COST
COUNCIL ON STATE TAXATION

State Corporate Income Tax Filing Methods

Policy Position

Generally, states apportion the unitary business income of each separate taxable entity (separate reporting) or apportion the business income of the unitary group that includes one or more such taxable entities (combined reporting). The goal of each method is to provide an accurate reflection of income earned in the state from unitary business operations. The following are principles that states should adhere to relative to each filing method to achieve that goal.

Separate Reporting States

- **Intercompany Adjustments/Forced Combination:** States should provide clear guidelines for when the state department of revenue can make intercompany adjustments or force combination, such as requiring a finding of lack of business purpose and economic substance.

- **State "Addback" Laws:** States should adhere to the COST Policy Statement on related party expense disallowance to avoid unintended negative consequences of such provisions, including by providing clear and objective safe harbors that allow deductions for legitimate business practices, such as for transactions that have a legitimate business purpose, for "conduit" transactions, and for payments subject to tax in the hands of the recipient, including in "treaty" countries.

- **Transfer Pricing**: For both separate reporting and combined reporting, when applying I.R.C. Section 482 or a state law equivalent, states should adhere to federal transfer pricing regulations. Applying federal law in this area promotes certainty and uniformity for taxpayers and state tax administrators within the authority granted under the statute.

- **Combined/Consolidated Elections in Separate Reporting States:** Separate reporting states should allow combined and consolidated filing elections, with such elections being binding for a term of years to avoid manipulation of the filing method. Such elections allow taxpayers to use the filing method (separate, combined, or consolidated) that best reflects their business operations and activity in a state.

Combined Reporting States

- **Mandatory Unitary Combined Reporting:** States should not impose *mandatory* unitary combined reporting (MUCR) as provided in the COST Policy Statement opposing MUCR. MUCR may attribute more income to a state than is justified by the level of a corporation's real economic activity in the state, and therefore combined reporting should be elective. Any state adopting MUCR, however, should provide a deduction to mitigate the financial statement impact of the change for publicly traded companies as provided in the COST Policy Statement.

- **MUCR States Should Allow Consolidated Elections:** MUCR states should allow a consolidated filing election fully conforming to the federal affiliated group and consolidated return rules. Because mandating state filing by the federal consolidated group might violate nexus rules or the unitary business principle, taxpayers should be able to elect such filing to ease administrative burdens and provide certainty.

- **Application of Federal Consolidated Rules:** States should apply the federal consolidated rules under I.R.C. Section 1502 (where applicable) in determining a combined or consolidated group's taxable income. Adhering to the federal rules reduces complexity and uncertainty in state combined and consolidated filings.

- **Respecting the Water's Edge:** States should limit the combined return to the water's edge but allow a worldwide election. The water's-edge return should exclude domestic "80/20" companies and all foreign domiciled entities except unitary foreign entities with in-state nexus, to the extent of their effectively connected income. States specifically should avoid adopting "tax haven" legislation as provided in the COST Policy Statement.

- **Excluding Foreign Income:** The combined return should exclude foreign income received or deemed received by domestic entities from foreign subsidiaries, including foreign dividends, "Subpart F income," and "global intangible low-taxed income" (GILTI). Such income is not related to business activity in a state and, in the case of GILTI, represents a violation of the water's edge consensus by including current earnings of foreign subsidiaries with minimal offsets for tangible property overseas and no credit for foreign taxes paid. However, to the extent GILTI is included in the combined return, there must be factor representation for the factors (*e.g.*, property, payroll, and/or sales) generating the income.

- **Treatment of Tax Attributes:** States should allow the utilization of pre-combination tax attributes consistent with federal SRLY rules and post-combination tax attributes among filing group members consistent with the combined filing approach. Limiting the use of tax attributes to separate entities within the combined group violates the principle of treating the group as an economic unit.

- ***Joyce* vs. *Finnigan* Apportionment:** States should adopt the "*Joyce*" rather than the "*Finnigan*" method of apportioning combined group income. By excluding from the numerator the factors of combined group members without a taxable presence in the state (such as those protected by P.L. 86-272), the *Joyce* method better reflects the business activity of the unitary group generating income in the state. However, especially when coupled with the *Joyce* method, states should not adopt throwback or throwout rules consistent with the COST Policy Statement. Throwback and throwout laws tax income that is, by definition, earned outside of the state, and such laws tax that income at the wrong rate and direct the resulting revenue to the wrong state.

- **Excluding Taxpayers Subject to Other Tax Regimes:** State combined groups should exclude taxpayers subject to another tax regime in lieu of the corporate income tax (*e.g.*, insurance companies subject to premiums taxes).