

WILL ALABAMA'S LEGISLATURE AGAIN BE ASKED TO ADOPT "COMBINED REPORTING" FOR CORPORATE INCOME TAX PURPOSES?

For the past few years, bills have been introduced in the legislature that would require certain corporations to prepare their income tax returns on a "combined" basis, *i.e.*, to include income and apportionment data from related business entities. In 2009, HB 865 was introduced by Representative McLaughlin, and, in 2008, HB 768 was introduced by Representatives McLaughlin, Schmitz, Oden, Thomas (E), Bentley, Keahey, Graham, Irons, Thomas (J), Taylor, Hinshaw, and Lindsey. It is expected that such a bill will be introduced in the 2010 session.

BACKGROUND

If a corporation operates in more than one state, the United States Constitution provides certain guarantees to that corporation as to the amount of its income that each state is allowed to tax. Specifically, as stated by the United States Supreme Court, a state may tax the income of a multi-state corporation only "on an apportionable share of the multi-state business carried on in part in the taxing state. That is the unitary business principle." *Allied-Signal, Inc. v. Director, Division of Tax'n*, 504 U.S. 768, 778 (1992). Once a corporation's "unitary business" is determined, "a state must then apply a formula apportioning the income of that business within and without the state. An apportionment formula must, under both the Due Process and Commerce Clauses, be fair." *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

Although the U.S. Supreme Court has not mandated the use of any one apportionment formula, it has approved the standard three-factor formula - which

consists of a payroll factor, a property factor, and a sales factor – as a “benchmark.” *Container Corp., supra*, 463 U.S. at 170. This three-factor formula is used by Alabama to apportion the income of a multi-state corporation. *See* Ala. Code § 40-27-1, Art. IV, ¶ 9.

To summarize, two elements are needed to calculate the amount of income of a multi-state corporation that a state may tax. The first element is the amount of unitary business income. *Allied-Signal; Container Corp.* The second element is the corporation’s apportionment percentage. *Container Corp.* The amount of unitary business income is then multiplied by the apportionment percentage, and the result is the most income of a multi-state corporation that a state may constitutionally tax.

Generally, Alabama’s apportionment methodology is applied to corporations on a separate-entity basis, *i.e.*, without regard to the income or apportionment data of related corporations. *See* Ala. Code § 40-18-39(a).¹ Of course, in Alabama’s current system, each separate entity must be subject to this state’s corporate income tax, as a threshold matter, before Alabama’s apportionment methodology can be applied to the data of that separate entity.

COMBINED REPORTING

Some states, such as California, seek to determine the income attributable to it from a corporate taxpayer by including income and apportionment data from other corporations in that taxpayer’s apportionment calculation. This reporting method is known as “combined reporting.” To be included in the taxpayer’s apportionment

¹ Pursuant to § 40-18-39(c), an affiliated group of corporations that files a federal consolidated income-tax return may elect to file an Alabama consolidated return.

calculation, the “other corporations” must be related to the taxpayer and must be involved in the same unitary business as the taxpayer. If these criteria are met, a combined-reporting state may include the data from other corporations in the taxpayer’s calculation even though the other corporations are separate legal entities and even if the other corporations are not themselves subject to that state’s corporate income tax.²

Generally, in a combined report, a single corporate taxpayer’s taxable income is determined by combining the net income (in some form) of each member of the unitary group, and then multiplying that amount by an apportionment percentage that reflects only the single corporate taxpayer’s data in the numerator of each factor and that reflects the data of the entire unitary group in the denominator of each factor. The product is the amount of income that the state will attribute to itself and thus tax. If a state treats the members of the unitary group as individual taxpayers, as opposed to treating the unitary group as one taxpayer, then this calculation is carried out for each member that is subject to that state’s corporate income tax. For example, in 2009, HB 865 read as follows:

(a) ... a taxpayer engaged in a unitary business with one or more other corporations shall file a combined report which includes the income and apportionment factors of all corporations that are members of the unitary business, and such other information as required by the commissioner. The taxpayer will use the combined report to determine its income apportioned to Alabama.

(b)(1) The use of a combined report does not disregard the separate identities of the taxpayer members of the combined group. Each taxpayer

² The constitutionality of such a reporting method was upheld in *Container Corp., supra*.

member is responsible for tax based on its taxable income or loss apportioned or allocated to this state

CONCLUSION

As of the date of submission of this article to the editor, a version of the combined-reporting bill has yet to be introduced in the 2010 legislative session. But, the session is young. There has been great interest in the two previous bills, and the introduction of such a bill in this session would continue that interest, especially in light of possible budget shortfalls. (Many believe that combined reporting increases the amount of tax that corporations pay.) For example, the Alabama Education Association has supported combined-reporting efforts, and the Business Council of Alabama opposes combined reporting. If your company or client would be affected by the imposition of combined reporting, it would seem to be worthwhile to monitor the legislative session and to communicate with your representative.

By Jeff Patterson
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