *Finnigan*, NOLs and credits are determined on the group level. However, the Multistate Tax Commission (MTC) noted that states can vary in their approaches.

e. Corporate Income Tax Reporting in Other States

Among the 50 states and the District of Columbia, 45 impose a corporate income tax; 28 have enacted mandatory unitary combined reporting. Texas, which imposes a gross receipts tax in place of a corporate income tax, has also adopted MUCR. Geographically, combined reporting is not common in the Southeast. Among Virginia's neighboring states, North Carolina, Tennessee, and Maryland are separate reporting states, while Kentucky and West Virginia have adopted combined reporting. Maryland studied the issue of combined reporting, in addition to its tax policy more generally, in the 2016 Augustine Commission report, which recommended against adoption.[20] In addition to Maryland, the states of Indiana, Louisiana, and Rhode Island have studied the issue of MUCR in recent years, with Rhode Island adopting it in 2014.

North Carolina law allows its Department of Revenue to require a unitary group to file a combined return if necessary to ensure that its return properly reflects the group's income.[21]

Unitary Combined Reporting Jurisdictions[22]	
***Finnigan* States**	***Joyce* States**
Arizona	Alaska
California	Colorado

[18] Va. Code § 58.1-443.
[19] *See generally* Attachment 4b - presentation of the Multistate Tax Commission at the August 16, 2021, meeting of the Work Group.
[20] Report of the Maryland Economic Development and Business Climate Commission, Phase II: Taxes, 39 (2016).
[21] North Carolina G.S. § 105-130.5A.
[22] Department of Taxation Fiscal Impact Statement, HB 719 (2020).

Connecticut	District of Columbia
Kansas	Hawaii
Maine	Idaho
Massachusetts	Illinois
Michigan	Kentucky
Montana	Mississippi
Minnesota	Nebraska
New York	New Hampshire
Rhode Island	New Mexico
Utah	North Dakota
Wisconsin	Texas
	Vermont
	West Virginia

f. Prior Legislative Efforts in Virginia

Unitary combined reporting has been proposed in the past in Virginia, with several bills being introduced in the General Assembly.[23] These bills generally were based on MTC model draft legislation with some adjustments to accommodate specific nuances of Virginia law. In the 2020 Session, legislation following the *Joyce* method was introduced, allocating losses and credits at the entity level and requiring worldwide combination unless a water's edge election was made. In the 2021 Session, legislation based on the *Finnigan* method was introduced, stipulating that net operating losses and tax credits were to be computed at the group level but for 10 years allowing certain deductions to be taken if the transition would have had adverse consequences for the unitary group. It also contained a default water's edge combination provision.

g. Arguments in Support of Unitary Combined Reporting

Proponents of unitary combined reporting believe that it is an effective way to combat tax sheltering strategies and is therefore a more complete measure of corporate income than a separate reporting regime. In addition, proponents believe it alleviates the need for states to adjust their laws to account for new and novel tax planning strategies.

Historically, a popular means of sheltering income from separate reporting states was using intangible holding companies (IHC). An intangible holding company is generally a corporation formed to hold intangible assets such as trademarks, trade names, or patents. The IHC is typically located in a state that does not impose a corporate income tax on it. A corporation transfers its intangible assets to the IHC and enters into an agreement to pay for the continued use of its intangible assets. When the corporation computed its state corporate income tax, it was able to deduct the expenses that it paid to the IHC to use these intangible assets.

[23] *Joyce* proposals: Del. J.M. Scott, HB 1267 (2012), Del. Watts, HB 739 (2020), Del. Hudson, HB 1109 (2020), Sen. Marsden, SB 756 (2020). *Finnigan*: Sen. Marsden, SB 1353 (2021).

One example of the intangible holding company issue involved the "Geoffrey Inc.," cases fought by Toys 'R' Us approximately 20 years ago against numerous states asserting nexus over the business.[24] Geoffrey Inc., a subsidiary of Toys 'R' Us, Inc., incorporated in Delaware, owned much of the parent firm's intellectual property. Geoffrey licensed this intellectual property to related entities in the group for use around the country. The related entities deducted the payments made to Geoffrey from their taxable income as an expense, substantially reducing their taxable income. This arrangement resulted in lengthy litigation around the country and was struck down in several states. Since the Geoffrey challenges, many states, including Virginia, have enacted statutes to nullify this strategy that had become a common corporate practice.

A similar tax planning strategy involves creating an affiliate entity that qualifies as a real estate investment trust (REIT). REITs were established in the 1960s by Congress and are exempt from paying taxes on dividends paid to its investors. Some retail stores created a "captive REIT" that owned the land and buildings in which the retail stores were located. The retail chain would pay rent, based on a percentage of sales, to the captive REIT, but the rent was paid back to the retail company or an affiliate as untaxed dividends. As discussed in the next section, Virginia passed an add-back statute to address such practices.

Without uniformity in corporate taxation among the states, corporate entities have utilized the provisions of Public Law 86-272 for a tax planning strategy that creates "nowhere income," which is untaxed income stemming from certain states' apportionment formulas being calculated to leave a portion of the taxpayer's income apportioned to another state that does not or may not impose income tax on the taxpayer. Some states have adopted "throwback rules" that modify the apportionment to include some or all of such nowhere income into the state's taxable base.

While separate reporting states have adopted policies to combat these strategies, novel tax planning methods continue to emerge. One argument for unitary combined reporting is that it is more adaptable to changing conditions and does not require gap-filling laws to counter these new tax planning strategies. Unitary combined reporting aims to nullify these intercompany transactions and other income shifting tactics by including all related firms into the taxable group and more accurately assessing the tax liability owed to various states that enact the policy.

h. Arguments Opposing Unitary Combined Reporting

Opponents of unitary combined reporting point to the added complexity and subjectivity in defining who should properly be included in the return, uncertainty surrounding tax revenue gains and losses due to activities in other states, and the unfair impact on particular taxpayers. Additionally, actions by states to combat some of the tax strategies referenced above have adequately addressed many of the issues unitary combined reporting intends to solve. Further, a transition to unitary combined reporting is a fundamental shift in a state's corporate tax policy, raising the question of whether the transition could decrease corporate investment and expansion.

There is considerable subjectivity in determining which entities must be included in the unitary group. As noted above, the unitary determination is based on a three-factor judicial test looking to functional integration, centralized management, and economies of scale. There is no bright line indication of when these factors are met, or whether all three must be present.

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[24] See generally *Geoffrey, Inc. v. SC Tax Comm'n*, 437 S.E.2d 13 (1993) and *Geoffrey, Inc. v. Tax Comm'n*, No. 99,938, CCH 980-200 (Okla. Civ. App. Dec. 23, 2005).

Opponents of combined reporting point out that these factors will apply to each company differently, depending on how their operations and management are structured. Audits and litigation that establish a ruling on one unitary group may therefore have no precedential value when applied to others causing a strain on state revenue departments. In addition, since every state that uses mandatory unitary combined reporting has distinct provisions, there is no precedent in case rulings across states.

Another issue is how to address mergers and acquisitions and other instances when entities may be coming into or out of the combined group. In a merger or acquisition, it is unclear at what point an entity becomes "unitary" with the rest of the group. Unitary combined returns can also be lengthier and more complicated than traditional separate filing returns.[25]

Based on estimates from the Department of Taxation and the experience of other states, there is likely to be an initial positive revenue impact if combined reporting is adopted. However, the additional tax burden would not be imposed equally on taxpayers. Some taxpayers may see a small change to their overall tax liability, while others see a substantial increase. Certain taxpayers may see a tax benefit from combined reporting. Opponents of combined reporting criticize this picking of "winners" and "losers" in the marketplace and believe that doing so undermines a state's reputation as a stable place to do business.

The transition would also be a major shift for the Department of Taxation. The Department would need at least two years to develop new regulations as well as the experience and expertise to audit unitary returns. An effective audit capability is critical to a state's ability to realize the positive revenue impacts that are projected in a switch to unitary reporting.

Regarding the tax planning strategies referenced above, opponents of combined reporting point to actions by Virginia and other states that have closed those loopholes. Specifically, Virginia has enacted an "add-back statute" to targets the intangible holding company issue.[26] This Virginia Code section requires taxpayers to add to their taxable income any "intangible expenses and costs directly or indirectly paid, accrued, or incurred to . . . one or more related members." Similar provisions exist for inter-group interest expenses and captive REITs.[27]

3. Other Corporate Tax Reform

For the Work Group meeting held on August 16, Delegate Watts requested that corporate Work Group members submit feedback regarding potential reforms to Virginia’s corporate income tax system other than a transition to unitary combined reporting. All responses received may be found in Attachment 4g of this Report.[28] The responses centered on the following proposals: modifying the filing election rules, adopting single sales factor apportionment, adopting market-based sourcing, and modifying Virginia's treatment of the § 163(j) limitation.

As noted above, Virginia offers three filing options, but does not allow affiliated groups to change their election for 20 years. Respondents were supportive of having different filing options. However, several suggested lowering the time period for changing the election to 10 years or fewer, arguing that this gives businesses the ability to adapt to changing conditions.

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[25] Mr. Tappana, of Anheuser-Busch, during the August 16, 2021, meeting referenced how his company’s New Jersey tax return increased from 20 pages to over 1,500 after that state adopted unitary reporting.
[26] Va. Code § 58.1-408.
[27] Id.
[28] See Attachment 4g - Corporate Feedback Submissions on Unitary Combined Reporting and Virginia Tax Law.

Single sales factor (SSF) apportionment would replace Virginia's current three-factor apportionment formula described above with a method that looks only to a corporation's amount of sales in Virginia to determine apportionment. Certain Virginia corporations such as manufacturers and retailers are currently able to use SSF apportionment. However, that option is not available to all entities in certain affiliated groups, and several Work Group members suggested broadening the use of single sales factor apportionment. SSF is typically seen as an economic development tool, as it does not impose an additional tax burden when a company expands its payroll and property investments in a state. In contrast, Under Virginia's current three-factor apportionment statute, the building of a new factory or headquarters results in higher payroll and property factors when calculating corporate income tax liability.

Related to the question of single sales factor apportionment is a potential change to market-based sourcing. "Sourcing" refers to the method a state uses in determining when the sale of intangible property is attributable to the state for corporate income tax purposes. There are two approaches that states generally use: cost of performance (the current policy in Virginia) and market-based sourcing. Cost of performance looks to where the income-producing activity is performed; market-based sourcing looks to where the product is ultimately used. States vary in which method they use, which can result in a corporation being taxed by multiple states for the same transaction.[29] Respondents were split on this issue, with representatives of defense contractors and telecommunications companies expressing concern that market-based sourcing would have an undue adverse impact on their industries and result in a loss of Virginia corporate tax revenue to states where the recipient of the product is located.

The federal Tax Cuts and Jobs Act introduced a new limit on the deductibility of business interest expenses under § 163(j) of the Internal Revenue Code. In response to that change, Virginia added a new provision that allowed a corporation to deduct 20% of the interest disallowed under federal law from its state taxable income.[30] However, for separate and consolidated filers, the § 163(j) limitation must be calculated separately for each entity. This can create distortions in the amount of interest that may be deducted on a tax return. Respondents suggested expanding the deductibility of interest or loosening the filing election to allow affected corporations to switch to consolidated filing.

PART II: DISCUSSION OF UNITARY COMBINED REPORTING IN VIRGINIA, OTHER CORPORATE TAX CHANGES, AND WORK GROUP FINDINGS

1. September 21, 2021, Work Group Meeting

After an introduction to the considerations and issues involved with a transition to unitary combined reporting in the first two meetings, members of the Work Group asked the Department of Taxation (the Department) to provide its perspectives before developing final recommendations. The Department prepared a presentation[31] on updates on the estimated unitary combined reporting revenue reports, provisions related to unitary combined reporting raised in

[29] *See generally The Corporate Executive Board Co. v. Virginia Department of Taxation*, record number 171627, Supreme Court of Virginia (February 7, 2019). The case discusses at length the issue of market-based versus cost of performance sourcing and the double taxation that can result.
[30] Va. Code § 58.1-402.
[31] See Attachment 5b - Department of Taxation 9/21/2021 PowerPoint Presentation.

the August 16 meeting,[32] and other potential corporate tax modifications in the Virginia Code raised in the August 16 meeting.[33]

a. Estimated Unitary Combined Reporting Revenue Reports

The presentation began with an update of data submitted pursuant to the 2021 Special Session I Budget Item 3-5.23 of the 2021 Appropriation Act[34] that estimated potential revenue impacts of any transition to unitary combined reporting. Corporations, except for banks and insurance companies, were required to submit an informational report to the Department of Taxation by July 1 based on taxable year 2019 data, with no extensions permitted. The Department is required to submit a report to the Chair of the Senate Finance and Appropriations Committee, the Chair of the House Appropriations Committee, and the Chair of the House Finance Committee.

The report was required for each member of a unitary group with nexus in Virginia and included information on the unitary group's income, apportionment, computation, tax credits, and tax liabilities, with calculations based upon both the *Joyce* and *Finnigan* unitary combined reporting approaches. However, Virginia unitary businesses were exempt from the filing requirement. Over 11,000 reports were submitted, of which 7,926 were validated and included in the following data.[35]

Of the validated reports, 73% of corporations showed essentially no change in tax liability, 13% showed an increase in tax liability, and 14% showed a decrease in tax liability before tax credits were applied. Some data limitations in the reporting were noted, including (i) how any potential unitary combined reporting law is structured may vary from policy assumptions utilized in the reports, (ii) the reference guide included with the reporting requirement documentation could not address every scenario so some companies may have reasonably applied different assumptions, (iii) certain factors such as the intangible holding company addition could result in distortions,[36] (iv) the estimates were based on a single year of information from taxable year 2019 whereby the actual impact might vary due to the inherent volatility of the corporate income tax, and (v) that the data collected was provided by taxpayers

[32] The presentation touched on aspects of unitary combined reporting including an option to file on a unitary combined basis or a current option under Virginia Code or federal consolidated, North Carolina's authority to force a separate filer to submit a combined return, the *Finnigan* versus *Joyce* models of unitary combined reporting, issues related to auditing and revenue stability.

[33] The presentation reviewed other considerations for changes to Virginia's corporate tax including reducing the 20-year limit on switching affiliated group filing elections, changing Virginia's three-factor apportionment formula, cost of performance versus market-based sourcing methods, simplifying Virginia's treatment of the business interest expenses (IRC § 163(j) limitation) deduction, tracking net operation losses and credits not in conformity with federal determination, and enhancing Virginia's add-back, determination of nexus, loss disallowance, or other means to prevent tax avoidance in multi-state businesses.

[34] § 3-5.23 Corporate Income Tax Informational Reporting

[35] The preliminary statistics evidenced 11,015 total reports submitted, 1,697 adjustments, 9,318 total reports submitted after adjustments of which 7,926 were validated as of the meeting time with 1,400 outstanding reports that required additional research for validation.

The validation process involved making adjustments for duplicate reports or for the omission of required information, such as the calculations of tax liability under the *Joyce* and *Finnigan* methods. Reports that could be reconciled with actual taxable year 2019 Virginia corporate income tax returns were validated to the extent possible and the outstanding reports still being validated did not match actual Virginia income tax return information and required additional research.

[36] These distortions could result because reporting an intangible holding company addition under combined reporting may account for the impact twice.

and not subject to more rigorous verification and auditing processes. The Department outlined its next steps, which would include completing the validation process, aggregating the information, and publishing the final report to the money committees by the December 1, 2021, deadline.

Members of the Work Group asked for more details on the amount of tax liability changes in the data received and were told the specific aggregated dollar amounts would be included in the final report. Senator Marsden inquired whether Tax was able to ascertain the difficulty involved in filing under the unitary combined reporting methods as some have favored a transition to unitary combined reporting due to its simpler filing requirements. The Department has received opinions both preferring and disfavoring filing under the unitary combined system.

b. Specific Issues Related to Unitary Combined Reporting

i. Potential Impact of Optional Unitary Combined Reporting

The Department discussed unitary combined reporting issues raised in previous Work Group meetings. Virginia's current reporting requirements and the existing filing elections for affiliated groups of corporations include reporting separately, on a consolidated basis, or using a Virginia combined return. Adopting unitary combined reporting would represent a new reporting method in Virginia and most states adopting unitary combined reporting have made it mandatory to avoid workarounds. These involve repealing alternative methods of reporting while also allowing, for example, a consolidated return election, with safeguards to avoid income-shifting practices. Allowing unitary combined reporting to be optional, while also maintaining the ability to opt into the existing methods of reporting would result in taxpayers electing to utilize the method that is the least burdensome from a tax perspective and would result in an overall revenue loss because Virginia would lose revenue from affiliated groups that would not benefit from unitary combined reporting, but would not gain revenue from those that pay increased taxes. Asked whether states who enacted unitary combined reporting, but also allowed a consolidated election, followed the federal consolidated standards, Work Group members clarified that such filing involves submitting a federal consolidated return with state-by-state apportionment factors.

ii. "Forced Combination" in North Carolina

The Department also reviewed North Carolina's "forced combination" statute,[37] which involves its Department of Revenue requesting information to substantiate intercompany transactions when it has reason to believe a corporation failed to accurately report net income attributable to business in North Carolina through use of intercompany transactions that lack economic substance or do not follow fair market value requirements. On the basis of the taxpayer response, the North Carolina Department of Revenue may make certain adjustments[38] or, if such adjustments are inadequate, can require the corporation to file a return that reflects North

[37] North Carolina G.S. § 105-130.5A. This law, passed as House Bill 619 in 2011, repealed G.S. § 105-130.6 and introduced two substantive changes to North Carolina law: The statute (1) requires the Department of Revenue to attempt to resolve income distortions through adjustments to intercompany payments before ordering a combined return and (2) adopts a two-pronged standard for determining when an adjustment to intercompany transactions or a combined return is justified by allowing the Department to adjust a corporation's net income if "the corporation's intercompany transactions lack economic substance or are not at fair market value." § G.S. 105-130.5A(b).

[38] Such adjustments include disallowing deductions, in whole or in part, attributing income to related corporations, disregarding transactions, or reclassifying income as apportionable or allocable.

Carolina income on a combined basis of all members of its affiliated group that are conducting a unitary business.

iii. Review and Comparison of *Joyce* and *Finnigan* Unitary Combined Reporting Approaches

This was followed by a comparison of the *Joyce* and *Finnigan* methods for apportioning a unitary group's business apportionable income with a note that the *Finnigan* method is considered more aggressive and is the more commonly adopted approach for unitary combined reporting states in recent years. Under *Joyce*, nexus determinations are made at the level of each individual entity and therefore sales by an entity without Virginia nexus are excluded from the sales factor numerator, while under *Finnigan*, nexus determinations are made at the level of the unitary combined group as a whole, so sales by all members of the group attributable to Virginia are included in the sales factor numerator, even for entities that would otherwise lack Virginia nexus if filing on a separate entity basis.

iv. Transitional Issues - Deferred Gain or Loss

The presentation then addressed certain transitional issues involving deferred gain or loss. Federal regulations defer recognition of certain gains and losses, such as those for asset transactions among affiliates in a consolidated federal return and when previously deferred gain or loss is recognized when the asset is sold to an entity not included in the federal consolidated return. Recognition of gain or loss affects the basis of an asset, its subsequent depreciation,[39] and the asset life. In Virginia though, a corporation is treated as external to the federal consolidated group when the group elects to file a combined or separate Virginia return or when the group elects to file a consolidated return, but not all of the affiliates have sufficient nexus with Virginia. Virginia corporate returns often have gain, loss, basis, and depreciation that differ from the federal return and create some complexities. This involves corporations often preparing pro-forma federal returns for Virginia purposes that assumes the federal return was based on the same filing method as in Virginia (separately or on a consolidated basis with the same affiliates).

Unitary combination is generally treated the same as federal consolidation because most states use the federal consolidated return regulations for accounting adjustments among corporations included in a state unitary combined return. Gain or loss would be deferred for asset transactions with other corporations included in the unitary combined return, but gain or loss (even if deferred) would be recognized for asset transactions with other corporations that are not included in the unitary combined return. Since corporations included in a federal return, but not in a Virginia consolidated return, may have deferred gains or losses that must be restored when included in a unitary combined return, implementing unitary combined reporting in Virginia, especially if made mandatory, should invite a transitional adjustment period to provide ample notice to taxpayers and guidance instead of an abrupt change to the new regime. The Department currently audits and tracks the Virginia driven nexus determinations by placing much of the burden on taxpayer provided information and therefore the audit process is highly complex and corporation specific. The Department also explained a hypothetical posed by Delegate Watts on how a tangible asset in Virginia established as part of a depreciation schedule that would be transferred to Wisconsin in a unitary group, and then lacks nexus in Virginia, would be treated by noting that the impact on liability in Virginia would be dictated by its representation in the

[39] Subsequent depreciation is unchanged on a consolidated return when gain or loss is deferred, but each corporation may maintain its own records.

property factor, but if it was transferred to another entity in the unitary group in Wisconsin, then one would not recognize gain or loss until it was actually transferred outside of the unitary group.

Delegate Watts inquired what time period would be appropriate for a binding filing election, if options were allowable, and the Department responded that it would be a decision for the General Assembly if they wished to alter the current 20-year binding election period. Senator Marsden also raised the issue of unitary combined reporting rooting out tax avoidance strategies because intercompany transactions within the same unitary group are not treated as a business expense. The Department noted that Virginia's add back statute[40] addresses royalties, management fees, and other types of expenses paid between related entities and is facing legal challenges currently, but that unitary combined reporting does seek to address that issue. As such, there is some similarity between enforcement authority under Virginia's existing add back statute and North Carolina's forced combination law in that both try to attack self-dealing among taxpayers.

Virginia's add back statute is found in Virginia Code § 58.1-402(B)(8):

> *8. a. For taxable years beginning on and after January 1, 2004, the amount of any intangible expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with one or more related members to the extent such expenses and costs were deductible or deducted in computing federal taxable income for Virginia purposes. This addition shall not be required for any portion of the intangible expenses and costs if one of the following applies:*
>
> *(1) The corresponding item of income received by the related member is subject to a tax based on or measured by net income or capital imposed by Virginia, another state, or a foreign government that has entered into a comprehensive tax treaty with the United States government;*
>
> *(2) The related member derives at least one-third of its gross revenues from the licensing of intangible property to parties who are not related members, and the transaction giving rise to the expenses and costs between the corporation and the related member was made at rates and terms comparable to the rates and terms of agreements that the related member has entered into with parties who are not related members for the licensing of intangible property; or*
>
> *(3) The corporation can establish to the satisfaction of the Tax Commissioner that the intangible expenses and costs meet both of the following: (i) the related member during the same taxable year directly or indirectly paid, accrued or incurred such portion to a person who is not a related member, and (ii) the transaction giving rise to the intangible expenses and costs between the corporation and the related member did not have as a principal purpose the avoidance of any portion of the tax due under this chapter.*
>
> *b. A corporation required to add to its federal taxable income intangible expenses and costs pursuant to subdivision a may petition the Tax Commissioner, after filing the related income tax return for the taxable year and remitting to the Tax Commissioner all taxes, penalties, and interest due under this article for such taxable year including tax upon any amount of intangible expenses and costs required to be added to federal taxable income pursuant to subdivision a, to consider evidence relating to the transaction or*

[40] Va. Code § 58.1-402(B)(8).

transactions between the corporation and a related member or members that resulted in the corporation's taxable income being increased, as required under subdivision a, for such intangible expenses and costs.

If the corporation can demonstrate to the Tax Commissioner's sole satisfaction, by clear and convincing evidence, that the transaction or transactions between the corporation and a related member or members resulting in such increase in taxable income pursuant to subdivision a had a valid business purpose other than the avoidance or reduction of the tax due under this chapter, the Tax Commissioner shall permit the corporation to file an amended return. For purposes of such amended return, the requirements of subdivision a shall not apply to any transaction for which the Tax Commissioner is satisfied (and has identified) that the transaction had a valid business purpose other than the avoidance or reduction of the tax due under this chapter. Such amended return shall be filed by the corporation within one year of the written permission granted by the Tax Commissioner and any refund of the tax imposed under this article shall include interest at a rate equal to the rate of interest established under § 58.1-15 and such interest shall accrue as provided under § 58.1-1833. However, upon the filing of such amended return, any related member of the corporation that subtracted from taxable income amounts received pursuant to subdivision C 21 shall be subject to the tax imposed under this article on that portion of such amounts for which the corporation has filed an amended return pursuant to this subdivision. In addition, for such transactions identified by the Tax Commissioner herein by which he has been satisfied by clear and convincing evidence, the Tax Commissioner may permit the corporation in filing income tax returns for subsequent taxable years to deduct the related intangible expenses and costs without making the adjustment under subdivision a.

The Tax Commissioner may charge a fee for all direct and indirect costs relating to the review of any petition pursuant to this subdivision, to include costs necessary to secure outside experts in evaluating the petition. The Tax Commissioner may condition the review of any petition pursuant to this subdivision upon payment of such fee.

No suit for the purpose of contesting any action of the Tax Commissioner under this subdivision shall be maintained in any court of this Commonwealth.

c. Nothing in subdivision B 8 shall be construed to limit or negate the Department's authority under § 58.1-446.

v. Resource and Auditing Concerns

Another consideration is the resource and auditing issues associated with a transition to unitary combined reporting. The Department estimated minimum costs of $700,000 in the initial year of implementation and more than $400,000 annually thereafter. A sufficient transitional time period would be necessary for more staff, resources, form updates, regulatory guidance, training, but noted that, like revenues, exact costs would depend on the form of any law passed by the General Assembly. In addition to minimum costs, additional costs would come in the form of increased staffing to support compliance efforts and an increased volume in appeals and rulings. Resource needs for auditors would depend on any law's structure and specific changes that alter the current corporate income tax reporting regime and additional resources would be necessary to account for an expected increase in volume of appeals and litigation resulting from various policy issues associated with the transition. Delegate Watts asked how much Virginia depends on the federal regime for auditing as a state generally conformed to federal tax law and the extent to which Virginia could rely on federal auditors. Commissioner Burns highlighted Virginia's reliance on the federal auditors, particularly on the corporate side, but noted that Virginia would have to increase auditing and compliance capacity to accommodate any of the proposed changes to Virginia law and a transition to unitary combined reporting would be a significant change from current law, evidenced by the Budget Item 3-5.23 information reporting requirement which required the establishment of a makeshift unitary combined filing system in a rapid manner. Thus, at least two years would be necessary to formally develop the new regulations and guidance for a unitary combined reporting system in Virginia.

vi. Revenue Stability Concerns

Regarding potential revenue issues involved in a transition to unitary combined reporting, the volatility of corporate income taxes generally should be considered with any revenue estimates that would ultimately depend on how the law is structured, the individual circumstances of impacted corporations, and the year-to-year impacts. Any positive revenue impacts would likely be lower in transitional years due to taxpayer noncompliance and the establishment of any necessary administrative guidance and updates thereto. Delegate Watts expressed concerns raised by economic development experts and the Secretary of Commerce and Trade that a transition to unitary combined reporting could result in an exodus of businesses that would actually result in a net revenue decrease, which, like any major tax policy change, could affect corporate investment and expansion in the Commonwealth.

c. Other Corporate Income Tax Policy Changes Considered with and Separate from Unitary Combined Reporting

i. Switching an Affiliated Group's Filing Election

The Department then addressed other corporate income tax issues, aside from unitary combined reporting, raised by the Work Group in prior meetings. First discussed was the issue of switching an affiliated group's filing election. Generally, the Department has statutory authority[41] to grant or deny requests by corporations to change their Virginia tax filing status, which must be approved by the Department. Elections between separate and Virginia combined returns do not affect the allocation and apportionment formulas for each corporation, and are therefore generally granted. However, switching to or from consolidated filing status will affect those formulas and may distort business done in Virginia and income arising from activity in Virginia. Thus, such changes to or from a consolidated filing status are generally granted only with evidence of extraordinary circumstances.

Virginia's 20-year rule was established under 2003 legislation[42] that effectively provided an exception to the general, revenue stabilizing rule against switching to or from an affiliated group's consolidated filing status. Virginia Code § 58.1-442(C)[43] states that an affiliated group that has filed on the same basis for at least the last 20 years may switch to or from consolidated if

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[41] Va. Code § 58.1 442(C) states that a corporate taxpayer may apply to the Tax Commissioner for permission to change from (i) consolidated to separate or (ii) separate to VA combined/ consolidated, if the "affiliated group . . . has filed on the same basis for at least the preceding 20 years." Permission for the change "shall be granted if there would have been no decrease in tax liability computed under the new election compared to the affiliated group's former filing method and the affiliated group agrees to file VA returns under both the new filing method and the former method and will pay the greater of the two amounts for the taxable year in which the new election is effective and for the prior taxable year.

[42] Senate Bill 1125 (2003, Stosch); 2003 Acts of Assembly Chapter 166.

[43] Va. Code § 58.1-442(C).

the group asks permission from the Tax Commissioner and it is determined that (i) there would have been no decrease in tax computed under the new filing method as compared to the old filing method for the year preceding the year for which the new election would be applicable and (ii) the affiliated group agrees to pay the greater of the tax liability under the old filing method and the new filing method for the taxable year in which the new election is effective and for the immediately succeeding taxable year. S.B. 1058[44] from the 2020 Session, which failed to pass, intended to permit switching of certain affiliated groups' filing elections because of the tax consequences of the federal Tax Cuts and Jobs Act and the imposition of a limitation on the deduction for business interest expenses, also known as the "§ 163(j) limitation."[45] Consideration of S.B. 1058 included shortening the time period that result in a revenue loss and the fluid corporate tax policy changes at the federal level could also affect the rationality of maintaining the existing 20-year binding election period. Delegate Watts asked how Virginia's 20-year rule compares to the binding election period of other states and requested the Department follow up on such time period ranges used elsewhere to determine whether Virginia's rule is too rigid.

ii. Changing Virginia's Three-Factor Apportionment

Another consideration was changing Virginia's current three-factor apportionment structure,[46] consisting of a property factor, payroll factor, and double-weighted sales factor, which most corporations are required to use in determining their amount of income subject to Virginia income taxation. Virginia law sets out special apportionment methods that are permitted or required for motor carriers, financial corporations, construction corporations, and railway companies.[47] Alternative apportionment methods are also allowed by request in situations where the statutory three-factor apportionment method is inapplicable or inequitable.[48]

Another alternative to Virginia's statutory three-factor method of apportionment is the single sales factor apportionment method for the share of a corporation's total profit that is taxed in Virginia based solely on the share of the corporation's sales occurring in Virginia, compared to

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[44] Senate Bill 1058 (2020, Lewis). The bill, which was left in the House Committee on Appropriations due its unknown and potentially significant revenue impact, provided that, for taxable years 2020 through 2021, certain affiliated corporations may elect to switch to or from consolidated corporate income tax return filing status under certain conditions. The option would have been available only to a group with at least one affiliate that is (i) a bank exempt from filing a Virginia corporate income tax return or (ii) an aerospace manufacturer. Current law requires a group of corporations to apply to the Tax Commissioner for permission to change the basis of the type of return filed and to meet certain specified requirements in order for permission to be granted. The provisions of the bill were contingent on funding in a general appropriation act.

[45] Public Law No: 115-97 (2017); IRS "Basic questions and answers about the limitation on the deduction for business interest expense." Prior to the 2017 Tax Cuts and Jobs Act, § 163(j) of the Internal Revenue Code applied only to certain interest paid or accrued by corporations.

[46] The property factor involves the value of property in Virginia divided by the value of property everywhere, the payroll factor includes compensation paid to employees in Virginia divided by compensation paid everywhere, and the double weighted sales factor, which involves the sales or gross receipts made in Virginia divided by sales everywhere.

[47] Special apportionment rules for certain businesses are found in §§ 58.1-417 (motor carriers), 58.1-418 (financial corporations), 58.1-419 (construction corporations), and 58.1-420 (railway companies). Additionally, House Bill 222 (2018 Acts of Assembly, Chapter 802) and Senate Bill 883 (2018 Acts of Assembly, Chapter 801), allow certain companies that have been certified by the Virginia Economic Development Partnership Authority ("certified companies") to decrease the amount of income taxed by Virginia by making specific modifications to their apportionment of income ("certified company apportionment"). Virginia Tax Certified Company Apportionment Guidelines.

[48] Va. Code § 58.1-421.

sales everywhere. Virginia law requires single sales factor apportionment for manufacturers, retailers, enterprise data centers (if they enter into a memorandum of understanding with the Virginia Economic Development Partnership), and debt buyers (in combination with market-based sourcing).[49] When asked what the impetus was for those exceptions, the Department noted that the changes were advocated for by those specific industries and normally for especially large businesses, and that transitions to market-based sourcing were in response to state, rather than federal, actions.

iii. Market-Based Sourcing

The next discussion focused on market-based sourcing and the potential for a switch from Virginia's cost of performance sourcing method. Virginia's current apportionment structure assigns sales of tangible personal property to Virginia, if delivered to a location in Virginia, and outside of Virginia if delivered to a location outside of Virginia. Sales of services or intangible property are assigned to Virginia if the greater portion of income-producing activity (measured by costs of performance) is in Virginia, and outside of Virginia if the greater portion of income-producing activity (measured by costs of performance) is outside of Virginia. The "cost of performance" method is an all-or-nothing determination for purposes of sourcing sales of services and intangible property where the income-producing activity and costs of performance are deemed to be performed at the location of the corporation's real and tangible property and its employees.[50] Until recently, the majority of states used the cost of performance method. Further, Virginia's statutory definition of the sales factor[51] for services and intangible property is consistent with Section 17 of the Uniform Division of Income for Tax Purposes Act and regulations promulgated by the Multistate Tax Commission.

Market-based sourcing is an alternative method for determining the sales factor for sales other than sales of tangible personal property, namely services and intangible property. Under market-based sourcing, sales of services and intangible property are sourced to a state if the taxpayer's market for such sales is in that state. The method for determining a taxpayer's market for a sale of such services or intangible property varies between the states, but the general rule, subject to more complex, state-specific rules, is to source intangible property to a state to the extent that such property was used in that state. The General Assembly considered market-based sourcing bills[52] in 2011, 2013, 2014, 2015, 2016, 2017, 2018 (enacted, but limited to debt buyers only), and 2020. The Department was asked whether any thought has been given to making any change to market-based sourcing that is elective, but the Department remains neutral, takes no position on the issue, and noted that any elective regime would be utilized to minimize tax liability and thereby decrease revenue, but impacts would still depend on the form of any enacted legislation.

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[49] Va. Code §§ 58.1 422 (manufacturing companies), 58.1 422.1 (retail companies), 58.1 422.2 (taxpayers with enterprise data center operations), and 58.1 422.3 (debt buyers).

[50] For example, a company with facilities in all 50 states and only 5% of its costs in Virginia would assign 100% of its sales of services and intangible property to Virginia if no other state had more than 5%.

[51] Va. Code § 58.1-416.

[52] House Bill 1604 (2011, Albo); Senate Bill 1006 (2011, Watkins); House Bill 2253 (2013, Albo); House Bill 442 (2014, Davis); House Bill 2233 (2015, Davis); House Bill 966 (2016, Davis); House Bill 1499 (2017, Davis); House Bill 798 (2018, Davis); and House Bill 796 (2020, Knight).

In 2015, the Department conducted a study on market-based sourcing, at the request of the Chairman of the House Committee on Finance,[53] which included meetings with tax practitioners, business representatives, and other stakeholders but the results of which were inconclusive owing to data limitations. As a result, budget language was introduced in 2016 that would have required additional data submissions from corporations to generate more accurate revenue estimates. The budget language would have included funding of $2,500 for each reporting entity, but it was not adopted by the General Assembly.[54]

Delegate Watts commented that a concern passed on to her was that out of state corporations could exploit advantages against Virginia-based businesses under market-based sourcing. Virginia's cost of performance apportionment structure, followed by the majority of states until recently, deems income producing activity and costs of performance to be performed at the location of the corporation's real and tangible property and its employees. Members of the Work Group also noted that unitary combined reporting would not itself address advantages and disadvantages of adopting market-based sourcing or retaining the cost of performance method. While some states who have adopted unitary combined reporting also adopted market-based sourcing, most states simply adopted unitary combined reporting alone. Many southeastern states that compete with Virginia have not adopted combined reporting, even if they have adopted single sales factor apportionment. The Department remarked that the revenue impact of a transition to market-based sourcing in Virginia would likely be positive, but negative in the initial years due to immediate compliance only by those who benefit the most from its becoming effective.

iv. Tracking Federal Consolidated Return Calculations

With respect to tracking federal consolidated return calculations on Virginia returns, current law states that for federal income tax purposes, an affiliated group of corporations has the option of filing a consolidated return in lieu of separate returns for each individual corporation. If a federal consolidated return is filed, the affiliated group members are treated as one entity and their financial activities are combined. Virginia similarly allows for the filing of a state consolidated return in lieu of separate returns for each corporation. Further, a Virginia consolidated return election can be made regardless of how the federal return was filed for that affiliated group. As such, Virginia generally follows the federal regulations for consolidated groups and, as a result, taxpayers filing consolidated federal and state returns may utilize federal computations of income and deductions to determine their state income tax, unless a specific state deconformity provision applies.[55] However, Virginia only allows corporations having nexus with Virginia to be included on the state consolidated return, which may require taxpayers to recalculate income

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[53] Virginia Tax 2015 Market-Based Sourcing Study. The Work Group was required to study the desirability and feasibility of Virginia's changing its method of sourcing a corporation's sales, other than sales of tangible personal property, from cost of performance to market-based sourcing; study the desirability and feasibility of adopting a bifurcated approach to sourcing a corporation's sales (under this method, all companies would be required to use market-based sourcing unless they exceed certain thresholds related to, but not limited to, property and payroll (any companies exceeding such thresholds would be allowed to elect whether to source all sales, other than sales of tangible personal property, using market-based sourcing); provide recommendations regarding the implementation of any of the above changes to Virginia's statutory method of apportionment; and draft a bill based on the Virginia Tax recommendations for potential consideration by the General Assembly.

[54] See 2016 Introduced Budget, Item 275; House Bill 30 (2016, Jones).

[55] See Virginia's conformity to the Internal Revenue Code under Va. Code § 58.1-301.

and deductions for state purposes to exclude entities lacking nexus with Virginia from the state return, even when such entities were included on the federal consolidated return.[56]

Some potential changes in Virginia law could be to allow non-nexus affiliates to be included or to require the inclusion of all affiliates on consolidated returns. Advantages of such changes would include allowing a Virginia consolidated group to more closely resemble the federal consolidated group and, if Virginia became a unitary combined state with a consolidated election, Virginia would more closely resemble the form of the federal unitary combined group. The disadvantages of such a change include transitional issues and the unknown impact on general fund revenues.

v. Business Interest Expense Limitation

The Department was also asked to discuss the IRC § 163(j) business interest expense limitation which is generally limited to 30% of a taxpayer's income for the taxable year under the federal Tax Cuts and Jobs Act.[57] Interest expenses not deductible on account of this limitation are allowed to be carried forward indefinitely, subject to some restrictions, and the limitation applies at the consolidated tax return filing level for a group of affiliated corporations filing a federal consolidated return. The Virginia General Assembly generally conformed to the Tax Cuts and Jobs Act and the limitation on the deductibility of business interest in 2019,[58] but allowed an additional deduction on the Virginia return equal to 20 percent of the amount of business interest that is disallowed as a deduction under the IRC § 163(j) limitation.[59]

Budget Item 272(E) in the 2019 Appropriation Act[60] required the Department of Taxation to convene a working group studying the impact of the business limitation on businesses part of an affiliated group that file a Virginia combined or consolidated return and to also publish guidelines regarding how taxpayers are required to account for the business interest limitation for Virginia income tax purposes. The Department held a work group meeting on May 20, 2019, to solicit comments from affected parties and then, later in 2019, issued guidelines requiring the business interest limitation to be computed on the basis of how taxpayers elected to file their Virginia tax return: applying the limitation at the separate entity level for combined filers and applied at the full entity level for consolidated filers, in line with Virginia's treatment of other federal deductions, such as the federal charitable contribution deduction and the federal net operating loss deduction. Differences between federal and Virginia limitations arise from groups that file a federal consolidated return, but either file separate or combined Virginia returns or a consolidated Virginia return that has different members for federal and Virginia purposes.

Some options to address issues associated with the business expense interest limitation include changes to Virginia's current filing methods or adoption of mandatory unitary combined reporting with a Virginia consolidated return (where the members of such return would be the same as those in the federal consolidated return). In light of these options, Pennsylvania's treatment was discussed where as long as there is no § 163(j) limitation in the federal return, then the taxpayer does not need to go forward with calculating and applying the limitation on a

[56] See 26 CFR § 1.1502-75.
[57] Public Law No: 115-97 (2017).
[58] House Bill 2529 (2019, Hugo); 2019 Acts of Assembly Chapter 17.
[59] Va. Code §§ 58.1-322.03 and 58.1-402.
[60] House Bill 1700 (2019, Jones); 2019 Acts of Assembly Chapter 854.

separate entity basis.[61] The Department cautioned that any change to existing law could result in a negative revenue impact and that the fiscal implications should be carefully considered in advance.

vi. Net Operating Loss Deduction

The next discussion reviewed the implications of federal net operating loss enhancements. Virginia has a history of deconforming from federal provisions that enhance net operating losses, such as the five-year carryback of certain net operating losses generated in taxable years 2001, 2002, 2008, and 2009. During 2019, Virginia conformed to the provisions eliminating net operating loss carrybacks, allowing unlimited net operating loss carryforwards and limiting net operating losses to 80% of taxable income.[62] During the 2021 Session, Virginia deconformed from the federal provisions, allowing a five-year net operating loss carryback for those incurred in 2018, 2019, and 2020 while also removing the 80% limitation.[63] If Virginia were to conform to these federal provisions, there would be a significant, negative revenue impact.

vii. Intangible Holding Company Add-Back

With respect to the intangible holding company add-back, Virginia adopted a statutory addition to federal taxable income for taxable years beginning on and after 2004 for royalty payments and similar expenses paid to an intangible holding company.[64] The add-back is intended to mitigate the impact of a tax planning structure that shelters income by setting up intangible holding companies in a state that does not tax such income. Essentially, the intangible holding company often licenses intangible property to the taxpayer for its continued use, the taxpayer pays a royalty to the intangible holding company, which is deductible from state income tax, and because the intangible holding company itself has no significant expenses, the taxpayer receives almost all of its royalty payments back as dividend income, which is generally exempt from state income taxation.

If Virginia were to adopt unitary combined reporting, the intangible holding company add-back might no longer be necessary to prevent such tax planning strategies and structures because the intangible holding company would likely be included and subject to inclusion on the Virginia return. The existence of Virginia's add-back statute would partially offset the positive revenue gains expected from the adoption of unitary combined reporting, but the Department suggested considering the retention of the add-back, even if unitary combined were adopted, to prevent improper income-shifting outside of the Virginia unitary combined group (like international affiliates). Delegate Watts noted the relative effectiveness of the add-back statute in plugging gaps in Virginia law, and the Department agreed while explaining that there are four pending cases challenging enforcement of the add-back statute.

d. Nexus Considerations

The final segment of the presentation focused on nexus considerations. The primary limitations on a state's ability to levy a tax on an out of state taxpayer are the U.S. Constitution's Commerce and Due Process clauses, which courts have interpreted to require a substantial nexus or

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[61] See Pennsylvania Department of Revenue Corporate Tax Bulletin 2019-03.
[62] House Bill 2529 (2019, Hugo); 2019 Acts of Assembly Chapter 17.
[63] House Bill 1935 (2021 Special Session I, Watts); Senate Bill 1146 (2021 Special Session I, Howell); 2021 Special Session I Acts of Assembly Chapters 117 and 118.
[64] See Va. Code § 58.1-402(B)(8).

sufficient connection between the taxpayer and the state seeking to impose a tax. The 2018 *Wayfair* U.S. Supreme Court decision[65] found that physical presence is not required for substantial nexus and approved the sufficiency of an economic nexus, under which states typically provide a bright-line test where substantial nexus is deemed to exist if a taxpayer's annual sales in the state exceed a defined threshold amount. As a result, certain states have begun asserting economic nexus over out of state taxpayers from their in state use of intangible property, like trademarks and trade names.[66]

In addition to the substantial nexus standard in the U.S. Constitution, Public Law 86-272,[67] passed in 1959, limits a state's ability to levy a tax on an out-of-state taxpayer by preventing the imposition of a net income tax on a taxpayer whose only in-state activity involves the solicitation of orders for the sale of tangible personal property if the orders are sent out of state for approval and shipped from out-of-state locations. Although P.L. 86-272 does not apply to the sales of services and intangibles, Virginia voluntarily extended P.L. 86-272's application to the treatment of services and intangibles through administrative action. When asked how the recent increase in remote work affects payroll and nexus considerations for revenue departments and whether it should be considered for any tax policy changes, the Department explained that Virginia has been looking into the issue, but has not yet issued guidance on the matter.

e. Public Comment

Mr. David Skiles of the Vectre Corporation, representing Raytheon, spoke first and focused his remarks on market sourcing. He noted that the defense industry, which comprises a significant portion of Virginia's tax base, has concerns with the possibility of all contracts getting sourced to a single place and thereby increasing tax liability in that location. From the defense industry perspective, the industry is comfortable with the existing three-factor apportionment method in Virginia and is particularly concerned with services, rather than property.

Mrs. Kate Peterson of McGuire Woods Consulting, representing Universal Corporation with its global headquarters in Richmond, opposed mandatory unitary combined reporting for the potential negative growth and tax implications on the agriculture, food, and beverage industry. She asked the Work Group and General Assembly generally for consistency and certainty moving forward by rejecting unitary combined reporting and reiterated that the existing Virginia tax regime was and is relied upon by businesses seeking to expand and diversify in the Commonwealth.

Finally, the Molson Coors Beverage Company submitted a letter[68] requesting that the Work Group reject the unitary combined reporting proposal and maintain the current system for corporate income tax reporting and collection.

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[65] See *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 201 L. Ed. 2d 403, 2018 U.S. LEXIS 3835, 27 Fla. L. Weekly Fed. S 388, 2018 Comm. Reg. (P & F) 74, 2018 WL 3058015.
[66] See *Geoffrey, Inc. v. South Carolina Tax Commission*, S.C. Sup. Ct., 437 SE2d 13; cert. denied, 114 S. Ct. 550.
[67] See P.L. 86-272.
[68] See Attachment 5d - Letter from Molson Coors.

f. Follow-Up Responses from the Department of Taxation

During the September 21, 2021, meeting, Work Group members asked the Department of Taxation to provide additional information[69] on the following matters:

1. *Provide the exact costs to corporations for compliance with mandatory unitary combined reporting*;
    a. Response: Since Virginia Tax does not have access to information regarding compliance costs of corporations, this cannot be estimated without further information. A sample of such information could be obtained by poll of the work group members or by a similar reporting requirement for corporations.
2. *Obtain additional information on forced combination either from North Carolina's Department of Revenue or other sources*;
    a. Response: North Carolina is generally a separate return state. This means that corporations are able to file separate North Carolina returns and may compute their state income tax on an entity-by-entity basis.
    b. Prior to 2011, North Carolina's forced combination statute gave the North Carolina Department of Revenue (NC DOR) broad discretion to effectively force audited corporations to file unitary combined reports to determine their true earnings. In response to criticism received regarding the broadness of the forced combination statute, such statute was repealed and replace by a new forced combination statute that places more restrictions on NC DOR's ability to effectively require unitary combined reporting.
    c. Under North Carolina's current forced combination statute:
        i. NC DOR must first attempt to resolve income distortions through adjustments to intercompany payments before ordering a combined return;
        ii. NC DOR then must attempt to come to an agreed combination; and
        iii. Only if the taxpayer rejects all NC DOR proposed combinations may a true forced unitary combination be imposed.
    d. NC DOR does not have the authority to require unitary combined reporting into the future.
        i. As a result, a unitary combined report is only required for those past years that are under audit by NC DOR and for which the taxpayer agrees or is required to file a unitary combined report. However, in practice, some taxpayers that have been audited in the past may use unitary combined reporting or make other adjustments in future years to avoid audit adjustments being made by NC DOR.
    e. On the basis of discussions with staff from the NC DOR, Virginia Tax understands that the vast majority of NC DOR audits of Fortune 1000 companies result in some type of intercompany pricing adjustment or unitary combined reporting.
        i. When unitary combined reporting is the result, it is typically because taxpayers agree to unitary combinations with NC DOR.
        ii. When taxpayers do not agree to file a unitary combined report, a forced unitary combination may be required. It is our understanding that this

[69] The Department of Taxation 9/21/2021 follow-up responses document may also be found in Attachment 5c.

forced unitary combination rarely happens (approximately once every four years).

3. *Provide the transitional rules on deferred gains or losses in other states*;
    a. Response: Most states that require unitary combined reporting incorporate the federal consolidated return regulations with respect to eliminations and deferrals.
    b. However, any treatment that depends on whether the federal consolidated return includes or excludes the parties to a transaction shall instead depend on the parties' inclusion or exclusion from the state combined return.
    c. Virginia Tax is aware that five states (Connecticut, Kentucky, Massachusetts, New Jersey, and New Mexico) and the District of Columbia have authorized a special transitional deduction when mandatory unitary combined reporting is adopted.
        i. When recognition of a gain or loss is deferred for tax purposes, the published financial statement usually will include a corresponding deferred tax asset or liability on the balance sheet.
        ii. The change in tax reporting policies may require that gain or loss previously recognized be re-categorized as deferred items.
        iii. The re-characterization may require that published financial reports be restated or that all such items be reflected in current income.
        iv. The states that have permitted adjustments for changes in deferred tax assets and liabilities attributable to the adoption of mandatory combined reporting have varying definitions of which corporations are eligible and which transactions qualify.
        v. For example, the deduction may only apply to publicly traded corporations with published financial statements. They may have to apply for and be granted the deduction, and the deduction may be spread over several years to reduce the potential revenue impact on the state.
        vi. There is some debate about whether such a deduction is necessary when transitioning to unitary combined reporting.[70]
4. *Determine whether Virginia's 20-year rule is an outlier and, if so, what other states use*;
    a. Response: Of the jurisdictions that impose a corporate income tax, 27 states and the District of Columbia have enacted mandatory unitary combined reporting (MUCR).
        i. These states sometimes provide a consolidated election, giving taxpayers the choice to file on a unitary combined return or consolidated return.
        ii. For the purposes of Virginia's 20-year rule, Virginia Tax did not compare its rule to these states because Virginia is not currently an MUCR state.
        iii. The computation of income tax on a unitary combined return and on a consolidated return can be substantially similar, meaning that there are fewer opportunities for taxpayers in an MUCR state to reduce their income tax by switching between such methods.

[70] Compare Lauren A. Cooper and Joel W. Walters, Mitigating the Impact of State Tax Law Changes on Company Financial Statements, State Tax Research Institute (June 2020) with Michael Mazerov, States Should Reject Corporate Demands for "Deferred Tax" Deductions, Center on Budget and Policy Priorities (2019).

        iv. As a result, MUCR states are often able to place less restrictions on switching between filing unitary combined and filing consolidated without risking state corporate tax revenues.
    b. The remaining 15 states that impose a corporate income tax are separate return states like Virginia.
        i. In such states, allowing a consolidated return election has significantly greater revenue implications because of the different ways that tax is computed on a separate return as compared to a consolidated return.
        ii. As a result, separate return states are generally more restrictive than MUCR states in allowing switching between filing separate returns and filing consolidated returns.
    c. For this reason, seven of these separate return states (Delaware, Louisiana, Maryland, Mississippi, Pennsylvania, South Carolina, and Tennessee) do not appear to offer taxpayers the option to file on a consolidated basis at all.
        i. Virginia's law allowing taxpayers to make a consolidated election, as well as a Virginia combined election, is more favorable to taxpayers than the law in these states, where no consolidated filing election is available.
    d. The remaining eight separate return states (Arkansas, Florida, Georgia, Indiana, Iowa, Missouri, North Carolina, and Oklahoma) allow taxpayers to file on a consolidated basis under certain circumstances.
        i. Like Virginia, all eight of the separate return states that allow consolidated filing require taxpayers to apply for permission from a state tax agency before they can change their filing method.
        ii. Unlike Virginia, none of these states appear to set forth a specific time period after which the taxpayer may be entitled to change its filing method.
        iii. Instead, these eight states impose varying restrictions on granting such permission.
            1. Some of the eight states provide minimal, if any, criteria regarding when they will grant or deny permission to change one's filing method.
            2. Other states provide that they will consider certain factors. One common factor appears to be the ability to request to change one's filing method if the taxpayer can show that a law change substantially alters its state income tax.
        iv. From preliminary research completed by Virginia Tax, Virginia's law on switching filing status, including its 20-year rule, does not appear to be significantly more restrictive than the law of these other eight states.[71]
        v. However, it is possible that these states administer these laws in a manner that is effectively less restrictive than Virginia.
5. *Provide the gain or loss in revenue in other states that have adopted market-based sourcing*:
    a. Response: Virginia Tax has been unable to locate this information.

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[71] See Ark. Code Ann. § 26-51-805(d); Fla. Admin. Code Ann. § 12C-1.0131(3)(b); Ga. Comp. R. & Regs. § 560-7-3-.13(4); Ind. Admin. Code 45 § 3.1-1-110; Iowa Admin. Code 701--53.15(3); Mo. Code Regs. 12 § 10-2.045(33)-(34); N.C. Gen. Stat. § 105-130.14; Okla. Stat. 68 § 2367.

6. *Provide information on the winners and losers, percent tax change, effects on different industries, and effects on in-state businesses of a transition to unitary combined reporting*:
    a. Response: Virginia Tax does not currently have detailed information regarding taxpayers that would be impacted by a transition to unitary combined reporting.
    b. Available details will be shared in the report that is due December 1, 2021.

2. October 12, 2021, Work Group Meeting

a. Additional Corporate Feedback Submissions and Public Comment

During the September 21, 2021, meeting of the Work Group, Delegate Watts asked members to submit feedback for the October meeting on whether to continue exploring the adoption of unitary combined corporate income tax reporting, as well as any other suggestions for modifying Virginia's current corporate tax structure.

Six members sent feedback[72] on these remaining considerations for the Work Group:

- Mr. Winks, of Ferguson Enterprises, identified inequity in the application of federal § 163(j) rules to Virginia returns, suggested amending Virginia Code § 58.1-442 to allow more flexibility in filing elections as a one-time-only ability or an ability to switch filing elections after a reasonable time period, requested consideration of a change to Virginia Code § 58.1-421 to provide greater flexibility in the Department granting requests for alternative methods of allocation when the currently applied method results in greater than one hundred percent of the corporation's receipts being subject to taxation, and suggested permitting elective combined reporting with election eligibility safeguards relating to economic development and investment in the Commonwealth.
- Mr. Elder, of Dollar Tree, recommended the adoption of single sales factor for all companies to ease calculations of taxpayers' apportionment factors and to eliminate existing mixed apportionment rules; and changing to market-based sourcing, over cost of performance, to follow the lead of other states and provide greater fairness for service based companies headquartered in Virginia.
- Mrs. Berenholz, of Comcast Corporation, disfavors a shift to single sales factor coupled with market-based sourcing and suggested a narrow, tailored approach for certain industries were such changes to be adopted. She expressed a preference against the adoption of mandatory unitary combined reporting, but if unitary combined were adopted along with market-based sourcing, suggested allowing a targeted election that allows for worldwide combined reporting with an election for apportioning income.
- Mrs. Malloy, of Verisign, recommends against the adoption of mandatory unitary combined reporting due to the unfairness of combination of mandatory unitary combined reporting and existing Virginia apportionment rules, its elimination of choice in filing status, the unfair attribution of income and losses in another state to the taxing state, inconsistent rules among mandatory unitary combined reporting states, increased audit difficulties, and its potential adverse impact on corporations headquartered in Virginia as a result of the current tax structure.
- Mr. Wright, of Smithfield Foods, recommends against the adoption of mandatory unitary combined reporting for the aforementioned reasons and asked for the Work Group to

[72] See Attachment 6b Corporate Feedback Submissions for October 12, 2021, Meeting.

send a clear message that Virginia has no plans to pursue mandatory unitary combined reporting. Additionally, he supports an increase in the deductibility of interest expenses allowed on Virginia corporate income tax returns.
- Mrs. Kittrick, of Verizon, supports language in any unitary combined reporting bill that provides for a deduction (amortized for 10 years) of net deferred tax liabilities and the repeal of Virginia's telecommunications minimum tax in Virginia Code § 58.1-400.1.

In addition to the feedback submissions from Work Group members, the Commonwealth Institute submitted written public comment[73] that highlighted its support for mandatory unitary combined reporting and other corporate tax changes, such as strengthening Virginia's add back statute and authorizing the Department of Taxation to compel certain returns where warranted. The Commonwealth Institute opposes elective options and maintains that mandatory unitary combined reporting would advance fairness in the tax code and generate new, sustainable revenue for the Commonwealth.

b. Discussion of a Transition to Unitary Combined Reporting

The ultimate question posed to the Work Group involved whether to continue studying the adoption of unitary combined reporting in Virginia.

Mrs. Berenholz, of Comcast Corporation, first noted that Virginia's status as the number one place to do business[74] stems from its consistency and stability for taxpayers. A state's incremental tax burden is a major consideration when evaluating where to invest infrastructure. She suggested a careful and measured approach before upending Virginia's longstanding tax regime. Additionally, she felt that unitary combined reporting is not a panacea and only opens up other controversies for taxpayers by its reorganization of tax liability winners and losers. Virginia's add-back statute addresses many of the problems unitary combined reporting seeks to resolve. Further, the additional resources, training, and time period necessary to implement such a radical shift in Virginia's tax regime contributes to confusion and legal challenges by taxpayers and the Department of Taxation. She feels the current, corporate reporting structure is predictable, is easily administered, and is a fundamentally fair tax system.

Mr. Tappana, of Anheuser-Busch, believes that mandatory unitary combined reporting would pose a severe risk to Virginia's reputation as a stable and predictive state for business. He noted the significant increase in the size of Anheuser-Busch's tax New Jersey return from 20 pages to 1,500 pages when unitary combined reporting was adopted there. The complexity involved in preparing a return under unitary combined reporting explains, in part, why no state in the Southeast has adopted unitary combined reporting, why Maryland and Florida rejected its adoption in 2021, and why North Carolina is retaining its separate return status while it considers whether to lower its 2.5% corporate income tax rate. He preferred other corporate tax changes that would focus on economic growth. Given the economic state of the country and Virginia, he felt now is not the time to upend the current tax regime. Virginia's existing add-back statute and other tools are adequate to combat tax avoidance and the erosion of Virginia's corporate tax base. The increased tax litigation invited by a switch to unitary combined reporting should be avoided. He believes the tax system should be simple and fair and that forced unitary combined reporting is not right for Virginia.

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[73] See Attachment 6c - Public Comment from the Commonwealth Institute.
[74] See CNBC: America's Top States for Business in 2021.

Mr. Wright, of Smithfield Foods, felt that unitary combined reporting would be unfavorable for Smithfield. That 73% of companies would realize no change in tax liability based on 2019 data in the Budget Item 3-5.23 report did not necessarily account for years of differing net operating losses. A large part of Virginia's reputation as the best state for business comes from the stable tax structure and he urged the Work Group to maintain that competitive advantage over other states by rejecting unitary combined reporting.

Mr. Brunori, of RSM, noted that none of the states who recently enacted unitary combined reporting experienced the supposed revenue gains that were relied upon to support that policy's adoption. He felt that Virginia's tax system is fair, strong, and unbroken such that unitary combined reporting would not solve any apparent issue.

Assistant Commissioner White took no position on unitary combined reporting. He expects unitary combined reporting would result in a revenue increase for Virginia, but the extent of that increase is indeterminable, in part because the report will be based only on taxable year 2019 data.

Secretary Ball reiterated the reliance on stable and predictable tax structure in Virginia that has resulted in vital business investment and expansion. He does not wish to provide any disincentives for those investments and suggested consideration of other corporate tax changes, such as altering the 20-year binding election period.

Mr. Henderson, of Amazon, noted that Amazon is supportive of unitary combined reporting in Virginia. He acknowledged the desire of all corporate taxpayers to see sustained consistency in Virginia's corporate tax structure, but that unitary combined reporting would provide that predictability for Amazon given their new investments and growth in the Commonwealth as they scale up their operations.

Senator Marsden remarked how there will always be winners and losers when tax policy changes are made, but that the emergence of tax havens across the country, like in South Dakota, requires tough decisions to be made. The direction of the country appears to be headed in favor of unitary combined reporting and Virginia will have to reckon with these issues at some point in time in the interests of fairness to taxpayers and to the Commonwealth.

These discussions and opinions led the Work Group to find that at this point in time, Virginia should not proceed with further study into the implementation of unitary combined reporting in the Commonwealth, notwithstanding the possibility of future, independent legislative efforts to adopt the policy.

c. Discussion of Other Changes to Virginia's Corporate Tax Structure

i. Transitioning to Market-Based Sourcing from Cost of Performance; Expanding Single Sales Factor Election

Mrs. Kittrick, of Verizon, felt that market-based sourcing generally sources sales in a manner that benefits in-state businesses. From the communications industry perspective, there is typically a negative effect when moving from cost of performance to market-based sourcing, due to the national networks, assets, property, and employees present in many other states. She noted that a prior market-based sourcing legislative effort, H.B. 1499 (2017), included special considerations for telecommunications and defense companies that maintained an investment threshold that adjusted the numerator factor to cut the receipts that would be taxable in Virginia.

Verizon prefers the cost of performance method under current law, but if market-based sourcing were to be considered for adoption in Virginia, Mrs. Kittrick hoped any law would account for those considerations and not punish communications companies with operations in Virginia. Further, she referenced Tennessee as an example of a state that adopted market-based sourcing with investment thresholds included for the communications industry.

Mrs. Nieto, of Northrop Grumman, agreed with the remarks of Mrs. Kittrick because a large portion of the defense contracting industry's customer base is in Virginia and at the Pentagon. She too prefers the cost of performance method under current law, but if market-based sourcing were to be considered for adoption in Virginia, she hoped any law would carve out exceptions for the defense contracting industry.

Mrs. Berenholz, of Comcast, remarked how market-based sourcing and moving to single sales factor would expose a fairness issue. New York and Massachusetts have policies that aggressively assert that they may tax employees even when employees move and work outside of their borders, thereby ignoring the actual place of work performance, of particular concern in light of the increase of remote work during the COVID-19 pandemic. When these policies are applied to networking companies like Comcast, they ignore the work done outside of the Commonwealth to provide service in Virginia. Proponents would argue that the policies benefit companies headquartered in Virginia, but a company headquartered in Virginia without any customers in Virginia would pay no corporate income tax under market-based sourcing with single sales factor apportionment. She felt that result would be inequitable and also hoped all investors in the Commonwealth would be considered through an investment threshold or industry specific rules to avoid penalizing certain businesses operating in Virginia.

Mr. Carchia, of Capital One, noted the specialized concerns of communications and defense contractors, but for the majority of service companies based in Virginia, market-based sourcing is the preferred method. Cost of performance places Virginia service companies at a disadvantage because they are taxed based on their customers located outside in Virginia in those external states, but are then taxed based on their services in Virginia, resulting in situations where companies are paying taxes on more than 100 percent of their income. He referenced the Corporate Executive Board case[75] as an example of that dynamic. Therefore, he felt market-based sourcing for service based companies should be adopted in Virginia, given the trend in favor of its adoption around the country and to avoid the competitive disadvantage that would result from retaining the cost of performance method.

Mrs. Malloy, of Verisign, agreed with Capital One's position for the technological services industry. Verisign relocated its headquarters to Virginia in 2010 and felt that market-based sourcing and single sales factor apportionment should be adopted in Virginia, at least for service-based companies.

Assistant Tax Commissioner White raised the fact that a cautious approach that should be taken with carveouts for certain industries. Broadly, adoption of market-based sourcing and single sales factor apportionment involves burden shifting from in-state companies to out-of-state companies. Regarding the Corporate Executive Board case, he felt the company was requesting a form of apportionment that the General Assembly rejected, and that this request was beyond the authority of the Department of Taxation to grant.

[75] See Corp. Exec. Bd. Co. v. Va. Dep't of Taxation, 297 Va. 57, 822 S.E.2d 918, 2019 Va. LEXIS 6, 2019 WL 476707.

Mr. Brunori, of RSM, discussed how the majority of states who have adopted market-based sourcing did include the aforementioned carveouts for certain industries. Generally, he felt revenue departments in other states are not as adept at administering the cost of performance method as in Virginia. Additionally, single sales factor adoption has the chief goal of incentivizing economic development by inviting more employees and property being moved in state without an increase in tax liability.

Secretary Ball found market-based sourcing and single sales factor apportionment to be more complex issues that deserved more discussion before he felt comfortable opining on its fitness for Virginia.

Mr. Elder, of Dollar Tree, believes that single sales factor is fit for adoption in Virginia even though the majority of states who adopted single sales factor saw greater tax liability for Dollar Tree. Its adoption would not discourage investment in property and payroll, which face their own separate taxation regimes. Mixed apportionment formulas required in Virginia for businesses in multiple sectors are difficult to administer and complicated for taxpayers. A flat single sales factor across the board would be much simpler. Further, he clarified that the issues are distinct: Whether the apportionment methodology follows the single sales factor is a separate question from how those sales are determined under market-based or cost of performance sourcing methods.

Mr. Tappana, of Anheuser-Busch, feels that single sales factor would encourage investment in the Commonwealth by not penalizing a company for adding employees or assets in Virginia.

Among the businesses with carveouts in the Virginia Code, manufacturers that are heavily invested in Virginia have an optional single sales factor apportionment under current law that reduces their tax burden. Other manufacturers out of state using Virginia as a market generally do not take that election. Retailers have a mandatory single sales factor, and debt buyers follow market-based sourcing coupled with single sales factor. Therefore, this topic has been handled industry by industry in narrowly tailored bills to this point in time. Assistant Tax Commissioner White acknowledged the slippery slope involved with exercising administrative authority to grant alternative methods of apportionment on a company-by-company basis and preferred industry sectors seeking legislative solutions instead of resorting to administrative consideration to maintain equal application of the tax code to all corporate taxpayers. Additionally, he noted that revenue estimates for policy changes depend on information readily available to the Department.

The Work Group therefore found that while there may be reasons to adopt market-based sourcing and single sales factor apportionment, it would be best to address its adoption legislatively, sector by sector, as appropriate for equity and fairness, rather than mandating them for all Virginia corporate taxpayers.

ii. Easing of Federal § 163(j) Intercompany Interest Deductibility Limitations

Mr. Tappana, of Anheuser-Busch, discussed how the § 163(j) interest limitation only allows taxpayers to deduct interest expenses of no more than 30% of EBITDA or operating income, but that the definition will become more restrictive on January 1, 2022, through operation of the federal Tax Cuts and Jobs Act, to become no more than 30% of EBIT, which no bank would generally use in consideration of how much debt a company could borrow and which greatly increases tax liability. Section 163(j) currently hurts already struggling companies, for example, in a recession where EBITDA decreases, but interest expense does not, thereby increasing the amount of non-deductible interest and placing a greater tax burden on companies, especially manufacturers, during an economic downturn. Many states in the Southeast have deconformed from § 163(j), raising competitive concerns for Virginia. Virginia's 20% easing of the burden in its conformity legislation suggests consideration fully deconforming from § 163(j) or further easing the burden on taxpayers. Additionally, he noted that Virginia will see an increase in revenues from § 163(j) due to the change in federal law on January 1, 2022, which will substantially raise the tax burden for some companies in Virginia.

Mr. Carchia added that § 163(j) was coupled with a corporate reduction in the tax rate and accelerated depreciation for investments, but Virginia did not reduce its tax rate and deconformed from the accelerated depreciation provisions. Moving forward, deconforming from § 163(j) is important for companies in Virginia. Assistant Commissioner White noted that the primary reason for Virginia deconforming only partially from the § 163(j) provisions was due to negative revenue considerations.

The Work Group therefore agreed that there is a need to understand the exact revenue impacts involved with easing of the § 163(j) intercompany interest deductibility limitations, but requested draft legislation addressing the issue.

The Department studied the revenue impacts[76] of such a change following the meeting found that if Virginia were to adopt legislation during the 2022 General Assembly Session to deconform from the IRC § 163(j) limitation, with an assumed effective date of taxable years beginning on and after January 1, 2022, it would have the following estimated impact on General Fund revenues:

	FY 2023	**FY 2024**	**FY 2025**	**FY 2026**
Estimated Impact (in millions)	($122.3)	($87.4)	($90.2)	($94.0)

If Virginia were to adopt legislation during the 2022 Session of the General Assembly to make changes to the IRC § 163(j) limitation other than full deconformity, the revenue impact would depend on what changes were adopted. For example, if Virginia were to increase the limitation percentage rather than entirely deconforming from it, the revenue impact would depend on both the exact amount of the increased limitation percentage and whether Virginia would choose to keep or repeal the state-specific deduction.

iii. Greater Flexibility to Change Virginia Filing Election

The Work Group members agreed that more flexibility to change filing elections and a reduction of the binding 20-year period is preferred.

[76] See Attachment 6d, Department of Taxation Revenue Estimates from 10/12/2021 Meeting.

Assistant Commissioner White noted that the corporate income tax is generally the most volatile of general fund revenues and that the impact of reducing the period would potentially increase volatility. Mrs. Collins, of the Department of Taxation, explained that among separate return states, seven allow no consolidated election (and are more restrictive than Virginia by requiring separate filing only) and eight states that allow elections to be a separate or consolidated filer, binding that initial election with state specific rules for changing the filing status. Most of these laws were vague, deferred to the authority of their revenue departments, and lacked a set number of years binding that election like the 20-year rule in Virginia. Several states require a change in circumstances, such as a major corporate law change that negatively affected the corporate taxpayer or a major change in ownership of the corporation. Mr. Carchia also highlighted a requirement that if you elect consolidated returns, that election would require no decrease in tax liability in the prior year and recommended doing away with it in any reform efforts.

The Work Group therefore requested draft legislation that reduces the binding election period from 20 to 12 years, retaining the two-year transitional provisions under current law, and any other considerations other states utilize for inclusion.

The Department studied[77] the revenue impacts of such a change and found that if Virginia were to reduce the 20-year requirement to a term of 12 years, the change would have an unknown negative general fund impact. The number of corporations that would switch and the filing basis that they would elect are unknown. Below is a table that summarizes the income tax liability by corporate income tax returns filing status. A portion of the revenue could be lost but the magnitude is unknown.

Taxable Year 2018	**Number of Returns**	**Percentage of Returns**	**Income Tax Liability (in millions)**	**Percentage of Total Income Tax Liability**
Separate Returns	65,790	96%	$615	54%
Consolidated Returns	2,072	3%	$282	25%
Combined Returns	481	1%	$247	21%
All Returns	68,343	100%	$1,144	100%

The Department also reviewed prior estimates of similar proposed changes. Senate Bill 1058[78] in 2020 proposed changes to the current rules for changing filing status. Several versions of the bill were considered. The Senate substitute would have allowed an affiliated group of corporations to change from the Virginia combined to the consolidated filing status if it meets the following requirements:

[77] See Attachment 6d Department of Taxation Revenue Estimates From 10/12/2021 Meeting.
[78] Senate Bill 1058 (2020, Lewis).

- It has filed on the same basis for at least the preceding 20 years;
- At least one member of the affiliated group is:
    - A related entity to either a state or national bank that is exempt from filing a Virginia corporate income tax return, or
    - An entity that is classified under North American Industrial Classification System (NAICS) Code 3364, aerospace product and parts manufacturing; and
- The affiliated group agrees to file returns computing its Virginia income tax liability under both the new filing method and the former method and pay the greater of the two amounts for the taxable year in which the new election is effective.

The bill was estimated to have an unknown, but potentially significant, negative general fund revenue impact. Since the bill was industry-specific and would have impacted a more narrow set of taxpayers, the Department of Taxation was able to identify affiliated groups that might have been eligible to change their filing status under the proposed legislation. The tax liability of such groups appeared to be approximately $25 million and it was estimated that an unknown, but likely significant, portion of the $25 million in revenue could be lost due to tax planning if the bill was enacted.

Since the bill did not limit eligibility to entities that reported the relevant NAICS codes or that were primarily involved in the relevant industries during a particular year, it was not possible to identify all affiliated groups that could potentially be eligible under the bill. In addition, concerns were raised regarding the possibility that corporations may add an entity to the affiliated group or otherwise restructure to qualify and, therefore, increase the negative impact of the bill.

iv. Forced Unitary Combined Reporting Audit Resolution

The Work Group then discussed the fitness of forced combination in Virginia based on that authority in North Carolina. Mrs. Collins, of the Department of Taxation, explained how the Department was able to contact the North Carolina Department of Revenue for more insight into their law. Prior to 2011, North Carolina had broader discretion to force unitary combination and then 2011 legislation passed which placed some restrictions on that authority. There is a three step process in North Carolina: (1) resolving any income distortions with the taxpayer by making intercompany adjustments, similar to Virginia's add back statute, (2) if unresolved, they attempt to come to an agreement on a hybrid combined reporting approach with the taxpayer, and (3) if unresolved, they may force combination, though that is rarely required. North Carolina may only force combination on a taxable year basis, not indefinitely. Assistant Commissioner White discussed a general reluctance to force unitary combination on a taxpayer under Virginia's add-back statute.

The Work Group therefore found that Virginia's existing add-back statute was sufficient and that no further action should be taken at this time.

v. Amortized Deduction for Net Deferred Tax Liabilities for Publicly Traded Companies

This topic was raised at the request of Verizon, but Mrs. Kittrick, of Verizon, advised that reviewing this issue would be unnecessary in light of the findings not to pursue further study of the adoption of unitary combined reporting. The Work Group therefore found that no further action should be taken at this time.

vi. Other Findings and Considerations

Delegate Watts raised the question of why budget language that was first introduced in the 2014 Appropriation Act stating that related members deriving at least one third of gross revenue from licensing to related parties shall be limited and applied to intangible property derived from licensing agreements has not yet been codified.

That budget provision is found in Item 3-5.09 of Chapter 552 of the 2021 Reconvened Special Session I Acts of Assembly[79]:

> *§ 3-5.09 INTANGIBLE HOLDING COMPANY ADD-BACK*
>
> *Notwithstanding the provisions of § 58.1-402(B)(8), Code of Virginia, for taxable years beginning on and after January 1, 2004:*
>
> *(i) The exception in § 58.1-402(B)(8)(a)(1) for income that is subject to a tax based on or measured by net income or capital imposed by Virginia, another state, or a foreign government shall be limited to and apply only to the portion of such income received by the related member that owns the intangible property, which portion is attributed to a state or foreign government in which such related member has sufficient nexus to be itself subject to such taxes; and*
>
> *(ii) The exception in § 58.1-402(B)(8)(a)(2) for a related member deriving at least one-third of its gross revenues from licensing to unrelated parties shall be limited and apply to the portion of such income received by the related member that owns the intangible property and derived from licensing agreements for which the rates and terms are comparable to the rates and terms of agreements that such related member has entered into with unrelated entities.*

The Work Group therefore urged considering codification of that budget provision statutorily to close that perceived loophole in future sessions.

<u>3. Recommendations and Work Group Findings</u>

The Work Group made the following recommendations after completing its charge over the course of the 2021 interim period:

- Unitary combined reporting
  - At this point in time, Virginia should not proceed with further study into the implementation of unitary combined reporting in the Commonwealth, notwithstanding the possibility of future, independent legislative efforts to adopt the policy. No draft legislation was requested.
- Market-Based Sourcing and Single Sales Factor Apportionment
  - While there may be reasons to adopt market-based sourcing and single sales factor apportionment, it would be best to address its adoption legislatively, sector by sector, as appropriate for equity and fairness, rather than mandating the policies for all Virginia corporate taxpayers. No draft legislation was requested.
- Easing of the § 163(j) Intercompany Interest Deductibility Limitation

[79] See Pg. 708, Item 3-5.09 of Chapter 552 of the 2021 Reconvened Special Session I Virginia Acts of Assembly.

    - There is need to understand the exact revenue impacts involved with easing of the 163(j) intercompany interest deductibility limitations, but draft legislation was requested.
- Greater Flexibility to Change Filing Elections
    - The Work Group requested draft legislation that reduces the binding election period from 20 to 12 years and retains the two-year transitional provisions under current law.
- Forced Unitary Combined Reporting Audit Resolution
    - The Work Group found that Virginia's existing add-back statute was sufficient and that no further action should be taken at this time. No draft legislation was requested.
- Codifying IHC Add-back Budget Language
    - The Work Group recommended considering codification of the relevant budget language in future sessions.

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ATTACHMENTS AND APPENDICES

SUMMARY

Tax returns of affiliated corporations; permission to change basis of type of return filed. Decreases from 20 years to 12 years the time period for which an affiliated group of corporations must file on the same basis before it may apply to the Tax Commissioner for permission to change the basis of the type of return filed (i) from consolidated to separate or (ii) from separate or combined to consolidated.

SENATE BILL NO. __________ HOUSE BILL NO. __________

A BILL to amend and reenact § 58.1-442 of the Code of Virginia, relating to tax returns of affiliated corporations; permission to change basis of type of return filed.

Be it enacted by the General Assembly of Virginia:

1. That § 58.1-442 of the Code of Virginia is amended and reenacted as follows:

§ 58.1-442. Separate, combined or consolidated returns of affiliated corporations.

A. Corporations which are affiliated within the meaning of § 58.1-302 may, for any taxable year, file separate returns, file a combined return or file a consolidated return of net income for the purpose of this chapter, and the taxes thereunder shall be computed and determined upon the basis of the type of return filed. Following an election to file on a separate, consolidated, or combined basis all returns thereafter filed shall be upon the same basis unless permission to change is granted by the Department.

B. For the purpose of subsection A:

1. A consolidated return shall mean a single return for a group of corporations affiliated within the meaning of § 58.1-302, prepared in accordance with the principles of § 1502 of the Internal Revenue Code and regulations promulgated thereunder. Permission to file a consolidated return shall not be denied to a group of affiliated corporations filing a consolidated federal return solely because two or more members of such affiliated group would be required to use different apportionment factors if separate returns were filed. The Tax Commissioner shall promulgate regulations setting forth the manner in which such an affiliated group shall compute its Virginia taxable income.

2. A combined return shall mean a single return for a group of corporations affiliated within the meaning of § 58.1-302, in which income or loss is separately determined in accordance with subdivisions a through d below:

a. Virginia taxable income or loss is computed separately for each corporation;

b. Allocable income is allocated to the state of commercial domicile separately for each corporation;

c. Apportionable income or loss is computed, utilizing separate apportionment factors for each corporation;

d. Income or loss computed in accordance with items a through c above is combined and reported on a single return for the affiliated group.

C. Notwithstanding subsection A, a group of corporations may apply to the Tax Commissioner for permission to change the basis of the type of return filed (i) from consolidated to separate or (ii) from separate or combined to consolidated, if such corporations are affiliated within the meaning of § 58.1-302 and the affiliated group of which they are members, as it has existed from time to time, has filed on the same basis for at least the preceding ~~20~~ 12 years. Permission shall be granted if:

1. For the taxable year immediately preceding the taxable year for which the new election would be applicable, there would have been no decrease in tax liability computed under the proposed election as compared to the affiliated group's former filing method; and

2. The affiliated group agrees to file returns computing its Virginia income tax liability under both the new filing method and the former method and will pay the greater of the two amounts for the taxable year in which the new election is effective and for the immediately succeeding taxable year.

#

SUMMARY

Virginia taxable income; deductions; business interest. Increases from 20 percent to 50 percent the Virginia individual and corporate income tax deduction for business interest disallowed as a deduction under § 163(j) of the Internal Revenue Code for taxable years beginning on and after January 1, 2022.

SENATE BILL NO. __________ HOUSE BILL NO. __________

A BILL to amend and reenact §§ 58.1-322.03 and 58.1-402 of the Code of Virginia, relating to Virginia taxable income; deductions; business interest.

Be it enacted by the General Assembly of Virginia:

1. That §§ 58.1-322.03 and 58.1-402 of the Code of Virginia are amended and reenacted as follows:

§ 58.1-322.03. Virginia taxable income; deductions.

In computing Virginia taxable income pursuant to § 58.1-322, there shall be deducted from Virginia adjusted gross income as defined in § 58.1-321:

1. a. The amount allowable for itemized deductions for federal income tax purposes where the taxpayer has elected for the taxable year to itemize deductions on his federal return, but reduced by the amount of income taxes imposed by the Commonwealth or any other taxing jurisdiction and deducted on such federal return and increased by an amount that, when added to the amount deducted under § 170 of the Internal Revenue Code for mileage, results in a mileage deduction at the state level for such purposes at a rate of 18 cents per mile; or

b. Provided that the taxpayer has not itemized deductions for the taxable year on his federal income tax return: (i) for taxable years beginning before January 1, 2019, and on and after January 1, 2026, $3,000 for single individuals and $6,000 for married persons (one-half of such amounts in the case of a married individual filing a separate return) and (ii) for taxable years beginning on and after January 1, 2019, but before January 1, 2026, $4,500 for single individuals and $9,000 for married persons (one-half of such amounts in the case of a married individual filing a separate return). For purposes of this section, any person who may be claimed as a dependent on another taxpayer's return for the taxable year may compute the deduction only with respect to earned income.

2. a. A deduction in the amount of $930 for each personal exemption allowable to the taxpayer for federal income tax purposes.

b. Each blind or aged taxpayer as defined under § 63(f) of the Internal Revenue Code shall be entitled to an additional personal exemption in the amount of $800.

The additional deduction for blind or aged taxpayers allowed under this subdivision shall be allowable regardless of whether the taxpayer itemizes deductions for the taxable year for federal income tax purposes.

3. A deduction equal to the amount of employment-related expenses upon which the federal credit is based under § 21 of the Internal Revenue Code for expenses for household and dependent care services necessary for gainful employment.

4. An additional $1,000 deduction for each child residing for the entire taxable year in a home under permanent foster care placement as defined in § 63.2-908, provided that the taxpayer can also claim the child as a personal exemption under § 151 of the Internal Revenue Code.

5. a. A deduction in the amount of $12,000 for individuals born on or before January 1, 1939.

b. A deduction in the amount of $12,000 for individuals born after January 1, 1939, who have attained the age of 65. This deduction shall be reduced by $1 for every $1 that the taxpayer's adjusted federal adjusted gross income exceeds $50,000 for single taxpayers or $75,000 for married taxpayers. For married taxpayers filing separately, the deduction shall be reduced by $1 for every $1 that the total combined adjusted federal adjusted gross income of both spouses exceeds $75,000.

For the purposes of this subdivision, "adjusted federal adjusted gross income" means federal adjusted gross income minus any benefits received under Title II of the Social Security Act and other benefits subject to federal income taxation solely pursuant to § 86 of the Internal Revenue Code, as amended.

6. The amount an individual pays as a fee for an initial screening to become a possible bone marrow donor, if (i) the individual is not reimbursed for such fee or (ii) the individual has not claimed a deduction for the payment of such fee on his federal income tax return.

7. a. A deduction shall be allowed to the purchaser or contributor for the amount paid or contributed during the taxable year for a prepaid tuition contract or college savings trust account entered into with the Virginia College Savings Plan, pursuant to Chapter 7 (§ 23.1-700 et seq.) of Title 23.1. Except as provided in subdivision b, the amount deducted on any individual income tax return in any taxable year shall be limited to $4,000 per prepaid tuition contract or college savings trust account. No deduction shall be

allowed pursuant to this subdivision 7 if such payments or contributions are deducted on the purchaser's or contributor's federal income tax return. If the purchase price or annual contribution to a college savings trust account exceeds $4,000, the remainder may be carried forward and subtracted in future taxable years until the purchase price or college savings trust contribution has been fully deducted; however, except as provided in subdivision b, in no event shall the amount deducted in any taxable year exceed $4,000 per contract or college savings trust account. Notwithstanding the statute of limitations on assessments contained in § 58.1-312, any deduction taken hereunder shall be subject to recapture in the taxable year or years in which distributions or refunds are made for any reason other than (i) to pay qualified higher education expenses, as defined in § 529 of the Internal Revenue Code or (ii) the beneficiary's death, disability, or receipt of a scholarship. For the purposes of this subdivision, "purchaser" or "contributor" means the person shown as such on the records of the Virginia College Savings Plan as of December 31 of the taxable year. In the case of a transfer of ownership of a prepaid tuition contract or college savings trust account, the transferee shall succeed to the transferor's tax attributes associated with a prepaid tuition contract or college savings trust account, including, but not limited to, carryover and recapture of deductions.

b. A purchaser of a prepaid tuition contract or contributor to a college savings trust account who has attained age 70 shall not be subject to the limitation that the amount of the deduction not exceed $4,000 per prepaid tuition contract or college savings trust account in any taxable year. Such taxpayer shall be allowed a deduction for the full amount paid for the contract or contributed to a college savings trust account, less any amounts previously deducted.

8. The total amount an individual actually contributed in funds to the Virginia Public School Construction Grants Program and Fund, established in Chapter 11.1 (§ 22.1-175.1 et seq.) of Title 22.1, provided that the individual has not claimed a deduction for such amount on his federal income tax return.

9. An amount equal to 20 percent of the tuition costs incurred by an individual employed as a primary or secondary school teacher licensed pursuant to Chapter 15 (§ 22.1-289.1 et seq.) of Title 22.1 to attend continuing teacher education courses that are required as a condition of employment; however, the deduction provided by this subdivision shall be available only if (i) the individual is not reimbursed

for such tuition costs and (ii) the individual has not claimed a deduction for the payment of such tuition costs on his federal income tax return.

10. The amount an individual pays annually in premiums for long-term health care insurance, provided that the individual has not claimed a deduction for federal income tax purposes, or, for taxable years beginning before January 1, 2014, a credit under § 58.1-339.11. For taxable years beginning on and after January 1, 2014, no such deduction for long-term health care insurance premiums paid by the individual during the taxable year shall be allowed if the individual has claimed a federal income tax deduction for such taxable year for long-term health care insurance premiums paid by him.

11. Contract payments to a producer of quota tobacco or a tobacco quota holder, or their spouses, as provided under the American Jobs Creation Act of 2004 (P.L. 108-357), but only to the extent that such payments have not been subtracted pursuant to subsection D of § 58.1-402, as follows:

a. If the payment is received in installment payments, then the recognized gain may be subtracted in the taxable year immediately following the year in which the installment payment is received.

b. If the payment is received in a single payment, then 10 percent of the recognized gain may be subtracted in the taxable year immediately following the year in which the single payment is received. The taxpayer may then deduct an equal amount in each of the nine succeeding taxable years.

12. An amount equal to 20 percent of the sum paid by an individual pursuant to Chapter 6 (§ 58.1-600 et seq.), not to exceed $500 in each taxable year, in purchasing for his own use the following items of tangible personal property: (i) any clothes washers, room air conditioners, dishwashers, and standard size refrigerators that meet or exceed the applicable energy star efficiency requirements developed by the U.S. Environmental Protection Agency and the U.S. Department of Energy; (ii) any fuel cell that (a) generates electricity using an electrochemical process, (b) has an electricity-only generation efficiency greater than 35 percent, and (c) has a generating capacity of at least two kilowatts; (iii) any gas heat pump that has a coefficient of performance of at least 1.25 for heating and at least 0.70 for cooling; (iv) any electric heat pump hot water heater that yields an energy factor of at least 1.7; (v) any electric heat pump that has a heating system performance factor of at least 8.0 and a cooling seasonal energy efficiency ratio of at least 13.0; (vi) any central air conditioner that has a cooling seasonal energy efficiency ratio of at least 13.5;

(vii) any advanced gas or oil water heater that has an energy factor of at least 0.65; (viii) any advanced oil-fired boiler with a minimum annual fuel-utilization rating of 85; (ix) any advanced oil-fired furnace with a minimum annual fuel-utilization rating of 85; and (x) programmable thermostats.

13. The lesser of $5,000 or the amount actually paid by a living donor of an organ or other living tissue for unreimbursed out-of-pocket expenses directly related to the donation that arose within 12 months of such donation, provided that the donor has not taken a medical deduction in accordance with the provisions of § 213 of the Internal Revenue Code for such expenses. The deduction may be taken in the taxable year in which the donation is made or the taxable year in which the 12-month period expires.

14. For taxable years beginning on and after January 1, 2013, the amount an individual age 66 or older with earned income of at least $20,000 for the year and federal adjusted gross income not in excess of $30,000 for the year pays annually in premiums for (i) a prepaid funeral insurance policy covering the individual or (ii) medical or dental insurance for any person for whom individual tax filers may claim a deduction for such premiums under federal income tax laws. As used in this subdivision, "earned income" means the same as that term is defined in § 32(c) of the Internal Revenue Code. The deduction shall not be allowed for any portion of such premiums paid for which the individual has (a) been reimbursed, (b) claimed a deduction for federal income tax purposes, (c) claimed a deduction or subtraction under another provision of this section, or (d) claimed a federal income tax credit or any income tax credit pursuant to this chapter.

15. For taxable years beginning on and after January 1, 2018, but before January 1, 2022, 20 percent of business interest disallowed as a deduction pursuant to § 163(j) of the Internal Revenue Code. For taxable years beginning on and after January 1, 2022, 50 percent of business interest disallowed as a deduction pursuant to § 163(j) of the Internal Revenue Code. For purposes of this subdivision, "business interest" means the same as that term is defined under § 163(j) of the Internal Revenue Code.

16. For taxable years beginning on and after January 1, 2019, the actual amount of real and personal property taxes imposed by the Commonwealth or any other taxing jurisdiction not otherwise deducted solely on account of the dollar limitation imposed on individual deductions by § 164(b)(6)(B) of the Internal Revenue Code.

17. For taxable years beginning on and after January 1, 2020, but before January 1, 2021, up to $100,000 of the amount that is not deductible when computing federal adjusted gross income solely on account of the portion of subdivision B 10 of § 58.1-301 related to Paycheck Protection Program loans.

§ 58.1-402. Virginia taxable income.

A. For purposes of this article, Virginia taxable income for a taxable year means the federal taxable income and any other income taxable to the corporation under federal law for such year of a corporation adjusted as provided in subsections B, C, D, E, G, and H.

For a regulated investment company and a real estate investment trust, such term means the "investment company taxable income" and "real estate investment trust taxable income," respectively, to which shall be added in each case any amount of capital gains and any other income taxable to the corporation under federal law which shall be further adjusted as provided in subsections B, C, D, E, G, and H.

B. There shall be added to the extent excluded from federal taxable income:

1. Interest, less related expenses to the extent not deducted in determining federal taxable income, on obligations of any state other than Virginia, or of a political subdivision of any such other state unless created by compact or agreement to which the Commonwealth is a party;

2. Interest or dividends, less related expenses to the extent not deducted in determining federal taxable income, on obligations or securities of any authority, commission or instrumentality of the United States, which the laws of the United States exempt from federal income tax but not from state income taxes;

3. [Repealed.]

4. The amount of any net income taxes and other taxes, including franchise and excise taxes, which are based on, measured by, or computed with reference to net income, imposed by the Commonwealth or any other taxing jurisdiction, to the extent deducted in determining federal taxable income;

5. Unrelated business taxable income as defined by § 512 of the Internal Revenue Code;

6. [Repealed.]

7. The amount required to be included in income for the purpose of computing the partial tax on an accumulation distribution pursuant to § 667 of the Internal Revenue Code;

8. a. For taxable years beginning on and after January 1, 2004, the amount of any intangible expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with one or more related members to the extent such expenses and costs were deductible or deducted in computing federal taxable income for Virginia purposes. This addition shall not be required for any portion of the intangible expenses and costs if one of the following applies:

(1) The corresponding item of income received by the related member is subject to a tax based on or measured by net income or capital imposed by Virginia, another state, or a foreign government that has entered into a comprehensive tax treaty with the United States government;

(2) The related member derives at least one-third of its gross revenues from the licensing of intangible property to parties who are not related members, and the transaction giving rise to the expenses and costs between the corporation and the related member was made at rates and terms comparable to the rates and terms of agreements that the related member has entered into with parties who are not related members for the licensing of intangible property; or

(3) The corporation can establish to the satisfaction of the Tax Commissioner that the intangible expenses and costs meet both of the following: (i) the related member during the same taxable year directly or indirectly paid, accrued or incurred such portion to a person who is not a related member, and (ii) the transaction giving rise to the intangible expenses and costs between the corporation and the related member did not have as a principal purpose the avoidance of any portion of the tax due under this chapter.

b. A corporation required to add to its federal taxable income intangible expenses and costs pursuant to subdivision a may petition the Tax Commissioner, after filing the related income tax return for the taxable year and remitting to the Tax Commissioner all taxes, penalties, and interest due under this article for such taxable year including tax upon any amount of intangible expenses and costs required to be added to federal taxable income pursuant to subdivision a, to consider evidence relating to the transaction or transactions between the corporation and a related member or members that resulted in the corporation's taxable income being increased, as required under subdivision a, for such intangible expenses and costs.

If the corporation can demonstrate to the Tax Commissioner's sole satisfaction, by clear and convincing evidence, that the transaction or transactions between the corporation and a related member or members resulting in such increase in taxable income pursuant to subdivision a had a valid business purpose other than the avoidance or reduction of the tax due under this chapter, the Tax Commissioner shall permit the corporation to file an amended return. For purposes of such amended return, the requirements of subdivision a shall not apply to any transaction for which the Tax Commissioner is satisfied (and has identified) that the transaction had a valid business purpose other than the avoidance or reduction of the tax due under this chapter. Such amended return shall be filed by the corporation within one year of the written permission granted by the Tax Commissioner and any refund of the tax imposed under this article shall include interest at a rate equal to the rate of interest established under § 58.1-15 and such interest shall accrue as provided under § 58.1-1833. However, upon the filing of such amended return, any related member of the corporation that subtracted from taxable income amounts received pursuant to subdivision C 21 shall be subject to the tax imposed under this article on that portion of such amounts for which the corporation has filed an amended return pursuant to this subdivision. In addition, for such transactions identified by the Tax Commissioner herein by which he has been satisfied by clear and convincing evidence, the Tax Commissioner may permit the corporation in filing income tax returns for subsequent taxable years to deduct the related intangible expenses and costs without making the adjustment under subdivision a.

The Tax Commissioner may charge a fee for all direct and indirect costs relating to the review of any petition pursuant to this subdivision, to include costs necessary to secure outside experts in evaluating the petition. The Tax Commissioner may condition the review of any petition pursuant to this subdivision upon payment of such fee.

No suit for the purpose of contesting any action of the Tax Commissioner under this subdivision shall be maintained in any court of this Commonwealth.

c. Nothing in subdivision B 8 shall be construed to limit or negate the Department's authority under § 58.1-446;

9. a. For taxable years beginning on and after January 1, 2004, the amount of any interest expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with one or more related members to the extent such expenses and costs were deductible or deducted in computing federal taxable income for Virginia purposes. This addition shall not be required for any portion of the interest expenses and costs, if:

(1) The related member has substantial business operations relating to interest-generating activities, in which the related member pays expenses for at least five full-time employees who maintain, manage, defend or are otherwise responsible for operations or administration relating to the interest-generating activities; and

(2) The interest expenses and costs are not directly or indirectly for, related to or in connection with the direct or indirect acquisition, maintenance, management, sale, exchange, or disposition of intangible property; and

(3) The transaction giving rise to the expenses and costs between the corporation and the related member has a valid business purpose other than the avoidance or reduction of taxation and payments between the parties are made at arm's length rates and terms; and

(4) One of the following applies:

(i) The corresponding item of income received by the related member is subject to a tax based on or measured by net income or capital imposed by Virginia, another state, or a foreign government that has entered into a comprehensive tax treaty with the United States government;

(ii) Payments arise pursuant to a pre-existing contract entered into when the parties were not related members provided the payments continue to be made at arm's length rates and terms;

(iii) The related member engages in transactions with parties other than related members that generate revenue in excess of $2 million annually; or

(iv) The transaction giving rise to the interest payments between the corporation and a related member was done at arm's length rates and terms and meets any of the following: (a) the related member uses funds that are borrowed from a party other than a related member or that are paid, incurred or passed-through to a person who is not a related member; (b) the debt is part of a regular and systematic funds management or portfolio investment activity conducted by the related member, whereby the funds of two or more related members are aggregated for the purpose of achieving economies of scale, the internal financing of the active business operations of members, or the benefit of centralized management of funds; (c) financing the expansion of the business operations; or (d) restructuring the debt of related members, or the pass-through of acquisition-related indebtedness to related members.

b. A corporation required to add to its federal taxable income interest expenses and costs pursuant to subdivision a may petition the Tax Commissioner, after filing the related income tax return for the taxable year and remitting to the Tax Commissioner all taxes, penalties, and interest due under this article for such taxable year including tax upon any amount of interest expenses and costs required to be added to federal taxable income pursuant to subdivision a, to consider evidence relating to the transaction or transactions between the corporation and a related member or members that resulted in the corporation's taxable income being increased, as required under subdivision a, for such interest expenses and costs.

If the corporation can demonstrate to the Tax Commissioner's sole satisfaction, by clear and convincing evidence, that the transaction or transactions between the corporation and a related member or members resulting in such increase in taxable income pursuant to subdivision a had a valid business purpose other than the avoidance or reduction of the tax due under this chapter and that the related payments between the parties were made at arm's length rates and terms, the Tax Commissioner shall permit the corporation to file an amended return. For purposes of such amended return, the requirements of subdivision a shall not apply to any transaction for which the Tax Commissioner is satisfied (and has identified) that the transaction had a valid business purpose other than the avoidance or reduction of the tax due under this chapter and that the related payments between the parties were made at arm's length rates and terms. Such amended return shall be filed by the corporation within one year of the written permission granted by the Tax Commissioner and any refund of the tax imposed under this article shall include interest at a rate equal to the rate of interest established under § 58.1-15 and such interest shall accrue as provided under § 58.1-1833. However, upon the filing of such amended return, any related member of the corporation that subtracted from taxable income amounts received pursuant to subdivision C 21 shall be subject to the tax imposed under this article on that portion of such amounts for which the corporation has filed an amended return pursuant to this subdivision. In addition, for such transactions identified by the Tax Commissioner herein by which he has been satisfied by clear and convincing evidence, the Tax Commissioner may permit the corporation in filing income tax returns for subsequent taxable years to deduct the related interest expenses and costs without making the adjustment under subdivision a.

The Tax Commissioner may charge a fee for all direct and indirect costs relating to the review of any petition pursuant to this subdivision, to include costs necessary to secure outside experts in evaluating the petition. The Tax Commissioner may condition the review of any petition pursuant to this subdivision upon payment of such fee.

No suit for the purpose of contesting any action of the Tax Commissioner under this subdivision shall be maintained in any court of this Commonwealth.

c. Nothing in subdivision B 9 shall be construed to limit or negate the Department's authority under § 58.1-446.

d. For purposes of subdivision B 9:

"Arm's-length rates and terms" means that (i) two or more related members enter into a written agreement for the transaction, (ii) such agreement is of a duration and contains payment terms substantially similar to those that the related member would be able to obtain from an unrelated entity, (iii) the interest is at or below the applicable federal rate compounded annually for debt instruments under § 1274(d) of the Internal Revenue Code that was in effect at the time of the agreement, and (iv) the borrower or payor adheres to the payment terms of the agreement governing the transaction or any amendments thereto.

"Valid business purpose" means one or more business purposes that alone or in combination constitute the motivation for some business activity or transaction, which activity or transaction improves, apart from tax effects, the economic position of the taxpayer, as further defined by regulation.

10. a. For taxable years beginning on and after January 1, 2009, the amount of dividends deductible under §§ 561 and 857 of the Internal Revenue Code by a Captive Real Estate Investment Trust (REIT). For purposes of this subdivision, a REIT is a Captive REIT if:

(1) It is not regularly traded on an established securities market;

(2) More than 50 percent of the voting power or value of beneficial interests or shares of which, at any time during the last half of the taxable year, is owned or controlled, directly or indirectly, by a single entity that is (i) a corporation or an association taxable as a corporation under the Internal Revenue Code; and (ii) not exempt from federal income tax pursuant to § 501(a) of the Internal Revenue Code; and

(3) More than 25 percent of its income consists of rents from real property as defined in § 856(d) of the Internal Revenue Code.

b. For purposes of applying the ownership test of subdivision 10 a (2), the following entities shall not be considered a corporation or an association taxable as a corporation:

(1) Any REIT that is not treated as a Captive REIT;

(2) Any REIT subsidiary under § 856 of the Internal Revenue Code other than a qualified REIT subsidiary of a Captive REIT;

(3) Any Listed Australian Property Trust, or an entity organized as a trust, provided that a Listed Australian Property Trust owns or controls, directly or indirectly, 75 percent or more of the voting or value of the beneficial interests or shares of such trust; and

(4) Any Qualified Foreign Entity.

c. For purposes of subdivision B 10, the constructive ownership rules prescribed under § 318(a) of the Internal Revenue Code, as modified by § 856(d)(5) of the Internal Revenue Code, shall apply in determining the ownership of stock, assets, or net profits of any person.

d. For purposes of subdivision B 10:

"Listed Australian Property Trust" means an Australian unit trust registered as a Management Investment Scheme, pursuant to the Australian Corporations Act, in which the principal class of units is listed on a recognized stock exchange in Australia and is regularly traded on an established securities market.

"Qualified Foreign Entity" means a corporation, trust, association or partnership organized outside the laws of the United States and that satisfies all of the following criteria:

(1) At least 75 percent of the entity's total asset value at the close of its taxable year is represented by real estate assets, as defined in § 856(c)(5)(B) of the Internal Revenue Code, thereby including shares or certificates of beneficial interest in any REIT, cash and cash equivalents, and U.S. Government securities;

(2) The entity is not subject to a tax on amounts distributed to its beneficial owners, or is exempt from entity level tax;

(3) The entity distributes, on an annual basis, at least 85 percent of its taxable income, as computed in the jurisdiction in which it is organized, to the holders of its shares or certificates of beneficial interest;

(4) The shares or certificates of beneficial interest of such entity are regularly traded on an established securities market or, if not so traded, not more than 10 percent of the voting power or value in such entity is held directly, indirectly, or constructively by a single entity or individual; and

(5) The entity is organized in a country that has a tax treaty with the United States.

e. For taxable years beginning on or after January 1, 2016, for purposes of subdivision B 10, any voting power or value of the beneficial interests or shares in a REIT that is held in a segregated asset account of a life insurance corporation as described in § 817 of the Internal Revenue Code shall not be taken into consideration when determining if such REIT is a Captive REIT.

11. For taxable years beginning on or after January 1, 2016, to the extent that tax credit is allowed for the same donation pursuant to § 58.1-439.12:12, any amount claimed as a federal income tax deduction for such donation under § 170 of the Internal Revenue Code, as amended or renumbered.

C. There shall be subtracted to the extent included in and not otherwise subtracted from federal taxable income:

1. Income derived from obligations, or on the sale or exchange of obligations, of the United States and on obligations or securities of any authority, commission or instrumentality of the United States to the extent exempt from state income taxes under the laws of the United States including, but not limited

to, stocks, bonds, treasury bills, and treasury notes, but not including interest on refunds of federal taxes, interest on equipment purchase contracts, or interest on other normal business transactions.

2. Income derived from obligations, or on the sale or exchange of obligations of this Commonwealth or of any political subdivision or instrumentality of this Commonwealth.

3. Dividends upon stock in any domestic international sales corporation, as defined by § 992 of the Internal Revenue Code, 50 percent or more of the income of which was assessable for the preceding year, or the last year in which such corporation has income, under the provisions of the income tax laws of the Commonwealth.

4. The amount of any refund or credit for overpayment of income taxes imposed by this Commonwealth or any other taxing jurisdiction.

5. Any amount included therein by the operation of the provisions of § 78 of the Internal Revenue Code (foreign dividend gross-up).

6. The amount of wages or salaries eligible for the federal Targeted Jobs Credit which was not deducted for federal purposes on account of the provisions of § 280C(a) of the Internal Revenue Code.

7. Any amount included therein by the operation of § 951 of the Internal Revenue Code (subpart F income) or, for taxable years beginning on and after January 1, 2018, § 951A of the Internal Revenue Code (Global Intangible Low-Taxed Income).

8. Any amount included therein which is foreign source income as defined in § 58.1-302.

9. [Repealed.]

10. The amount of any dividends received from corporations in which the taxpaying corporation owns 50 percent or more of the voting stock.

11. [Repealed.]

12, 13. [Expired.]

14. For taxable years beginning on or after January 1, 1995, the amount for "qualified research expenses" or "basic research expenses" eligible for deduction for federal purposes, but which were not deducted, on account of the provisions of § 280C(c) of the Internal Revenue Code.

15. For taxable years beginning on or after January 1, 2000, the total amount actually contributed in funds to the Virginia Public School Construction Grants Program and Fund established in Chapter 11.1 (§ 22.1-175.1 et seq.) of Title 22.1.

16. For taxable years beginning on or after January 1, 2000, but before January 1, 2015, the gain derived from the sale or exchange of real property or the sale or exchange of an easement to real property which results in the real property or the easement thereto being devoted to open-space use, as that term is defined in § 58.1-3230, for a period of time not less than 30 years. To the extent a subtraction is taken in accordance with this subdivision, no tax credit under this chapter for donating land for its preservation shall be allowed for three years following the year in which the subtraction is taken.

17. For taxable years beginning on and after January 1, 2001, any amount included therein with respect to § 58.1-440.1.

18. For taxable years beginning on and after January 1, 1999, income received as a result of (i) the "Master Settlement Agreement," as defined in § 3.2-3100; and (ii) the National Tobacco Grower Settlement Trust dated July 19, 1999, by (a) tobacco farming businesses; (b) any business holding a tobacco marketing quota, or tobacco farm acreage allotment, under the Agricultural Adjustment Act of 1938; or (c) any business having the right to grow tobacco pursuant to such a quota allotment.

19, 20. [Repealed.]

21. For taxable years beginning on and after January 1, 2004, any amount of intangible expenses and costs or interest expenses and costs added to the federal taxable income of a corporation pursuant to subdivision B 8 or B 9 shall be subtracted from the federal taxable income of the related member that received such amount if such related member is subject to Virginia income tax on the same amount.

22. For taxable years beginning on and after January 1, 2009, any gain recognized from the sale of launch services to space flight participants, as defined in 49 U.S.C. § 70102, or launch services intended to provide individuals the training or experience of a launch, without performing an actual launch. To qualify for a deduction under this subdivision, launch services must be performed in Virginia or originate from an airport or spaceport in Virginia.

23. For taxable years beginning on and after January 1, 2009, any gain recognized as a result of resupply services contracts for delivering payload, as defined in 49 U.S.C. § 70102, entered into with the Commercial Orbital Transportation Services division of the National Aeronautics and Space Administration or other space flight entity, as defined in § 8.01-227.8, and launched from an airport or spaceport in Virginia.

24. For taxable years beginning on or after January 1, 2011, any income taxed as a long-term capital gain for federal income tax purposes, or any income taxed as investment services partnership interest income (otherwise known as investment partnership carried interest income) for federal income tax purposes. To qualify for a subtraction under this subdivision, such income must be attributable to an investment in a "qualified business," as defined in § 58.1-339.4, or in any other technology business approved by the Secretary of Administration, provided the business has its principal office or facility in the Commonwealth and less than $3 million in annual revenues in the fiscal year prior to the investment. To qualify for a subtraction under this subdivision, the investment must be made between the dates of April 1, 2010, and June 30, 2020. No taxpayer who has claimed a tax credit for an investment in a "qualified business" under § 58.1-339.4 shall be eligible for the subtraction under this subdivision for an investment in the same business.

25. a. Income, including investment services partnership interest income (otherwise known as investment partnership carried interest income), attributable to an investment in a Virginia venture capital account. To qualify for a subtraction under this subdivision, the investment shall be made on or after January 1, 2018, but before December 31, 2023. No subtraction shall be allowed under this subdivision for an investment in a company that is owned or operated by an affiliate of the taxpayer. No subtraction shall be allowed under this subdivision for a taxpayer who has claimed a subtraction under subdivision C 24 for the same investment.

b. As used in this subdivision 25:

"Qualified portfolio company" means a company that (i) has its principal place of business in the Commonwealth; (ii) has a primary purpose of production, sale, research, or development of a product or service other than the management or investment of capital; and (iii) provides equity in the company to the Virginia venture capital account in exchange for a capital investment. "Qualified portfolio company" does not include a company that is an individual or sole proprietorship.

"Virginia venture capital account" means an investment fund that has been certified by the Department as a Virginia venture capital account. In order to be certified as a Virginia venture capital account, the operator of the investment fund shall register the investment fund with the Department prior to December 31, 2023, (i) indicating that it intends to invest at least 50 percent of the capital committed to its fund in qualified portfolio companies and (ii) providing documentation that it employs at least one investor who has at least four years of professional experience in venture capital investment or substantially equivalent experience. "Substantially equivalent experience" includes, but is not limited to, an undergraduate degree from an accredited college or university in economics, finance, or a similar field of study. The Department may require an investment fund to provide documentation of the investor's training, education, or experience as deemed necessary by the Department to determine substantial equivalency. If the Department determines that the investment fund employs at least one investor with the experience set forth herein, the Department shall certify the investment fund as a Virginia venture capital account at such time as the investment fund actually invests at least 50 percent of the capital committed to its fund in qualified portfolio companies.

26. a. Income attributable to an investment in a Virginia real estate investment trust. To qualify for a subtraction under this subdivision, the investment shall be made on or after January 1, 2019, but before December 31, 2024. No subtraction shall be allowed for an investment in a trust that is managed by an affiliate of the taxpayer. No subtraction shall be allowed under this subdivision for a taxpayer who has claimed a subtraction under subdivision C 24 or 25 for the same investment.

b. As used in this subdivision 26:

"Distressed" means satisfying the criteria applicable to a locality described in subdivision E 2 of § 2.2-115.

"Double distressed" means satisfying the criteria applicable to a locality described in subdivision E 3 of § 2.2-115.

"Virginia real estate investment trust" means a real estate investment trust, as defined in 26 U.S.C. § 856, that has been certified by the Department as a Virginia real estate investment trust. In order to be certified as a Virginia real estate investment trust, the trustee shall register the trust with the Department prior to December 31, 2024, indicating that it intends to invest at least 90 percent of trust funds in Virginia and at least 40 percent of trust funds in real estate in localities that are distressed or double distressed. If the Department determines that the trust satisfies the preceding criteria, the Department shall certify the trust as a Virginia real estate investment trust at such time as the trust actually invests at least 90 percent of trust funds in Virginia and at least 40 percent of trust funds in real estate in localities that are distressed or double distressed.

27. For taxable years beginning on and after January 1, 2019, any gain recognized from the taking of real property by condemnation proceedings.

28. For taxable years beginning on and after January 1, 2020, but before January 1, 2021, up to $100,000 of all grant funds received by the taxpayer under the Rebuild Virginia program established by the Governor and administered by the Department of Small Business and Supplier Diversity.

D. For taxable years beginning on and after January 1, 2006, there shall be subtracted from federal taxable income contract payments to a producer of quota tobacco or a tobacco quota holder as provided under the American Jobs Creation Act of 2004 (P.L. 108-357) as follows:

1. If the payment is received in installment payments, then the recognized gain, including any gain recognized in taxable year 2005, may be subtracted in the taxable year immediately following the year in which the installment payment is received.

2. If the payment is received in a single payment, then 10 percent of the recognized gain may be subtracted in the taxable year immediately following the year in which the single payment is received. The taxpayer may then deduct an equal amount in each of the nine succeeding taxable years.

E. Adjustments to federal taxable income shall be made to reflect the transitional modifications provided in § 58.1-315.

F. Notwithstanding any other provision of law, the income from any disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business, as defined in § 453(l)(1)(B) of the Internal Revenue Code, of property made on or after January 1, 2009, may, at the election of the taxpayer, be recognized under the installment method described under § 453 of the Internal Revenue Code, provided that (i) the election relating to the dealer disposition of the property has been made on or before the due date prescribed by law (including extensions) for filing the taxpayer's return of the tax imposed under this chapter for the taxable year in which the disposition occurs, and (ii) the dealer disposition is in accordance with restrictions or conditions established by the Department, which shall be set forth in guidelines developed by the Department. Along with such restrictions or conditions, the guidelines shall also address the recapture of such income under certain circumstances. The development of the guidelines shall be exempt from the Administrative Process Act (§ 2.2-4000 et seq.).

G. For taxable years beginning on and after January 1, 2018, but before January 1, 2022, there shall be deducted to the extent included in and not otherwise subtracted from federal taxable income 20 percent of business interest disallowed as a deduction pursuant to § 163(j) of the Internal Revenue Code. For taxable years beginning on and after January 1, 2022, there shall be deducted to the extent included in and not otherwise subtracted from federal taxable income 50 percent of business interest disallowed as a deduction pursuant to § 163(j) of the Internal Revenue Code. For purposes of this subsection, "business interest" means the same as that term is defined under § 163(j) of the Internal Revenue Code.

H. For taxable years beginning on and after January 1, 2020, but before January 1, 2021, there shall be deducted to the extent not otherwise subtracted from federal taxable income up to $100,000 of the amount that is not deductible when computing federal taxable income solely on account of the portion of subdivision B 10 of § 58.1-301 related to Paycheck Protection Program loans.

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HOUSE JOINT RESOLUTION NO. 563

Directing the Division of Legislative Services, in conjunction with the Department of Taxation, to establish a work group to assess the feasibility of transitioning to a unitary combined reporting system for corporate income tax purposes.

Agreed to by the House of Delegates, January 29, 2021
Agreed to by the Senate, February 23, 2021

WHEREAS, almost all corporations conduct business beyond the confines of a single state; and

WHEREAS, it is common for corporations to be engaged in multiple businesses and to utilize different entities, subsidiaries, and affiliates in the conduct of their operations; and

WHEREAS, of the 44 states and the District of Columbia that levy a corporate income tax, 29 have adopted unitary combined reporting to treat multistate members and operations of unitary business enterprises as if they were a single company in the determination of the amount of corporate tax liability under the state's corporate income tax; and

WHEREAS, 13 of these 29 states have changed to unitary combined reporting in the last 15 years; and

WHEREAS, Virginia is one of the 20 states that treat each corporation as a separate taxpayer in the determination of corporate tax liability; and

WHEREAS, under separate filing, Virginia generally requires corporations to use a three-factor formula of property, payroll, and double-weighted sales in Virginia to apportion the corporate tax liability with nexus in Virginia; and

WHEREAS, other special apportionment provisions have been adopted by the General Assembly for various entities, including motor carriers, financial corporations, construction corporations, railway companies, manufacturing companies, retail companies, and taxpayers with enterprise data center operations; and

WHEREAS, changing to unitary combined filing will affect corporations differently; and

WHEREAS, adopting unitary combined reporting will require changes to compliance oversight and administration by the Department of Taxation; and

WHEREAS, combining losses of affiliated taxpayers may offset taxable profits of an entity with Virginia nexus resulting in reduced Virginia corporate tax revenue or, in contrast, combining the contribution of business activities in other states with affiliates in Virginia may increase Virginia corporate tax revenue; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That the Division of Legislative Services, in conjunction with the Department of Taxation, be directed to establish a work group to assess the feasibility of transitioning to a unitary combined reporting system for corporate income tax purposes. The work group of stakeholders shall assess the administrative feasibility, the impact on major classifications of corporations operating in Virginia, the impact on corporate expansion within and into Virginia, and the projected impact on Virginia's tax revenue as a result of adopting corporate income tax unitary combined reporting. The Secretary of Finance, the Secretary of Commerce and Trade, and the Chairmen of the House Committee on Finance and the Senate Committee on Finance and Appropriations shall be represented on the work group and shall participate in selecting its members.

The work group shall identify and make recommendations as to any legislation necessary should Virginia transition to unitary combined reporting, including the repeal of obsolete provisions and amendments to existing provisions of the Code of Virginia. The work group also shall identify the different legal authorities and requirements that would apply to corporations under a unitary combined reporting system and identify and solicit input from corporations that may be affected by such a transition. The work group shall also identify, to the extent possible, the fiscal impact to Virginia of transitioning to a unitary combined corporate reporting system.

The work group shall submit a summary of its findings, recommendations, and a draft of any recommended legislation to the Chairmen of the House Committee on Finance and the Senate Committee on Finance and Appropriations no later than November 1, 2021.

Work Group to Study Unitary Combined Corporate Income Tax Reporting

https://studies.virginiageneralassembly.gov/studies/607W
ednesday June 16, 2021, 1:00 p.m.
Various locations (virtual meeting)
Public livestream link:
https://virginiageneralassembly.gov/house/committees/commstream.html

I. **Call to Order and Welcome** - Delegate Vivian E. Watts, Chair, House Committee on Finance

II. **Presentation by Legislative Services Staff** - Stephen Kindermann and Joshua Kaplan

- Summary of HJR 563
- Discussion of current Virginia law and previous legislation
- Overview of some unitary combined reporting policy questions

III. **Presentation by Department of Taxation -** Kristin Collins and Matthew Huntley

- Overview of the existing corporate data, potential revenue implications of policy decisions, the administrative challenges of a transition, and Budget item 3.5-23

IV. **Discussion: Initial impressions on combined reporting and the 2021 work plan**

V. **Adjourn**

Work Group Membership

Executive and Legislative Officials

Delegate Vivian E. Watts	*Chair, House Finance*
Senator David W. Marsden	*Member, Senate Finance and Appropriations*
Aubrey L. Layne	*Secretary of Finance*
Craig Burns	*Tax Commissioner*
William White	*Asst. Tax Commissioner*
Brian Ball	*Secretary of Commerce and Trade*
Cassidy Rasnick	*Deputy Secretary of Commerce and Trade*

Corporate Tax Professionals

Tyler Henderson, *Sr. Manager, State and Local Tax*	*Amazon*
Gary Tappana, *Vice President of Tax Policy*	*Anheuser-Busch*
Mike Carchia, *Head of State Tax Planning*	*Capital One*
Tammy Herrin, *In-house Tax Counsel*	*ExxonMobil*
Jon Elder, *Sr. Manager, State and Local Tax*	*Dollar Tree*
Tim Winks, *Sr. Manager, Indirect Tax*	*Ferguson Enterprises*
Glen Page, *Sr. Manager, State Income & Franchise Tax*	*HCA Healthcare*
Tom Powers, *Executive Director, Corporate Tax Department*	*JP Morgan Chase*
Karen Lint, *Corporate Tax Director*	*Huntington Ingalls Industries*
Lori Nieto, *Corporate Tax Director*	*Northrop Grumman*
Ken Wright, *Sr. Manager, State Tax*	*Smithfield Foods*
Alison Malloy, *Sr. Director of Tax*	*Verisign*
Kathleen Kittrick, *Director, State Tax Policy*	*Verizon*
David Brunori, *Senior Director*	*RSM LLP, and*
Research Professor of Public Policy	*George Washington University*
Greg Matson, *Executive Director*	*Multistate Tax Commission*
William L.S. "Sandy" Rowe, *Of Counsel*	*HuntonAndrewsKurth*
Ellen Berenholz, *Executive Director, Tax Policy*	*Comcast*

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Stephen Kindermann	Matt Huntley	Charles Kennington
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HJR 563 - 2021 Interim Workgroup

Introductory Presentation
June 16, 2021

Division of Legislative Services

Stephen Kindermann, Attorney
Joshua Kaplan, Attorney

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Review of HJR 563

- Passed the House and Senate during the 2021 Special Session
  - House (73-Y-21-N) and Senate (voice vote)
- "*Directing the Division of Legislative Services, in conjunction with the Department of Taxation, to establish a work group to* ***assess the feasibility of transitioning to a unitary combined reporting system*** *for corporate income tax purposes*."
- The resolution also noted that making such a change:
  - Would affect each corporation differently
  - Would require substantial changes to oversight and administration by the Department of Taxation
  - May result in certain taxpayers facing higher Virginia taxable income and others lower Virginia taxable income as a result of consolidating the profit or loss of all affiliated entities into a single unitary return

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Charge of the Workgroup

- To investigate these and other concerns, the resolution directed the workgroup to study six topics:
  - Assess the administrative feasibility of any transition to unitary combined reporting;
  - Ascertain impacts on major classifications of corporations operating in Virginia
  - Effects on corporate expansion within and into the Commonwealth;
  - Identify the different legal authorities and requirements that would apply to corporations under a unitary combined reporting system and to solicit input from those corporations who may be affected by a transition to unitary combined reporting;
  - Identify and make recommendations on any legislation necessary should Virginia transition to unitary combined reporting, including the repeal of obsolete provisions and amendments to the existing provisions in the Code of Virginia;
  - Project the fiscal impact if unitary combined reporting were adopted;
- Work Product:
  - Submit a summary of findings, recommendations, and a draft of any recommended legislation to the Chairmen of the House Committee on Finance and the Senate Committee on Finance and Appropriations by November 1, 2021

3

Overview of Current Virginia Law-Nexus

- To impose a corporate income tax, states must determine:
  - Whether the corporation or its affiliates have sufficient nexus to be lawfully subject to taxation by the state;
    - A state has nexus when a non-resident entity has sufficient contacts with that state to be taxed
    - Nexus requires more than just solicitation of sales.
      - P.L. 86-272 - prohibits states from subjecting the sale of tangible personal property to a net income tax where the taxpayer's only business activities within the state during the taxable year are the solicitation of orders by the taxpayer or the taxpayer's representative for the sale of tangible personal property (lack nexus with taxing state)
      - Dep't of Taxation voluntarily extended protections to sales of intangible property and services in VA
  - Other key issues
    - Apportionment
    - Reporting

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Overview of Current Virginia Law-Apportionment

- To impose a corporate income tax, states must determine:
  - How to allocate and apportion income among various states
    - § 58.1-408: VA generally requires VA taxable income of a multistate corporation to be apportioned to VA by:
      - Income x [(property factor + payroll factor + (2 x sales factor))/ 4]
        - where the sales factor does not exist, the denominator of the fraction is number of existing factors
        - where the sales factor exists, but the payroll factor or the property factor does not exist, the denominator of the fraction is the number of existing factors plus one
      - Special apportionment rules for certain businesses in § 58.1-417 (motor carriers), 58.1-418 (financial corps), 58.1-419 (construction corps), 58.1-420 (railway companies), 58.1-422 (manufacturing companies), 58.1-422.1 (retail companies), 58.1-422.2 (taxpayers with enterprise data center operations), or 58.1-422.3 (debt buyers).
    - No allocation or apportionment when entire business of a corporation is conducted in VA

5

Overview of Current Virginia Law-Reporting

- To impose a corporate income tax, states must determine:
  - How the corporation reports its income and that of any affiliates to the state:
    - Generally – every corporation must file a corporate income tax return if
      - Incorporated in VA, registered with the State Corporation Commission to conduct business here, or
      - Receiving income from VA sources
    - § 58.1-442 - VA allows filing **election** for an affiliated group of corporations:
      - Separate (default) – each corporation in affiliated group w/ nexus in VA required to file own, separate corporate income tax return and report only its income, expenses, gains, losses, allocation, and apportionment factors
      - Consolidated – aggregate liability of all corporations in an affiliated group w/ nexus to VA and entire affiliated group files a single return
      - Virginia Combined – each corporation in an affiliated group w/ nexus to VA determines its data separately → each corporation separately computes its tax liability → post- apportionment final corporate income tax liability of each corporation is combined and included on a single return
    - § 58.1-302 defines an "affiliated group" as
      - *two or more corporations subject to Virginia income taxes whose relationship to each other is such that (i) one corporation owns at least 80 percent of the voting stock of the other or others or (ii) at least 80 percent of the voting stock of two or more corporations is owned by the same interests.*

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Overview of Current Virginia Law-Reporting

- To impose a corporate income tax, states must determine:
  - How the corporation reports its income and that of any affiliates to the state:
    - Corporate income tax return filing election is made:
      - By the affiliated group
      - In the 1st year where group of affiliated corporations become eligible to file a VA consolidated/ VA combined return
    - Generally: once an election is made, returns thereafter are required to be filed in same manner
      - § 58.1-442(C) – may apply to Tax Commissioner for permission to change from (i) consolidated to separate or (ii) from separate to VA combined/ consolidated, if "*affiliated group . . . has filed on the same basis for at least the preceding 20 years.*"
        - Permission for the change "*shall be granted if*"
          - There would have been no decrease in tax liability computed under the new election compared to the affiliated group's former filing method AND
          - The affiliated group agrees to file VA returns under both the new filing method and the former method and will pay the greater of the two amounts for the taxable year in which the new election is effective and for the prior taxable year.

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Overview of Current Virginia Law

- Treatment of Foreign Corporations
  - § 58.1-443. Prohibition of worldwide consolidation or combination.
    - Notwithstanding any other provisions of this chapter, the Department shall not require, and no corporation may elect, that a consolidation or combination of an affiliated group include any controlled foreign corporation, the income of which is derived from sources without the United States.
    - Adopted during the 1981 Session

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Overview of Unitary Combined Reporting

- Corporate return required to combine income, expenses, gains, losses, and allocation and apportionment factors of all related corporations and affiliates that are engaged in a unitary business/group, regardless of the state's nexus with or the location of the various corporations in the unitary group
  - Idea is to calculate a tax burden of unitary group as if all merged into single firm
- To be considered a "unitary group," separate entities must generally be
  - interdependent
  - working towards a mutual benefit, and
  - stand as part of a single, integrated business.
- Constitutes a single economic enterprise so a state may apportion transactions and operations within its borders to determine the unitary group's taxable income
- States that require unitary combined reporting generally do not provide other reporting options for corporations with affiliates outside of the taxing state

9

Overview of Unitary Combined Reporting

- Considers both ownership and business relationships of related corps
- In most states with unitary combined reporting, a group of two or more corporations will be treated as related only if they share common ownership exceeding 50%
- States generally define the factors used to determine whether a group of corporations qualify as a unitary group
  - Have developed interdependent economic relationships, more than a passive investment relationship
  - Demonstrate functional integration between the corporations

10

Overview of Unitary Combined Reporting

- Enacting states seek to provide more accurate measures of income, control income-shifting, and thereby increase state corporate income tax revenues
  - Many arguments in favor of unitary combined reporting reference efforts to root out "nowhere income" tax planning strategies where untaxed income stemming from certain states' apportionment formulas are calculated in a manner that leaves a portion of the taxpayer's income apportioned to a different state that does not or, may not, impose income tax on the taxpayer
  - Affiliate Captive REITs - exempt from paying taxes on dividends paid to its investors, so retail chain pays rent to a captive REIT, but the rent is paid back to the retail company or an affiliate as untaxed dividends.
  - Intangible Holding Companies - typically located in states that do not impose a corporate income tax on them → corporation transfers intangible assets to their IHC and enter into an agreement to pay for use of the intangible assets → then corporation deducts the expenses that it paid to the IHC
  - Add-back, gap-plugging laws argued to be insufficient to keep up with the newest tax planning strategies and inefficient in their administration by state revenue departments
    - Unitary combined method does not require individual identification of income-shifting transactions through audit and compliance procedures

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Some Considerations for Adoption of Unitary Combined Reporting

- Determination of a Unitary Group
  - Legislature must define what comprises a "unitary group"
    - Interpretations of similar definitions vary significantly in some cases
  - Generally based on a number of unity tests from SCOTUS that may consider:
    - Unity of ownership, generally requires direct or indirect control of over 50% voting stock
    - Unity of operations in management, accounting, or sales
    - Unity of use as evidenced by the presence of a central executive authority which performs important line functions for each member of the group
    - A contribution and dependency test to determine whether the in-state affiliate is an integral part of profit generation of an out-of-state entity
    - Other factors of profitability, functional integration, centralized management, and economies of scale that evidence interdependence, interrelation, and integration.
  - Identifying the specific activities of each corporation in the group is difficult and could require access to data from entities that do not have nexus with the state
    - Unitary group determinations may face challenges by those whose tax liability increases as a result
    - Can lead to complex and length audits, appeals, and litigation
  - Effects of M&A, restructuring, and newly created entities
    - Annual reevaluation of the unitary group
    - Presumptions for inclusion in the unitary group
  - Unitary Business Principle in VA
    - Tax Bulletin 93-4 – guidance to corporations seeking to allocate certain non-apportionable investment income away from VA

12

Some Considerations for Adoption of Unitary Combined Reporting

- Nexus Determination
  - Adoption of unitary combined reporting requires legislatures to determine when and how to assert nexus
  - Prohibition on states applying a net income tax where taxpayer's only business activities within the state during taxable year are the solicitation of orders by the taxpayer or the taxpayer's representative for the sale of tangible personal property to the sale of tangible personal property.
    - Under the traditional application of Public Law 86-272, such corporations lack nexus with the taxing state
  - VA does not subject a business to its corporate income tax if the only business activities within Virginia are activities protected by Public Law 86-272, now extended the Department voluntarily extended to sales of intangible property and services in Virginia.
  - Some states have clarified a "solicitation" to be narrower or broader in their unitary combined reporting statutes

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Some Considerations for Adoption of Unitary Combined Reporting

- Treatment of Unitary Group Members Lacking Nexus
  - State courts left to deal with question of whether unitary combined reporting violates P.L. 86-272 because it includes the income and apportionment factors of all members of a unitary group, even when a unitary group member lacks nexus with the state.
  - 2 Approaches
    - In the Matter of the Appeal of Joyce, Inc., 66-SBE-070, 11/23/1966
      - Approach taken when concerned with litigation over whether P.L. 86-272 protects entities lacking nexus
      - Entity-by-entity apportionment (not disregarding separate IDs of members of unitary group)
      - Corporations within same unitary group calculate apportionment depending on whether each corporation has nexus with the state
    - In the Matter of the Appeal of Finnigan Corporation, 88-SBE-022, 08/25/1988
      - More commonly adopted approach in recent decades (no P.L. 86-272 litigation; Joyce method criticized for corporate reduction of state income tax by avoiding the inclusion of sales in state sales factor for unitary group by isolating activities into separate entities)
      - Group-level apportionment (whole unitary group apportions income to state based on total income for the unitary business, including income attributed to entities over which state lacks jurisdiction)
        - Generally uses same apportionment factors in denominator as Joyce method

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Some Considerations for Adoption of Unitary Combined Reporting

- Treatment of International Corporations of a Unitary Group
  - Decision whether to limit the inclusion of certain types of corporations in the unitary group's income and apportionment calculations
  - Unitary Combination Types (on an elective basis in some states)
    - Domestic – only unitary corporations incorporated in the United States
    - Water's Edge – all unitary corporations of a business regardless of affiliate locations, but only including foreign corporations to the extent they conduct business in the United States
      - Definitions vary, but usually applies to corporations with greater than 20% of business in United States
      - Some statutes allow revenue departments to disregard water's edge election in order to include related foreign entities and when determined that tax avoidance is the purpose of the unity
    - Worldwide – all corporations of a unitary group, including foreign entities, and regardless of their location or level of business activity in the United States
      - Generally disfavored in the business community
      - Prohibited in many states, including VA

15

Some Considerations for Adoption of Unitary Combined Reporting

- Transition of Certain Tax Incentives
  - Net Operating Losses
    - Generally, a taxpayer in a separate reporting state may reduce its future profit by carrying over/ carrying forward its losses to future years. Some states also allow a carryback of losses.
      - Federal and state tax codes allow them to deduct those losses against previous or future tax liabilities
    - Must determine whether the net operating losses of an originally separate entity could offset profits of its affiliates under unitary combined reporting
      - The extent to which this is allowed and the number of years NOLs may be carried forward or backwards could limit the increase of state revenues expected initially from a transition to unitary combined reporting if not restricted
      - Some suggest allowing one member to of the unitary group to offset income from other members only when the NOLs were generated from the business activities of the newly determined unitary group
  - Tax Credits and Deductions
    - Similar concerns because tax credits and other tax advantages often include carryforward provisions
  - Any statute would have to discuss combinations of tax incentives and how they may be utilized under a unitary combined reporting system

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Some Considerations for Adoption of Unitary Combined Reporting

- Certain Industry Apportionment Formulas
  - Must consider how to deal with unique apportionment formulas for certain industries in VA:
    - Motor carriers
    - Financial corporations
    - Construction companies
    - Railway companies
    - Manufacturing companies
    - Retail companies
    - Debt Buyers
    - Enterprise Data Centers
  - Would they all remain in the Code as exceptions to mandatory unitary combined reporting, only some, or should all be repealed?

17

Some Considerations for Adoption of Unitary Combined Reporting

- Impact of Adoption on Corporations Headquartered in Virginia
  - The study charge directs us to examine the following aspects of unitary reporting:
    - (i) impact on different classifications of corporations in VA, and
    - (ii) impact on corporate expansion in VA
  - How would unitary combined reporting impact corporations headquartered or with substantial operations in VA?
    - Generally, under current VA law, such businesses would report more of their operations compared with those headquartered elsewhere. A greater proportion of their total payroll, property, and sales would be located here.
    - However, the actual impact would depend on what policy provisions are adopted and would vary by business.
  - The traditional goal of unitary reporting is to address out of state corporations, as was the case in the Joyce case
    - But, would some Virginia businesses see a much larger percentage of their national or global operations become taxable? If so which ones and how would they be accommodated?

18

Review of Legislative Efforts

- 2012 Session
  - HB 1267 - Delegate J.M. Scott (continued to 2013 Session, left in House Finance)
    - *Joyce* method
- 2020 Session (all *Joyce* method)
  - HB 739 – Delegate Watts (continued to 2021 Session)
  - HB 1109 – Delegate Hudson (continued to 2021 Session
    - Also required a public disclosure report from corporations that was classified/ redacted to preserve anonymity of particular taxpayers before publication by Dep't of Taxation
  - SB 756 – Senator Marsden (continued to 2021 Session)
- 2021 Session
  - HJR 563 – Delegate Watts (creating this workgroup)
  - SB 1353 – Senator Marsden (left in Senate Finance and Appropriations)
    - *Finnigan* method

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Review of Legislative Efforts

- 2020 *Joyce* Method Legislation
  - Individual group members would be recognized as separate taxpayers
  - Deduction or credit would be allowed to be taken only by the specific taxpayer that earned it, and not against the total combined income or liability of the group
  - The amount of total combined business income apportioned to Virginia would be calculated as a function of each taxpayer's own factors in Virginia
  - Required worldwide combination unless a water's edge election is made
- 2021 *Finnigan* Method Legislation
  - Income tax = VA's share of unitary group's apportionable income combined with combined group's non-apportionable income that is specifically allocable to VA
  - Carved out exceptions to *Finnigan* and retained alternate apportionment formulas in VA for members of group to determine their apportionment share
  - NOLs and tax credits applied at combined group level
    - Included an offsetting deduction for certain changes to net deferred tax assets and liabilities for 10 years after the first unitary combined group return was filed

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Next Steps and Questions

- Summaries of meetings and all materials will be posted
- Working on draft report informed by discussion during meetings for 11/1/2021 deadline
- State survey of combined reporting statutes, with follow up research questions on specific provisions informed by experiences of workgroup members in various states
- Next meeting date

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HJ 563 Workgroup

June 16, 2021

Virginia Tax

Current Corporate Income Tax Data

Virginia Tax

Corporate Income Tax Revenue (FY 2010-2020)

3

Fiscal Year	Amount
2010	$806,472,760
2011	$822,258,803
2012	$859,922,840
2013	$796,728,154
2014	$757,490,742
2015	$831,906,887
2016	$764,948,014
2017	$826,960,822
2018	$861,897,138
2019	$943,390,661
2020	$1,011,649,618

Source: Table 2.1, Virginia Tax Annual Report, Fiscal Year 2020

Virginia Tax

Corporate Returns, Income & Liability (TY 2018)

4

Income	Number of Returns	Percent	Taxable Income	Percent	Tax Assessed	Percent
$0 or less	43,048	63.0%	$0	0.0%	$7,425,767	0.6%
$1 to $24,999	14,278	20.9%	$92,154,825	0.5%	$5,606,479	0.5%
$25,000 to $49,999	2,673	3.9%	$96,376,109	0.5%	$5,812,446	0.5%
$50,000 to $99,999	2,390	3.5%	$170,025,447	0.9%	$10,201,569	0.9%
$100,000 to $499,999	3,540	5.2%	$804,029,730	4.3%	$48,306,216	4.2%
$500,000 to $999,999	861	1.3%	$606,486,927	3.2%	$36,648,143	3.2%
$1,000,000 to $1,999,999	565	0.8%	$798,164,763	4.3%	$47,889,895	4.2%
$2,000,000 to $9,999,999	738	1.1%	$3,147,611,709	16.8%	$189,336,221	16.6%
$10,000,000 and Over	250	0.4%	$12,975,301,274	69.5%	$792,767,743	69.3%
Total before adjustments	68,343	100.0%	$18,690,150,784	100.0%	$1,143,994,480	100.0%
Adjustments			($7,780,549)		($466,831)	
Total Tax Assessment			**$18,682,370,234**		**$1,143,527,649**	

Source: Table 2.2, Virginia Tax Annual Report, Fiscal Year 2020

Virginia Tax

Fiscal Considerations of Combined Reporting

Virginia Tax

Potential Revenue Implications

6

- Developing a reliable revenue estimate for the adoption of unitary combined reporting is significantly limited by insufficient data:
  - Requires information regarding the income, accumulated NOLs, and apportionment of corporations that are not currently filing in Virginia
  - Requires information regarding which corporations in an affiliated group are engaged in the same unitary business
  - Current Virginia data only identifies subsidiaries that corporations elect to be included in Virginia combined or consolidated returns
  - Federal data does not include apportionment factors or the nature of each business and its functional integration, centralized management, and economies of scale needed to identify the members of a unitary group

Virginia Tax

Potential Revenue Implications

- Prior fiscal impact statements indicated that unitary combined reporting would have an unknown, but potentially significant General Fund revenue impact
- Impact in the initial years would likely be a revenue loss due to compliance
- Impact in later years is unknown - some corporations would pay more and some would pay less; corporations may adjust their tax planning to reduce impact
- The impact could vary based on specific policy decisions, such as:
  - Whether to adopt a *Joyce* or *Finnigan* approach,
  - Whether to provide a consolidation election, and
  - Transitional rules related to NOLs, eliminations, and the business interest deduction limitation

Virginia Tax

Administrative & Transitional Challenges

- Minimum estimated costs of $700,000 in the initial year of implementation and more than $400,000 annually thereafter
  - Initial implementation costs would include significant updates to existing forms, instructions, and systems
  - Ongoing costs would include hiring additional staff
- Additional costs would include training, development of guidance, staffing to support compliance efforts, and increased volume of appeals/rulings
- Like revenues, costs would likely depend in part on how the law is structured and may be significantly higher than the minimum specified above
- Sufficient time would be necessary to develop regulatory guidance, generate new forms, inform taxpayers, and adequately train staff

Virginia Tax

Unitary Combined Reporting Requirement

Virginia Tax

Unitary Combined Reporting Requirement

Reporting Requirement – Item 3-5.23

- Item 3-5.23 of the 2021 Appropriation Act requires corporations that are part of a unitary business to submit an informational report to Virginia Tax based on Taxable Year 2019 data
- Banks and insurance companies not subject to the reporting requirement
- Report is due July 1, 2021; no due date extensions permitted
- $10,000 penalty for failure to file; Virginia Tax has authority to waive penalty
- Virginia Tax must the submit a report to the chairmen of the money committees by December 1, 2021 summarizing the data

Virginia Tax

Unitary Combined Reporting Requirement

Reporting Requirement – Implementation

- Reference Guide and webpage provide information to taxpayers and practitioners
  - The Reference Guide provides basic guidance and line instructions for submitting the report
  - In the absence of specific guidance on a particular issue, the Reference Guide refers taxpayers to consult guidance from the Multistate Tax Commission
- Web Upload application available for electronic submission of reports
- Voluntary questionnaire available to notify Virginia Tax whether a particular corporation is subject to the requirement

Virginia Tax

Unitary Combined Reporting Requirement

Reporting Requirement – Implementation

- Report must be submitted by a designated corporation for each unitary business
  - Must report information about the unitary group's income, apportionment computation, tax credits, and tax liability calculation
  - Must prepare calculations under both the *Joyce* and *Finnigan* approaches
  - Must also provide information about calculations under the current filing requirements for all members of the unitary group that have nexus with Virginia
- In-state unitary businesses are exempt from the filing requirement

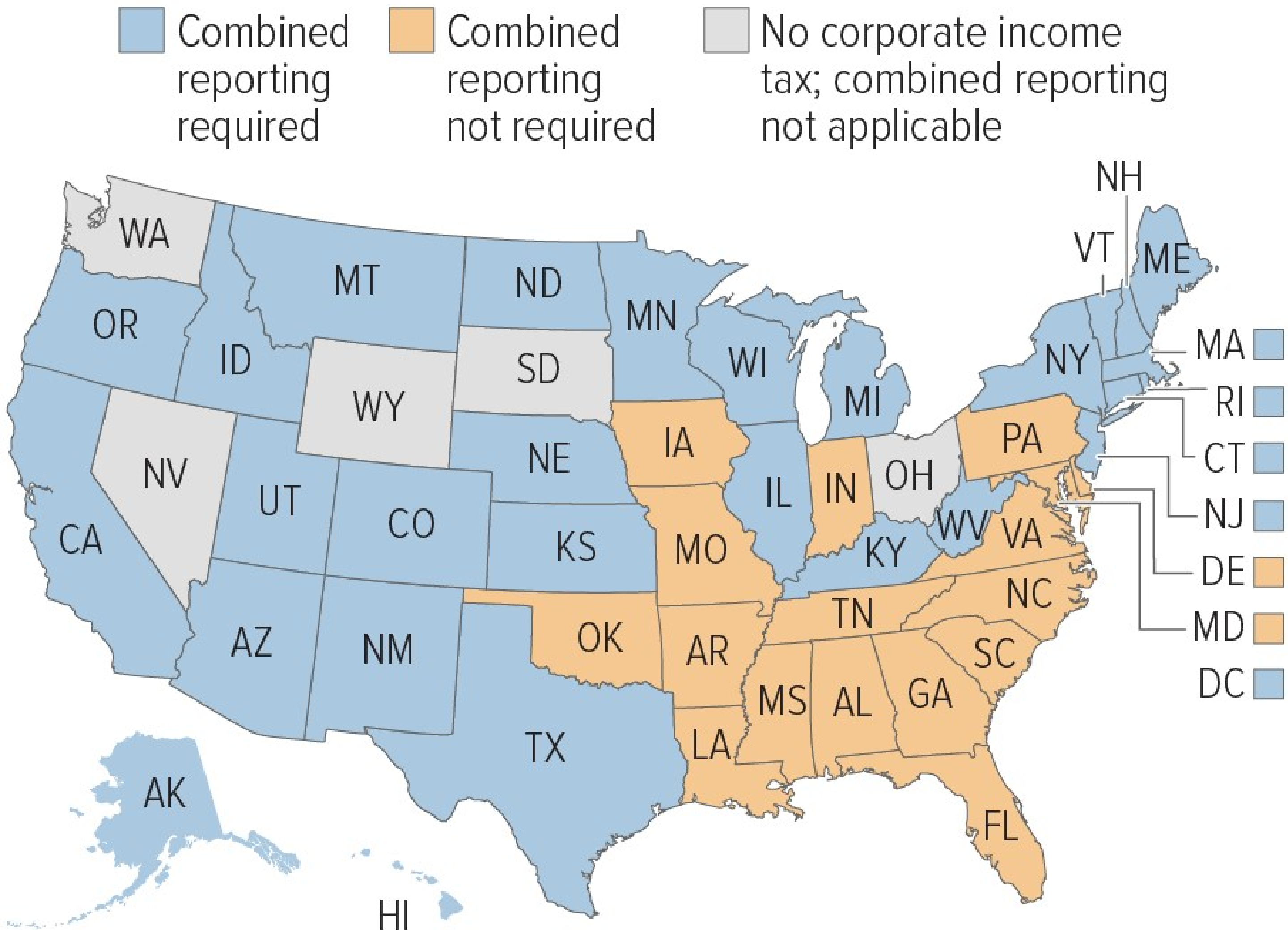
Virginia Tax

Unitary Combined Reporting Requirement

Reporting Statistics (as of June 3, 2021)

- Letters mailed to 71,950 corporations notifying them of the requirement
- Optional questionnaire may be submitted electronically to notify Virginia Tax whether a particular corporation is subject to the requirement; responses received from 16,822 corporations
- Reports submitted by 521 unitary businesses (830 corporations)

28 States Plus D.C. Require Combined Reporting for the State Corporate Income Tax



Note: Combined reporting treats a parent company and its subsidiaries as one entity for state income tax purposes, thereby helping prevent income shifting.

Source: John C. Healy and Michael S. Schadewald, "2019 Multistate Corporate Tax Guide, Vol. 1," Kentucky HB 487 (2018), effective January 1, 2019; New Jersey AB 4262 (2018), effective July 1, 2019, New Mexico, HB 6 (2019), effective January 1, 2020

CENTER ON BUDGET AND POLICY PRIORITIES | CBPP.ORG

Meeting
Summary

Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes

June 16, 2021, at 1:00 p.m.

Electronic Meeting

https://studies.virginiageneralassembly.gov/studies/607

The Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes (the Work Group) met electronically with Delegate Vivian E. Watts, chair, presiding.[1] The meeting began with introductions and opening remarks followed by presentations by Division of Legislative Services staff and Department of Taxation representatives and discussion. Materials presented at the meeting are accessible through the Work Group's website.

Presentation: HJR 563, Current Virginia Law, and Unitary Combined Reporting Policy Issues

Division of Legislative Services Staff

Division of Legislative Services (DLS) staff reviewed the components of HJR 563 (Watts, 2021 Special Session I), which passed during the 2021 Special Session I and creates the Work Group. HJR 563 directs DLS, in conjunction with the Department of Taxation, to establish the Work Group to assess the feasibility of transitioning to a unitary combined reporting system for corporate income tax purposes. Specifically, HJR 563 directs the Work Group to (i) assess the administrative feasibility of any such transition; (ii) ascertain the impact of such transition on major classifications of corporations operating in Virginia and the effects on corporate expansion within and into Virginia; (iii) identify the different legal authorities and requirements that would apply to corporations under a unitary combined reporting system; (iv) solicit input from those corporations that may be affected by such transition; (v) identify and make recommendations on any legislation necessary should Virginia make such transition, including the repeal of obsolete provisions and amendments to existing provisions in the Code of Virginia; and (vi) project the fiscal impact of adopting unitary combined reporting. The Work Group is required to submit a summary of its findings, recommendations, and any draft of recommended legislation to the Chairmen of the House Committee on Finance and the Senate Committee on Finance and Appropriations by November 1, 2021.

DLS staff then presented an overview of existing Virginia law, including how Virginia currently asserts nexus to subject corporate entities to taxation; the current apportionment formula that takes into account the income, property, payroll, and double-weighted sales factors of the corporate taxpayer; how the default separate reporting system for a group of affiliated corporations works; how consolidated and Virginia combined filing options are offered on an elective basis for an

[1] **Members Present:** Delegate Vivian E. Watts, Senator David W. Marsden, Brian Ball, Ellen Berenholz, David Brunori, Craig Burns, Mike Carchia, Jon Elder, Joe Flores, Tyler Henderson, Kathleen Kittrick, Karen Lint, Alison Malloy, Greg Matson, Lori Nieto, Glen Page, William Rowe, Gary Tappana, Tim Winks, and Ken Wright

Members Absent: Tammy Herrin and Tom Powers affiliated group of corporations; and Virginia's prohibition of worldwide consolidation or combination.

Additionally, DLS staff reviewed the concept of unitary combined reporting and how it differs from existing law and noted several policy issues that would have to be dealt with in any transition to unitary combined reporting, including the determination of a "unitary group," the determination of nexus under a unitary combined reporting system, the treatment of members of a unitary group that lack nexus (under the Joyce and Finnigan methods), the treatment of international corporations in a unitary group, the utilization of net operating losses and other tax incentives after any potential transition, the addressing of existing special apportionment formulas for certain industries that would conflict with the uniformity sought by unitary combined reporting, and the impact adopting unitary combined reporting would have on corporations headquartered in Virginia.

Finally, DLS staff reviewed prior unsuccessful legislative efforts on the issue, including HB 1267 (Scott, J.M., 2012), HB 739 (Watts, 2020), HB 1109 (Hudson, 2020), SB 756 (Marsden, 2020), and SB 1353 (Marsden, 2021). The Work Group discussed the unique characteristics of these bills and how they expanded on model legislation drafted by the Multistate Tax Commission.

Presentation: Fiscal Considerations of Unitary Combined Reporting

Kristin Collins, Policy Development Director, Department of Taxation
Matthew Huntley, Lead Tax Policy Analyst, Department of Taxation

Ms. Collins and Mr. Huntley provided the corporate income tax revenues for fiscal years 2010 through 2020 and noted the number of returns, income, and tax liabilities of corporations in Virginia during taxable year 2018. They discussed potential revenue implications of the adoption of unitary combined reporting, highlighting that development of a reliable revenue estimate is limited by data and information not currently required or obtainable by the Department of Taxation. However, they noted that adoption would have an unknown, but potentially significant, general fund revenue impact, that the impact in the first few years after adoption would likely be negative due to compliance changes, that the impact in later years is unknown and would differ from taxpayer to taxpayer, and that the impact would depend upon answers to specific policy questions. They also noted the estimated administrative costs of $700,000 in the initial year of implementation and roughly $400,000 annually thereafter, but said the costs would depend on the structure of any new law and would require lead time to promulgate regulatory guidance, generate new forms, inform taxpayers, and train staff.

The 2021 Special Session I added language in Budget Item 3.5-23 of the 2021 Appropriation Act requiring corporations that are part of a unitary business to submit to the Department of Taxation an informational report related to the potential adoption of unitary combined reporting based on data from taxable year 2019. Each report must include information about the unitary group's income, apportionment computation, tax credits, and tax liability calculation under both the Joyce and Finnigan approaches as well as under current filing requirements for all members of the unitary group having nexus with Virginia. The reports from the corporations are due by July 1, 2021, and the Department of Taxation must submit its own report of that data to the House Committees on Appropriations and Finance and the Senate Committee on Finance and Appropriations by December 1, 2021. As of June 3, 2021, the Department of Taxation had notified 71,950 corporations of the reporting requirement, received responses from 16,822 corporations, and received reports from 521 unitary businesses comprised of 830 corporations.

Discussion: 2021 Interim Work Plan

Delegate Watts then sought input from the Work Group members on the presentations. The members of the Work Group agreed that the discussion would assume corporate taxation rates would remain unchanged, asked for staff to review the apportionment formulas in other states, considered the reliability of data collected under Budget Item 3.5-23 given that is limited to a single taxable year, and solicited input on the drawbacks of current Virginia law to corporations.

The Work Group then discussed its work plan moving forward and requested a presentation for its next meeting from the Multistate Tax Commission on its model legislation and feedback from the members on its contents. Additionally, to facilitate future policy discussion on the Multistate Tax Commission model drafts, Work Group members were asked to submit their two most preferred provisions under unitary combined reporting used in any state in which their corporation files, two most problematical provisions under unitary combined reporting used in any state in which their corporation files, two most preferred provisions of Virginia's corporate tax structure in determining tax liability, and the two most problematical provisions of Virginia's corporate tax structure in determining tax liability.

DLS staff were asked to incorporate any feedback in a survey of states with unitary combined systems and nuances in each of those laws, including a review of the immediate and long-term revenue impacts in those states. Work Group members also requested information from staff on where states competing with Virginia stand on the issue and why they did, did not, or have not moved to a unitary combined reporting system. To that end, the Work Group also considered the requesting a presentation by the Council on State Taxation at a future meeting and a review by staff of Virginia's apportionment formula, including when the formula came into existence and whether it should be amended in any transition to unitary combined reporting.

Next Meeting

The Work Group agreed to hold its next meeting before August 1, 2021, subject to the General Assembly meeting for the 2021 Special Session II. The exact date, time, and location were not determined.

For more information, see the *Work Group's website* or contact the Division of Legislative Services staff:

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Work Group to Study Unitary Combined Corporate Income Tax Reporting

https://studies.virginiageneralassembly.gov/studies/607

Monday August 16, 2021, 2:00 p.m.

House Committee Room, Pocahontas Building

Public livestream link:

https://virginiageneralassembly.gov/house/committees/commstream.html

I. **Call to Order and Welcome** - Delegate Vivian E. Watts, Chair, House Committee on Finance

II. **Presentation by the Multistate Tax Commission:** *The Multistate Tax Commission and Overview of its Combined Reporting Model Statutes* - Gregory Matson and Helen Hecht

III. **Presentation by the Council on State Taxation** - Doug Lindholm

IV. **Summary of Workgroup Member Submissions** - Stephen Kindermann and Joshua Kaplan, Division of Legislative Services

V. **Discussion**

VI. **Public Comment**

VII. **Adjourn**

Work Group Membership

Executive and Legislative Officials

Delegate Vivian E. Watts	*Chair, House Finance*
Senator David W. Marsden	*Member, Senate Finance and Appropriations*
Joseph Flores	*Secretary of Finance*
June Jennings	*Deputy Secretary of Finance*
Craig Burns	*Tax Commissioner*
William White	*Asst. Tax Commissioner*
Brian Ball	*Secretary of Commerce and Trade*
Cassidy Rasnick	*Deputy Secretary of Commerce and Trade*

Corporate Tax Professionals

Tyler Henderson, *Sr. Manager, State and Local Tax*	*Amazon*
Gary Tappana, *Vice President of Tax Policy*	*Anheuser-Busch*
Mike Carchia, *Head of State Tax Planning*	*Capital One*
Tammy Herrin, *In-house Tax Counsel*	*ExxonMobil*
Jon Elder, *Sr. Manager, State and Local Tax*	*Dollar Tree*
Tim Winks, *Sr. Manager, Indirect Tax*	*Ferguson Enterprises*
Glen Page, *Sr. Manager, State Income & Franchise Tax*	*HCA Healthcare*
Tom Powers, *Executive Director, Corporate Tax Department*	*JP Morgan Chase*
Karen Lint, *Corporate Tax Director*	*Huntington Ingalls Industries*
Lori Nieto, *Corporate Tax Director*	*Northrop Grumman*
Ken Wright, *Sr. Manager, State Tax*	*Smithfield Foods*
Alison Malloy, *Sr. Director of Tax*	*Verisign*
Kathleen Kittrick, *Director, State Tax Policy*	*Verizon*
David Brunori, *Senior Director*	*RSM LLP, and*
Research Professor of Public Policy	*George Washington University*
Greg Matson, *Executive Director*	*Multistate Tax Commission*
William L.S. "Sandy" Rowe, *Of Counsel*	*HuntonAndrewsKurth*
Ellen Berenholz, *Executive Director, Tax Policy*	*Comcast*

Staff

Division of Legislative Services	Department of Taxation	Senate Finance and Appropriations
Amigo Wade	Kristin Collins	April Kees
Stephen Kindermann	Matt Huntley	Charles Kennington
Joshua Kaplan	James Savage	
Connor Garstka	John Josephs	House Appropriations
	Aisha Yededji	Anne Oman
	Vanessa Vinoles	

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Cathy Hooe (chooe@house.virginia.gov), Senior Operations Clerk, House of Delegates
Stephen Kindermann (skindermann@dls.virginia.gov) and Joshua Kaplan (jkaplan@dls.virginia.gov), Attorneys, Division of Legislative Services

Multistate Tax Commission Combined Reporting Model Statutes

Virginia General Assembly Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes

August 16, 2021

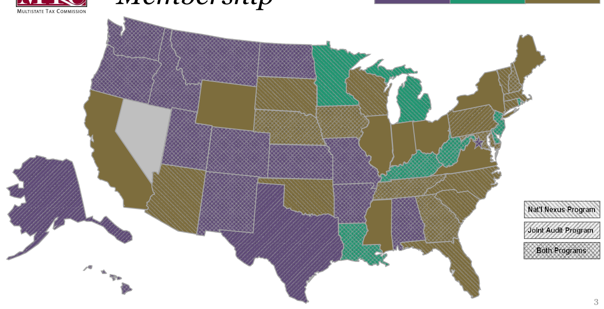
Greg Matson, Executive Director
Helen Hecht, Uniformity Counsel
Multistate Tax Commission

Overview

- An intergovernmental state tax agency whose mission is to—
  - Promote uniform and consistent tax policy and administration among the states
  - Assist taxpayers in achieving compliance with existing tax laws, and
  - Advocate for state and local sovereignty in the development of tax policy
- Established in 1967 by states to protect their tax authority in the face of previous proposals to transfer key features of state tax lawmaking and administration to the federal government.
- Works through a range of activities and programs that includes—
  - Developing recommended uniform state tax laws with respect to interstate commerce
  - Encouraging compliance with tax laws and consistency in enforcement through its Joint Audit and National Nexus Programs
  - Training and education in complex multistate tax issues
  - Supporting states engaged in major tax litigation through amicus briefs and technical assistance
  - Advocacy of state interests in the field of multistate taxation to all three branches of federal government

2

Membership



3

General Attributes of Combined Filing

- Affiliates who are members of a unitary business compute their tax using a tax base determined as if they are a single entity—eliminating all intercompany transactions
- This tax base is apportioned—either using the so-called *Joyce* method or *Finnigan* method
- Other items such as net operating losses and credits are calculated either on a separate or a group basis with rules for what happens when the group changes
- Many states that require combined filing also offer a consolidated filing method election

4

Joyce versus Finnigan Methods

***Joyce* Method – Common Attributes**

- Each entity is a "taxpayer"
- The combined tax base is apportioned by each company using an apportionment factor that divides its in-state amounts by the group everywhere amounts
- Nexus is determined company-by-company
- NOLs and credits are tracked by company

***Finnigan* Method – Common Attributes**

- The group is the taxpayer
- The combined tax base is apportioned by the group using group apportionment factors
- Nexus is determined on the basis of the group
- NOLs and credits are generally treated as group tax attributes but may be separately tracked

5

Two Uniformity Models

- The 2006 model statute follows the *Joyce* method and the Commission's newly adopted model statute follows the *Finnigan* method
- The *Finnigan* method follows the single-entity approach to calculating NOL carryforwards and relies on federal consolidating rules to limit NOLs when the group changes
- Both models —
  - Provide that the worldwide group is the default group
  - Allow an election for water's edge using a definition designed to identify true foreign entities
  - Would be compatible with a consolidated filing election

6

Why Two Models?

- The Uniformity Committee approved the project to develop a *Finnigan* model combined reporting statute in 2018 but at no point has considered the withdrawal or modification of the 2006 *Joyce* model
- The *Finnigan* model has always been envisioned as a stand-alone alternative to the *Joyce* model
- The immediate advantages of having a detailed *Finnigan* model available for states outweighed the theoretical disadvantages stemming from having two models
- The adoption of an alternative model should be not be interpreted as either an endorsement of the *Finnigan* methodology or a rejection of the *Joyce* methodology

7

Critical Issue – How to Define the Group

- Almost without exception, the group states use is the so-called "water's edge" group of companies
- The goal of the water's edge group is to exclude companies that are truly foreign — in terms of where they are incorporated and in terms of their activities
- Care needs to be taken to make sure that the group is not so narrow that foreign companies can be used to shift income

8

Transition Issues

- What to do with separate company NOLs and credits?
- What lead time do administrators and taxpayers need for systems changes?

9

Two Contentions with the Finnigan Model

- During the Development of the Finnigan Model, COST was critical of two things —
  - The model did not have consolidated election language
  - The burden of separately tracking capital gains and losses
- A drafters' note was added to alert policymakers to the potential benefits and drawbacks of a consolidated or affiliated group filing election and that the lack of one in the model should not be construed as a rejection of either as a policy matter
- A drafter's note was added explaining that treatment of capital gains and losses in the model conforms generally to the treatment of such attributes under federal consolidated filing, and notes that if a state concludes the federal-style limitations on the sharing of loss carryovers are too burdensome, it should consider adopting the simpler, while stricter, limits on those carryovers in order to prevent potential abuse

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Issues with Separate Filing

- Companies must impute intercompany transactions, where none may exist, and then accurately price those transactions
  - Example—a parent company may have no outside sales but may provide numerous services to subsidiaries for which there is no "contract"
- Companies can be established within a group solely for the purpose of shifting income and lowering state taxes
  - Example—intangible companies charging royalties to affiliates
- Even companies that don't currently benefit from separate filing (e.g., because of the inability to offset losses) may nevertheless choose not to elect combined filing since switching back to separate filing is generally prohibited due to the issues this creates

Certain Developments and Effects on Separate Filing

- Separate filing states first enacted add-back statutes for certain transactions commonly used to shift income, which continue to be litigated extensively (e.g., *Kohl's Dep't Stores, Inc. v. Virginia Dep't of Taxation*)
- States have begun scrutinizing intercompany transactions that are not subject to add-back statutes to determine if they have been properly priced
- States are moving to market-based sourcing of sales of services and intangibles, so special purpose entities created solely to shift income may now have a sales apportionment factor in the taxing state
- The recent Supreme Court decision in *South Dakota v. Wayfair* has removed any doubt that states can tax corporations based solely on sales into the state — including intercompany sales
- Bottom Line: It's now much more difficult to properly comply with — and for states to properly administer — separate filing, and any tax benefits to taxpayers are likely to be greatly reduced

Multistate Tax Commission
Proposed Model Statute for Combined Reporting

As approved by the Multistate Tax Commission August 17, 2006
As amended by the Multistate Tax Commission July 29, 2011

Section 1. Definitions.

A. "Person" means any individual, firm, partnership, general partner of a partnership, limited liability company, registered limited liability partnership, foreign limited liability partnership, association, corporation (whether or not the corporation is, or would be if doing business in this state, subject to [state income tax act]), company, syndicate, estate, trust, business trust, trustee, trustee in bankruptcy, receiver, executor, administrator, assignee or organization of any kind.

B. "Taxpayer" means any person subject to the tax imposed by [State Corporate income tax act].

C. "Corporation" means any corporation as defined by the laws of this state or organization of any kind treated as a corporation for tax purposes under the laws of this state, wherever located, which if it were doing business in this state would be a "taxpayer." The business conducted by a partnership which is directly or indirectly held by a corporation shall be considered the business of the corporation to the extent of the corporation's distributive share of the partnership income, inclusive of guaranteed payments to the extent prescribed by regulation.

D. "Partnership" means a general or limited partnership, or organization of any kind treated as a partnership for tax purposes under the laws of this state.

E. "Internal Revenue Code" means Title 26 of the United States Code of [date] [and amendments thereto] without regard to application of federal treaties unless expressly made applicable to states of the United States.

F. "Unitary business" means [a single economic enterprise that is made up either of separate parts of a single business entity or of 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.] Drafter's note: This portion of the definition is drafted to follow MTC Reg. IV(b), defining a "unitary business." A state that does not wish to define unitary business in this manner should consider alternative language. In addition, this MTC Regulation defining unitary business includes a requirement of common ownership or control. A state which treats ownership or control requirements separately from the unitary business requirement will need to make additional amendments to the statutory language. Any business conducted by a partnership shall be treated as conducted by its partners, whether directly held or indirectly held through a series of partnerships, to the extent of the partner's distributive share of the partnership's income, regardless of the percentage of the partner's ownership interest or its distributive or any other share of partnership income. A business conducted directly or indirectly by one corporation is unitary with that portion of a business conducted by another corporation through its direct or indirect interest in a partnership if the conditions of the first sentence of this section 1.F. are satisfied, to wit: there is a synergy, and exchange and flow of value between the two parts of the business and the two corporations are members of the same commonly controlled group.

G. "Combined group" means the group of all persons whose income and apportionment factors are required to be taken into account pursuant to Section 2.A. or 2.B. in determining the taxpayer's share of the net business income or loss apportionable to this State.

H. "United States" means the 50 states of the United States, the District of Columbia, and United States' territories and possessions.

I. "Tax haven" means a jurisdiction that, during the tax year in question has no or nominal effective tax on the relevant income and:

> **(i)** has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
> **(ii)** has tax regime which lacks transparency. A tax regime lacks transparency if the details of legislative, legal or administrative provisions are not open and apparent or are not consistently applied among similarly situated taxpayers, or if the information needed by tax authorities to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation, is not adequately available;
> **(iii)** facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;
> **(iv)** explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or
> **(v)** has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy.

Section 2. Combined reporting required, when; discretionary under certain circumstances.

A. Combined reporting required, when. A taxpayer engaged in a unitary business with one or more other corporations shall file a combined report which includes the income, determined under Section 3.C. of this act, and apportionment factors, determined under [provisions on apportionment factors and Section 3.B. of this act], of all corporations that are members of the unitary business, and such other information as required by the Director.

B. Combined reporting at Director's discretion, when. The Director may, by regulation, require the combined report include the income and associated apportionment factors of any persons that are not included pursuant to Section 2.A., but that are members of a unitary business, in order to reflect proper apportionment of income of entire unitary businesses. Authority to require combination by regulation under this Section 2.B. includes authority to require combination of persons that are not, or would not be if doing business in this state, subject to the [State income tax Act].

In addition, if the Director determines that the reported income or loss of a taxpayer engaged in a unitary business with any person not included pursuant to Section 2.A. represents an avoidance or evasion of tax by such taxpayer, the Director may, on a case by case basis, require all or any part of the income and associated apportionment factors of such person be included in the taxpayer's combined report.

With respect to inclusion of associated apportionment factors pursuant to Section 2.B., the Director may require the exclusion of any one or more of the factors, the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State, or the employment of any other method to effectuate a proper reflection of the total amount of income subject to apportionment and an equitable allocation and apportionment of the taxpayer's income.

Section 3. Determination of taxable income or loss using combined report.

The use of a combined report does not disregard the separate identities of the taxpayer members of the combined group. Each taxpayer member is responsible for tax based on its taxable income or loss apportioned or allocated to this state, which shall include, in addition to other types of income, the taxpayer member's apportioned share of business income of the combined group, where business income of the combined group is calculated as a summation of the individual net business incomes of all members of the combined group. A member's net business income is determined by removing all but business income, expense and loss from that member's total income, as provided in detail below.

A. Components of income subject to tax in this state; application of tax credits and post apportionment deductions.

i. Each taxpayer member is responsible for tax based on its taxable income or loss apportioned or allocated to this state, which shall include:

(a) its share of any business income apportionable to this State of each of the combined groups of which it is a member, determined under Section 3.B.,

(b) its share of any business income apportionable to this State of a distinct business activity conducted within and without the state wholly by the taxpayer member, determined under [provisions for apportionment of business income],

(c) its income from a business conducted wholly by the taxpayer member entirely within the state,

(d) its income sourced to this state from the sale or exchange of capital or assets, and from involuntary conversions, as determined under Section 3.C.ii.(g), below,

(e) its nonbusiness income or loss allocable to this State, determined under [provisions for allocation of non-business income],

(f) its income or loss allocated or apportioned in an earlier year, required to be taken into account as state source income during the income year, other than a net operating loss, and

(g) its net operating loss carryover or carryback. If the taxable income computed pursuant to Section 3 results in a loss for a taxpayer member of the combined group, that taxpayer member has a [state] net operating loss (NOL), subject to the net operating loss limitations, carryforward and carryback provisions of [provisions on NOLs]. Such NOL is applied as a deduction in a prior or subsequent year only if that taxpayer has [State] source positive net income, whether or not the taxpayer is or was a member of a combined reporting group in the prior or subsequent year.

ii. Except where otherwise provided, no tax credit or post-apportionment deduction earned by one member of the group, but not fully used by or allowed to that member, may be used in whole or in part by another member of the group or applied in whole or in part against the total income of the combined group; and a post-apportionment deduction carried over into a subsequent year as to the member that incurred it, and available as a deduction to that member in a subsequent year, will be considered in the computation of the income of that member in the subsequent year, regardless of the composition of that income as apportioned, allocated or wholly within this state.

B. Determination of taxpayer's share of the business income of a combined group apportionable to this State.

The taxpayer's share of the business income apportionable to this State of each combined group of which it is a member shall be the product of:

i. the business income of the combined group, determined under Section 3.C., and

ii. the taxpayer member's apportionment percentage, determined under [provisions on apportionment factors], including in the [property, payroll and sales factor]numerators the taxpayer's [property, payroll and sales, respectively,] associated with the combined group's unitary business in this state, and including in the denominator the [property, payroll and sales] of all members of the combined group, including the taxpayer, which property, payroll and sales are associated with the combined group's unitary business wherever located. The [property, payroll, and sales] of a partnership shall be included in the determination of the partner's apportionment percentage in proportion to a ratio the numerator of which is the amount of the partner's distributive share of partnership's unitary income included in the income of the combined group in accordance with Section 3.C.ii.(c). and the denominator of which is the amount of the partnership's total unitary income.

C. Determination of the business income of the combined group.

The business income of a combined group is determined as follows:

i. From the total income of the combined group, determined under Section 3.C.ii., subtract any income, and add any expense or loss, other than the business income, expense or loss of the combined group.

ii. Except as otherwise provided, the total income of the combined group is the sum of the income of each member of the combined group determined under federal income tax laws, as adjusted for state purposes, as if the member were not consolidated for federal purposes. The income of each member of the combined group shall be determined as follows:

(a) For any member incorporated in the United States, or included in a consolidated federal corporate income tax return, the income to be included in the total income of the combined group shall be the taxable income for the corporation after making appropriate adjustments under [state tax code provisions for adjustments to taxable income].

(b) (1) For any member not included in Section 3.C.ii.(a), the income to be included in the total income of the combined group shall be determined as follows:

(A) A profit and loss statement shall be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained.

(B) Adjustments shall be made to the profit and loss statement to conform it to the accounting principles generally accepted in the United States for the preparation of such statements except as modified by this regulation.

(C) Adjustments shall be made to the profit and loss statement to conform it to the tax accounting standards required by the [state tax code]

(D) Except as otherwise provided by regulation, the profit and loss statement of each member of the combined group, and the apportionment factors related thereto, whether United States or foreign, shall be translated into the currency in which the parent company maintains its books and records.

(E) Income apportioned to this state shall be expressed in United States dollars.

(2) In lieu of the procedures set forth in Section 3.C.ii.(b)(1), above, and subject to the determination of the Director that it reasonably approximates income as determined under [the State tax code], any member not included in Section 3.C.ii.(a) may determine its income on the basis of the consolidated profit and loss statement which includes the member and which is prepared for filing with the Securities and Exchange Commission by related corporations. If the member is not required to file with the Securities and Exchange Commission, the Director may allow the use of the consolidated profit and loss statement prepared for reporting to shareholders and subject to review by an independent auditor. If above statements do not reasonably approximate income as determined under [the State tax code] the Director may accept those statements with appropriate adjustments to approximate that income.

(c) If a unitary business includes income from a partnership, the income to be included in the total income of the combined group shall be the member of the combined group's direct and indirect distributive share of the partnership's unitary business income.

(d) All dividends paid by one to another of the members of the combined group shall, 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, be eliminated from the income of the recipient. This provision shall not apply to dividends received from members of the unitary business which are not a part of the combined group.

(e) Except as otherwise provided by regulation, business income from an intercompany transaction between members of the same combined group shall be deferred in a manner similar to 26 CFR 1.1502-13. Upon the occurrence of any of the following events, deferred business income resulting from an intercompany transaction between members of a combined group shall be restored to the income of the seller, and shall be apportioned as business income earned immediately before the event:

(1) the object of a deferred intercompany transaction is

(A) re-sold by the buyer to an entity that is not a member of the combined group,

(B) re-sold by the buyer to an entity that is a member of the combined group for use outside the unitary business in which the buyer and seller are engaged, or

(C) converted by the buyer to a use outside the unitary business in which the buyer and seller are engaged, or

(2) the buyer and seller are no longer members of the same combined group, regardless of whether the members remain unitary.

(f) A charitable expense incurred by a member of a combined group shall, to the extent allowable as a deduction pursuant to Internal Revenue Code Section 170, be subtracted first from the business income of the combined group (subject to the income limitations of that section applied to the entire business income of the group), and any remaining amount shall then be treated as a nonbusiness expense allocable to the member that incurred the expense (subject to the income limitations of that section applied to the nonbusiness income of that specific member). Any charitable deduction disallowed under the foregoing rule, but allowed as a carryover deduction in a subsequent year, shall be treated as originally incurred in the subsequent year by the same member, and the rules of this section shall apply in the subsequent year in determining the allowable deduction in that year.

(g) Gain or loss from the sale or exchange of capital assets, property described by Internal Revenue Code Section 1231(a)(3), and property subject to an involuntary conversion, shall be removed from the total separate net income of each member of a combined group and shall be apportioned and allocated as follows.

(1) For each class of gain or loss (short term capital, long term capital, Internal Revenue Code Section 1231, and involuntary conversions) all members' business gain and loss for the class shall be combined (without netting between such classes), and each class of net business gain or loss separately apportioned to each member using the member's apportionment percentage determined under Section 3.B., above.

(2) Each taxpayer member shall then net its apportioned business gain or loss for all classes, including any such apportioned business gain and loss from other combined groups, against the taxpayer member's nonbusiness gain and loss for all classes allocated to this State, using the rules of Internal Revenue Code Sections 1231 and 1222, without regard to any of the taxpayer member's gains or losses from the sale or exchange of capital assets, Section 1231 property, and involuntary conversions which are nonbusiness items allocated to another state.

(3) Any resulting state source income (or loss, if the loss is not subject to the limitations of Internal Revenue Code Section 1211) of a taxpayer member produced by the application of the preceding subsections shall then be applied to all other state source income or loss of that member.

(4) Any resulting state source loss of a member that is subject to the limitations of Section 1211 shall be carried forward [or carried back] by that member, and shall be treated as state source short-term capital loss incurred by that member for the year for which the carryover [or carryback] applies.

(h) Any expense of one member of the unitary group which is directly or indirectly attributable to the nonbusiness or exempt income of another member of the unitary group shall be allocated to that other member as corresponding nonbusiness or exempt expense, as appropriate.

Section 4. Designation of surety.

As a filing convenience, and without changing the respective liability of the group members, members of a combined reporting group may annually elect to designate one taxpayer member of the combined group to file a single return in the form and manner prescribed by the department, in lieu of filing their own respective returns, provided that the taxpayer designated to file the single return consents to act as surety with respect to the tax liability of all other taxpayers properly included in the combined report, and agrees to act as agent on behalf of those taxpayers for the year of the election for tax matters relating to the combined report for that year. If for any reason the surety is unwilling or unable to perform its responsibilities, tax liability may be assessed against the taxpayer members.

Section 5. Water's-edge election; initiation and withdrawal.

A. Water's-edge election.

Taxpayer members of a unitary group that meet the requirements of Section 5.B. may elect to determine each of their apportioned shares of the net business income or loss of the combined group pursuant to a water's-edge election. Under such election, taxpayer members shall take into account all or a portion of the income and apportionment factors of only the following members otherwise included in the combined group pursuant to Section 2, as described below:

i. the entire income and apportionment factors of any member incorporated in the United States or formed under the laws of any state, the District of Columbia, or any territory or possession of the United States;

ii. the entire income and apportionment factors of any member, regardless of the place incorporated or formed, if the average of its property, payroll, and sales factors within the United States is 20 percent or more;

iii. the entire income and apportionment factors of any member which is a domestic international sales corporations as described in Internal Revenue Code Sections 991 to 994, inclusive; a foreign sales corporation as described in Internal Revenue Code Sections 921 to 927, inclusive; or any member which is an export trade corporation, as described in Internal Revenue Code Sections 970 to 971, inclusive;

iv. any member not described in [Section 5.A.i.] to [Section 5.A.iii.], inclusive, shall include the portion of its income derived from or attributable to sources within the United States, as determined under the Internal Revenue Code without regard to federal treaties, and its apportionment factors related thereto;

v. any member that is a "controlled foreign corporation," as defined in Internal Revenue Code Section 957, to the extent of the income of that member that is defined in Section 952 of Subpart F of the Internal Revenue Code ("Subpart F income") not excluding lower-tier subsidiaries' distributions of such income which were previously taxed, determined without regard to federal treaties, and the apportionment factors related to that income; any item of income received by a controlled foreign corporation shall be excluded if such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in Internal Revenue Code Section 11;

vi. any member that earns more than 20 percent of its income, directly or indirectly, from intangible property or service related activities that are deductible against the business income of other members of the combined group, to the extent of that income and the apportionment factors related thereto; and

vii. the entire income and apportionment factors of any member that is doing business in a tax haven, where "doing business in a tax haven" is defined as being engaged in activity sufficient for that tax haven jurisdiction to impose a tax under United States constitutional standards. If the member's business activity within a tax haven is entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in Section 1.I., the activity of the member shall be treated as not having been conducted in a tax haven.

B. Initiation and withdrawal of election

i. A water's-edge election is effective only if made on a timely-filed, original return for a tax year by every member of the unitary business subject to tax under [state income tax code]. The Director shall develop rules and regulations governing the impact, if any, on the scope or application of a water's-edge election, including termination or deemed election, resulting from a change in the composition of the unitary group, the combined group, the taxpayer members, and any other similar change.

ii. Such election shall constitute consent to the reasonable production of documents and taking of depositions in accordance with [state statute on discovery].

iii. In the discretion of the Director, a water's-edge election may be disregarded in part or in whole, and the income and apportionment factors of any member of the taxpayer's unitary group may be included in the combined report without regard to the provisions of this section, if any member of the unitary group fails to comply with any provision of [this act] or if a person otherwise not included in the water's-edge combined group was availed of with a substantial objective of avoiding state income tax.

iv. A water's-edge election is binding for and applicable to the tax year it is made and all tax years thereafter for a period of 10 years. It may be withdrawn or reinstituted after withdrawal, prior to the expiration of the 10 year period, only upon written request for reasonable cause based on extraordinary hardship due to unforeseen changes in state tax statutes, law, or policy, and only with the written permission of the Director. If the Director grants a withdrawal of election, he or she shall impose reasonable conditions as necessary to prevent the evasion of tax or to clearly reflect income for the election period prior to or after the withdrawal. Upon the expiration of the 10 year period, a taxpayer may withdraw from the water's edge election. Such withdrawal must be made in writing within one year of the expiration of the election, and is binding for a period of 10 years, subject to the same conditions as applied to the original election. If no withdrawal is properly made, the water's edge election shall be in place for an additional 10 year period, subject to the same conditions as applied to the original election.

MULTISTATE TAX COMMISSION

Model Statute for Combined Reporting – "Finnigan Method"
Adopted August 4, 2021

Section 1. Definitions.

A. "Combined group" means the group of all persons that must file a combined return as required by Section 2.A. or 2.B, including a group properly making a water's edge election under Section 4.

B. "Combined return" means a tax return required to be filed for the combined group containing information as provided in [this Act] or required by the [Director].

C. "Corporation" means an organization of any kind treated as a corporation for tax purposes under the laws of this state, wherever located, which if it were doing business in this state would be a "taxpayer."

D. "Internal Revenue Code" means Title 26 of the United States Code of [date] [and amendments thereto] without regard to application of federal treaties unless expressly made applicable to states of the United States.

E. "Partnership" means an organization of any kind treated as a partnership for tax purposes under the laws of this state.

F. "Person" means an individual, firm, partnership, general partner of a partnership, limited liability company, registered limited liability partnership, foreign limited liability partnership, association, corporation (whether or not the corporation is, or would be if doing business in this state, subject to [reference to state income tax act]), company, syndicate, estate, trust, business trust, trustee, trustee in bankruptcy, receiver, executor, administrator, assignee, or organization of any kind. For purposes of the [reference to state corporate income tax act] "person" also means a combined group. *[DRAFTER'S NOTE: The state may have a definition of "person" that it wishes to reference here. What is important is that the model relies on the inclusion of the combined group in the definition of "person." See also the definition of "taxpayer" below.]*

G. "Tax haven" means a jurisdiction that, during the tax year in question has no or nominal effective tax on the relevant income and:

i. has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;

ii. has tax regime that lacks transparency. A tax regime lacks transparency if the details of legislative, legal or administrative provisions are not open and apparent or are not consistently applied among similarly situated taxpayers, or if the information needed by tax authorities to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation, is not adequately available;

iii. facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;

iv. explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or

v. has created a tax regime that is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial or other services sector relative to its overall economy.

H. "Taxpayer" means a person subject to the tax imposed by [reference to state corporate income tax act].

[DRAFTER'S NOTE: The tax imposition sections of the state code should be clear that tax is imposed on the combined group or corporations as part of a combined group.]

I. "Unitary business" means a single economic enterprise made up either of separate parts of a single business entity or of 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. A unitary business includes that part of the business that meets the definition in this Section 1.I. and is conducted by a taxpayer through the taxpayer's interest in a partnership, whether the interest in that partnership is held directly or indirectly through a series of partnerships or other pass-through entities.

[DRAFTER'S NOTE: This definition follows the MTC Model General Allocation and Apportionment Regulations, Sec. IV.1.(b)., defining a "unitary business." Reg. Sec. IV.1.(b). includes a definition of a "commonly controlled group." A state which treats ownership or control requirements separately from the unitary business requirement will need to make additional amendments to the statutory language. A state that does not wish to define unitary business in this manner should consider alternative language.]

J. "United States" means the 50 states of the United States, the District of Columbia, and United States' territories and possessions.

Section 2. Requirement to file a combined return; joint and several liability.

A. Except as provided in Section 4, all the corporations, wherever incorporated or domiciled, that are members of a unitary business shall file a combined return as a combined group. That return must include the income and apportionment factors, determined under Section 3, and other information required by the [Director] for all members of the combined group wherever located or doing business. The combined return must be filed under the name and federal employer identification number of the parent corporation if the parent is a member of the combined group. If there is no parent corporation, or if the parent is not a group member, the members of the combined group shall choose a member to file the return. The filing member must remain the same in subsequent years unless the filing member is no longer the parent corporation or is no longer a member of the combined group. The return must be signed by a responsible officer of the filing member on behalf of the combined group members. Members of the combined group are jointly and severally liable for the tax liability of the combined group included in the combined return.

B. The [Director], by regulation, may require that the combined return include the income and associated apportionment factors of persons that are not included pursuant to Section 2.A., but that are members of a unitary business, in order to reflect proper apportionment of income of the entire unitary business. Authority to require combination by regulation under this Section 2.B. includes authority to require combination of the income and associated apportionment factors of persons that are not subject to the [state income tax act], or would not be subject to the [state income tax act] if doing business in this state.

In addition, if the [Director] determines that the reported income or loss of a taxpayer engaged in a unitary business with a person not included pursuant to Section 2.A., or pursuant to an election under Section 4, represents an avoidance or evasion of tax by such taxpayer, the [Director] may, on a case by case basis, require all or part of the income and associated apportionment factors of such person be included in the taxpayer's combined return.

With respect to inclusion of associated apportionment factors pursuant to this Section 2.B., the [Director] may require the exclusion of one or more of the factors, the inclusion of one or more additional factors that will fairly represent the taxpayer's business activity in this State, or the employment of any other method to effectuate a proper reflection of the total amount of income subject to apportionment and an equitable allocation and apportionment of the taxpayer's income.

Section 3. Determination of combined group income subject to tax.

A. The combined group calculates its state taxable net income as provided in this Section 3.A.

i. Determine the total combined group income or loss, before net operating loss deduction, as follows:

(a) Each member of the combined group determines its separate income or loss, before net operating loss deduction, as follows:

(1) For a member incorporated in the United States, or included in a consolidated federal corporate income tax return, the member's income or loss is the taxable income for the member under the Internal Revenue Code, on a separate entity basis, after making appropriate adjustments under [state tax code provisions for adjustments to taxable income].

(2) For any member not included in Section 3.A.i.(a)(1):

(I) The member's income or loss is determined from a profit and loss statement prepared for that member on a separate entity basis in the currency in which its books of account are regularly maintained, provided this profit and loss statement is subject to an independent audit, adjusted to conform it to the accounting principles generally accepted in the United States for the preparation of such statements and further modified to take into account any book-tax adjustments necessary to reflect federal and [state] tax law. Income or loss so computed includes all income wherever derived and is not limited to items of U.S. source income or effectively connected income within the meaning of the Internal Revenue Code. Items of income, expense, gain or loss and related apportionment factors that are denominated in a foreign currency must also be translated into U.S. dollars on a reasonable basis consistently applied year-to-year and entity-by-entity. Unrealized foreign currency gains and losses are not recognized. Income apportioned to this state is to be expressed in U.S. dollars.

(II) In lieu of the procedures set forth in Section 3.A.i.(a)(2)(I) or in any case where it is necessary to fairly and consistently reflect the income or loss and apportionment factors of foreign operations included in the unitary business, the [Director] may provide for other procedures to reasonably approximate the income or loss and apportionment factors of members with foreign operations.

(b) Unless otherwise provided by this Act, or by regulation, income or loss of the members as determined under Section 3.A.i.(a) are combined, eliminating items of income, expense, gain and loss from transactions between members of the combined group, applying the consolidated filing rules under Internal Revenue Code and agency regulations as if the combined group was a consolidated filing group.

(1) Dividends paid by one member of the combined group to another member are excluded from that member's income 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.

(2) A charitable expense incurred by a member of a combined group, to the extent allowable as a deduction pursuant to Internal Revenue Code Section 170, is subtracted first from the apportionable income of the combined group subject to the income limitations of that section applied to the entire apportionable income of the group, and any excess may be carried over as provided in Section 170, subject to limitations in that section.

ii. Determine combined group ordinary apportionable income or loss by eliminating from the amount determined in Section 3.A.i:

(a) The amount of any net capital gain resulting from application of the Internal Revenue Code, Subchapter P; and

(b) Any other income or loss, or item of income, expense, gain or loss, that is nonapportionable.

iii. Determine state share of combined group ordinary apportionable income or loss by multiplying the amount determined under Section 3.A.ii. times the combined group apportionment factor as determined under Section 3.B.

iv. Determine the combined group state net capital gain or loss from the application of the Internal Revenue Code, Subchapter P, and the amount of any state net capital loss carryover, as follows:

[DRAFTER'S NOTE: The treatment of capital gains and losses in this model conforms generally to the treatment of such attributes under federal consolidated filing rules. If the state decouples from federal treatment of depreciation and tax basis and requires taxpayers to compute separate state amounts for capital gains, losses and/or loss carryovers, then insert language here referring to the section that instructs taxpayers how to report state-adjusted capital gains and losses. If a state declines to follow the provisions of this section, it is recommended that language eliminating the use of capital loss carryforwards for entities joining the combined filing or leaving the combined filing group.]

(a) Each separate item of capital gain or loss for the combined group is determined [following Internal Revenue Code, Subchapter P or state provisions requiring the computation of state-adjusted capital gains and losses].

(b) Each separate item of apportionable capital gain or loss is then apportioned using the combined group's apportionment factor determined under Section 3.B., and each separate item of nonapportionable capital gain or loss is allocated under [reference to state allocation and apportionment statute].

(c) The capital gains or losses allocated or apportioned to this state are then netted consistent with the provisions of the Internal Revenue Code, Subchapter P.

(d) If the amount determined in Section 3.A.iv.(c) is a net capital gain, that gain is included in combined group taxable net income or loss before net operating loss deduction as computed under Section 3.A.vi.

(e) If the amount determined in Section 3.A.iv.(c) is a net capital loss, that loss may not be deducted from other income but may be carried over by the combined group and used to offset combined group capital gains, subject to [state law allowing a net capital loss carryover], but only to the extent that the amount or use of such capital loss carryover is not subject to limitations under any provision of the Internal Revenue Code or applicable federal regulations, or would not be subject to such limitations applied as if the combined group was the consolidated group.

(f) If the combined group capital loss carryover must be attributed to particular members of the group for purposes of determining limitations applicable to the amount or use of the capital loss under Section 3.A.iv(e) above, then this will be done by multiplying the combined group net capital loss generated for any applicable year times a faction the numerator of which is the separate entity net capital loss of the member for that year, if any, and the denominator of which is the total separate entity net capital losses for all the members of the combined group that had net capital losses for that year. A member's separate entity net capital loss carryover will be determined as follows:

(I) For each year in which the combined group recognized a net capital loss, multiply the combined group net apportionable gains and losses times the member's separate entity apportionment factor determined under Section 3.B, netting the resulting apportioned gains and losses as provided in this Section 3.A.iv; then adding any nonapportionable gains and subtracting any losses allocated to the state that were generated by that member.

(II) In no case may members of the combined group be attributed total capital losses under this Section 3.A.iv(f) in excess of the combined group net capital loss properly reported to this state in the tax year.

(III) In computing the net capital loss carryover for the member of the combined group, the separate entity capital losses for all members computed under this Section 3.A.iv.(f) will be deemed to be used to offset combined group capital gains in other years, as allowed under [federal or separate state law], on a pro-rata basis, starting with the earliest year.

v. Determine the amount of any combined group nonapportionable items of income, expense, gain or loss not allocated under Section 3.A.iv.(b) that are allocable to the state under [reference to state allocation and apportionment statute].

vi. Determine the combined group state net income or loss before net operating loss deduction by combining and netting the results from Section 3.A.iii., iv.(d), and v.

vii. Determine the combined group state taxable net income after any net operating loss deduction, by deducting from the amount of combined group state net income computed under Section 3.A.vi an allowable amount of the combined group's net operating loss carryover, determined under this Section 3.A.vii, as follows:

(a) The allowable amount of the combined group net operating loss carryover in any tax year is:

(1) The total of the combined group state losses determined under Section 3.A.vi for prior years to the extent such losses have not been used to offset the combined group's state net income and to the extent those losses are not otherwise limited by state law or this Section 3.A.vii; plus

(2) The net operating loss carryover of any members of the group created before the member became a part of the group, but only to the extent that the net operating loss carryover:

(I) represents net operating losses that were properly attributed to the member under Section 3.A.vii(b) below if the member was part of a separate combined group when the losses were created;

(II) represents net operating losses properly allocated or apportioned to this state in the year created;

(III) has not been used to offset income of any taxpayer;

(IV) would not be subject to limitations as to the amount or use applicable under any provision of the Internal Revenue Code or federal regulations, or would not be subject to such limitations applied as if the combined group was the consolidated group; and

(V) is not otherwise not limited by state law; minus

(3) The net operating loss carryover of a member of the combined group attributed to that member under Section 3.A.vii.(c) below, that has not been used to offset income and is not otherwise limited by state law as of the date that member is no longer part of the combined group.

(b) If the combined group net operating loss carryover must be attributed to particular members of the group for purposes of determining limitations applicable to the amount or use of the net operating loss carryover under this Section 3.A.vii, then this will be done by multiplying the combined group net loss generated for any applicable year times a fraction the numerator of which is the separate entity net loss of the member for that year, if any, and the denominator of which is the total separate entity net losses for all the members of the combined group that had net losses for that year. A member’s separate entity net loss will be determined as follows:

(1) The amount of combined group ordinary apportionable income determined under Section 3.A.ii multiplied times the member’s separate entity apportionment factor as determined under Section 3.B; plus

(2) The amount of any combined group net gain determined under Section 3.A.iv. multiplied times the member’s separate entity apportionment factor as determined under Section 3.B; plus or minus

(3) The amount of any nonapportionable items of income, expense, gain or loss allocated to the state under Section 3.A.v. that were generated by the member; plus or minus

(4) Any adjustments to properly reflect the member’s separate entity loss.

(5) In no case shall members be attributed total losses under this Section 3.A.vii.(b) in excess of the combined group loss properly reported to this state in the tax year.

(6) In computing the net operating loss carryover for the member of the combined group, the separate entity net operating losses for all members computed under this Section 3.A.iv.(f) will be deemed to be used to offset combined group net income in other years, as allowed under [federal or separate state law], on a pro-rata basis, starting with the earliest year.

viii. Application of state tax credits.

If the use of a tax credit provided in any other section of [this act] is limited to the [state] tax attributed to a member of a combined group, then the tax that may be offset by the credit is calculated as follows:

(1) The amount of combined group ordinary apportionable income determined under Section 3.A.ii multiplied times the member’s separate entity apportionment factor as determined under Section 3.B; plus

(2) The amount of any combined group net gain determined under Section 3.A.iv. multiplied times the member’s separate entity apportionment factor as determined under Section 3.B; plus or minus

(3) The amount of any nonapportionable items of income, expense, gain or loss allocated to the state under Section 3.A.v. that were generated by the member; plus or minus

(4) Any adjustments to properly reflect the member's separate entity loss; multiplied by

(5) The applicable tax rate.

B. Allocation and apportionment.

i. Allocation and apportionment.

Unless otherwise provided in this Act, [reference to state allocation and apportionment statute] determines how income or loss, or items making up income or loss, are allocated and apportioned to this state.

ii. combined group apportionment factor.

The combined group apportionment factor is a percentage determined under [reference to state allocation and apportionment statute] where the numerator of the factor[s] includes amounts sourced to the state for the combined group's unitary business, regardless of the separate entity to which those factors may be attributed, and the denominator of the factor[s] includes amounts associated with the combined group's unitary business wherever located.

iii. Separate entity apportionment factor.

The separate entity apportionment factor for a member of the combined group is a percentage determined under [reference to state allocation and apportionment statute] where the numerator of the factor[s] includes amounts sourced to the state for the member, and the denominator of the factor[s] includes amounts associated with the combined group's unitary business wherever located.

iv. If a member of the combined group holds a partnership interest from which it derives apportionable income, the share of the partnership's apportionment factor[s] to be included in the apportionment factor[s] of the group is determined by multiplying the partnership's factor[s] by a ratio the numerator of which is the amount of the partnership's apportionable income properly included in the member's income, whether received directly or indirectly, and including any guaranteed payments, and the denominator of which is the amount of the partnership's total apportionable income. If a member of the combined group directly or indirectly receives an allocation of a partnership tax item, such as an item of loss or expense, so that it is not possible to determine the member's share of apportionable income, the [Director] may provide rules for inclusion of particular partnership factors, or portions of factors, in the combined group's factors.

Section 4. Water's -edge election; initiation and withdrawal.

A. Water's-edge election.

Members of a unitary group that meet the requirements of Section 4.B. may elect to file as a combined group pursuant to a water's-edge election. Under such election, the combined group takes into account all or a portion of the income and apportionment factors of only the following members, otherwise included in the combined group pursuant to Section 2, as described below:

i. the entire income and apportionment factors of a member incorporated in the United States or formed under the laws of any state, the District of Columbia, or any territory or possession of the United States;

ii. the entire income and apportionment factors of a member, regardless of the place incorporated or formed, if the average of its property, payroll, and receipts factors within the United States is 20 percent or more;

iii. the entire income and apportionment factors of a member which is a domestic international sales corporations as described in Internal Revenue Code Sections 991 to 994, inclusive; a foreign sales corporation as described in Internal Revenue Code Sections 921 to 927, inclusive; or a member which is an export trade corporation, as described in Internal Revenue Code Sections 970 to 971, inclusive;

iv. for a member not described in Section 4.A.i. to Section 4.A.iii., inclusive, include the portion of its income derived from or attributable to sources within the United States, as determined under the Internal Revenue Code without regard to federal treaties, and its apportionment factors related thereto;

v. for a member that is a "controlled foreign corporation," as defined in Internal Revenue Code Section 957, include income to the extent of the income of that member that is defined in Section 952 of Subpart F of the Internal Revenue Code ("Subpart F income") not excluding lower-tier subsidiaries' distributions of such income which were previously taxed, determined without regard to federal treaties, and the apportionment factors related to that income; any item of income received by a controlled foreign corporation is excluded if such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in Internal Revenue Code Section 11;

vi. for a member that earns more than 20 percent of its income, directly or indirectly, from intangible property or service related activities that are deductible against the apportionable income of other members of the combined group, include the related income and the apportionment factors; and

vii. the entire income and apportionment factors of a member that is doing business in a tax haven, where "doing business in a tax haven" is defined as being engaged in activity sufficient for that tax haven jurisdiction to impose a tax under United States constitutional standards. If the member's business activity within a tax haven is entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in Section 1.JI., the activity of the member shall be treated as not having been conducted in a tax haven.

B. Initiation and withdrawal of election

i. A water's-edge election is effective only if made on a timely-filed, original return for a tax year by the members of the unitary business. The Director shall develop rules and regulations governing the impact, if any, on the scope or application of a water's-edge election, including the procedures for election and termination or deemed election, resulting from a change in the composition of the unitary group, the combined group, the members, and any other similar change.

ii. Such election constitutes consent to the reasonable production of documents and taking of depositions in accordance with [state statute on discovery].

iii. In the discretion of the Director, a water's-edge election may be disregarded in part or in whole, and the income and apportionment factors of any member of the unitary group may be included in the combined report without regard to the provisions of this section, if any member of the unitary group fails to comply with any provision of [this act] or if a person otherwise not included in the water's-edge combined group was availed of with a substantial objective of avoiding state income tax.

iv. A water's-edge election is binding for and applicable to the tax year it is made and all tax years thereafter for a period of 10 years. It may be withdrawn or reinstituted after withdrawal, prior to the expiration of the 10 year period, only upon written request for reasonable cause based on extraordinary hardship due to unforeseen changes in state tax statutes, law, or policy, and only with the written permission of the Director. If the Director grants a withdrawal of election, he or she shall impose reasonable conditions as necessary to prevent the evasion of tax or to clearly reflect income for the election period prior to or after the withdrawal. Upon the expiration of the 10 year period, the members of a combined group may withdraw from the water's edge election. Such withdrawal must be made in writing within one year of the expiration of the election, and is binding for a period of 10 years, subject to the same conditions as applied to the original election. If no withdrawal is properly made, the water's edge election will be in place for an additional 10 year period, subject to the same conditions as applied to the original election.

C. Effect of water's edge election on excluded entities.

The election under this Section 4 has no effect on whether entities that are excluded from the water's edge combined group may be separately liable for tax under [the state income tax act]. Entities subject to the state tax must separately file and pay tax in the state.

[DRAFTER'S NOTE: In addition to allowing an election to file a group return on a unitary domestic basis ("water's edge"), many states offer a group filing election based on inclusion in the taxpayer's federal consolidated return ("federal consolidated filing") or based on common ownership and control of domestic corporations ("affiliated group filing"). These filing methods

have the advantage of eliminating controversy and uncertainty about the proper make-up of the filing group occasioned by the model's reliance on the unitary business principle. States must still establish policies and procedures for determining the group's income tax base, treatment of tax attributes and apportioning the tax base. Because the filing group may include the incomes, losses and apportionment factors of non-unitary entities, states should consider an explicit provision providing for the full apportionment of all of the group's income. The absence of a consolidated or affiliated group filing election in this model should not be construed as a rejection of either election as a policy matter.]

Virginia Work Group on Unitary Combined Reporting, per HJR 563

Is Unitary Combination the Right Choice for the Commonwealth of Virginia?

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A Brief History of Unitary Combined Reporting

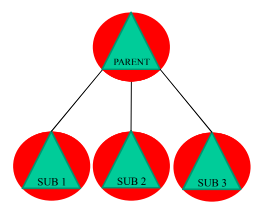
- Railroad Property Tax Cases in the 1800s
- California and the Movie Industry
- Worldwide vs. Domestic Water's-Edge
- *Mobil Oil (1980); Container (1983); Barclays (1994)*
- Retaliatory Taxation and the Regan Report
- *Geoffrey* (1993) and State Add-Back Statutes

The Concept of "Unitary" or "Unity" is a Judicial (Constitutional) Determination

- As a result, definitions and guidance available for taxpayers and tax administrators seeking a unitary determination arise from US Supreme Court case law and are therefore necessarily overbroad and vague:
  - Functional Integration
  - Centralized Management
  - Economies of Scale
  - Flow of Value and the "Three Unities" Test
- Every unitary audit is unique because it is specific to a single group of companies.
- Audits and litigation can take decades, can be prohibitively expensive, and carry zero precedential value for the Commonwealth, its taxpayers, or the Department of Taxation.

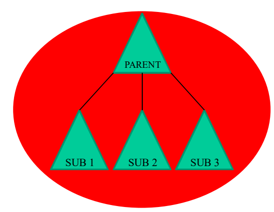
Combined Unitary Reporting: Who is the "Taxpayer"?

Appeal of Joyce, Inc.



Each individual entity is a "taxpayer"

Appeal of Finnigan



The unitary group is the "taxpayer"

Administrative Concerns: Unitary Combined Reporting

- Definitional uncertainty over composition of the unitary group
- Uncertainty over revenue impacts in the future; Impacts on current financial reporting/company share price
- Lack of certainty and predictability on definitional and jurisdictional issues: *Joyce/Finnigan*, sharing of tax attributes, M&A (instant unity), nexus, throwback, P.L. 86-272
- Increases taxpayer compliance burdens; Costly and extensive audits and litigation; no precedential value of decisions
- Lack of trained and experienced DoT personnel
- Dollars tend to drive audit activity

Tax Policy Concerns: Unitary Combined Reporting

- For Taxpayers: The CR revenue impact will not fall evenly on taxpayers. Combined reporting will bring tax reductions to some taxpayers, but significant tax increases to others. CR creates winners and losers in the tax arena, and will increase taxpayer compliance burdens
- For Virginia: CR will have an unpredictable revenue impact; it may raise corporate income tax revenues or decrease corporate income tax revenues.
- As a net number, CR revenue estimates are not helpful to policy makers. True revenue impact is very difficult to estimate. Numerous and varied studies indicate the only certainty about combined reporting is that it will increase the volatility of the corporate income tax.
- CR is meant to ease distortions of separate filing, but it merely replaces existing distortions with new ones by assuming all members of the group have the same level of profitability.

Economic Development Concerns: Unitary Combined Reporting

- Virginia has a well-earned reputation for a fair and predictable business tax system and effective tax administration. Once gone, it is difficult to bring back.
  - See June 2021 CNBC study: VA ranked #1 in "America's Top States for Business"
  - COST Scorecard on State Tax Administration gives VA an A-
- Virginia's competitors (NC) are moving in the opposite direction, significantly decreasing reliance on the corporate income tax
- Tax increases on select taxpayers through CR will result in a decrease in investment in Virginia

Statement on Combined Reporting from the 2016 Augustine Commission Report (Maryland)

Recommendation 5: Do not adopt combined reporting and indicate clearly the intent not to do so.

For many years, the General Assembly has considered whether to impose combined reporting in Maryland. This debate causes uncertainty and sends a negative message to businesses considering expansion in or relocation to the State. In its effort to reform the corporate income tax and generate additional revenues, combined reporting can create revenue volatility and winners and losers among corporate taxpayers. Combined reporting can also lead to additional litigation from taxpayers and create additional administrative costs for both taxpayers and the State.

Bibliography

Understanding the Revenue and Competitive Effects of Combined Reporting, by Dr. Robert Cline

COST Policy Statement on Mandatory Unitary Combined Reporting

Maryland's Augustine Commission Report on Economic Development

Mitigating the Impact of State Tax Law Changes on Company Financial Statements

An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes

Total State and Local Business Taxes, FY 2019

Questions?

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HJR 563 Unitary Combined Reporting Workgroup: Initial Summary of Member Feedback

August 16, 2021

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Overview of Feedback Request

- Following the first meeting of the workgroup, Delegate Watts requested each corporate representative to submit feedback to the following questions:
  - (i) Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - (ii) Two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - (iii) Two most preferred provisions of Virginia's corporate tax structure in determining tax liability; and
  - (iv) Two most problematic provisions of Virginia's corporate tax structure in determining tax liability

2

Summary of Corporate Feedback on Unitary Combined Reporting

- Retaining election of filing method for affiliated group of corporations
  - Many preferred having elective reporting type while prescribing a default
    - Unitary combined basis OR
    - One of the other filing elections permitted under state law (ex. consolidated)
  - Concerns:
    - unitary combined regimes unfairly attribute income and losses in another state to the taxing state simply by virtue of being a member of the unitary group
    - Complexity of unitary combined filing
  - Background: VA (§58.1-442) currently allows filing election for an affiliated group of corporations:
    - Separate (default) – each corporation in affiliated group w/ nexus in VA required to file own, separate corporate income tax return and report only its income, expenses, gains, losses, allocation, and apportionment factors
    - Consolidated – aggregate liability of all corporations in an affiliated group w/ nexus to VA and entire affiliated group files a single return
    - Virginia Combined – each corporation in an affiliated group w/ nexus to VA determines its data separately → each corporation separately computes its tax liability → post- apportionment final corporate income tax liability of each corporation is combined and included on a single return

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Summary of Corporate Feedback on Unitary Combined Reporting

- Mirroring Federal Rules
  - General preference to match up with federal filing and reporting rules
    - Ex. Intercompany transactions, including intercompany interest expense, are generally eliminated under unitary combined reporting and thus do not require related member add back adjustments, consistent with federal consolidated reporting
    - Should follow IRC §1502/§1.1502 regulations
    - OR, NE, and NM cited as having very simple UCR returns but that many (especially NY, CA, MA) take a more complicated path
      - Inconsistent compliance rules across states increase the amount of time to prepare and file returns
      - Audits last longer and can be more involved and costly
    - VA was commended for following federal consolidated group rules

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Summary of Corporate Feedback on Unitary Combined Reporting

- Treatment of International Corporations of a Unitary Group
  - Proponents of both water's edge or worldwide combination as the default
    - Water's Edge – only includes affiliated foreign corporations to the extent they conduct business in the United States
      - Default in almost all unitary combined states
        - Conforming VA unitary filing to other states as much as possible reduces complexity
      - Usually applies to corporations with greater than 20% of business in United States, but application criteria across unitary combined states varies
    - Worldwide – all corporations of a unitary group, including foreign entities, and regardless of their location or level of business activity in the United States
      - Prohibited in many states, including VA
      - Only four states default to worldwide currently (CA, ID, MT, and ND)
      - When tied to federal filing, eliminates controversies over which entities are "in or out" of an affiliated filing group, how the 80/20 or tax haven rules apply, and disputes over transactions with foreign affiliates

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Summary of Corporate Feedback on Unitary Combined Reporting

- Treatment of Tax Attributes
  - Several praised unitary combined reporting states who allow the sharing of tax credits and net operating losses generated by the combined group's members against the group's taxable income as supporting an attractive investment climate.
  - Others criticized reducing the VA tax value of VA business activity by combining it in the total corporate unitary tax base.
  - Concerns were raised with tracking tax attributes in unitary combined states due to lack of uniformity
    - Ex. separate entity tracking for generation and use of NOLs and credits, such as in CA
- Including Accounting Standards Codification 740 Relief
  - It was noted that a transition to unitary combined reporting would require re-computing the value of tax assets or liabilities previously recorded on a publicly traded company's financial statements to allow recovery spread over a specified period of time.
    - Adopted in CT, DC, MA, MI, and NJ

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Summary of Corporate Feedback on Unitary Combined Reporting

- Other Positive Impressions about UCR
  - Several respondents indicated they did not expect a major change in VA tax liability
  - It could be a safe harbor for starting point of depreciation or amortization computation with regard to foreign members' assets by allowing groups to simply use basis and asset life already in use by the group as reported in a state in which the group files on a worldwide combined basis
  - Preference for single factor apportionment instead of resorting to multiple apportionment factors
    - Preference for clear ownership rules in defining the unitary group/ clarity in the law and regulations

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Summary of Corporate Feedback on Unitary Combined Reporting

- Other Negative Impressions about UCR
  - Administrative burden on taxpayers and government in return preparation, compliance, enforcement, and legal challenges
    - Significant new burden to compute multiple tax bases with lack of uniformity in apportionment rules even among UCR states makes filing extremely complex and cumbersome
    - New rules and complexity leads to increased legal challenges
  - Administrative burden on government in developing clear regulations, enforcement, and legal challenges
    - Emphasis on engaging with business community; dissatisfaction with unclear, incomplete laws
    - The Tax Department would need significant new staff resources
  - Decision to transition to unitary system must not be rushed
  - Inclusion of transitional period and rules that allow a time-limited deduction for those for businesses who see increased tax liability under unitary combined rules
  - Competitive disadvantage with MD, NC, and other southeastern states
  - Tax instability undercuts VA's business climate

8

Current Virginia Corporate Tax System Overview

- Summarizing the slides that follow, major issues raised were:
  - Flexibility in methods of filing
  - Apportionment
    - Single sales factor approach
    - Market based sourcing
  - Business interest deduction
  - Need for broader reform

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Current Virginia Corporate Tax System – Filing Options

- Virginia allows affiliated groups to elect one of three filing options:
  - separate (default), consolidated, and Virginia combined.
- Respondents were supportive of having this option
  - Assists in bringing in new economic development prospects
- However, was strong concern about 20-year limit before the initial filing election can be switched.
  - 5 to 7 years suggested as more appropriate for current dynamics of business decisions.

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Current Virginia Corporate Tax System – Apportionment

- A number of respondents raised the issue of changing apportionment of corporate income to single sales factor (SSF) apportionment.
- Generally, VA apportions corporate income based on the proportion of payroll, property, and sales attributable to VA.
- However, VA gives manufacturers and retailers the option to use a single factor sales formula in place of the default.
  - Respondents in those industries supported this option, noting that such a formula allows expanded employment and investment without additional taxes.
- Several responders supported expanding single sales apportionment to other industries as well.
  - Roughly 30 states use the single sales factor method
  - Within an affiliated group, different corporations may be subject to different apportionment factors.
  - Some suggested out of state corporations may be taxed more under SSF and in-state corporations less.
  - Important for service corporations and government contractors

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Current Virginia Corporate Tax System – Sourcing

- Sourcing refers to the method used to determine which sales of services are attributable to a state and is, generally, either cost of performance or market-based
- VA uses the cost of performance approach where the sale is sourced to the state where the income producing activity is performed
- Roughly 30 states use market-based sourcing where the sale is sourced to the state where the customer uses the services
- Some respondents suggested adopting the market-based approach, in whole or in part
  - When two states apply different approaches, double taxation of sales may result
    - Corp. Exec. Bd. Co. v. Va. Dep't of Taxation, 2019 Va. Lexis 6
  - For certain service sector businesses, the cost of performance approach may result in all sales being sourced to Virginia.
- Others preferred adopting specific rules for certain industries as a way to balance potential disparities
  - government contractors, for example, may be disadvantaged by market-based sourcing; internet service providers may be advantaged

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Current Virginia Corporate Tax System – Interest Deduction

- The federal Tax Cuts and Jobs Act imposed a limitation on deducting business interest expenses.
  - Sec. 163(j) limitation
  - In response, Virginia added a new deduction for 20% of the interest expense disallowed under the new federal rule.
- Respondents expressed concern that the 20% 163(j) add back that VA filers can deduct applies on a separate legal entity basis and there may be disparities between state treatment and the federal consolidated return.
- Some suggested either fully decoupling from the federal limitation or following the federal method more closely.

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Current Virginia Corporate Tax System – Comprehensive Reform

- The last major corporate tax reform was in the early 1980's
  - This has promoted stability and predictability overall, but also means certain provisions may be outdated
- Respondents broadly indicated that while they supported this consistency, the system may not be ideally suited to today's economy.
- Respondents suggested looking at the entire corporate tax structure as opposed to mandatory unitary combined reporting in isolation. In addition to apportionment, sourcing, and issues covered in prior slides, concerns included
  - Codifying intangible holding company addback budget language
  - Statutory definition of Virginia net operating loss
  - Treatment of pass-through entities
  - Updated regulations to reflect years of Virginia Tax guidelines

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Questions and Discussion

Thank you for your feedback and participation.

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<u>HJR 563 Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes:</u>

<u>Corporate Feedback Submissions for August 16, 2021 Meeting</u>

1. **Lori Nieto - Northrop Grumman Corporation**
    - Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;
        - Section 163(j) limitation is typically calculated at a unitary combined level, not a separate entity level, which is in line with federal consolidated reporting. However, Pennsylvania is a separate reporting state, and PA Corporation Tax Bulletin 2019-03 provides a threshold that companies are not expected to limit separate company interest expense if there is no Sec. 163(j) limitation in the federal consolidated group. PA's law exemplifies that unitary combined reporting is not necessary to achieve results consistent with federal consolidated reporting.
        - Intercompany transactions, including intercompany interest expense, are generally eliminated under unitary combined reporting and thus do not require related member add back adjustments. This is consistent with federal consolidated reporting.
    - Two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files;
        - Attribute tracking can be very complex in unitary combined states with separate company limitations (credits/NOLs). IRC Section 482 limits and SRLY calculations are complicated and present tracking challenges. Treatments of tax attributes vary between the unitary combined states.
        - Mandatory worldwide can present challenges adjusting CFCs E&P to a federal taxable income basis. Water's edge 80/20 criteria for CFCs and domestic incorporated companies with foreign activities vary between the unitary combined states. Unitary combined groups consist of different members resulting in lack of consistency between the unitary combined states.
    - Two most preferred provisions of Virginia's corporate tax structure in determining tax liability;
        - The single sales factor apportionment for manufacturers does not penalize in-state companies for investing in VA manufacturing assets & facilities while expanding the VA workforce payroll & benefits. VA based companies have placed reliance on the state's steady tax structure.
        - Predictability in decisions that have already been made based on the current company's reporting method and company structure impact future business and ability to remain competitive so we can bring more jobs and revenue to the state. The Aerospace & Defense industry is required to forecast detailed costs, including state income taxes, at least 5 years in advance to establish future rates with our customers. A major change to any state's tax system, like Virginia's contemplated unitary combined reporting, would result in a detrimental impact to our ability to forecast accurately and deliver expected results.

- Two most problematic provisions of Virginia's corporate tax structure in determining tax liability.
  - VA is the only state I am aware of that limits requesting permission to change a reporting method to once every 20 years only if certain criteria are met, and only with Tax Commissioner's permission. This archaic law needs to be modified to remove the 20 year requirement and the limiting criteria.
  - Sec. 163(j) limitation applies on a separate legal entity basis under VA combined reporting even when there is no Sec. 163(j) limitation in the federal consolidated return. This lack of conformity can deliver distortive results to highly solvent companies.

2. Ellen Berenholz - Comcast

- Note: Comcast appreciates the opportunity to provide input from our experience as a taxpayer to the Unitary Combined Corporate Reporting (MUCR) Workgroup. Attached please find a summary of two issues we believe should be considered and ultimately incorporated should the legislature transition the Commonwealth's corporate taxation law to MUCR. Since the workgroup created by HJR 563 was mandated to focus on unitary combined reporting, our comments are limited to our experience with that methodology. For this reason, we have not addressed any specific elements of the existing statute (such as how the MUCR base will be apportioned to the Commonwealth), but please note that the current corporate tax filing regime has certainly long been a significant competitive factor to VA consistently being at the top of the list of the best states in which to do business.
- Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - Worldwide Combined Reporting – Default methodology:
    - Several states which require MUCR allow a worldwide filing methodology (e.g., CA, CT, NJ and MA). Worldwide reporting simply includes all income, no matter where generated, as the starting point for the tax base computation. We believe worldwide makes the most sense from both an accuracy and administrative ease perspective; and is also necessary to not run afoul of Constitutional prohibitions of discrimination against foreign commerce. Comcast (as does most any public company) reports its worldwide income in its annual SEC filings and this publicly available information would be the starting point for return filings before any book/tax adjustments are applied. Worldwide reporting eliminates potential controversies between taxpayers and tax administrators over which entities are "in or out" of an affiliated filing group, how the 80/20 or tax haven rules apply, and disputes over the most controversial flavor of intercompany transactions, those with foreign affiliates. Accordingly, we believe that worldwide combination of an affiliated group should be the default MUCR unitary group methodology with water's edge combination available for taxpayers via an election.

- NOTE: For the informational report mandated to be filed on or before July 1, 2021, Virginia used a waters-edge definition of the unitary group. So those informational reports do not include any foreign corporation (organized or incorporated in a foreign country) if the foreign corporation's average property, payroll and sales factors outside of the U.S. are 80% or more. Further, the informational report computations do not include the income of any foreign corporation whose income is not subject to federal income tax because of a United States tax treaty.
- We believe that the information report should capture both water's edge and worldwide, so that this body can issue a fully informed report.

o Depreciable or Amortizable Cost Basis and Date Placed in Service of Foreign Assets:

- Asset basis and date placed in service are two related issues that would require statutory clarity in the transition to MUCR because foreign companies that do not file U.S. federal income tax returns would not have established depreciation or amortization protocol for U.S. tax purposes at the federal level. However, if a unitary group of corporations has already filed on a worldwide combined basis in the U.S. at the state level, it has established basis and asset life protocol in states in which it has filed. California has enforced worldwide combined reporting by unitary groups (while allowing a water's edge election) as long as or longer than any other state, and its case law, statutes and regulations are more detailed and comprehensive than any other state with regard to worldwide combined filing. To avoid the inevitable controversies around depreciation or amortization with regard to foreign members' assets, we suggest that Virginia allow such groups to simply use basis and asset life already in use by the group for state income tax purposes as reported in California. If a group has not filed in California, then another state in which the group already files on a worldwide combined basis.
- To be clear, the purpose of this provision is to avoid disputes regarding date placed in service and original cost. This would not change the deprecation method or life the Commonwealth requires for these foreign assets. The below suggested provision provides a safe harbor for the starting point of the deprecation or amortization computation. For example, if a unitary group has a foreign 5-year asset that was placed in service in the year 2012, depreciation in Virginia for that foreign asset would be $0.
- Suggested Statutory Language:
  - *THE DEPRECIABLE OR AMORTIZABLE COST BASIS AND DATE PLACED IN SERVICE OF FOREIGN ASSETS SHALL BE THE SAME AS REPORTED ON THE WORLDWIDE COMBINED INCOME TAX RETURN FILED FOR 2019 IN CALIFORNIA, OR, IF THE GROUP HAS NOT FILED IN*

CALIFORNIA, IN ANOTHER STATE IN WHICH THE GROUP HAS FILED IN 2019 ON A WORLDWIDE COMBINED BASIS.

3. Gary Tappana - Anheuser- Busch

- Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - We have not found unitary combined reporting to have much in the way of preferred provisions and we reserve comment at this time.
- Two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - Lack of Factor Representation.
    - Lack of factor representation related to foreign income. If foreign income is included in the tax base, related factors should be in the apportionment factor as well. For example, if a state includes foreign dividend income in the tax base, the foreign factors of the entities generating the dividends should also be included in the apportionment data.
  - Multiple Tax Bases & Administrative Complexity.
    - Multiple computations of tax due (i.e. having a tax regime of paying the greater of two tax computations or paying a tax based on income plus a tax based on net worth). Closely related is the extreme administrative complexity involved in unitary combined reporting which may result in a return over a thousand pages long.
- Two most preferred provisions of Virginia's corporate tax structure in determining tax liability;
  - Single Sales Factor.
    - Single sales factor apportionment methodology for manufacturers, so the state doesn't penalize manufacturing companies located in the state relative to other less property and/or payroll intensive companies which are not located in the state.
- Two most problematic provisions of Virginia's corporate tax structure in determining tax liability.
  - Interest Expense Disallowance.
    - The federal limitation on interest expense does not translate well to the state tax level, causing a number of unintended consequences. A number of states have decoupled from federal 163(j). A positive change to tax policy in Virginia would be to fully decouple from federal IRC 163(j).

4. Tim Winks - Ferguson Enterprises

- Note: The following comments represent my own personal views as a citizen of Virginia and someone profoundly interested in maintaining prudent state tax policies that will help Virginia retain its hard-earned status as a great place to do business. They do not represent the official views of my employer, Ferguson Enterprises, LLC ("Ferguson").

- Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;
    - Ferguson's experience with combined reporting across the U.S. is that it does not materially impact the company's bottom line corporate income tax liability compared to separate reporting. For instance, the pro forma Virginia combined reports that Ferguson recently submitted for taxable year 2019 reflected a small decrease in Virginia tax compared to the company's current consolidated filing methodology. However, the savings would have been immaterial to financial results and any benefit going forward may be outweighed by other considerations, such as the added complexity of combined reporting or its possible negative impact on the vibrancy of Virginia's business community as a whole.
- Two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files;
    - Combined reporting could pose a severe risk to Virginia's reputation for stable and predictable tax reporting and administration. The actual risk will be heavily dependent upon how the General Assembly and Department of Taxation design and implement a combined reporting regime. If Virginia chooses to go this route, a studied and cautious approach would be advisable, one which seeks to preserve the best of our current structure and tax administration philosophy while carefully listening to and learning from stakeholders in order to avoid the mistakes other states have made. To be avoided are overly complex forms, procedures which result in adding multipliers to current return preparation time, inadequately tested compliance software, rules/procedures that result in unduly lengthy returns, unclear regulations (or none at all) and taxpayer communications, insufficient consideration of "transitional provisions" to bridge from the current regime to a combined reporting regime, and ill-prepared auditors, just to name a few.
    - If combined reporting comes to pass, the General Assembly and Executive Branch should also resist the urge to do it on the cheap. Combined reporting will represent a huge challenge for the existing staff and resources of the Department of Taxation, as well as the Office of the Attorney General, and their staffing and funding needs should not be underestimated. Among other things, there should be sufficient funding for Department representatives to hold focus group meetings with stakeholders and travel to other combined reporting states to learn firsthand what has and hasn't worked in terms of form design, systems development, taxpayer education, policy and regulation development, auditing procedures, auditor and customer service training, communications strategies with the business community, etc. Likewise, the Department should be given a long runway to implementation -- two years at a minimum and ideally more -- in order to hire and train needed new staff, develop comprehensive regulations (not mere guidelines), and otherwise prepare for a change of this magnitude.
- Two most preferred provisions of Virginia's corporate tax structure in determining tax liability;
    - Virginia has a long-held and well-deserved reputation in the global marketplace as a good place to do business, which has been driven in large part by the

consistency and predictability of the state's tax structure and tax administration. Unlike many states in the Northeast, Industrial Midwest, and Pacific Coast, the Commonwealth has resisted the urge to constantly tinker with its corporate tax structure in a way that erodes business confidence, tars the state's reputation, and negatively impacts future business investments. Separate reporting has been one the hallmarks of Virginia's tax policy for decades, not to mention a key marketing point to economic development prospects, particularly as states in other parts of the country have enacted mandatory unitary combined reporting and earned hard-to-lose reputations as bad places to do business. The Southeastern states with which Virginia competes most heavily for economic development have likewise resisted the urge to enact combined reporting, and retention of separate reporting will help continue to keep Virginia competitive with the likes of North and South Carolina, Georgia, Florida, and Tennessee. Another underappreciated aspect of Virginia's tax structure is that there have only been six Tax Commissioners since 1927, almost all of whom have served under Governors of both parties. This degree of stability and non-partisanship is in stark contrast to other states where chief tax administrators typically change with each gubernatorial administration.

- Two most problematic provisions of Virginia's corporate tax structure in determining tax liability.
    - While the consistency of Virginia's tax policy has been a blessing, it may too be a curse in that it has kept the Commonwealth from considering much needed structural changes that our competitors in the Southeast have more fully embraced and aggressively used to drive economic growth at Virginia's expense. The last comprehensive overhaul of Virginia's corporate income tax structure occurred in 1981 when the Commonwealth was a model for the nation, but four decades of inactivity later we are left with a very dated system that simply doesn't reflect 21st Century economic and competitive realities. These realities beg a comprehensive reconsideration of the entire corporate tax structure as opposed to simply looking at combined reporting in isolation. Otherwise, Virginia will remain at a competitive disadvantage to other Southeastern states and continue to lose investment and jobs that should rightfully be ours.
    - Unlike combined reporting, which creates disadvantage for some and advantage for others, there are tried and true ideas adopted by a majority of the states that hardly make losers of anyone, while at the same time incentivizing state economic growth virtually across the board. The two opportunities that stand out are (1) use of the "single sales factor" method of apportionment for all businesses (Virginia currently just allows this for manufacturers and retailers), and (2) replacing the obsolete "costs of performance" method of determining the taxable income of service businesses with the "market sourcing" method for most, but not all, such businesses.
    - Single Sales Factor
        - Virginia continues to utilize outdated "three-factor" apportionment to determine how much of the income of a multi-state business should be assigned to the Commonwealth, i.e., the total income of the business is

assigned to Virginia on the basis of instate property, payroll, and sales over total property, payroll, and sales everywhere, with sales counting twice in the equation. This antiquated approach creates a disincentive for companies to make new investments in human or physical infrastructure as such investments will lead to a higher Virginia tax bill. But at the same time, companies that exploit the lucrative Virginia marketplace likely pay much less in tax than their sales in Virginia might reasonably suggest – for example, a North Carolina company with 40% of its sales in Virginia, but no jobs or facilities here, will only pay Virginia tax on 20% of its income, while a Virginia company in the opposite situation will pay North Carolina tax on 40% of its income.

    - The more modern approach, adopted by 28 states including Virginia's key economic development competitors Georgia, North Carolina, and South Carolina, is to use a "single sales factor" where multi-state income is apportioned solely on the basis of a company's sales into the state over total sales everywhere. This would eliminate the current Virginia disincentive for adding jobs and investment, meaning that a company can add thousands of jobs or millions in investment without increasing its Virginia corporate income tax bill, while at the same time promoting tax equity by taxing out-of-state businesses exploiting the Virginia market commensurate with what they earn from Virginia customers (in the above example, the North Carolina company would now pay Virginia tax on the entire income derived from Virginia customers, not just half).

- Market Sourcing
    - Virginia's outdated apportionment methodologies are particularly harsh as applied to businesses in the services sector, e.g., technology and financial services companies, where obsolete "cost of performance" rules require income to be sourced based on the location where services are performed. As a result, if a business performs its service more heavily at Virginia locations, then all receipts are sourced to Virginia, even though the services may be sold to customers around the US or the World. This is patently unfair to such businesses as Virginia can tax close to 100% of receipts while other states are taxing the very same receipts based on the location of the customer (the aforementioned "market sourcing") – a very real double tax situation -- and represents a huge disincentive for any service business to ever again locate or expand in Virginia.
    - In an increasingly service-based economy it is imperative to replace a 1950's methodology with one that works in the 21st Century and will help reposition Virginia as the best place for service enterprises to do business. 34 states have already adopted market sourcing, including North and South Carolina, Georgia, Florida, Tennessee, DC, and Maryland. The problem is particularly acute in Northern Virginia where a company can save tax dollars merely by moving across the Potomac.

        - At the same time, however, market sourcing may not be the best answer for all service businesses – government contractors, for example, which are so critical to the economies of Northern Virginia and Hampton Roads – and It may be necessary to craft specific rules for certain select industries to help ensure that Virginia remains as competitive as possible.
- Summary
    - If Virginia is to consider combined reporting, then too it should consider other structural changes that are potentially more beneficial for a wider swath of the business community and will put Virginia more in the mainstream, not just nationally but in the critical Southeastern region where the Commonwealth competes for new jobs and investment and in the National Capital region where corporate tax rules for technology and other service businesses are less favorable than across the Potomac in DC and Maryland. A more comprehensive approach to corporate income tax restructuring is all the more critical as some of our competitor states roll out even more powerful economic development strategies, including but not limited to North Carolina slashing its corporate income tax rate to less than half of Virginia's.

5. Glen Page - HCA Healthcare

- Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;
    - Clear ownership rules i.e. direct and indirect ownership greater than 50% and combined group only includes entities taxed as corporations under federal classification rules.
    - Clear adherence to IRC §1502/§1.1502 regulations.
- Two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files;
    - Dividend haircuts (i.e. California insurance company dividend received deduction, Colorado – foreign dividends treatment).
    - Not following IRC §1502/§1.1502 regulations.
- Two most preferred provisions of Virginia's corporate tax structure in determining tax liability;
    - NOL Treatment (i.e., use of historical federal NOLs).
    - Nexus consolidated/combined elections under current law.
- Two most problematic provisions of Virginia's corporate tax structure in determining tax liability.
    - Taxed on net addition modifications.
    - Bonus depreciation treatment.

6. Ken Wright - Smithfield Foods

- Note: The following comments represent my own personal views as a Virginia resident and state and local tax professional. They do not represent the official views of my employer, Smithfield Foods, Inc.

- Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;
    - Optional combined or separate filing. Many states, like Virginia, allow for companies to elect the manner of filing – combined or separate. This is a much-preferred method than mandatory unitary combined reporting.
- Two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files;
    - Lack of stability.
        - A stable tax environment is a very important factor for businesses looking to locate or invest in a state. Businesses are looking for a welcoming tax environment but also an understanding that the environment will not change drastically. Changing to mandatory unitary combined reporting is a major shift in tax policy that creates disruptions in business operations in a state and will require the Department to devote a vast amount of resources to implement such a change. Policy changes like this create winners and losers, and losers will face an increased tax burden for little to no actual benefit.
    - Adoption of MUCR.
        - Adoption of mandatory unitary combined reporting in Virginia would penalize Virginia companies for expanding and growing around the country. If a company that is heavily invested in Virginia wants to expand through acquisitions in other states and create new jobs in Virginia as a result, mandatory unitary combined reporting could create disincentives for making these types of investments. Virginia ranked #1 in CNBC's America's Top Business States in 2019 and 2021 with its current tax regime. As competing states lower corporate tax rates and offer other incentives to attract more businesses, Virginia, if it switched to MUCR, would not be considered as business friendly.
- Two most preferred provisions of Virginia's corporate tax structure in determining tax liability;
    - Stable tax policy.
        - Virginia is known to be a stable tax environment, not subject to big shifts in tax policy. That characteristic is one of the factors that makes Virginia a great place to do business. Companies that have invested here and created jobs knew the rules when they did so, and it would not be fair to those corporate citizens to change the rules of the road on tax policy.
        - The corporate income tax accounts for $1 billion in revenue for the state, and it has been a relatively steady source of income for the Commonwealth. It would be risky to make a change that has unknown implications on the stability of this important revenue source. It would be even worse to make this change to MUCR, see corporate tax revenue decrease as a result (as some states have seen), and then come back and try to increase the corporate tax rate to make up for lost revenue.
    - The lack of mandatory unitary combined reporting.

        - The lack of mandatory combined unitary reporting makes Virginia a good place to do business and keeps us competitive with our neighbors. Virginia's current tax regime is considered business friendly and is partly responsible for its #1 Top Business state rating.
- Two most problematic provisions of Virginia's corporate tax structure in determining tax liability.
    - Limitations on 163(j) Deductions.
        - Following the federal Tax Cuts and Jobs Act (TCJA), Virginia imposed a new limit in interest expense that Virginia corporate taxpayers could deduct. Prior to the TCJA, companies could deduct interest expenses as a business expense. While other states have continued that policy, Virginia has limited that deduction for Virginia corporate taxpayers while also not allowing bonus depreciation deductions. This change in tax policy has been an effective tax increase for many Virginia corporate citizens.
    - Virginia's Tax Rate Relative to Competitor States.
        - Virginia's corporate tax rate is over twice that of its primary competitor's rate of 2.5% (North Carolina). Virginia companies have moved their headquarters to North Carolina as a result (e.g., Advance Auto Parts).

7. William Rowe - Virginia Manufacturers Association

- Note: Because Virginia Manufacturers Association is a trade association representing Virginia's 6,750 manufacturers and suppliers, each of which has its own experience, VMA is not able to provide the specific information you requested. Nevertheless, VMA hopes the following observations will be helpful to you and the General Assembly.
- Unitary Combined Reporting.
    - Although a few corporations may prefer unitary combined reporting, VMA believes the great majority do not. Virginia's current reporting method for corporations is relatively simple for both taxpayers and tax administrator. Unitary Combined Reporting is not. There are numerous cases in both state and federal courts litigating the application of Unitary Combined Reporting, while the number of litigated Virginia corporate income tax cases over the last 40 years is relatively small. Changing to Unitary Combined Reporting would represent a great cost increase for all concerned and require the appropriation of significant additional resources to the Virginia Department of Taxation to analyze and implement any change to Unitary Combined Reporting.
- Complex Issue Requiring Careful Study, More Time and Resources.
    - Converting to Unitary Combined Reporting is not a simple matter of changing the form of the income tax return. Rather, it will require careful analysis of how such a change will affect every aspect of Virginia's corporate income tax and its application to members of the corporate community. This, in turn, will require significant additional resources from the Virginia Department of Taxation and significant additional time. States that have made this change have taken years to do so.

- Particular issues.
    - Just one meeting of the Workgroup identified a number of problems with Virginia's corporate income tax, e.g., apportionment, NOL's, irrevocable election as to filing method, and others will certainly be identified in this on-going process. Of special importance is how Virginia apportions the income of its services and government contracting sectors which are currently subject to double taxation because of the different ways Virginia and other states apportion income. The General Assembly has addressed the apportionment problems for manufacturers with the adoption of optional single sales factor apportionment. Either as part of the Unitary Combined Reporting study or otherwise, similarly fair apportionment needs to be provided for Virginia's important services and government contracting sectors.
- Economic Development.
    - The single most important reason for not adopting Unitary Combined Reporting is that doing so would undermine Virginia's economic development efforts. Virginia's competition for new business is primarily in the Southeast United States where states do not have Unitary Combined Reporting. Following the lead of states like California, which use Unitary Combined Reporting and are losing businesses, is not the path for Virginia. Virginia has attracted many new corporate headquarters and significant corporate investment in recent years, and the Commonwealth's current corporate income tax system was an important factor in their decisions. It would be unfair to these corporations to change the fundamental tax fact on which our new partners made their decisions.
- Conclusion
    - In conclusion, there are aspects of Virginia's corporate income tax which merit consideration and change, but changing to Unitary Combined Reporting is not one Virginia should adopt, and certainly not without much more study and consideration than is possible in the brief time available to the Workgroup.

8. Michael Carchia - Capital One

- Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;
    - Unitary group filing as a single entity, using federal consolidated return rules to calculate taxable income.
        - The theory behind adopting unitary combined filing is to treat the group of corporations as a single economic enterprise. Accordingly, taxable income and apportionment should be calculated consistent with this theory. This should be the easiest way to calculate taxable income, especially if the entities use the federal consolidated tax return rules as Virginia currently requires under its elective consolidated return filings. Adopting the method of calculating taxable income as currently used by Virginia for its consolidated return filing would also be the easiest way for the Department of Taxation to move to unitary combined filing since it would minimize the number of changes necessary for the Department.
    - Sharing of losses and credits among members of the unitary group.

        - Tax attributes such as tax losses and tax credits should be easily shared among the members of the group. Failure to share losses and tax credits among members of the group is a disincentive for companies to invest in Virginia because it increases the likelihood that a company may not be able to utilize the tax credits or losses.
- Two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files;
    - Not allowing taxpayers to elect whether to file using unitary combined return or separate returns
        - Unitary combined filing should be an election rather than mandatory. This would enhance Virginia's status as one of the best states for businesses to locate. While Virginia technically allows an election to file among its current separate, nexus combined and nexus consolidated filing methods, the election is binding for 20 years and it is prohibitively difficult to change methods. A more reasonable period for binding taxpayers to the election, such as 5 or 7 years, is a much better alternative.
- Two most preferred provisions of Virginia's corporate tax structure in determining tax liability;
    - Using federal consolidated return rules to calculate taxable income under the Virginia consolidated return method
        - Using the federal consolidated return rules to determine taxable income for the unitary group is as Virginia currently does under its consolidated return method is preferable. Taxpayers already have this calculation completed for its federal tax return. While there may be some differences in the entities included in the federal and Virginia returns, making adjustments to account for those differences should be easier than using a different method for calculating Virginia taxable income.
- Two most problematic provisions of Virginia's corporate tax structure in determining tax liability.
    - Apportionment for mixed factor companies is very complicated and time consuming to calculate.
        - As we discovered while completing the Virginia pro forma combined return in June, the method to combine apportionment for groups of corporations that use different apportionment methods is very difficult. Our compliance team spent more time calculating those factors than on any other segment of the pro forma filing. While we understand the purpose of the method, it is a challenge to complete.
    - Overall apportionment methodology for services companies.
        - Virginia should use this workgroup to review its apportionment methods overall. Virginia's current apportionment method, especially for services companies, creates a significant disadvantage for Virginia companies versus other states. Most states have moved toward using customer based sourcing for most services. The costs of performance method utilized by the Commonwealth puts Virginia based companies at a competitive disadvantage compared to similar companies located in

other states. See, e.g., The Corporate Executive Board Co. v. Virginia Dept. of Tax'n., 822 SE2d 918 (2019).

9. Allison Malloy - Verisign

- Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;
    - Apportionment rules.
        - Most states who adopt mandatory unitary combined reporting have also changed their rules to calculate apportionment based on sales (adoption of market-based sourcing for sales of services).
        - For example, when New Mexico adopted mandatory combined reporting in 2019, it also adopted market-based sourcing for sales of other than tangible personal property. When New Jersey adopted mandatory unitary combined reporting in 2018, it also adopted market-based sourcing for sales of services. In 2014, when Rhode Island adopted mandatory combined reporting, it also adopted single sales factor apportionment and market-based sourcing for sales of other than tangible personal property.
        - Adoption of mandatory unitary combined reporting without also transitioning to market-based sourcing would be extremely unfair and punitive to Virginia companies that sell services over the Internet.
- Two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files;
    - Unfairly attributes income (and losses) in another state to the taxing state.
        - The general concept is that income earned in a state should be taxed by that state. MUCR throws out that concept by including income (or losses) earned in State B on the State A's corporate income tax return, whether or not there is any connection to State A. This can lead to very different (and unfair) results for different companies based on their unique circumstances. For example, a company that is very profitable in State A could end up paying no taxes to State A under MUCR because it has an unprofitable subsidiary in State B. Alternatively, a company that is trying to get profitable in State A may see its tax liability jump up in State A for no other reason than because it is part of a unitary group with a company in State B.
    - Inconsistent rules between states.
        - MUCR rules are not "one size fits all". There is no consistent set of rules that can be simply applied across all state compliance – this increases the amount of time to prepare and file returns that were most likely simpler to file.
    - Difficulty with audits.
        - Audits last longer and can be more involved and costly. Post 2017 Tax Cuts Act, the avalanche of new Federal rules and regulations is still being sorted out at the state level. The combination of already inconsistent MUCR rules among states, and shifting guidance increases

the workload for tax departments that are already expected to perform at high levels with low staffing.

- Two most preferred provisions of Virginia's corporate tax structure in determining tax liability;
  - Filing status.
    - Currently, taxpayers may elect to file on either a consolidated or separate basis where the separate legal entity of each member of the combined group is respected and taxes are calculated separately, thus sparing entities with no nexus the burden of taxation. There are already several protections in place in Virginia to prevent companies from gaming the system. Companies may only change their method of filing (consolidated to separate or vice versa) if they meet certain criteria designed to prevent taking advantage of the system. Also, contrary to what some believe, Virginia has fixed the issue of intellectual property shell corporations and intangible holding companies, so companies are prevented from gaming the system in this manner, as well (See Item 3-5.09 in the 2021 Budget – Chapter 552). Lastly, the Virginia Tax Department has tools to determine and correct if companies are engaging in intercorporate transactions designed to reduce their tax liability. See § 58.1-446. These provisions have already addressed many of the reasons that caused other states to adopt MUCR and means that MUCR would be more disruptive than helpful to Virginia.
  - Low Taxes.
    - Virginia is a relatively low tax jurisdiction, compared to other states – this has mitigated the competitive edge that other states might have in attracting corporate headquarters and growing a particular state's economy. The ability of corporations to file using consolidated or separate basis also makes Virginia attractive to companies looking to locate or expand because they know that income from around the country will not be unfairly taxed in Virginia.
- Two most problematic provisions of Virginia's corporate tax structure in determining tax liability.
  - Regulations.
    - The Department has not issued new regulations for many years, rather they have issued guidelines which are open to interpretation. To obtain clarity on existing guidance, taxpayers are often left to request a ruling on specific issues, and at times the Department of Taxation either cannot or will not rule on the specific requests which leaves the Taxpayer at risk during an audit. The promulgation of new regulations will require significant resources that the Department does not currently have, and take resources away from other needs such as rulings and appeals.
  - Apportionment Calculation.
    - Virginia calculates its apportionment percentage using the Cost of Performance methodology for service providers which assigns 100% of sales to Virginia if the majority of the revenue generating activities take place within the state. This can and does cause taxpayers to pay more

than 100% of their share of taxable income (i.e., double taxation) as many other states have adopted market-based sourcing or single sales factor sourcing, thus leaving Virginia based taxpayers paying tax on 100 percent of their nation-wide sales to Virginia in addition to paying tax to other states based on their sales. This makes Virginia an unattractive jurisdiction for companies that sell services over the Internet. Such a company would be better off (from a tax perspective) by locating in Washington, D.C., or Maryland, even though those states have higher corporate tax rates, because they have adopted market-based sourcing.

  - Net Operating Losses.
    - The Code of Virginia has never contained a provision which creates a Virginia NOL. The Department has created administrative positions (e.g., regulations and rulings) regarding the application of the federal NOL in a Virginia context.
  - Nonbusiness income / business income.
    - Virginia currently has no provision for nonbusiness income. Rather, the Code of Virginia creates an unconstitutional assessment when a taxpayer has income that meets the requirements of US Supreme Court rulings such as Allied-Signal. This forces the Department to address constitutional issues at an administrative level.

10. Jon Elder - Dollar Tree

- Note: The comments below are my individual views and not the official views of my employer, Dollar Tree Inc. Most of my experience with Virginia has been with companies filing nexus consolidated returns and this experience is the driving force of my views detailed below.
- Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - In theory, combined reporting can be simple. Starting with the federal group one makes the required state modifications and apportions the income to determine the tax liability. Since all the income of the unitary group is reported, there is less risk of controversy with the state taking a position that income is not fairly derived. If the state leverages the federal return from a reporting standpoint, the individual state specific return forms can be simple and straight forward. Likewise leveraging the federal income calculation as much as possible reduces the uncertainty associated with how to calculate the state tax liability. For example, OR, NE, and NM all have very simple returns. Unfortunately, few states actually adopt this simple approach and many take a more complicated path (e.g., NY, CA, and MA).
- Two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - In practice, many states ask for substantial amounts of entity specific detail that makes the return preparation very complex. Most of the information can be found on the federal return, so it would be ideal to leverage the information already available. If you adopt unitary combined reporting Virginia should take

special care to make the returns easy to prepare and the tax calculation clear and easy to administer. The more arbitrary information requested, the more time it takes for the business community to prepare and for the state to manage. In addition, if unitary combined reporting is adopted, then the state modifications should be calculated on a unitary basis. Currently, the method used by Virginia to apply the new Section 163(j) interest expense limitations are unnecessarily complex. Following the federal calculation would be much simpler for the taxpayer and the state.

- Two most preferred provisions of Virginia's corporate tax structure in determining tax liability;
  - Virginia has allowed taxpayers a great deal of flexibility when starting operations in Virginia by allowing companies the election to file separate, nexus consolidated or nexus combined. Not many states allow this type of flexibility which is to be applauded. The drawback with this provision is that once this election is made, changing it can be very difficult. Currently one can only change this election after 20 years of filing and only if certain criteria are met. It is hard to forecast a few years, let alone 20.
  - Virginia's tax rate has been steady for many years and is a moderate tax rate when compared to all 50 states. When compared to many states in the Northeast and West, the Virginia 6% rate is very competitive. The Southeastern states are a different issue and one Virginia should consider carefully. Many of the states that Virginia competes for business with including NC, SC, GA, and FL have lower rates. Another point to consider regarding the corporate tax rate is states that have passed or considered mandatory Unitary Combined Reporting have included lowering their tax rates at the same time to try and remain competitive with other states.
- Two most problematic provisions of Virginia's corporate tax structure in determining tax liability.
  - Over the past 20 years, many states have converted their apportionment calculations to a single sales approach. No longer is the three factor formula developed with UTIDPA the dominant taxing formula for multistate companies. Single sales factor is used by approximately 35 states, with additional states adopting this approach on an annual basis. Virginia has changed to the single sales factor apportionment for certain industries over the past 10 years. But it has done so surgically leaving other businesses to use the old UTIDPA three factor formula with double weighted sales. Unlike many states that have combined or consolidated filing requirements, Virginia requires each legal entity to determine the apportionment methodology to be used. Even if a consolidated group is predominantly one business, retail or manufacturer, they can be forced to use the mixed apportionment rules that Virginia developed many years ago. These rules are very complex and provide results that encourage investment and employment outside of Virginia.
  - Impact on Virginia Businesses
    - The more property and payroll in Virginia, the higher the tax these businesses will pay relative to competing companies outside Virginia. Adopting the single sales factor for all businesses would benefit

Virginia headquartered businesses and allow them to compete better with non-Virginia based companies.

- A subsidiary issue to the sales apportionment factor is Virginia's continued use of the cost of performance for sourcing sales. Over the last 20 years, many states have adopted market sourcing which apportions sales to the customer's location. Virginia's cost of performance rule requires the sale to be sourced where the work is performed. This provides a substantial advantage to companies headquartered outside of Virginia performing services to Virginia companies and a competitive disadvantage to Virginia companies doing work for out of state companies.

11. Tyler Henderson - Amazon

- Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - Attributes like credits and NOLs shareable among the group.
  - Flexibility in determining group composition (i.e., allowed to choose between water's edge, worldwide or federal consolidated).
- Two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - Intrastating of attributes (i.e., separate entity tracking for generation and use of NOLs and credits like in CA).
  - Special apportionment rules for entities operating in certain types of business lines (for example, motor carriers/logistics in IL).
- Two most preferred provisions of Virginia's corporate tax structure in determining tax liability;
  - Allowed a group filing option within what is still ostensibly separate reporting (like nexus-combined) because there is an administrative benefit compared to filing a separate return for every entity in the group.
  - Extension of PL 86-272 to services.
- Two most problematic provisions of Virginia's corporate tax structure in determining tax liability.
  - Separate entity nature of reporting requirements makes overall tax liability difficult to predict because of number of entities filing in state and variability of income and apportionment for each entity given investments in the state.
  - Separate entity reporting increases potential duration and friction of audits due to scrutiny over intercompany transactions and potentially leads to lengthy litigation (see, Kohl's Department Stores, Inc. v. Virginia Department of Taxation).

12. Tom Powers - JP Morgan Chase

- Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;

  - Single factor apportionment, applying multiple apportionment factors in a combined unitary return is difficult.
  - Consolidated election.
    - Any election to include all the member of your federal consolidated group
- Two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - Varying apportionment rules, different rules for different states.
  - Lack of clarity or guidance on apportionment and rules in general.
- Two most preferred provisions of Virginia's corporate tax structure in determining tax liability;
  - Filing separate tax returns for the legal entities is easier then preparing a combined return for an entire group.
  - The forms are easy to follow and relatively straight forward to complete.
- Two most problematic provisions of Virginia's corporate tax structure in determining tax liability.
  - Regarding the unitary filing the very compressed time frame to file. We are generally granted 6 month extensions and use every bit of that time to pull together information to complete the return and we are familiar with the rules and process. This was a whole new process that didn't need to be crammed into as tight a deadline as July 1st.
  - Other states have used a similar approach in preparing mock unitary filings and concluded it did not provide additional benefits. However, it's a huge burden on the taxpayer to prepare a second set of filings for the same tax year.

13. Karen Lint - Huntington Ingalls Industries

- Note: The following comments represent my own personal views as a citizen of the Commonwealth and do not represent the official views of my employer, Huntington Ingalls Industries, Inc. (HII).
- Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - HII files a nexus combined return in Virginia. My experience with unitary combined reporting states is that the rules are significantly more complex and difficult to comply with than the tax laws in states without mandatory combined reporting.
- Two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - From my perspective, it is the unitary combined reporting system itself that is problematic. While the adoption of unitary combined reporting does not necessarily result in higher tax revenues, the adoption of unitary combined reporting does result in a more complex and less business friendly state income tax system. A recent example is Kentucky, where unitary combined reporting was adopted effective with the 2019 tax year. It took my team many hours to prepare and efile this return. The return was extremely difficult to follow, some of the supporting schedules were virtually incomprehensible, and there were

almost thirty pages of validation errors when we generated the efile. It took several months to successfully efile this return. Prior to the 2019 tax year, our KY return was less than 30 pages. The 2019 KY unitary combined return was almost 300 pages.

- If Virginia does choose to be the first state in the Southeast to adopt unitary combined reporting, it should be after a thorough and careful study to be sure that the benefits of implementing unitary combined reporting outweigh the costs and the potential harm to the Commonwealth's reputation as a good place to do business. This is particularly important in light of the steps being taken by other states in the Southeast, such as North Carolina, to implement changes in their tax systems that make their state more attractive to businesses.

- Two most preferred provisions of Virginia's corporate tax structure in determining tax liability;
  - One of the things that I really like about Virginia's corporate income tax system is that it is relatively consistent and predictable in comparison with other states. Even when Virginia de-couples from federal tax law, it's done in a way that is not overly burdensome on businesses. For example, in de-coupling from federal bonus depreciation, taxpayers calculate state depreciation on assets under the normal federal rules. Our systems are already set up for those calculations so it's not as difficult and costly for us as having to calculate depreciation under a completely different set of rules for state tax purposes.
- Two most problematic provisions of Virginia's corporate tax structure in determining tax liability.
  - The last major reform of Virginia's corporate income tax structure was in the early 1980s and much has changed since then. Accordingly, I think it would be worthwhile to undertake a comprehensive study of our entire corporate tax structure and make changes that would align our taxing system with the current business environment and economy.

14. Kathleen Kittrick - Verizon

- Note: In our opinion, combined reporting is an administratively complicated process and the details are important and should not be left to interpretation or to "regulations". Clear definitions and policies should be spelled out in statute.
- Two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - Recommendation 1: Mitigate the Consequences of Significant Tax Law Changes By Providing ACS740 Relief.
    - The #1 most important provision that must be included in any combined reporting bill is a provision commonly referred to as ASC740 (Accounting Standards Codification 740) which seeks to mitigate the consequences of significant tax law changes on the financial statement reporting of publicly traded companies.
    - Companies record deferred tax assets and liabilities for financial reporting purposes under Generally Accepted Accounting Principles (GAAP) rules. The Internal Revenue Code and associated state rules for

recording income and expenses are often different from the GAAP rules for recording income and expenses. The different accounting methods typically result in the creation of tax assets and tax liabilities on the balance sheets of companies. Significant tax law changes—for example, a move to mandatory unitary combined reporting or the adoption of an entirely new tax structure—typically requires companies to re-compute the value of tax assets or liabilities they had previously recorded. The cumulative effect of that re-computation often requires companies to immediately record additional tax expenses under Accounting Standards Codification (ASC) 740, "Income Taxes." The recognition of those expenses may result in an immediate market adjustment of the company's stock price and value.

- The proposed policy has been adopted in many states that more recently enacted mandatory combined reporting statutes, including, CT, DC, MA, MI and NJ. Essentially the provision allows the recovery of book/tax differences through a deduction to be claimed in the future that can be spread equally over a specified period of time. By providing a reasonable schedule to allow the future deduction of the additional expenses triggered from any book/tax differences, Virginia could eliminate any financial reporting impact that may be required under ASC 740. We urge the Workgroup to adopt this policy and provide a deduction for the deferred tax impact for publically traded companies amortized over 10 years.
- Suggested language:
  - *SECTION (NEW). – Mitigation of financial statement impact on Publicly Traded Companies*
  - *(1) THERE SHALL BE ALLOWED AS A DEDUCTION AN AMOUNT COMPUTED IN ACCORDANCE WITH THIS PARAGRAPH.*
  - *(2) FOR PURPOSES OF THIS PARAGRAPH, "NET DEFERRED TAX LIABILITY" MEANS DEFERRED TAX LIABILITIES THAT EXCEED THE DEFERRED TAX ASSETS OF THE COMBINED GROUP, AS COMPUTED IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, AND "NET DEFERRED TAX ASSET" MEANS THAT DEFERRED TAX ASSETS EXCEED THE DEFERRED TAX LIABILITIES OF THE COMBINED GROUP, AS COMPUTED IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES.*
  - *(3) ONLY PUBLICLY TRADED COMPANIES, INCLUDING AFFILIATED CORPORATIONS PARTICIPATING IN THE FILING OF A PUBLICLY TRADED COMPANY'S FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, AS OF THE EFFECTIVE DATE OF THIS PARAGRAPH, SHALL BE ELIGIBLE FOR THIS DEDUCTION.*

- *(4) IF THE PROVISIONS OF THE ACT (XX) RESULT IN AN AGGREGATE INCREASE TO THE MEMBERS' NET DEFERRED TAX LIABILITY OR AN AGGREGATE DECREASE TO THE MEMBERS' NET DEFERRED TAX ASSET, OR AN AGGREGATE CHANGE FROM A NET DEFERRED TAX ASSET TO A NET DEFERRED TAX LIABILITY, THE COMBINED GROUP SHALL BE ENTITLED TO A DEDUCTION, AS DETERMINED IN THIS PARAGRAPH.*
- *(5) FOR TAX YEARS BEGINNING WITH THE COMBINED GROUP'S FIRST TAXABLE YEAR BEGINNING ON OR AFTER JANUARY 1 OF THE FIFTH YEAR AFTER THE EFFECTIVE DATE OF THE ACT (XX), A COMBINED GROUP SHALL BE ENTITLED TO A DEDUCTION FROM COMBINED GROUP MODIFIED INCOME IN AN AMOUNT UP TO ONE-TENTH OF THE AMOUNT NECESSARY TO OFFSET THE INCREASE IN THE NET DEFERRED TAX LIABILITY OR DECREASE IN THE NET DEFERRED TAX ASSET, OR AGGREGATE CHANGE FROM A NET DEFERRED TAX ASSET TO A NET DEFERRED TAX LIABILITY. SUCH INCREASE IN THE NET DEFERRED TAX LIABILITY OR DECREASE IN THE NET DEFERRED TAX ASSET OR THE AGGREGATE CHANGE FROM A NET DEFERRED TAX ASSET TO A NET DEFERRED TAX LIABILITY SHALL BE COMPUTED BASED ON THE CHANGE THAT WOULD RESULT FROM THE IMPOSITION OF THE CHANGES IN REPORTING REQUIREMENTS UNDER THE ACT (XX) BUT FOR THE DEDUCTION PROVIDED UNDER THIS PARAGRAPH AS OF THE EFFECTIVE DATE OF THIS PARAGRAPH. IN NO EVENT WILL THE CUMULATIVE DEDUCTIONS CLAIMED UNDER THIS SECTION EXCEED THE AMOUNT NECESSARY TO OFFSET THE INCREASE IN THE NET DEFERRED TAX LIABILITY OR DECREASE IN THE NET DEFERRED TAX ASSET, OR AGGREGATE CHANGE FROM A NET DEFERRED TAX ASSET TO A NET DEFERRED TAX LIABILITY.*
- *(6) THE DEFERRED TAX IMPACT DETERMINED IN SUBPARAGRAPH (5) OF THIS PARAGRAPH MUST BE CONVERTED TO THE ANNUAL DEFERRED TAX DEDUCTION AMOUNT, AS FOLLOWS:*
- *(I) THE DEFERRED TAX IMPACT DETERMINED IN SUBPARAGRAPH (5) OF THIS PARAGRAPH SHALL BE DIVIDED BY THE RATE DETERMINED UNDER §10-105(B) AT THE DATE OF ENACTMENT OF THE ACT (XX);*

- *(II) THE RESULTING AMOUNT SHALL BE FURTHER DIVIDED BY THE VIRGINIA APPORTIONMENT FRACTION THAT WAS USED BY THE COMBINED GROUP IN THE CALCULATION OF THE DEFERRED TAX ASSETS AND DEFERRED TAX LIABILITIES AS DESCRIBED IN SUBPARAGRAPH (5) OF THIS PARAGRAPH;*
- *(III) THE RESULTING AMOUNT REPRESENTS THE TOTAL NET DEFERRED TAX DEDUCTION AVAILABLE OVER THE TEN-YEAR PERIOD AS DESCRIBED IN SUBPARAGRAPH (5) OF THIS PARAGRAPH.*
- *(7) THE DEDUCTION CALCULATED UNDER THIS PARAGRAPH SHALL NOT BE ADJUSTED AS A RESULT OF ANY EVENTS HAPPENING SUBSEQUENT TO SUCH CALCULATION, INCLUDING, BUT NOT LIMITED TO, ANY DISPOSITION OR ABANDONMENT OF ASSETS. SUCH DEDUCTION SHALL BE CALCULATED WITHOUT REGARD TO THE FEDERAL TAX EFFECT AND SHALL NOT ALTER THE TAX BASIS OF ANY ASSET. IF THE DEDUCTION UNDER THIS SECTION IS GREATER THAN COMBINED GROUP MODIFIED INCOME, ANY EXCESS DEDUCTION SHALL BE CARRIED FORWARD AND APPLIED AS A DEDUCTION TO COMBINED GROUP MODIFIED INCOME IN FUTURE TAXABLE YEARS UNTIL FULLY UTILIZED.*
- *(8) ANY COMBINED GROUP INTENDING TO CLAIM A DEDUCTION UNDER THIS PARAGRAPH SHALL FILE A STATEMENT WITH THE COMPTROLLER ON OR BEFORE JULY 1 OF THE YEAR SUBSEQUENT TO THE FIRST TAXABLE YEAR FOR WHICH A COMBINED RETURN IS REQUIRED. SUCH STATEMENT SHALL SPECIFY THE TOTAL AMOUNT OF THE DEDUCTION WHICH THE COMBINED GROUP CLAIMS ON SUCH FORM AND IN SUCH MANNER AS PRESCRIBED BY THE COMPTROLLER. NO DEDUCTION SHALL BE ALLOWED UNDER THIS PARAGRAPH FOR ANY TAX YEAR EXCEPT TO THE EXTENT CLAIMED ON SUCH TIMELY FILED STATEMENT IN ACCORDANCE WITH THIS PARAGRAPH.*

- Recommendation 2: Tax Attributes Including Tax Credits and Net Operating Losses
  - How are Tax Attributes, i.e., Net Operating Losses (NOLs) and tax credits that were generated under separate reporting, carried into and used by the unitary group? Current Combined Reporting legislation does not address this issue, making it ripe for controversy and potential litigation.
  - Recommendation: NOLs and tax credits generated by combined group members should be able to be used against group taxable income to avoid the inequity and inconsistency of enacting combined reporting

based on the unitary principle, while treating companies as separate entities for purposes of NOLs and tax credits.

- Two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files;
  - Lack of clarity in statute.
    - If a mandatory unitary combined reporting law is unclear and subject to interpretation by either the tax department or the tax payer, costly, time consuming audits and even litigation can occur. What constitutes a unitary group should be clearly defined. 80% ownership preferred.
  - Recommendation 1: Allow a taxpayer to use a Consolidated Group Election based on the company's Federal tax filing. This would greatly ease administration and prevent complicated audits and potential litigation related to what is considered a unitary entity.
    - Suggested Language:
      - *CONSOLIDATED GROUP ELECTION. AN AFFILIATED GROUP OF CORPORATIONS, PURSUANT TO § 1504 OF THE INTERNAL REVENUE CODE, MAY ELECT TO BE TREATED AS A COMBINED GROUP WITH RESPECT TO THE COMBINED REPORTING REQUIREMENTS IMPOSED BY THIS SECTION. SUCH ELECTION MAY BE MADE ONLY IF ALL CORPORATIONS THAT AT ANY TIME DURING THE TAXABLE YEAR HAVE BEEN MEMBERS OF THE COMBINED GROUP CONSENT TO BE INCLUDED IN SUCH GROUP. THE ELECTION IS EFFECTIVE ONLY IF MADE ON A TIMELY FILED ORIGINAL RETURN AND IS BINDING FOR THE TAXABLE YEAR PLUS AN ADDITIONAL FIVE TAXABLE YEARS UNLESS REVOCATION IS APPROVED BY THE COMPTROLLER. SUBSEQUENT ELECTIONS MAY BE MADE IN THE SAME MANNER AND FOR THE SAME APPLICABLE PERIOD.*
  - Recommendation 2: Default to a Water's Edge (Domestic Operations Only) reporting to bring Virginia in line with most other states but allow a taxpayer to make a Worldwide Combination Election. Defaulting to world-wide would make Virginia an outlier among its neighboring states as well as the nation, as only four states default to world-wide reporting: CA, ID, MT, and ND.
    - Suggested language:
      - *WORLDWIDE COMBINATION ELECTION. A UNITARY GROUP MAY ELECT TO FILE A WORLDWIDE COMBINED RETURN COMPRISED OF THE APPROPRIATE INCOME AND APPORTIONMENT FACTORS OF ALL THE MEMBERS OF A UNITARY GROUP IRRESPECTIVE OF THE COUNTRY IN WHICH THE CORPORATIONS ARE INCORPORATED OR CONDUCT BUSINESS ACTIVITY. THE ELECTION IS EFFECTIVE ONLY IF MADE ON A TIMELY FILED ORIGINAL RETURN AND IS BINDING FOR THE TAXABLE YEAR PLUS AN ADDITIONAL FIVE TAXABLE YEARS*

UNLESS REVOCATION IS APPROVED BY THE TAX COMMISSIONER. SUBSEQUENT ELECTIONS MAY BE MADE IN THE SAME MANNER AND FOR THE SAME APPLICABLE PERIOD.

- Two most preferred provisions of Virginia's corporate tax structure in determining tax liability;
    - N/A
- Two most problematic provisions of Virginia's corporate tax structure in determining tax liability.
    - For Verizon, the most difficult and unnecessary requirement is related the Telecommunications Minimum Tax. The Telecommunications Minimum Tax (TMT) is an outdated and discriminatory gross receipts tax that is administratively burdensome. The tax does not apply equally among telecommunications competitors and the rules around the calculation of the tax are unclear.
    - The statute requires that companies calculate the liability of both this tax AND the Corporate Income Tax and pay the higher of the two taxes. More often than not, the taxpayer ends up paying the corporate income tax. If Virginia were to move to adopt a mandatory unitary combined reporting law, tax receipts from corporations are likely to increase substantially, which makes it a great time to eliminate the burdensome TMT filing requirements.

Meeting Summary

Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes

August 16, 2021, at 2:00 p.m.

Pocahontas Building, House Committee Room

https://studies.virginiageneralassembly.gov/studies/607

The Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes (the Work Group) met in Richmond with Delegate Vivian E. Watts, chair, presiding. The meeting began with introductions and opening remarks followed by presentations by the Multistate Tax Commission, the Council on State Taxation, and the Division of Legislative Services and discussion. Materials presented at the meeting are accessible through the *Work Group's website*.

Presentation: Multistate Tax Commission Combined Reporting Model Statutes

Gregory Matson, Executive Director, Multistate Tax Commission
Helen Hecht, Uniformity Counsel, Multistate Tax Commission

Mr. Matson and Ms. Hecht provided an overview of their organization as an intergovernmental state tax agency whose mission is to promote uniform and consistent tax policy and administration among the states, assist taxpayers in achieving compliance with existing tax laws, and advocate for state and local sovereignty in the development of tax policy. Mr. Matson and Ms. Hecht discussed the general attributes of combined filing, compared common attributes between the Joyce and Finnigan unitary combined reporting methods, discussed the corresponding uniformity model statutes' provisions, explained the reason for developing the two models, noted the critical issues involved with defining and identifying the group of companies under combined reporting, and addressed common transitional issues. Additionally, they identified two criticisms of the Finnigan model during its development: the absence of consolidated election language and the burden of separately tracking capital gains and losses. Mr. Matson and Ms. Hecht then discussed the issues with the separate filing method and highlighted recent developments with and effects on separate filing in recent years, including that it is now much more difficult to properly comply with — and for states to properly administer — separate filing and that any tax benefits to taxpayers are likely to be greatly reduced.

The Work Group then posed questions to Mr. Matson and Ms. Hecht. Delegate Watts asked whether mandatory unitary combined reporting and consolidated reporting methods can coexist under a single tax system, and Mr. Matson and Ms. Hecht noted that the two can coexist but that the operation of mandatory combined reporting can refer to requiring an initial tax return filing on a combined basis, rather than on a separate basis, from the outset. Further, they noted that the Multistate Tax Commission endorses combined reporting as the most efficient method but that, although Finnigan models are generally simpler and have been adopted more than Joyce models in recent years, the ultimate determination lies with states considering the issue. Delegate Watts asked for information on the effects that federal tax reform has and can have on the issue of combined reporting, and Mr. Matson noted that federal tax law changes are more of an issue for separate reporting states that must address the changes through addback statutes, related expenses, and intercompany transaction provisions but that unitary combined reporting avoids the litigation and drawbacks associated with those issues under separate reporting. Delegate Watts and Senator David W. Marsden then requested an explanation of the fundamental difference between combined and consolidated reporting generally, to which Ms. Hecht responded that, depending on how the law is drafted, the fundamental question is which business is included in the affiliated group of corporations filing the return. Mr. Matson and Ms. Hecht then explained that under Virginia's consolidated reporting method, each entity is doing its taxes separately, but they all agree to file a single group return to avoid administrative burdens, while unitary combined reporting is similar in that a single entity files on behalf of the group.

Presentation: Is Unitary Combination the Right Choice for the Commonwealth of Virginia?

Douglas Lindholm, President and Executive Director, Council on State Taxation

Mr. Lindholm began by addressing his viewpoint on the difference between a combined and federal consolidated return, noting that the combined return is focused on unity and the unitary group, the federal consolidated return focuses on a bright-line 80/20 rule, and the Virginia consolidated return is slightly different because the liability is calculated after the separate entities calculate their own returns. He then walked through a brief history of unitary combined reporting and discussed the difficulty for lawyers, jurists, and governments in defining and guiding taxpayers on the concept of a unitary group because of its genesis in a set of judicial opinions. Additionally, he noted that because every business is different in its structure and operations, there is no precedential value that comes out of the litigation concerning which business is properly considered a part of a particular entity's unitary group. Delegate Watts and Senator Marsden asked whether trademark transactions between affiliated entities are utilized as a tax avoidance strategy to artificially reduce tax liability and whether adoption of unitary combined reporting would be effective in rooting out such avoidance. Mr. Lindholm responded that the key is whether the transaction is conducted at arm's length and that addback provisions, such as Virginia's addback law on intangibles and interest, adequately address those concerns. On that point, Tim Winks noted that a unitary group is a subjective concept that invites litigation to the point where legal disputes over it are now being settled at a higher rate, such as in California, whereas states relying on addback statutes are not experiencing such increased litigation levels.

Mr. Lindholm described how each individual entity is a "taxpayer" under the Joyce unitary combined reporting method while the unitary group itself is the "taxpayer" under the Finnigan unitary combined reporting method He then discussed a number of administrative, taxation, and economic development concerns that should be considered by Virginia and any other state studying unitary combined reporting. He noted that the Council on State Taxation supports adopting the federal consolidated 80/20 bright-line standards in Virginia to simplify compliance or to amend the law's 20-year binding filing method election rules. Mr. Lindholm summarized his discussion points by noting that unitary combined reporting is an issue because it promotes volatility in corporate tax receipts, is less predictable for taxpayers and state revenue departments, and results in large impacts at all levels of a corporation and its affiliate entities. He also cited the a 2016 Maryland report that recommended that Maryland, which was studying the same issue, should not adopt unitary combined reporting and should "clearly indicate the intent not to do so."

Senator Marsden noted the distinction between supporting those taxpayers following the rules and those "gaming the system." Mr. Lindholm said that he would argue those gaming the system are not doing so simply by taking advantage of a gray area in the law but also noted that unitary combined reporting is not the answer to making those types of entities pay their fair share.

Additionally, Mr. Lindholm expressed support for adopting the single sales factor apportionment method in place of Virginia's current three-factor apportionment formula. He noted that the single sales factor approach has been adopted by a majority of states but may not be ideally suited for certain industries including Virginia's large base of defense contractors. Mr. Lindholm also suggested adopting market-based sourcing of corporate sales in place of Virginia's cost of performance approach, noting that the use of cost of performance can result in double taxation. Lori Nieto noted that double taxation can occur under the market-based approach as well and that it tends to be adopted in unitary combined states. Mr. Lindholm said that the Multistate Tax Commission's model statutes do include a market-based sourcing model.

Gary Tappana also discussed how the adoption of unitary combined reporting in states where Anheuser-Busch files dramatically increased the length of the company's tax returns. Several Work Group members related experiencing the same issue in their organizations.

Presentation: Initial Summary of Work Group Member Feedback

Stephen Kindermann and Joshua Kaplan, Attorneys, Division of Legislative Services

DLS staff presented an initial summary of the feedback submitted pursuant to a request made by Delegate Watts during the June 16, 2021, meeting that each corporate member of the Work Group provide his views on the following: (i) the two most preferred provisions under unitary combined reporting used in any state(s) in which your corporation files, (ii) the two most problematic provisions under unitary combined reporting used in any state(s) in which your corporation files, (iii) the two most preferred provisions of Virginia's corporate tax structure in determining tax liability, and (iv) the most problematic provisions of Virginia's corporate tax structure in determining tax liability.

Following the presentation, Senator Marsden inquired why a corporation requested legislation adopting unitary combined reporting in Virginia and was willing to pay a higher tax bill if the policy was so burdensome and complex for the business community. Other Work Group members disagreed with that stance and voiced concerns that unitary combined reporting was ultimately much harder for compliance and accurate tax liability calculations. Delegate Watts also commented that a number of the responses to her request suggested a need for the Department of Taxation to update formal regulations in place of existing guidelines.

Next Meeting

The Work Group agreed to hold its next meeting in September with an agenda to include the following: the identification and discussion of top concerns for the Work Group members, an update by the Department of Taxation on data reports submitted pursuant to Budget Item 3.5-23 of the 2021 Appropriation Act, public comment, and the formulation of the direction of the Work Group's final findings and recommendations that are required to be submitted to the General Assembly by November 1, 2021. The exact date, time, and location of the September meeting were not determined.

For more information, see the *Work Group's website* or contact the Division of Legislative Services staff:

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Work Group to Study Unitary Combined Corporate Income Tax Reporting

https://studies.virginiageneralassembly.gov/studies/607

Tuesday September 21, 2021, 1:00 p.m.

House Committee Room, Pocahontas Building

Public livestream link:

https://virginiageneralassembly.gov/house/committees/commstream.html

I. **Call to Order and Welcome** - Delegate Vivian E. Watts, Chair, House Committee on Finance

II. **Presentations by the Department of Taxation -** Kristin Collins, Policy Development Director and Matthew Huntley, Lead Tax Policy Analyst

- Report on estimated revenue reports submitted pursuant to Budget Item 3.5-23
- Potential provisions of Unitary Combined Reporting raised in August 16 meeting, including but not limited to:
    - Option to file on a unitary combined basis or a current option under Virginia Code or federal consolidated;
    - NC authority to force separate filer to submit a combined return;
    - Finnigan versus Joyce;
    - Issues related to auditing;
    - Revenue stability
- Potential modifications of Virginia Tax Code raised in August 16 meeting, including but not limited to:
    - Reducing the 20-year limit on switching affiliated group filing elections;
    - Changing Virginia's three-factor apportionment formula;
    - "Cost of performance" versus "Market-based" sourcing methods;
    - Simplifying Virginia's treatment of the business interest expenses (Sec. 163 (j) limitation) deduction;
    - Tracking net operation losses and credits not in conformity with federal determination;
    - Enhancing Virginia's add-back, determination of nexus, loss disallowance, or other means to prevent tax avoidance in multi-state businesses

III. **Discussion**

IV. **Request(s) for Draft Legislation**

V. **Public Comment**

VI. **Adjourn**

Work Group Membership

Executive and Legislative Officials

Delegate Vivian E. Watts	*Chair, House Finance*
Senator David W. Marsden	*Member, Senate Finance and Appropriations*
Joseph Flores	*Secretary of Finance*
June Jennings	*Deputy Secretary of Finance*
Craig Burns	*Tax Commissioner*
William White	*Asst. Tax Commissioner*
Brian Ball	*Secretary of Commerce and Trade*
Cassidy Rasnick	*Deputy Secretary of Commerce and Trade*

Corporate Tax Professionals

Tyler Henderson, *Sr. Manager, State and Local Tax*	*Amazon*
Gary Tappana, *Vice President of Tax Policy*	*Anheuser-Busch*
Mike Carchia, *Head of State Tax Planning*	*Capital One*
Tammy Herrin, *In-house Tax Counsel*	*ExxonMobil*
Jon Elder, *Vice President of Taxes*	*Dollar Tree*
Tim Winks, *Sr. Manager, Indirect Tax*	*Ferguson Enterprises*
Glen Page, *Sr. Manager, State Income & Franchise Tax*	*HCA Healthcare*
Tom Powers, *Executive Director, Corporate Tax Department*	*JP Morgan Chase*
Karen Lint, *Corporate Tax Director*	*Huntington Ingalls Industries*
Lori Nieto, *Corporate Tax Director*	*Northrop Grumman*
Ken Wright, *Sr. Manager, State Tax*	*Smithfield Foods*
Alison Malloy, *Sr. Director of Tax*	*Verisign*
Kathleen Kittrick, *Director, State Tax Policy*	*Verizon*
David Brunori, *Senior Director*	*RSM LLP, and*
Research Professor of Public Policy	*George Washington University*
Greg Matson, *Executive Director*	*Multistate Tax Commission*
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HJ 563 Workgroup

September 21, 2021

Virginia Tax

Update: Unitary Combined Reporting Requirement

Virginia Tax

Reporting Requirement

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Budget Requirement (Item 3-5.23)

- Item 3-5.23 of the 2021 Appropriation Act required corporations that are part of a unitary business to submit an informational report to Virginia Tax based on Taxable Year 2019 data
- Banks and insurance companies not subject to the reporting requirement
- Report was due July 1, 2021; no due date extensions permitted
- Virginia Tax must submit a report to the chairmen of the money committees by December 1, 2021 summarizing the data

Virginia Tax

Reporting Requirement

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Data Elements

- Report submitted by a designated corporation for each unitary business
  - Reported information about the unitary group's income, apportionment computation, tax credits, and tax liability calculation
  - Prepared calculations under both the *Joyce* and *Finnigan* approaches
  - Provided information about calculations under the current filing requirements for all members of the unitary group that have nexus with Virginia
- In-state unitary businesses were exempt from the filing requirement

Virginia Tax

Reporting Requirement

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Preliminary Statistics on Report Submissions

Category	Number of Reports
Total Reports Submitted	11,015
Adjustments	1,697
Total After Adjustments	9,318
Validated Reports	7,926
Remaining Reports to be Validated	1,392

Virginia Tax

Reporting Requirement

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Validation Process

- Adjustments were made for the following:
  - Duplicate reports
  - Reports missing crucial information (such as the calculations of tax liability under *Joyce* and *Finnigan*)
- Reports that could be matched to actual TY 2019 Virginia corporate income tax returns were validated to the extent possible
- The remaining reports to be validated did not match actual Virginia income tax return information and require additional research/validation

Virginia Tax

Reporting Requirement

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Preliminary Analysis of Impact to Corporations

- Of the 7,926 reports that have been validated, below is a summary of the percentage of corporations that are estimated to have a change in tax liability (before tax credits):

Change in Tax Liability	Percentage
No Change	73%
Increase in Tax Liability (Losers)	13%
Decrease in Tax Liability (Winners)	14%

Virginia Tax

Reporting Requirement

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Data Limitations

- Revenues would depend in part on how the law is structured; legislative policy may vary from the assumptions utilized in reports submitted
- Reference Guide addressed some policy issues, but did not address every scenario and different companies may have reasonably applied different assumptions
- Factors such as the intangible holding company ("IHC") addition may result in distortions, since reporting an IHC addition under combined reporting may result in accounting for the impact twice
- Estimates will be based on one year of information (TY 2019); actual impact could vary due to volatility of the corporate income tax
- Data collected was provided by taxpayers and not subject to more detailed verification/audit

Virginia Tax

Reporting Requirement

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Next Steps

- Complete the validation process
- Aggregate the information in summary fashion, showing the potential impact of both the *Joyce* and *Finnigan* methods
- Publish the final report for submission to the Chairmen of the House Finance, House Appropriations, and Senate Finance & Appropriations Committees

Virginia Tax

Issues Related to Unitary Combined Reporting

Virginia Tax

Summary of Combined Reporting Issues

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- Potential impact of optional unitary combined reporting
- Forced combination (North Carolina)
- Joyce v. Finnigan methods for business apportionable income
- Transitional issues related to deferred gains or losses
- Potential resource needs, particularly for compliance and appeals
- Revenue stability

Virginia Tax

Optional Unitary Combined Reporting

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Virginia's Current Reporting Requirement

- Every corporation that is incorporated in Virginia, has registered with the State Corporation Commission for the privilege of conducting business in Virginia, or receives income from Virginia sources is required to file a Virginia corporate income tax return
- An affiliated group of corporations is permitted to elect to file in one of the following three ways: (i) separately, (ii) on a consolidated basis, or (iii) using a Virginia combined return

Virginia Tax

Optional Unitary Combined Reporting

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Election for Unitary Combined Reporting

- Unitary combined reporting would represent a new Virginia reporting method
- States that have enacted this method of reporting have generally made it mandatory, by repealing alternative methods of reporting while also allowing a consolidated return election, which has similar safeguards against income-shifting
- Allowing unitary combined reporting to be optional, while also maintaining the ability to opt into the existing methods of reporting would result in taxpayers electing to utilize the method that is the least burdensome from a tax perspective
- This would result in an overall revenue loss, since Virginia would lose revenue from affiliated groups that would benefit from unitary combined reporting, while not gaining revenue from those that would pay increased taxes

Virginia Tax

North Carolina Forced Combination

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General Information

- North Carolina is a separate entity state and does not generally permit corporations to file consolidated returns
- When the North Carolina Department of Revenue (DOR) has reason to believe that corporation fails to accurately report net income attributable to business in NC through use of intercompany transactions that lack economic substance or are not at fair market value, DOR may request information to substantiate intercompany transactions

Virginia Tax

North Carolina Forced Combination

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Required Adjustments

- Based on response, DOR may make adjustments, including:
  - Disallowing deductions in whole or in part,
  - Attributing income to related corporations,
  - Disregarding transactions, or
  - Reclassifying income as apportionable or allocable
- If such adjustments are deemed inadequate, DOR can require the corporation to file a return that reflects the North Carolina income on a combined basis of all members of its affiliated group that are conducting a unitary business

Virginia Tax

Joyce vs. Finnigan

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Apportioning a Unitary Group's Business Apportionable Income

- Two approaches:
  - Joyce – Nexus determinations are made at the level of each individual entity, so sales by an entity without Virginia nexus are excluded from the sales factor numerator
  - Finnigan – Nexus determinations are made at the level of the unitary combined group as a whole, so sales by all members of the group attributable to Virginia are included in the sales factor numerator, even for entities that would lack Virginia nexus if filing on a separate entity basis
- Finnigan is considered to be the more aggressive approach, but is increasingly the method being adopted by unitary combined reporting states

Virginia Tax

Transitional Issues - Deferred Gain or Loss

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Basis and Depreciation

- Federal regulations defer recognition of certain gains and losses
  - Gains and losses will be deferred for asset transactions among affiliates in a consolidated federal return
  - Previously deferred gain or loss will be recognized when the asset is sold to an entity not included in the consolidated federal return
- Recognition of gain or loss affects basis of asset and subsequent depreciation
  - Subsequent depreciation unchanged on consolidated return when gain or loss is deferred, but each corporation may maintain its own records
  - Recognition of gain or loss will affect basis and subsequent depreciation amounts and asset life

Virginia Tax

Transitional Issues - Deferred Gain or Loss

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Impact on Virginia Return

- A corporation is treated as outside the federal consolidated group:
  - When the group elects to file a combined or separate Virginia return
  - When the group elects to file a consolidated Virginia return, but not all of the affiliates have nexus with Virginia
- Virginia corporate returns often have gain, loss, basis and depreciation that differ from federal return
  - Corporations often prepare a pro-forma federal return for Virginia purposes that assumes that the federal return was based on the same filing method as Virginia (separate, or consolidated with the same affiliates)

Virginia Tax

Transitional Issues - Deferred Gain or Loss
19

Implementation of Unitary Combination

- Unitary combination is generally treated the same as federal consolidation
  - Most states use federal consolidated return regulations for accounting adjustments among corporations included in a state unitary combined return
  - Thus, gain or loss would be deferred for asset transactions with other corporations included in the unitary combined return; however, gain or loss (including deferred gain/loss) would be recognized for asset transactions with other corporations that are not included in the unitary combined return
- A transitional adjustment may be required when corporations are first included in a unitary combined return - corporations included in a federal return but not in a Virginia consolidated return may have deferred gains or losses that must be restored when included in a unitary combined return

Virginia Tax

Resource/Auditing Issues
20

Resource Needs – Start Up Costs and Staffing

- Minimum estimated costs of $700,000 in the initial year of implementation and more than $400,000 annually thereafter
  - Upfront costs would include changes to systems and forms; ongoing costs would include hiring additional staff
  - Like revenues, costs would likely depend in part on how the law is structured
- Sufficient time would be necessary to develop regulatory guidance, generate new forms, inform taxpayers, and adequately train staff

Virginia Tax

Resource/Auditing Issues
21

Resource Needs – Compliance and Appeals

- In addition to minimum costs, additional costs would include training, development of guidance, staffing to support compliance efforts, and increased volume of appeals/rulings
  - Resource needs for auditors would depend on how the law is structured and the specific changes made to the current corporate income tax reporting regime
  - Similarly, resources may be necessary for an increased volume of appeals, rulings, and litigation resulting from various policy issues associated with the change

Virginia Tax

Revenue Stability
22

Potential Revenue Issues

- Any revenue estimates should be considered tentative/preliminary
- Actual impact would depend on how the law is structured and individual circumstances of the impacted corporations
- Volatility of the corporate income tax impacts not only the reliability of revenue estimates, but also the actual impact each year
- Initial revenues could be affected by taxpayer compliance and establishment of any necessary administrative guidance
- Like many major tax changes, any positive revenue impact would likely be less in the transitional years due to taxpayer compliance

Virginia Tax

Other Potential Corporate Income Tax Policy Changes

Virginia Tax

Summary of Other Corporate Income Tax Issues
24

- Switching an affiliated group's filing election
- Changing Virginia's three-factor apportionment method
- Market-based sourcing
- Tracking federal consolidated return calculations
- Business interest expense limitation
- Net operating losses
- Intangible holding company addback
- Nexus considerations

Virginia Tax

Switching an Affiliated Group's Filing Election 25

General Rule

- The Department has the statutory authority to grant or deny requests by corporations to change their Virginia tax filing status
- Because switching to/from the consolidated filing status affects the allocation and apportionment formulas and may distort the business done in Virginia and the income arising from activity in Virginia, the Department generally will not grant permission to change to/from a consolidated filing status, absent extraordinary circumstances
- In contrast, separate and Virginia combined returns do not affect the allocation and apportionment formulas for each corporation; therefore, permission to change from separate to Virginia combined returns or from Virginia combined to separate returns is generally granted

Virginia Tax

Switching an Affiliated Group's Filing Election 26

20-Year Rule

- During the 2003 Session, the General Assembly enacted legislation that effectively provided an exception to the general rule against switching to/from consolidated
- This provided that an affiliated group that has filed on the same basis for at least the last 20 years may switch to/from consolidated if they ask permission and it is determined that:
  - For the year preceding the year for which the new election would be applicable, there would have been no decrease in tax computed under the new filing method as compared to old filing method; and
  - The affiliated group agrees to pay the greater of the tax under the old filing method and the new filing method for the taxable year in which the new election is effective and for the immediately succeeding taxable year

Virginia Tax

Switching an Affiliated Group's Filing Election 27

2020 Proposed Legislation

- During the 2020 Session, 2020 SB 1058 was introduced to make it simpler for certain affiliated groups to switch to/from consolidated
- The federal Tax Cuts and Jobs Act made several important changes to business taxation, including imposing a business interest limitation
- The bill was intended to permit switching of certain affiliated groups' filing elections because of the tax consequences of such changes
- It is the Department's understanding that the bill was not enacted due to its unknown and potentially significant revenue impact

Virginia Tax

Changing Virginia's Three Factor Apportionment 28

Virginia's Current Apportionment Structure

- Most corporations are required to use Virginia's statutory method of apportionment to determine the amount of income that is subject to Virginia income taxation
- The statutory method of apportionment generally consists of three factors:
  - Property: Value of property in Virginia divided by the value of property everywhere
  - Payroll: Compensation paid to employees in Virginia divided by compensation paid everywhere
  - Sales: Sales (gross receipts) made in Virginia divided by sales everywhere. The sales factor is double weighted

Virginia Tax

Changing Virginia's Three Factor Apportionment 29

Special Apportionment Methods

- For certain taxpayers, Virginia permits or requires the use of special apportionment methods that differ from the statutory three factor apportionment method
  - Virginia law includes special apportionment methods for certain industries, including: financial corporations, construction contractors, motor carriers, and railway companies
  - In 2018, the General Assembly authorized certified company apportionment for companies operating in certain disadvantaged localities (administered by VEDP)
- Virginia also allows companies to request an alternative method of apportionment in situations where the statutory three-factor apportionment method is inapplicable or inequitable

Virginia Tax

Changing Virginia's Three Factor Apportionment 30

Single-Sales Factor

- Another alternative to Virginia's statutory three factor method of apportionment is the single-sales factor method of apportionment
- Under single-sales factor apportionment the share of a corporation's total profit that is taxed in Virginia is based solely on the share of the corporation's sales occurring in Virginia as compared to sales everywhere
- The General Assembly has enacted single-sales factor methods for:
  - Manufacturers (elective - 2009)
  - Retailers (2012)
  - Enterprise data centers (2015) and
  - Debt buyers (in combination with market-based sourcing - 2018)

Virginia Tax

Market-Based Sourcing 31

Virginia's Current Apportionment Structure – How Sales Are Assigned

- Sales of tangible personal property:
  - In Virginia if delivered to a location in Virginia
  - Outside Virginia if delivered to a location outside of Virginia
- Sales of services or intangible property:
  - In Virginia if the greater portion of income producing activity (measured by costs of performance) is in Virginia
  - Outside Virginia if the greater portion of income producing activity (measured by costs of performance) is outside of Virginia

Virginia Tax

Market-Based Sourcing 32

Virginia's Current Apportionment Structure – Cost of Performance

- "Cost of performance" is an all-or-nothing determination for purposes of sourcing sales of services and intangible property
  - For example, a company with facilities in all 50 states and only 5% of its costs in Virginia would assign 100% of its sales of services and intangible property to Virginia if no other state had more than 5%
  - The income producing activity and costs of performance are deemed performed at the location of the corporation's real and tangible property and its employees
- Virginia's statutory definition of the sales factor for services and intangible property is consistent with Section 17 of UDITPA and regulations promulgated by the MTC
- Until recently, the majority of states used the cost of performance method

Virginia Tax

Market Based Sourcing 33

What is Market-Based Sourcing?

- An alternative method for determining the sales factor for sales other than sales of tangible personal property (services and intangible property)
- Under market-based sourcing, sales of services and intangible property are sourced to a state if the taxpayer's market for such sales is in that state
- The method for determining a taxpayer's market for a sale of services or intangible property varies between the states
- The general rule is to source intangible property to a state to the extent such property was used in that state, but the specific rules for each state may be much more complicated

Virginia Tax

Market Based Sourcing 34

Proposed Legislative Changes

- Since 2011, the General Assembly has considered several market-based sourcing bills:
  - 2011 House Bill 1604 & Senate Bill 1006
  - 2013 House Bill 2253
  - 2014 House Bill 442
  - 2015 House Bill 2233
  - 2016 House Bill 966
  - 2017 House Bill 1499
  - 2018 House Bill 798 (enacted – limited to debt buyers only)
  - 2020 House Bill 796

Virginia Tax

Market Based Sourcing 35

Proposed Legislative Changes

- In 2015, Virginia Tax conducted a market-based sourcing study upon request of the Chairman of House Finance
  - The study included meetings with tax practitioners, business representatives, and other stakeholders
  - The results of such study were inconclusive due to limited data
- Introduced budget in 2016 included language that would have allowed Virginia Tax to collect data from corporations to generate a more accurate revenue estimate
  - Funding included to pay each reporting entity $2,500
  - Proposal not adopted by the General Assembly
- In 2018, House Bill 798 enacted market based sourcing for debt buyers

Virginia Tax

Tracking Federal Consolidated Return Calculations 36

Current Law

- For federal income tax purposes, an affiliated group of corporations has the option of filing a consolidated return in lieu of separate returns for each corporation
- If a federal consolidated return is filed, the affiliated group members are treated as one entity and their financial activities are combined
- Similarly, Virginia also allows for the filing of a state consolidated return in lieu of separate returns for each corporation
- A Virginia consolidated return election can be made, regardless of how the federal return was filed

Virginia Tax

Tracking Federal Consolidated Return Calculations 37

Current Law (Continued)

- Virginia generally follows the federal regulations for consolidated groups
- As a result, taxpayers that file consolidated federal and state returns may use federal computations of income and deductions to determine their state income tax, unless a specific state deconformity provision applies
- However, Virginia only allows corporations that have nexus with Virginia to be included on the state consolidated return
- This means that taxpayers may need to re-compute income and deductions for state purposes to exclude non-nexus entities included on the federal consolidated return that cannot be included on the state return

Virginia Tax

Tracking Federal Consolidated Return Calculations 38

Potential Changes

- Virginia law could be amended to allow non-nexus affiliates be included or to require the inclusion of all affiliates on consolidated returns
- The advantages include that the Virginia consolidated group:
  - Would more closely resemble the federal consolidated group
  - If Virginia became a unitary combined state with a consolidated election, would more closely resemble the unitary combined group
- The disadvantages of such approach include:
  - There would be transition issues that would need to be addressed
  - It is unclear how the transition would affect General Fund revenues

Virginia Tax

Business Interest Expense Limitation 39

Business Interest Expense Limitation - IRC § 163(j)

- Under the TCJA, the deduction for business interest is generally limited to 30% of the taxpayer's income for the taxable year
- Interest expenses not deductible on account of this limitation are permitted to be carried forward indefinitely, subject to certain restrictions
- In the case of a group of affiliated corporations that file a federal consolidated return, the limitation applies at the consolidated tax return filing level
- During the 2019 Session, legislation was enacted that generally conforms Virginia to the TCJA, including the limitation on the deductibility of business interest. Such legislation also enacted a deduction equal to 20% of the amount of business interest that is disallowed as a deduction under the IRC § 163(j) limitation

Virginia Tax

Business Interest Expense Limitation 40

Budget Language – Item 272(E) of the 2019 Appropriation Act

- During the 2019 Session, the Virginia General Assembly enacted budget language that required the Department to convene a working group to study the impact of the business interest limitation on businesses that are part of an affiliated group and file a Virginia combined or consolidated returns
- On May 20, 2019, the Department held a working group meeting and solicited comments from affected parties
- The budget language also required the Department to publish guidelines regarding how taxpayers are required to account for the business interest limitation for Virginia income tax purposes

Virginia Tax

Business Interest Expense Limitation 41

Current Guidelines and Additional Considerations

- In 2019, the Department issued guidelines that require the business interest limitation be computed based upon how taxpayers elected to file their Virginia tax return
  - This is consistent with how Virginia treats other federal deductions, such as the federal charitable contribution deduction and the federal NOL deduction
- Differences between federal and Virginia limitations arise from groups that file a federal consolidated return but either file:
  - Separate or combined Virginia returns, or
  - A consolidated Virginia return that has different members for federal and Virginia purposes

Virginia Tax

Business Interest Expense Limitation 42

Current Guidelines and Additional Considerations

- Options to address this issue:
  - Changes to Virginia's current filing methods
  - Adoption of mandatory unitary combined with a Virginia consolidated return election, where the members of such return would be the same as the federal consolidated return
- However, such changes could have a negative revenue impact, and the fiscal implications should be carefully considered before making any changes

Virginia Tax

Net Operating Loss Deduction 43

Deconformity from Federal NOL Enhancements

- Virginia has a long-standing history of deconforming from provisions enhancing NOLs, such as the 5-year carryback of certain NOLs generated in Taxable Years 2001, 2002, 2008, and 2009
- During the 2019 Session, Virginia conformed to the provisions eliminating NOL carrybacks, allowing unlimited NOL carryforwards, and limiting NOLs to 80% of taxable income
- During the 2021 Session, Virginia deconformed from the provisions allowing 5-year NOL carrybacks for those incurred in 2018, 2019, and 2020, and removing the 80% limitation
- Conformity to such provisions would have a significant negative revenue impact

Virginia Tax

Intangible Holding Company Addback 44

General Overview

- In 2004, Virginia adopted a statutory addition to federal taxable income for royalty payments and similar expenses paid to an Intangible Holding Company (“IHC”)
- This addback is intended to mitigate the impact of a tax planning structure that sheltered income by setting up an IHC in a state without a tax on such income:
  - The IHC licenses the intangible property to the Taxpayer, which continues to use
  - Taxpayer pays a royalty to the IHC, which is deductible from state income tax
  - The IHC usually has no significant expenses
  - Taxpayer receives almost all of its royalty payments back as dividend income, which is generally exempt from state income tax

Virginia Tax

Intangible Holding Company Addback 45

IHC Addback and Unitary Combined Reporting

- If Virginia adopts unitary combined reporting, the IHC addback may no longer be necessary to prevent this tax planning structure because the IHC would likely be included in the Virginia unitary combined return
- Because Virginia already has an IHC addback, this would partially offset the positive revenue impact of adopting unitary combined reporting
- However, Virginia may want to consider maintaining an IHC addback under unitary combined reporting to prevent improper income-shifting outside the Virginia unitary combined group, such as to international affiliates

Virginia Tax

Nexus Considerations 46

Constitutional and Federal Law Restrictions on State Taxation

- The U.S. Constitution's Commerce and Due Process Clauses are the primary limitations on a state's ability to levy a tax on an out-of-state taxpayer
- The courts have interpreted these clauses as requiring “substantial nexus,” which generally means a sufficient connection exists between the taxpayer and the state to allow the state to impose tax
- In the 2018 *Wayfair* decision, the U.S. Supreme Court stated that physical presence is not required for substantial nexus and approved of economic nexus
- Under economic nexus, states typically provide a bright-line test where substantial nexus exists if a taxpayer’s annual sales in the state exceed a threshold amount

Virginia Tax

Nexus Considerations 47

Constitutional and Federal Law Restrictions on State Taxation

- Certain states have asserted economic nexus over out-of-state taxpayers from the in-state use of intangible property (i.e., trademarks, trade names, etc.). See *Geoffrey, Inc. v. South Carolina Tax Commission*, S.C. Sup. Ct., 437 SE2d 13; cert. denied, 114 S. Ct. 550
- In addition to substantial nexus under the U.S. Constitution, a 1959 federal law referred to as “Public Law 86-272” limits a state's ability to levy a tax on an out-of-state taxpayer
- Such law prevents imposing a net income tax on a taxpayer whose only in-state activity consists of the solicitation of orders for the sale of tangible personal property if the orders are sent out of state for approval and shipped from out-of-state locations
- Notably, Public Law 86-272 does not apply to sales of services and intangibles; however, Virginia has administratively extended this treatment to services and intangibles

Virginia Tax

Information in Response to Questions from September 21, 2021 Meeting

The Department of Taxation ("Virginia Tax") was asked to provide follow-up information in response to the following requests:

1. Provide the exact costs to corporations for compliance with mandatory unitary combined reporting;
2. Obtain additional information on forced combination either from North Carolina's Department of Revenue or other sources;
3. Provide the transitional rules on deferred gains or losses in other states;
4. Determine whether Virginia's 20-year rule is an outlier and, if so, what other states use;
5. Provide the gain or loss in revenue in other states that have adopted market-based sourcing; and
6. Provide information on the winners and losers, percent tax change, effects on different industries, and effects on in-state businesses of a transition to unitary combined reporting.

1. Provide the exact costs to corporations for compliance with mandatory unitary combined reporting:

- Since Virginia Tax does not have access to information regarding compliance costs of corporations, this cannot be estimated without further information.

- A sample of such information could be obtained by poll of the work group members or by a similar reporting requirement for corporations.

2. Obtain additional information on forced combination either from North Carolina's Department of Revenue or other sources:

- North Carolina is generally a separate return state. This means that corporations are able to file separate North Carolina returns and may compute their state income tax on an entity-by-entity basis.

- Prior to 2011, North Carolina's forced combination statute gave the North Carolina Department of Revenue ("NC DOR") broad discretion to effectively force audited corporations to file unitary combined reports to determine their true earnings.

- In response to criticism received regarding the broadness of the forced combination statute, such statute was repealed and replace by a new forced combination statute that places more restrictions on NC DOR's ability to effectively require unitary combined reporting.

- Under North Carolina's current forced combination statute,
    - NC DOR must first attempt to resolve income distortions through adjustments to intercompany payments before ordering a combined return;
    - NC DOR then must attempt to come to an agreed combination; and
    - Only if the taxpayer rejects all NC DOR proposed combinations may a true forced unitary combination be imposed.

- NC DOR does not have the authority to require unitary combined reporting into the future.
    - As a result, a unitary combined report is only required for those past years that are under audit by NC DOR and for which the taxpayer agrees or is required to file a unitary combined report.
    - However, in practice, some taxpayers that have been audited in the past may use unitary combined reporting or make other adjustments in future years to avoid audit adjustments being made by NC DOR.

- Based on discussions with staff from the NC DOR, Virginia Tax understands that the vast majority of NC DOR audits of Fortune 1,000 companies result in some type of intercompany pricing adjustment or unitary combined reporting.
    - When unitary combined reporting is the result, it is typically because taxpayers agree to unitary combinations with NC DOR.
    - When taxpayers do not agree to file a unitary combined report, a forced unitary combination may be required. It is our understanding that this forced unitary combination rarely happens (approximately once every four years).

3. Provide the transitional rules on deferred gains or losses in other states:

- Most states that require unitary combined reporting incorporate the federal consolidated return regulations with respect to eliminations and deferrals.

- However, any treatment that depends on whether the federal consolidated return includes or excludes the parties to a transaction shall instead depend on the parties' inclusion or exclusion from the state combined return.

- Virginia Tax is aware of five states (Connecticut, Kentucky, Massachusetts, New Jersey, and New Mexico) and the District of Columbia that have authorized a special transitional deduction when mandatory unitary combined reporting is adopted.

    - When recognition of a gain or loss is deferred for tax purposes, the published financial statement usually will include a corresponding deferred tax asset or liability on the balance sheet.

    - The change in tax reporting policies may require that gain or loss previously recognized be re-categorized as deferred items.

    - The re-characterization may require that published financial reports be restated or that all such items be reflected in current income.

    - The states that have permitted adjustments for changes in deferred tax assets and liabilities attributable to the adoption of mandatory combined reporting have varying definitions of which corporations are eligible and which transactions qualify.

  - For example, the deduction may only apply to publicly traded corporations with published financial statements. They may have to apply for and be granted the deduction, and the deduction may be spread over several years to reduce the potential revenue impact on the state.

  - There is some debate about whether such a deduction is necessary when transitioning to unitary combined reporting. Compare Lauren A. Cooper and Joel W. Walters, Mitigating the Impact of State Tax Law Changes on Company Financial Statements, State Tax Research Institute (June 2020) with Michael Mazerov, States Should Reject Corporate Demands for "Deferred Tax" Deductions, Center on Budget and Policy Priorities (2019).

4. Determine whether Virginia's 20-year rule is an outlier and, if so, what other states use:

- Of the jurisdictions that impose a corporate income tax, 27 states and the District of Columbia have enacted mandatory unitary combined reporting ("MUCR").
  - These states sometimes provide a consolidated election, giving taxpayers the choice to file on a unitary combined return or consolidated return.
  - For the purposes of Virginia's 20-year rule, Virginia Tax did not compare its rule to these states because Virginia is not currently an MUCR state.
  - The computation of income tax on a unitary combined return and on a consolidated return can be substantially similar, meaning that there are less opportunities for taxpayers in an MUCR state to reduce their income tax by switching between such methods.
  - As a result, MUCR states are often able to place less restrictions on switching between filing unitary combined and filing consolidated without risking state corporate tax revenues.

- The remaining 15 states that impose a corporate income tax are separate return states like Virginia.
  - In such states, allowing a consolidated return election has significantly greater revenue implications because of the different ways that tax is computed on a separate return as compared to a consolidated return.
  - As a result, separate return states are generally more restrictive than MUCR states in allowing switching between filing separate returns and filing consolidated returns.

- For this reason, seven of these separate return states (Delaware, Louisiana, Maryland, Mississippi, Pennsylvania, South Carolina, and Tennessee) do not appear to offer taxpayers the option to file on a consolidated basis at all.

  - Virginia's law allowing taxpayers to make a consolidated election, as well as a Virginia combined election, is more favorable to taxpayers than the law in these states, where no consolidated filing election is available.

- The remaining eight separate return states (Arkansas, Florida, Georgia, Indiana, Iowa, Missouri, North Carolina, and Oklahoma) allow taxpayers to file on a consolidated basis under certain circumstances.
    - Like Virginia, all eight of the separate return states that allow consolidated filing require taxpayers to apply for permission from a state tax agency before they can change their filing method.
    - Unlike Virginia, none of these states appear to set forth a specific time period after which the taxpayer may be entitled to change its filing method.
    - Instead, these eight states impose varying restrictions on granting such permission.
        - Some of them provide minimal, if any, criteria regarding when they will grant or deny permission to change one's filing method.
        - Other states provide that they will consider certain factors. One common factor appears to be the ability to request to change one's filing method if the taxpayer can show that a law change substantially alters their state income tax.
    - From preliminary research completed by Virginia Tax, Virginia's law on switching filing status, including its 20-year rule, does not appear to be significantly more restrictive than the law of these other eight states. See Ark. Code Ann. §26-51-805(d); Fla. Admin. Code Ann. §12C-1.0131(3)(b); Ga. Comp. R. & Regs. §560-7-3-.13(4); Ind. Admin. Code 45 §3.1-1-110; Iowa Admin. Code 701--53.15(3); Mo. Code Regs. 12 §10-2.045(33)-(34); N.C. Gen. Stat. § 105-130.14; Okla. Stat. 68 §2367.
    - However, it is possible that these states administer these laws in a manner that is effectively less restrictive than Virginia.

5. Provide the gain or loss in revenue in other states that have adopted market-based sourcing:

- Virginia Tax has been unable to locate this information.

6. Provide information on the winners and losers, percent tax change, effects on different industries, and effects on in-state businesses of a transition to unitary combined reporting:

- Virginia Tax does not currently have detailed information regarding taxpayers who would be impacted by a transition to unitary combined reporting.
- Available details will be shared in the report that is due December 1, 2021.

MOLSON COORS beverage company

5135 S East Side Highway
Elkton, VA 22827
540-289-8000

September 20, 2021

The Honorable Vivian E. Watts
Virginia House of Delegates
Chair, Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes

VIA-EMAIL: delvwatts@house.virginia.gov; chooe@house.virginia.gov

Dear Chairman Watts and members of the work group:

On behalf of the Molson Coors Beverage Company and our 500 employees based in Rockingham County, I am writing to request that the Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes reject that proposal and maintain the current reporting systems for corporate income tax collections.

For over 30 years, we have proudly been one of the largest employers in the Shenandoah Valley offering an ideal business climate and workforce needed to brew some of the biggest beer brands in the United States including Miller Lite, Coors Light, Blue Moon, Miller High Life and Keystone Light. In 1987, we chose Virginia over competing sites for a new brewery because of the access to natural resources, proximity to our wholesalers and most importantly because of the business-friendly environment of the Commonwealth.

If this proposal were to be enacted, it would increase our Virginia tax burden by close to $2 million additionally per year which would make Shenandoah less competitive within our brewery network which could potentially hinder future investment and job creation.

Several years ago, our brewery was chosen in the network to invest over $60 million to expand our capacity to brew up to 7.5 million barrels of beer per year. This investment in part was due to the business partnership in the state. If this proposal comes to fruition, we may not be selected for future growth and investment opportunities within our world class network. This could result in loss of revenue for the state and employment growth for the hard-working men and women in Rockingham County.
I thought that I would provide the committee with a perspective of what we currently do and why it works for our business.

- **Corporate income tax** – We currently use a double-weighted sales apportionment (Property plus Payroll plus Sales (x2). This double-weighted percentage was 10.3% in 2019.
- **Corporate taxes in other brewery states** – As of 2020, Colorado, Georgia, Illinois (corporate headquarters), Texas and Wisconsin are all taxed solely based on sales.

- **Long-term disadvantages of switching to this type of taxation-** MUCR is a complex, subjective and costly process that is not required in separate filing states and could result in expensive and time-consuming litigation. This change could result in our brewery being less competitive and could cost us the ability for long-term investment and updates within our network. This could impact job growth and other taxes currently paid in the state.
- **How much other taxes do we currently pay in Virginia** – Based on our most recent annual tax filing we paid over $700k in property taxes, $50k in excise taxes, $100k in sales and use tax which is only in Virginia and close to $2.4 million in withholding taxes. If this proposal were to pass it would increase our tax burden in the state by close to $2 million additionally per year.
- **Local Tax** – Virginia is the only state in our brewery network which we are assessed a local machinery and tools tax which adds substantially to our Virginia tax burden.

We stand with the other Virginia companies as well as the Council on State Taxation (COST) in asking the work group to reject this proposal and maintain the current system for corporate income tax reporting and collection. We will be happy to answer any additional questions the group may have.

Sincerely,

Lori Michelin

Lori Michelin
Molson Coors Beverage Company
Vice-President and Brewery Manager
Molson Coors Shenandoah Brewery

Meeting Summary

Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes

September 21, 2021, at 1:00 p.m.

Pocahontas Building, House Committee Room

https://studies.virginiageneralassembly.gov/studies/607

The Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes (the Work Group) met in Richmond with Delegate Vivian E. Watts, chair, presiding.[1] The meeting began with introductions and opening remarks followed by a presentation by Department of Taxation representatives, public comment, and discussion. Materials presented at the meeting are accessible through the Work Group's website.

Presentation: Department of Taxation

Kristin Collins, Policy Development Director, Department of Taxation
Matthew Huntley, Lead Tax Policy Analyst, Department of Taxation

Ms. Collins began the Department of Taxation presentation with a review of data submitted pursuant to Budget Item 3.5.23 of the 2021 Appropriation Act, which required corporations that are members of a unitary group with nexus in Virginia to submit an informational report to the Department of Taxation by July 1, 2021, based on taxable year 2019 data. The report was required to contain information on the unitary group's income, apportionment, computation, tax credits, and tax liabilities, with calculations based on both the Joyce and Finnigan unitary combined reporting approaches. Ms. Collins said that, of the validated reports, 73 percent showed essentially no change in tax liability, 13 percent showed an increase in tax liability, and 14 percent showed a decrease in tax liability before tax credits were applied. She noted some data limitations in the reporting, including caveats for the following: how the structure of any potential unitary combined reporting law may vary from assumptions utilized in the reports, that the estimates were based on a single year of information from taxable year 2019, and that the data was provided by taxpayers and not subject to more rigorous verification and auditing processes. Ms. Collins said that the next steps in the corporate income tax informational reporting requirement will include completing the validation process, aggregating the information, and publishing the final report to the Senate Committee on Finance and Appropriations, House Committee on Appropriations, and House Committee on Finance by December 1, 2021.

Mr. Huntley then began a discussion of unitary combined reporting issues that were raised during previous Work Group meetings and mentioned Virginia's current reporting requirements and the existing filing elections for affiliated groups of corporations (separate, consolidated

[1] **Members Present:** Delegate Vivian E. Watts (chair), Senator David W. Marsden, Brian Ball, Ellen Berenholz, David Brunori, Craig Burns, Mike Carchia, Jon Elder, Tyler Henderson, Kathleen Kittrick, Karen Lint, Alison Malloy, Greg Matson, Lori Nieto, Cassidy Rasnick, William Rowe, Gary Tappana, Tom Powers, Glen Page, Ken Wright, and Tim Winks

Members Absent: Joe Flores and Tammy Herrin basis, or Virginia combined). He then discussed what a transition to unitary combined reporting would involve, noting that most states adopting unitary combined reporting have made it mandatory to avoid workarounds where, if other options were allowed, a taxpayer would elect the reporting method that minimizes tax liability. Delegate Watts asked whether states that enacted unitary combined reporting but also allowed a consolidated election followed the federal consolidated standards, and members of the Work Group responded that filing involves filing a federal consolidated return with state-by-state apportionment factors.

Mr. Huntley then provided an overview of North Carolina's "forced combination," which involves its Department of Revenue requesting information to substantiate intercompany transactions when it has reason to believe that a corporation failed to accurately report net income attributable to business in North Carolina through the use of intercompany transactions that lack economic substance or do not follow fair market value requirements. He explained that, based on the response, the North Carolina Department of Revenue may make certain adjustments or, if such adjustments are inadequate, can require the corporation to file a return that reflects North Carolina income on a combined basis of all members of its affiliated group that are conducting a unitary business.

Mr. Huntley then provided information about the Joyce and Finnigan methods for apportioning a unitary group's business apportionable income and noted that the Finnigan method is considered more aggressive and recently has become the more commonly adopted approach for unitary combined reporting states.

Mr. Huntley continued with a discussion of transitional issues that involve deferred gain or loss. Federal regulations defer recognition of certain gains and losses, such as those for asset transactions among affiliates in a consolidated federal return, and Mr. Huntley highlighted that recognition of gain or loss affects the basis of an asset, its subsequent depreciation, and the asset life and that implementing unitary combined reporting, especially if made mandatory, should include a transitional period to provide ample notice and guidance to taxpayers instead of an abrupt change to a new regime. He noted that there is some similarity between enforcement authority under Virginia's existing addback statute and North Carolina's forced combination in that both try to attack self-dealing in taxpayers.

Mr. Huntley then discussed the resource and auditing issues with a transition to unitary combined reporting. He estimated a required budget of $700,000 in the initial year of implementation and $400,000 annually thereafter for more staff, resources, form updates, regulatory guidance, and training but noted that the required funding would depend on the form of any law passed by the General Assembly. He also noted the possibility for increased appeals and rulings under unitary combined reporting. Delegate Watts asked how much Virginia, as a state generally conformed to federal tax law, depends on the federal regime for auditing and the extent to which Virginia could rely on federal auditors. Commissioner Craig Burns answered that Virginia does rely on the federal auditors, particularly on the corporate side, but would have to increase auditing and compliance capacity to accommodate changes to Virginia law and suggested that at least two years would be necessary to develop the new regulations and guidance for a unitary combined reporting system in Virginia.

The potential revenue issues of the transition were then discussed. Mr. Huntley noted the volatility of corporate income taxes generally and that any revenue estimate should keep that point in mind. He added that any positive revenue impacts would likely be lower in transitional years due to taxpayer noncompliance.

Ms. Collins then addressed other corporate income tax issues raised by the Work Group during prior meetings. First, she mentioned the issue of affiliated groups switching their filing election, which must be approved by the Department of Taxation, and said that elections between separate and Virginia combined returns do not affect the allocation and apportionment formulas for each corporation and are thus generally granted, while switching to or from consolidated filing status will affect those formulas and are therefore generally granted only with evidence of extraordinary circumstances. She highlighted Virginia's 20-year rule, which seeks to preserve revenues and said that shortening the time period would result in a revenue loss.

Second, Ms. Collins discussed changing Virginia's three-factor apportionment, consisting of a property, payroll, and double-weighted sales factor, along with special apportionment methods for certain taxpayers and requests for alternative apportionment methods when the statutory three-factor apportionment method is inapplicable or inequitable. She noted that Virginia also mandates single-sales factor apportionment for the share of a corporation's total profit that is taxed in Virginia based solely on the share of the corporation's sales occurring in Virginia, compared to sales everywhere, for manufacturers, retailers, enterprise data centers (if they enter into a memorandum of understanding with the Virginia Economic Development Partnership), and debt buyers.

Third, Ms. Collins delved further into market-based sourcing, explaining that Virginia's cost-of-performance apportionment structure, which was followed by a majority of states until recently, deems income producing activity and costs of performance to be performed at the location of the corporation's real and tangible property and of its employees. She also laid out the market-based sourcing bills that were introduced in the 2011, 2013, 2014, 2015, 2016, 2017, 2018, and 2020 Regular Sessions of the General Assembly and said that the revenue impact of a switch to market-based sourcing would likely be positive overall but negative in the initial years due to compliance by those corporations that benefit the most from the outset of market-based sourcing's effective date.

Fourth, Mr. Huntley discussed the issue of tracking federal consolidated return calculations on Virginia returns and mentioned that some potential changes to Virginia law could include allowing non-nexus affiliates to be included, or to require the inclusion of all affiliates, on consolidated returns, the advantages of which would include allowing a Virginia consolidated group to more closely resemble the federal consolidated group. He added that if Virginia became a unitary combined state with a consolidated election, Virginia would more closely resemble the form of the federal unitary combined group. Mr. Huntley said that the disadvantages of such a change would include transitional issues and the unknown impact on general fund revenues.

Fifth, Mr. Huntley addressed the business interest expense limitation in § 163(j) of the Internal Revenue Code, which limits deductions to 30 percent of a taxpayer's income for the taxable year under the federal Tax Cuts and Jobs Act of 2017. He said that the General Assembly conformed to that limitation in 2019 but allowed an additional 20 percent deduction in the Virginia return and mentioned that Budget Item 272(E) in the 2019 Appropriation Act required the Department of Taxation to convene a working group to study the impact of the business interest limitation on businesses that are part of an affiliated group that file a Virginia combined or consolidated return. Mr. Huntley said that the Department of Taxation issued guidelines requiring the business interest limitation to be computed based on how taxpayers elected to file their Virginia tax return. He also noted that some options to this limitation would include changes to Virginia's current filing methods and the adoption of mandatory unitary combined reporting with a Virginia consolidated return (where the members of such return would be the same as those in the federal consolidated return) but added that such changes could result in a negative revenue impact and other fiscal implications.

Sixth, Mr. Huntley discussed the net operating loss deduction. He said that Virginia has a history of deconforming from federal provisions that enhance net operating losses. During 2019, he said, Virginia conformed to the provisions eliminating net operating loss carrybacks, allowing unlimited net operating loss carryforwards, and limiting net operating losses to 80 percent of taxable income. During the 2021 Regular Session, Virginia deconformed from the federal provisions allowing a five-year net operating loss carryback for those losses incurred in 2018, 2019, and 2020, while also removing the 80 percent limitation. Mr. Huntley stated that conforming to such federal provisions would have had a significant, negative revenue impact in Virginia.

Seventh, Mr. Huntley highlighted the addback statute implemented in Virginia in 2004 for royalty payments and similar expenses paid to an intangible holding company, explaining that the statute is intended to mitigate the impact of a tax planning structure that shelters income by setting up intangible holding companies in a state that does not tax such income. Virginia's addback statute would partially offset the positive revenue gains expected from the adoption of unitary combined reporting, but Mr. Huntley suggested considering retention of the addback, even if unitary combined reporting is adopted, in order to prevent improper income shifting outside of the Virginia unitary combined group (like international affiliates).

Finally, Mr. Huntley explained nexus considerations to the Work Group. He said that primary limitations on a state's ability to levy a tax on an out-of-state taxpayer are the United States Constitution's Commerce and Due Process clauses, which courts have interpreted to require a "substantial nexus" or sufficient connection between the taxpayer and the state seeking to impose a tax. Mr. Huntley noted that the 2018 *Wayfair* case in the Supreme Court of the United States led states to begin asserting economic nexus over out-of-state taxpayers from their in-state use of intangible property, like trademarks and trade names. He said that in addition to the substantial nexus standard, P.L. 86-272, which was passed in 1959, limits a state's ability to levy a tax on an out-of-state taxpayer. Although P.L. 86-272 does not apply to the sales of services and intangibles, Mr. Huntley said that Virginia voluntarily extended P.L. 86-272's application to the treatment of services and intangibles through administrative action.

Public Comment and Discussion of Work Plan for October Meeting

The Work Group then heard public comment. A representative for Raytheon Technologies spoke about market sourcing and said that the defense industry is comfortable with the existing three-factor apportionment method in Virginia and is particularly concerned with services rather than with property. A representative of Universal Corporation, which is headquartered in Richmond, said that the company opposes mandatory unitary combined reporting because of the potential negative growth and tax implications on the agriculture, food, and beverage industry. Finally, Molson Coors Beverage Company submitted a letter, read into the record by Delegate Watts, requesting that the Work Group reject the unitary combined reporting proposal and maintain the current system for corporate income tax reporting and collection.

The Work Group members asked the Department of Taxation representatives for the following:

- Provide the exact costs to corporations for compliance with mandatory unitary combined reporting;
- Obtain additional information on forced combination either from North Carolina's Department of Revenue or other sources;
- Provide the transitional rules on deferred gains or losses in other states;
- Determine whether Virginia's 20-year rule is an outlier and, if so, what other states use;
- Provide the gain or loss in revenue in other states that have adopted market-based sourcing; and
- Provide information on the winners and losers, percent tax change, effects on different industries, and effects on in-state businesses of a transition to unitary combined reporting.

Senator David W. Marsden urged the Work Group as its final recommendations are considered in the coming weeks to be mindful of treating businesses well and maintaining Virginia's attractive business climate while also treating businesses fairly and ensuring that tax policy is not taken advantage of. Delegate Watts expressed her intent to survey the Work Group members prior to the next meeting for written input on how to proceed on the matter of unitary combined reporting and which other tax policy issues the members wish to be addressed in the final report. She noted that the next meeting will take place in October and that members' physical presence at the meeting will be necessary in order to participate in any votes and formal recommendations.

Next Meeting

The Work Group agreed to hold its final meeting in October to develop the final findings and recommendations that are required to be submitted to the General Assembly by November 1, 2021. The exact date, time, and location were not determined.

For more information, see the *Work Group's website* or contact the Division of Legislative Services staff:

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Work Group to Study Unitary Combined Corporate Income Tax Reporting

https://studies.virginiageneralassembly.gov/studies/607

Tuesday October 12, 2021, 1:00 p.m.

Shared Committee Room, Pocahontas Building

Public livestream link:

https://virginiageneralassembly.gov/house/committees/commstream.html

I. **Call to Order and Welcome** - Delegate Vivian E. Watts, Chair, House Committee on Finance

II. **Discussion, Public Comment, and Votes and Recommendations for Work Group Report**

- A transition to unitary combined reporting;
- Corporate tax changes for consideration with, or separate from, a transition to unitary combined reporting;
    - Transitioning to market-based sourcing from cost for performance method;
    - Expanding single sales factor election;
    - Easing of 163(j) intercompany interest deductibility limitations;
    - Greater flexibility to change filing election;
    - Forced unitary combined reporting audit resolution;
    - Amortized deduction for net deferred tax liabilities for publicly traded companies.
- Other.

III. **Adjourn**

Work Group Membership

Executive and Legislative Officials

Delegate Vivian E. Watts	*Chair, House Finance*
Senator David W. Marsden	*Member, Senate Finance and Appropriations*
Joseph Flores	*Secretary of Finance*
June Jennings	*Deputy Secretary of Finance*
Craig Burns	*Tax Commissioner*
William White	*Asst. Tax Commissioner*
Brian Ball	*Secretary of Commerce and Trade*
Cassidy Rasnick	*Deputy Secretary of Commerce and Trade*

Corporate Tax Professionals

Tyler Henderson, *Sr. Manager, State and Local Tax*	*Amazon*
Gary Tappana, *Vice President of Tax Policy*	*Anheuser-Busch*
Mike Carchia, *Head of State Tax Planning*	*Capital One*
Tammy Herrin, *In-house Tax Counsel*	*ExxonMobil*
Jon Elder, *Vice President of Taxes*	*Dollar Tree*
Tim Winks, *Sr. Manager, Indirect Tax*	*Ferguson Enterprises*
Glen Page, *Sr. Manager, State Income & Franchise Tax*	*HCA Healthcare*
Tom Powers, *Executive Director, Corporate Tax Department*	*JP Morgan Chase*
Karen Lint, *Corporate Tax Director*	*Huntington Ingalls Industries*
Lori Nieto, *Corporate Tax Director*	*Northrop Grumman*
Ken Wright, *Sr. Manager, State Tax*	*Smithfield Foods*
Alison Malloy, *Sr. Director of Tax*	*Verisign*
Kathleen Kittrick, *Director, State Tax Policy*	*Verizon*
David Brunori, *Senior Director*	*RSM LLP, and*
Research Professor of Public Policy	*George Washington University*
Greg Matson, *Executive Director*	*Multistate Tax Commission*
William L.S. "Sandy" Rowe, *Of Counsel*	*HuntonAndrewsKurth*
Ellen Berenholz, *Executive Director, Tax Policy*	*Comcast*

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HJR 563 Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes:

Corporate Feedback Submissions for October 12, 2021 Meeting

1. **Tim Winks - Ferguson Enterprises**

More Fundamental Change

Reading the room and from informal discussions with other working group members, it appears that a critical mass of the group believes that mandatory unitary combined reporting will *not* be good for Virginia. There are no doubt some members who favor it, but if you take a show of hands at the next meeting I believe a majority will be opposed. At the same time, however, those members generally seem to agree that changes in the corporate tax structure are in order to stay abreast of our competitors for economic development in the mid-Atlantic and southeast, e.g., adoption of single sales factor across the board + market sourcing for service businesses with some type of carve-out for government contractors. Legislation to move such changes ahead and/or create a study commission, with citizen input similar to the current work group model, to consider fundamental changes in advance of the 2023 session would be desirable.

Intercompany Interest – Section 163(j)

I believe most group members also recognize the fundamental inequity of the federal 163(j) rules as applied in Virginia returns, where companies filing on a consolidated basis generally see little or no impact while those that file on a combined basis face significant issues. This is an issue that seems to affect relatively few filers and a fix for them seems to make sense for sake of tax equity.

Filing Elections

As you discussed in the most recent meeting, this is an area that deserves attention as the Department of Taxation's restrictive rules on changing elections from separate or combined to consolidated don't make as much sense today as they made forty years ago. I have seen many examples over the years where a company made an election in a very different place and time and is arbitrarily barred from making a change when events such as mergers or acquisitions reasonably merit a change. In that case, it makes sense to allow greater flexibility, which can be as little as a one-time only ability to change from separate or combined to consolidated or the ability to change after a reasonable period of years, e.g., five, seven, or ten years. Such a fix could also resolve the 163(j) issue for many combined filers.

> § 58.1-442. Separate, combined or consolidated returns of affiliated corporations.
> A. Corporations which are affiliated within the meaning of § 58.1-302 may, for any taxable year, file separate returns, file a combined return or file a consolidated return of net income for the purpose of this chapter, and the taxes thereunder shall be computed and determined upon the basis of the type of return filed. Following an election to file on

a separate, consolidated, or combined basis all returns thereafter filed shall be upon the same basis unless permission to change is granted by the Department.

B. For the purpose of subsection A:

1. A consolidated return shall mean a single return for a group of corporations affiliated within the meaning of § 58.1-302, prepared in accordance with the principles of § 1502 of the Internal Revenue Code and regulations promulgated thereunder. Permission to file a consolidated return shall not be denied to a group of affiliated corporations filing a consolidated federal return solely because two or more members of such affiliated group would be required to use different apportionment factors if separate returns were filed. The Tax Commissioner shall promulgate regulations setting forth the manner in which such an affiliated group shall compute its Virginia taxable income.

2. A combined return shall mean a single return for a group of corporations affiliated within the meaning of § 58.1-302, in which income or loss is separately determined in accordance with subdivisions a through d below:

a. Virginia taxable income or loss is computed separately for each corporation;

b. Allocable income is allocated to the state of commercial domicile separately for each corporation;

c. Apportionable income or loss is computed, utilizing separate apportionment factors for each corporation;

d. Income or loss computed in accordance with items a through c above is combined and reported on a single return for the affiliated group.

C. Effective for taxable years beginning on and after January 1, 2022 and ~~N~~notwithstanding subsection A, a group of corporations may apply to the Tax Commissioner for permission to change the basis of the type of return filed (i) from consolidated to separate or (ii) from separate or combined to consolidated, or vice versa, if such corporations are affiliated within the meaning of § 58.1-302 ~~and the affiliated group of which they are members, as it has existed from time to time, has filed on the same basis for at least the preceding 20 years. Permission shall be granted if:~~ and such permission shall be granted, provided that such change shall be binding upon the corporation for a period of XXX taxable years.

~~1. For the taxable year immediately preceding the taxable year for which the new election would be applicable, there would have been no decrease in tax liability computed under the proposed election as compared to the affiliated group's former filing method; and~~

~~2. The affiliated group agrees to file returns computing its Virginia income tax liability under both the new filing method and the former method and will pay the greater of the~~

~~two amounts for the taxable year in which the new election is effective and for the immediately succeeding taxable year.~~

Alternative Methods of Apportionment

This is another example where greater flexibility by the Department of Taxation can go a long ways. Virginia Code Section 58.1-421 grants the Department authority to administratively deal with situations where Virginia's apportionment statutes create unfair or inequitable tax results, but the Department almost never invokes this authority. That's unfortunate because we are increasingly seeing Virginia-based service businesses, as Verisign's tax director pointed out, having 100% of their receipts taxed by Virginia under our outdated cost of performance rules while other states that have adopted market sourcing are taxing the very same receipts, with the result being that companies are facing taxation on 125%, 150% or more of their receipts nationwide. Either a statutory change (see below for possible language) or a gentle nudge to the Department to be more flexible would be a big help to Virginia's service economy and, at a minimum, can help bring shorter-term relief until the General Assembly can fully evaluate market sourcing.

> § 58.1-421. Alternative method of allocation.
> If any corporation believes that the method of allocation or apportionment hereinbefore prescribed as administered by the Department has operated or will so operate as to subject it to taxation on a greater portion of its Virginia taxable income than is reasonably attributable to business or sources within this Commonwealth, it shall be entitled to file with the Department a statement of its objections and of such alternative method of allocation or apportionment as it believes to be proper under the circumstances with such detail and proof and within such time as the Department may reasonably prescribe. If the Department concludes that the method of allocation or apportionment theretofore employed is in fact inapplicable or inequitable, it shall redetermine the taxable income by such other method of allocation or apportionment as seems best calculated to assign to the Commonwealth for taxation the portion of the income reasonably attributable to business and sources within the Commonwealth, not exceeding, however, the amount which would be arrived at by application of the statutory rules for allocation or apportionment. The Department shall give specific consideration and deference to requests for alternative methods of apportionment in cases where a corporation can demonstrate that the currently applicable method of apportionment results in greater than one hundred percent of the corporation's receipts being subject to taxation in the aggregate as a result of the operation of the apportionment regimes of Virginia and other states.

Elective Combined Reporting

The Department of Taxation's concerns around the fiscal impact of totally elective reporting regimes are well taken. Plus, as someone with an extensive background in tax policy, I believe uniform application among similarly situated taxpayers should be the Commonwealth's preferred approach. That said, if the General Assembly sees fit to allow elective combined reporting for a corporation or some corporations, it should be feasible to accomplish that objective without opening the floodgates wide and, hence, limit the fiscal impact. One approach could be limit a unitary combined reporting election to corporations which create a specific number of jobs in the Commonwealth over a defined period of time, in effect making it an "economic development election" applicable only to corporations that make extraordinary investments in Virginia. That automatically limits potential fiscal losses and ties the benefit to a valid public policy objective. It also eliminates the possibility that unitary combined reporting will drive existing companies from Virginia or discourage others from coming in the first place.

2. Jon Elder - Dollar Tree

My recommendation for changes to the Virginia income tax law is to adopt single sales factor for all companies. Currently, only certain companies (manufacturers, retailers, enterprise data centers, debt buyers) can either elect or are required to file on a single sales factor approach. By making it universal for all, the law will no longer discourage investments in VA property and payroll. Both of these metrics drive other taxes, e.g., real estate taxes, personal property taxes and payroll taxes. Having the income tax apportionment factor increased for these items increase taxes that Virginia based companies pay and decrease taxes that companies based outside of Virginia pay. It seems that we would want to encourage the opposite.

By going to a single sales factor approach, it is much easier on taxpayers to calculate their apportionment factor and will eliminate the need for the mixed apportionment rules that the Department of Taxation promulgated many years ago. These regulations are very complex. Simplification would benefit the majority of taxpayers. Virginia would also be apportioning income similarly to about 35 other states. Research suggests that all states will convert to the single sales factor in due time. Most of the states that Virginia competes with have already adopted single sales factor.

In addition, changing to a market based sourcing concept over the cost of performance method would also be a benefit to Virginia. Most of the states have adopted this approach already and will be a fairer approach for service based companies headquartered in Virginia.

3. Ellen Berenholz - Comcast Corporation

Comcast appreciates the continued opportunity to provide feedback from the taxpayer community directly to the Unitary Combined Corporate Reporting (MUCR) Workgroup. In response to the September 23, 2021 email request to share other productive legislative changes (beyond MUCR) to Virginia's current corporate tax regime, we first reiterate our articulated belief from our prior submission that that the current corporate tax filing regime has long been a significant competitive factor to the Commonwealth consistently being recognized as one of the best states in which to do business and our preference is to not upend the corporate tax structure with significant policy upheaval especially, at this time when job creators and capital investors navigate the economy shaken up by the pandemic. A state's incremental tax burden is most definitely a relevant factor when evaluating both when and where to deploy infrastructure capital expenditures, particularly allocation of funds to broadband technology.

We limited our first submission to two issues that impact the preliminary tax base determination in a shift to MUCR: (1) the ability to file worldwide combination, and (2) the use of historical data from another state that has long imposed MUCR as the starting point for quantifying fixed asset basis. We now here address the apportionment of the income base under two scenarios - should there be no imposition of combined reporting and should there be adoption of MUCR.

Considerations of Apportionment Changes under the Current Separate Reporting Regime:

There has been discussion over many years and, again specifically during the MUCR working group meetings, suggesting that a change to single sales factor and market-based sourcing for service income could be beneficial. But we believe that the proponents ignore a glaring fairness issue which the pandemic has highlighted --- you should be taxed based on where you actually do the work. Many states, most notably New York and Massachusetts, have asserted that they can tax employees even when the employees have moved and worked outside of those states permanently or for extended periods. These states' policies are widely regarded as fundamentally unfair because they ignore where the employee is actually doing her work. Single sales factor and market-based sourcing rules, when applied to a networking company like Comcast, likewise ignore all the significant and valuable work that Comcast does outside of Virginia.

Proponents of these changes assert that single sales factor and market-based sourcing is a way of helping certain Virginia headquartered companies that generate much of their sales revenue outside the state. If a Virginia headquartered company has no customers in Virginia, then it will have a $0 income tax liability. We certainly acknowledge that result benefits the Virginia headquartered company. But, as noted above, it also is a policy which completely ignores the earnings producing activities which occur in Virginia. It's difficult to understand how this is a fair and equitable result.

The reality is that single sales factor coupled with market-based sourcing produces a shift of tax burden to companies who robustly contribute to jobs and investment in Virginia, but simply happen to also conduct significant earnings producing activities outside of Virginia. Note that while Comcast is headquartered in Philadelphia, Pennsylvania, the nature of being a nationwide broadband provider necessitates that we have significant capital investment and payroll deployed nationwide in the provision of our services to the citizens of Virginia.

In the last three years alone, Comcast has invested $1.6 billion in Virginia, including capital expenditures, employee wages and benefits, taxes and fees, and charitable giving. But in that same period Comcast has also committed tens of billions to investment nationwide. An investment which singles sales factor and market sourcing would completely ignore.

A shift to single sales factor coupled with market-based sourcing from the current law three factor costs of performance would negatively impact a segment of the large employers in the service industry and would indeed pick winners and losers among the business community. Should there be a desire to benefit one segment of the business community, we hope that the consequences to all large investors be taken into consideration. This could be accomplished with the allowance of an election to maintain the status quo apportionment regime for corporations in the state meeting a significant dollar threshold of measurable investment.

Considerations of Apportionment Changes under a Change to a MUCR Reporting Regime:

We preface the comments in this section with an acknowledgement of shared concerns expressed in Workgroup testimony by both COST and the Department of Taxation about the potential of MUCR policy to lead to future uncertainty for both taxpayers and tax administrators and the inevitable controversy from changes to the current longstanding statute which has already been updated with add-back provisions to mitigate loopholes in the separate reporting regime.

However, should the legislature choose to revamp the corporate tax law to MUCR in tandem with changing the methodology of sourcing of services from costs of performance to market-based sourcing - -- with the elimination of the property and payroll factors from apportionment calculations --- we note that these changes could negatively impact certain employers in the Commonwealth. As we noted above, Comcast is headquartered outside Virginia and, as highlighted in our prior submission, in recent years operates globally, both of which are common to many companies and industries and provide unique implications in the mechanics of measuring corporate income tax.

If a goal of tax policy change is to mitigate choosing winners and losers among the companies with consistent large capital expenditures in the Commonwealth, this investment contribution could be recognized with a targeted election that allows for worldwide combined reporting with an election for apportioning income. The election would allow for apportionment of worldwide income based on audience factor market sourcing – that is, Virginia audience divided by worldwide audience since market for a broadcaster is the audience in a jurisdiction. The use of audience, or as we call it – "eyeballs", allows for a fair and objective measurement of activity occurring in Virginia. Market sourcing is not easily determined for certain types of services, but the use of broadcasting audience should mitigate much of the grey area of market-based sourcing methodology. This specific market-sourcing calculation targeted to communications companies that significantly contribute to the Virginia economy would acknowledge the contribution of significant communications industry taxpayers to the Commonwealth, not just headquartered companies, should there be a policy change to both MUCR and apportionment.

4. **Alison Malloy - Verisign**

The Commonwealth of Virginia should <u>not</u> adopt Mandatory Unitary Combined Reporting (MUCR) for the following reasons

- **Unfairness of combination of MUCR and existing Virginia apportionment rules**

When combined with MUCR, Virginia's all-or-nothing Cost of Performance apportionment rules would make Virginia very inhospitable to Internet-based sellers of sellers of services that operate nationally but have a strong Virginia presence. As a result, most states who adopt mandatory unitary combined reporting have also changed their rules to calculate apportionment based on sales (adoption of market-based sourcing for sales of services).

For example, when New Mexico adopted mandatory combined reporting in 2019, it also adopted market-based sourcing for sales of other than tangible personal property. When New Jersey adopted mandatory unitary combined reporting in 2018, it also adopted market-based sourcing for sales of services. In 2014, when Rhode Island adopted mandatory combined reporting, it also adopted single sales factor apportionment and market-based sourcing for sales of other than tangible personal property.

Adoption of mandatory unitary combined reporting without also transitioning to market-based sourcing would be extremely unfair and punitive to Virginia companies that sell services over the Internet.

- **Elimination of choice in filing status**

Currently, taxpayers may elect to file on either a consolidated or separate basis where the separate legal entity of each member of the combined group is respected and taxes are calculated separately, thus sparing entities with no nexus the burden of taxation. There are already several protections in place in Virginia to prevent companies from gaming the system. Companies may only change their method of filing (consolidated to separate or vice versa) if they meet certain criteria designed to prevent taking advantage of the system. Also, contrary to what some believe, Virginia has fixed the issue of intellectual property shell corporations and intangible holding companies, so companies are prevented from gaming the system in this manner, as well (See Item 3-5.09 in the 2021 Budget – Chapter 552). Lastly, the Virginia Tax Department has tools to determine and correct if companies are engaging in intercorporate transactions designed to reduce their tax liability. See § 58.1-446.

These provisions have already addressed many of the reasons that caused other states to adopt MUCR and means that MUCR would be more disruptive than helpful to Virginia.

- **MUCR unfairly attributes income (and losses) in another state to the taxing state**

The general concept is that income earned in a state should be taxed by that state. MUCR throws out that concept by including income (or losses) earned in State B on the State A's corporate income tax return, whether or not there is any connection to State A. This can lead to very different (and unfair) results for different companies based on their unique circumstances. For example, a company that is very profitable in State A could end up paying no taxes to State A under MUCR because it has an unprofitable subsidiary in State B. Alternatively, a company that is trying to get profitable in State A may see its tax liability jump up in State A for no other reason than because it is part of a unitary group with a company in State B.

- **MUCR rules are inconsistent between states**

MUCR rules are not "one size fits all." There is no consistent set of rules that can be simply applied across all state compliance – this increases the amount of time to prepare and file returns that were most likely simpler to file.

- **MUCR audits are more difficult**

Audits under MUCR last longer and can be more involved and costly. Post -2017 Tax Cuts & Jobs Act, the avalanche of new Federal rules and regulations is still being sorted out at the state level. The combination of already inconsistent MUCR rules among states, and shifting guidance increases the workload for tax departments that are already expected to perform at high levels with low staffing.

- **Corporations who are headquartered in Virginia as a result of the current tax structure may be adversely impacted by the adoption of MUCR**

Virginia is a relatively low tax jurisdiction, compared to other states – this has mitigated the competitive edge that other states might have in attracting corporate headquarters and growing a particular state's economy. The ability of corporations to file using consolidated or separate basis also makes Virginia attractive to companies looking to locate or expand because they know that income from around the country will not be unfairly taxed in Virginia.

MUCR would however negatively impact companies that are acquisitive and have subsidiaries with no nexus, who will be pulled into Virginia's calculation and unfairly taxed. Additionally, because Virginia uses the Cost of Performance methodology for service providers, the forced combination rules of MUCR will cause many taxpayers to pay more than 100% of their share of taxable income (i.e., double taxation) as many other states have adopted market-based sourcing or single sales factor sourcing, thus leaving Virginia based taxpayers paying tax on 100 percent of their nation-wide sales to Virginia in addition to paying tax to other states based on their sales. This inability to file on a separate basis will particularly make Virginia an unattractive jurisdiction for companies that sell services over the Internet. Such a company would be better off (from a tax perspective) by locating in Washington, D.C., or Maryland, even though those states have higher corporate tax rates, because they have adopted market-based sourcing.

5. Ken Wright - Smithfield

Smithfield Foods has been operating in Virginia for 85 years. We have our corporate offices in Smithfield, Virginia, and we have operations across the United States, Europe, and Mexico. We have roughly 3,000 employees in Virginia and have invested heavily in the Commonwealth of Virginia over the years. For the reasons stated below we hope that the Work Group will 1) recommend against adoption of mandatory unitary combined reporting (MUCR) in Virginia and 2) send a clear message that Virginia has no plans to pursue MUCR.

Based upon information presented during the Work Group's sessions, under MUCR some taxpayers would be required to pay more in Virginia income tax even though their business activities in Virginia did not change. Adoption of mandatory unitary combined reporting in Virginia would penalize Virginia companies for expanding and growing around the country. If a company that is heavily invested in Virginia wants to expand through acquisitions in other states and create new jobs in Virginia as a result, mandatory unitary combined reporting could create disincentives for making these types of investments.

Enacting MUCR would present challenges for the Department of Taxation (DOT) as well. In the September meeting, the DOT highlighted the complexities of enacting a new tax regime in terms of updating systems to accommodate MUCR, hiring and training additional staff, increased volume of appeals/rulings, and developing guidance for complex MUCR statutes the legislature will have to draft.

Virginia's stable business environment is partially responsible for Virginia's number one ranking in CNBC's America's Top Business States in 2019 and 2021. A change such as MUCR will make Virginia less competitive with surrounding states which do not have MUCR. Virginia's tax rate is already amongst the highest of its competitors, and none of the southeastern states have MUCR. A stable tax environment is a very important factor for businesses looking to locate or invest in a state. To paraphrase Secretary Ball at the last Work Group meeting, “No company moved to Virginia hoping that the rules might someday change, but lots of companies moved to Virginia hoping the rules would stay the same.” Businesses are looking for a welcoming tax environment but also an understanding that the environment will not change drastically. Changing to mandatory unitary combined reporting is a major shift in tax policy that creates disruptions in business operations in a state. Policy changes like this create winners and losers, and losers will face an increased tax burden for little to no actual benefit.

The 2019 informational report required pursuant to 3-5.23 of the 2021 Appropriation Act should be viewed as inconclusive and not be a decision factor when considering MUCR. Using information from one year to compare the income tax of the two regimes does not accurately reflect the impact on some companies. For instance, the report findings indicate 73% of respondents showed essentially no change in tax liability; however, some companies with existing Net Operating Losses (NOL) would utilize more NOL’s in the 2019 year under MUCR than under the existing regime. While the 2019 income tax reported on the informational report under MUCR appears to be substantially the same, some companies with NOLS’s would have an increase in NOL utilization under MUCR thereby reducing NOL’s available for future utilization. This would not be reflected in the amount of 2019 income tax reported; however, it would result in paying more income tax in those future years under MUCR once the NOL’s are fully utilized. As you may recall, Maryland studied MUCR for five years before deciding not to enact it.

Other Modifications to Virginia’s Corporate Income Tax

Following the federal Tax Cuts and Jobs Act (TCJA), Virginia imposed a new limit in interest expense under § 163(j) of the Internal Revenue Code that Virginia corporate taxpayers could deduct. Prior to the TCJA, companies could deduct interest expenses as a business expense. While other states have continued that policy, Virginia has limited that deduction for Virginia corporate taxpayers. This change in tax policy has been an effective tax increase for many Virginia corporate citizens. We would support an increase of the deductibility of interest expenses allowed on Virginia corporate income taxes. This change would encourage greater investment in Virginia.

6. Kathleen Kittrick - Verizon

As been previously mentioned, Verizon’s number one issue related to a possible move to mandatory unitary combined reporting relates to the ability to use an ASC 740 protection/deduction on our quarterly financial statements for deferred tax impacts. Verizon is consistently one of the top capital investors in the United States, annually investing $16-$18 billion in advancing its broadband networks, resulting in a huge number of assets and associated depreciation on its balance sheet.

Publicly traded companies must account for their assets in two separate but distinct ways – for tax purposes (tax books) and for quarterly financial statements using GAAP methodology. Depreciation of these assets is treated differently and can result in a large impact for deferred tax liability on the financial statement. That large impact can and does negatively affect a company's ETR or "effective tax rate" and consequently a company's EPS or "earnings per share" which can have the cascading effect of reducing a company's stock price.

Verizon strongly supports the language that was inserted into Senator Marsden's bill SB1353, as introduced, that provides for a deduction (amortized for 10 years) for net deferred tax liabilities.

Other Corporate Tax Reform Suggestions for Virginia

Repeal or Amend Virginia's Telecommunication's Minimum Tax (§ 58.1-400.1):

Virginia requires telecommunications companies to calculate two separate taxes – the Telecommunications Minimum Tax (TMT) (a gross receipts tax, rate of .05%) and the corporate income tax. The taxpayer pays the higher of the two taxes.

The TMT is an onerous, outdated and time consuming process and more often than not, the taxpayer ends up paying the corporate income tax anyway. And depending on the company structure, not all communications competitors share this tax filing burden.

Verizon supports either an outright repeal of the TMT or an amendment that allows the taxpayer to opt out of the TMT tax calculation if they have filed it for a number of years and have determined that the "higher" of the taxes is the corporate income tax and paid that.

If Virginia truly hopes to "modernize" the tax structure, this issue is a great place to start.

Public Comments for 10/12/2021 Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes

Last Name: Wodicka **Organization:** The Commonwealth Institute for Fiscal Analysis **Locality:** City of Richmond

The Commonwealth Institute (TCI) would like to thank Chair Watts, Sen. Marsden, the other work group members, and agency and legislative staff for their discussion and deliberations around the feasibility of unitary combined reporting in the commonwealth. We support policy changes that would modernize Virginia's corporate tax system and minimize opportunities for aggressive tax avoidance by large multi-state corporations. TCI views unitary combined reporting as a sensible policy change that would accomplish this goal. In addition, TCI also supports other options, such as strengthening the state's add-back statute and providing the Department of Taxation with greater authority to compel corporations to submit combined or consolidated returns where warranted. We believe that any recommendation around either combined reporting or other corporate tax changes should be enacted on a mandatory basis. Otherwise, as noted by staff, corporations would likely only opt in if it reduces their taxes, while corporations that would see a tax increase would likely not choose that option if given the choice. An optional policy would likely result in greater state revenue loss and add additional complexity to the system. This kind of issue has emerged in the case of the state's single-sales factor apportionment for manufacturers, which is available as an option. The option has a larger negative impact on state revenues than requiring it for all manufacturers would, according to the Joint Legislative Audit and Review Commission. We also would like to note that many of the largest corporations continue to operate nationally, including with substantial presences in states that use combined reporting. We documented these findings in our report from earlier this year, Combined Reporting: A Widely Used Tool to Counter Corporate Tax Avoidance (https://thecommonwealthinstitute.org/research/combined-reporting-a-widely-used-tool-to-counter-corporate-tax-avoidance/). Our analysis of publicly-available information on 83 large corporate employers in Virginia found that: 79 operate in at least one combined reporting jurisdiction; 71 operate in multiple combined reporting jurisdictions; and 51 operate in at least 10 combined reporting jurisdictions. Establishing mandatory combined reporting for large multi-state corporations is an important tool to advancing fairness in our tax code. It would allow Virginia to generate new, sustainable revenue that is critically needed now to continue the General Assembly's investments over the past two years. Thank you, Chris Wodicka Senior Policy Analyst The Commonwealth Institute for Fiscal Analysis wodicka@thecommonwealthinstitute.org

End of Comments

Estimated Impact of HJR 563 Work Group Findings from October 12, 2021 Meeting

Proposal 1: Deconform from the IRC § 163(j) Limitation

TCJA Background: On December 22, 2017, the federal Tax Cuts and Jobs Act ("the TCJA") was signed into law. This federal tax reform legislation substantially changed the federal income taxation of individuals and businesses. One of the provisions that impacted certain businesses was a limitation on the deductibility of business interest. Under the TCJA, the deduction of business interest is generally limited to the sum of business interest income, 30 percent of adjusted taxable income, and floor plan financing interest ("the business interest limitation"). Any business interest that is disallowed because of this business interest limitation is treated as business interest paid or accrued in the following taxable year, and may be carried forward indefinitely, subject to certain restrictions.

The business interest limitation does not apply to certain taxpayers including small businesses that have annual gross receipts for the three-taxable-year period ending with the prior taxable year equal to or less than $25 million. In addition, real property and farming businesses may opt out of the new limitation if they use the alternative depreciation system to depreciate certain property used in their businesses.

Virginia Tax Treatment: During the 2019 Session, the General Assembly enacted legislation generally conforming to the TCJA (HB 2529 and SB 1372), including the federal business interest limitation. In addition, the legislation allowed a state-specific deduction beginning with Taxable Year 2018 to individuals and corporations subject to the federal business interest limitation. The state-specific deduction is equal to 20 percent of the amount of business interest that is disallowed as a deduction under the business interest limitation. The effect of this state-specific deduction is to accelerate a taxpayer's ability to claim their business interest for Virginia income tax purposes by allowing a larger aggregate deduction during the year in which interest expense is paid or accrued than is allowed on the federal return. However, in future taxable years, taxpayers are required to reconcile this acceleration on their Virginia income tax returns.

CARES Act: On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security ("CARES") Act was signed into law. Among other changes, the CARES Act increased the federal limitation on the business interest deduction for Taxable Year 2019 and 2020. Although Virginia generally conformed to the tax provisions of the CARES Act during 2021 Special Session I (HB 1935 and SB 1146), Virginia did not conform to the temporary increase in the business interest deduction limitation.

Proposal: If Virginia were to adopt legislation during the 2022 General Assembly Session to deconform from the IRC § 163(j) limitation, with an assumed effective date of taxable years beginning on and after January 1, 2022, it would have the following estimated impact on General Fund revenues:

	FY 2023	FY 2024	FY 2025	FY 2026
Estimated Impact (in millions)	($122.3)	($87.4)	($90.2)	($94.0)

Proposal 2: Ease Virginia's Rule for Corporate Filing Status Changes

Federal Filing Election: For federal income tax purposes, an affiliated group of corporations has the option of filing a consolidated return in lieu of separate returns for each corporation. If a consolidated return is filed, the affiliated group members are treated as one entity and their financial activities are combined for purposes of computing their federal income tax liability. A corporation generally meets the federal requirements for affiliation if it possesses at least 80 percent of the total voting power and at least 80 percent of the total value of a corporation's stock.

Virginia Filing Election: Virginia is a separate return state. As a result, Virginia allows each corporation with nexus with the state the ability to elect to file a separate Virginia return, regardless of its federal tax filings. In addition, Virginia allows corporations that are members of an affiliated group of corporations with Virginia nexus the ability to elect to file on a consolidated or Virginia combined basis. All returns for subsequent years are required to be filed on the same basis unless permission to change is granted by the Department. If a new corporation becomes a member of an affiliated group, the new corporation must follow the filing method previously elected by the group.

If an affiliated group of corporations elects to file separately, each corporation in the affiliated group that has nexus in Virginia is required to file its own separate corporate income tax return and report only its income, expenses, gains, losses, and allocation and apportionment factors on such return. This type of reporting follows the separate entity concept, in which each corporation in an affiliated group is treated as distinct and separate from the other corporations in such group for purposes of determining each corporation's corporate income tax liability.

A consolidated return includes the aggregate income, expenses, gains, and losses, allocation and apportionment factors of all of the corporations in an affiliated group that have nexus with Virginia. The corporate income tax liability of the affiliated group is computed in the aggregate, and the entire affiliated group files one corporate income tax return.

In a Virginia combined return, each corporation in an affiliated group that has nexus with Virginia determines its income, expenses, gains, losses, and allocation and apportionment factors separately. Each corporation then separately computes its individual corporate income tax liability. The final corporate income tax liability, after apportionment, of each corporation is then combined and included on one corporate income tax return.

Changing Virginia Filing Status: The Department has the statutory authority to grant or deny requests by corporations to change their Virginia tax filing status. Because switching to or from the consolidated filing status affects the allocation and apportionment formulas and may distort the business done in Virginia and the income arising from activity in Virginia, the Department generally will grant permission to change to or from a consolidated filing status only in extraordinary circumstances. In contrast, separate and Virginia combined returns do not affect the allocation and apportionment formulas for each corporation. Therefore, permission to change from separate to Virginia combined returns or from Virginia combined to separate returns is generally granted.

During the 2003 Session, the General Assembly enacted legislation that effectively provided an exception to the Department's general rule against switching to or from the consolidated filing status. This legislation provided that an affiliated group that has filed on the same basis for at least the preceding 20 years is allowed to change the basis of the type of return filed from consolidated to separate or from separate or combined to consolidated if:

- The tax computed under the affiliated group's requested return basis would be equal or greater than the tax for the full taxable year immediately preceding the taxable year for which the requested return basis would be applicable; and

- The affiliated group agrees to compute its tax liability under both the requested return basis and the elected return basis and would be liable for the greater of the two amounts for the taxable year in which the requested basis is effective and the immediately succeeding taxable year.

Proposal: If Virginia were to reduce the 20 year requirement to a term of 12 years, the change would have an unknown negative General Fund impact. The number of corporations that would switch and the filing basis that they would elect are unknown. Below is a table that summarizes the income tax liability by corporate income tax returns filing status. A portion of the revenue could be lost but the magnitude is unknown.

Taxable Year 2018	Number of Returns	Percentage of Returns	Income Tax Liability (in millions)	Percentage of Total Income Tax Liability
Separate Returns	65,790	96%	$615	54%
Consolidated Returns	2,072	3%	$282	25%
Combined Returns	481	1%	$247	21%
All Returns	68,343	100%	$1,144	100%

If Virginia were to adopt legislation during the 2022 General Assembly Session to make changes to the IRC § 163(j) limitation other than full deconformity, the revenue impact would depend on what changes were adopted. For example, if Virginia were to increase the limitation percentage rather than entirely deconforming from it, the revenue impact would depend on both the exact amount of the increased limitation percentage and whether Virginia would choose to keep or repeal the state-specific deduction.

Prior Estimates: 2020 Senate Bill 1058 proposed changes to the current rules for changing filing status. Several versions of the bill were considered. The Senate substitute would have allowed an affiliated group of corporations to change from the Virginia combined to the consolidated filing status if it meets the following requirements:

- It has filed on the same basis for at least the preceding 20 years;
- At least one member of the affiliated group is:

    - A related entity to either a state or national bank that is exempt from filing a Virginia corporate income tax return, or
    - An entity that is classified under North American Industrial Classification System ("NAICS") Code 3364, aerospace product and parts manufacturing; and

- The affiliated group agrees to file returns computing its Virginia income tax liability under both the new filing method and the former method and pay the greater of the two amounts for the taxable year in which the new election is effective.

The bill was estimated to have an unknown, but potentially significant, negative General Fund revenue impact. Since the bill was industry-specific and would have impacted a more narrow set of taxpayers, the Department of Taxation was able to identify affiliated groups that might have been eligible to change their filing status under the proposed legislation. The tax liability of such groups appeared to be approximately $25 million and it was estimated that an unknown, but likely significant, portion of the $25 million in revenue could be lost due to tax planning if the bill was enacted.

Since the bill did not limit eligibility to entities that reported the relevant NAICS codes or that were primarily involved in the relevant industries during a particular year, it was not possible to identify all affiliated groups that could potentially be eligible under the bill. In addition, concerns were raised regarding the possibility that corporations may add an entity to the affiliated group or otherwise restructure to qualify and, therefore, increase the negative impact of the bill.