SALT WATCH

Rhode Island Adopts Combined Reporting Regulation

Summary

On March 10, 2016, Rhode Island adopted Regulation CT-16-17, which provides guidance regarding the state's water's edge unitary combined reporting requirement for Business Corporation Tax purposes starting with taxable periods beginning after December 31, 2014. The regulation, which is divided into 23 rules, explains all aspects of Rhode Island combined reporting, including determination of the combined group, computation of taxable income and apportionment, tracing and utilization of net operating losses ("NOLs") and credits, and various administrative requirements. See **Regulation CT-16-17**.

Details

Background

On June 19, 2014, Rhode Island Governor Lincoln Chafee signed into law H.B. 7133 (now codified under Title 44, chapter 11 of the General Laws of Rhode Island), which implemented the water's edge unitary combined reporting requirement. The law also implemented single sales factor apportionment, market-based sourcing of receipts from sales of other than tangible personal property, a lower 7-percent tax rate, and the elimination of the requirement to addback related member intangible expenses and interest.

Composition of Combined Group

H.B. 7133 requires combined reporting with respect to two or more unitary corporations, wherever incorporated, that are more than 50 percent owned by a common owner, whether that owner is corporate or non-corporate, or whether or not that owner is a member of the combined group. While a corporation, wherever incorporated, may be included in a combined return, Rhode Island excludes a non-U.S. corporation from the combined group if more than 80 percent of its sales factor is outside the United States. Rhode Island also excludes the income (and attributed expenses and apportionment) of an included non-U.S. corporation, to the extent that such income is subject to the provisions of a comprehensive income tax treaty between the United States and a foreign jurisdiction. This exclusion does not apply (with some exceptions) if the foreign jurisdiction is a "tax haven" jurisdiction. The definition of "tax haven" in the regulation is the same as it is in H.B. 7133, and the regulation does not expand on or interpret it.

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The regulation specifies that the following unitary entities that meet the 50-percent direct or indirect ownership requirement are included in a combined report:

- U.S. C corporations;
- Any C corporation, regardless of where it is incorporated or formed, if its sales factor for total receipts inside the United States. is 20 percent or more; and
- A C corporation that is a resident of a country that does not have a comprehensive income tax treaty with the United States, and earns more than 20 percent of its income from intangible property or service-related activities that are deductible against the business income of the other members of the combined group to the extent of that income and related apportionment factor.

The following entities are excluded from a combined report:

- A non-U.S. C corporation if its sales factor for total receipts outside the United States is more than 80 percent;
- S corporations, and partnerships and LLCs treated as pass-through entities for federal tax purposes;
- Any sole proprietorship or similar entity that is disregarded for federal income tax purposes;
- State banks, mutual savings banks, federal savings banks, trust companies, national banking associations, building and loan associations, credit unions, and loan and investment companies;
- Public service corporations;
- Insurance companies; and
- Captive insurance companies subject to the insurance premiums tax.

Common Ownership Requirement

H.B. 7133 defines "common ownership" to mean "more than fifty percent (50%) of the voting control of each member of the group is directly or indirectly owned by a common owner or owners, either corporate or non-corporate, whether or not owner or owners are members of the combined group."

The regulation specifies that the 50-percent ownership test is satisfied in the following circumstances:

- A parent corporation and one or more corporations or chains of corporations which are directly or indirectly connected through voting stock ownership with the parent, if:
- The parent owns more than 50 percent of the outstanding voting stock of at least one corporation; and
- More than 50 percent of the outstanding voting stock of each of the corporations, other than the parent, is owned directly or indirectly by one or more of the other corporations.
- Two or more corporations, if more than 50 percent of the outstanding voting stock of each of the corporations is directly or indirectly owned by the same person; and
- Two or more corporations, more than 50 percent of whose voting stock is cumulatively owned, or for the benefit of, members of the same family (i.e., an individual, his or her spouse, a party to a civil union, ancestors, brothers or sisters, lineal descendants, and their respective spouses).

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For purposes of ascertaining ownership, the regulation requires the use of the following rules:

- An individual indirectly owns voting stock that is owned by any of the following:
  - A spouse who is not legally separated from the individual,
  - A party to a civil union,
  - Children, grandchildren, and parents, and
  - An estate or trust of which the individual is an executor, trustee, or grantor, to the extent that the estate or trust is for the benefit of that individual's spouse, party to a civil union, children, grandchildren or parents;
- Voting stock owned by a corporation is indirectly owned by any shareholder (or group of shareholders if acting in concert) owning more than 50 percent of the voting stock of the corporation;
- Voting stock owned by a general partnership is indirectly owned by a partner in proportion to the partner's capital interest in the partnership;
- Voting stock owned by a limited partnership is indirectly owned by the general partner who has authority to determine how the stock is voted; and
- The Rhode Island Division of Taxation may rely on the constructive ownership rules under IRC § 318 to demonstrate that the direct or indirect ownership requirement is met.

Unitary Business Requirement

H.B. 7133 defines "unitary business" as follows:

> [T]he activities of a group of two (2) or more corporations under common ownership that are sufficiently interdependent, integrated or interrelated through their activities so as to provide mutual benefit and produce a significant sharing or exchange of value among them or a significant flow of value between the separate parts. The term unitary business shall be construed to the broadest extent permitted under the United States Constitution.

The regulation provides a detailed description of the definition of "unitary business." Specifically, the regulation notes that the following characteristics indicate sufficient interdependence to support a finding of a unitary relationship between two or more entities or businesses:

- Same line of business;
- Vertically structured business;
- Strong centralized management;
- Non-arm's length prices;
- Existence of benefits from joint, shared or common activity; and
- Exercise of control.

In addition, the regulation notes that for purposes of assessing whether a unitary relationship exists between two entities or businesses, unity of operations and unity of use (i.e., common purchasing, common advertising, common accounting, common marketing, etc.) should be considered. Guidance is provided with respect to holding companies, and newly formed and acquired entities.

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Affiliated Group Election

H.B. 7133 allows an "affiliated group," as defined in IRC § 1504, to make a five-year election to be treated as a combined group in lieu of a unitary business group, notwithstanding the absence of a unitary relationship. The election may not be revoked unless approved by the Division.

The regulation notes that, to make the election, a taxpayer must check the box on Form RI-1120C and file a completed return. Once made, the election is binding for five consecutive tax years beginning with the year of election. This rule is also applicable to an entity that enters the affiliated group after the year of the election. To revoke the election, a taxpayer must petition the Division in writing, citing reasonable cause (e.g., a significant restructuring).

An affiliated group may not make the election if those entities in which it has an ownership interest between 50 percent and 80 percent would materially impact the combined return were they to be included in the combined return. To clearly reflect income, the Division may require an affiliated group to include certain entities that are not included in its federal consolidated return, or exclude certain entities that are so included.

Combined Group Net Income and Apportionment

The regulations note the following with respect to the calculation of a combined group's net income:

- Determination of taxable income for the combined group is based on the product of the pre-apportioned taxable income of the combined group, and the apportionment factor of the combined group;
- The taxable income of the combined group and the apportionment factor includes each member's pro-rata share of income and receipts from a flow-through entity;
- The principles relating to deferral, eliminations, and exclusions as set forth in the IRS's consolidated return regulations are applied for purposes of determining the taxable income and apportionment of the combined group;
- The numerator of the apportionment factor includes the Rhode Island receipts of each member of the combined group in the numerator, regardless of whether or not a member has nexus with Rhode Island – a Finnigan approach;
- A combined group member's apportionment factor includes its distributive share of the apportionment factor of a flow-through entity based on costs of performance sourcing rather than market sourcing, as generally required under the Corporation Business Tax;
- The taxable year of the combined group is the taxable year of the federal consolidated group if two or more members are included in a federal consolidated return – otherwise, use the taxable year of the designated agent (see discussion below); and
- Where one or more members of a combined group have different accounting periods, the designated agent must elect to determine the taxable income of all such members in one of the following ways:
  - A separate income statement prepared from the books and records for the months included in the group's taxable year; or
  - Include all of the income for the year that ends during the group's taxable year.

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NOLs and Tax Credits

With respect to NOLs and tax credits, H.B. 7133 limits the use of an NOL carryforward or tax credit created before January 1, 2015, to the entity that created it. H.B. 7133 allows the use of an NOL and tax credit created in a taxable year beginning after December 31, 2014, by the combined group.

In addition to the rules noted in H.B. 7133, the regulation specifies the following with respect to the use of NOLs (the same rules apply to tax credits), and provides a number of examples demonstrating the operation of these rules:

- No deduction is allowable for an NOL sustained during any taxable year in which a taxpayer was not subject to Business Corporation Tax;
- For the year in which an NOL is allowed, such NOL is limited by the amount of that corporation's federal taxable income for that year;
- NOLs are be carried forward from year-to-year separately by the individual entity that originally incurred the underlying loss, and remain the tax attribute of that entity;
- Where a member ceases to be a member of the combined group, any NOL carryforward owned by the member is no longer available for use by the other members of the combined group;
- If a member joins a new combined group, the member may not share the NOL carryforward with the members of its new combined group, unless one of the members of the new combined group was also a member of the combined group during the year the loss was incurred; and
- Where a member has an NOL carryforward and subsequently merges out-of-existence, the surviving entity assumes the NOL carryforward.

Minimum Tax

The Rhode Island tax is the greater of a $500 minimum tax or the tax computed on apportioned net income. The regulation notes that the minimum tax of a combined group is the product of the number of members in the combined group with Rhode Island nexus and the amount of the minimum tax.

Administrative Requirements

Designated Agent. The regulation requires a combined group to appoint a designated agent as the filer of the combined return, and to act on behalf of the combined group with respect to all matters relating to the combined return (e.g., responding to notices and correspondences, participating in audits, executing documents, etc.). The designated agent must be a member of the combined group that itself is subject to a Business Corporation Tax filing responsibility. The corporation that files the first combined return is deemed to be the designated agent, and remains the designated agent until the Division is notified that another member of the combined group will act as the designated agent.

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Combined Report. A combined return is required to include the following:

- Listing of companies included in the combined report, along with each company's federal Employer Identification Number ("EIN") and North American Industry Classification System ("NAICS") code;
- On a combined basis, federal taxable income, Rhode Island additions and deductions, receipts using the Finnigan method, and Rhode Island tax;
- Copy of the first four pages of the completed U.S. Form 1120 as filed with the IRS;
- Copy of the separate company income and loss consolidation spreadsheet as filed with the IRS; and
- Information on credits and NOLs.

Affiliated Group. An affiliated group must include copies of the following with its return:

- Its federal consolidated return;
- Any and all supporting documents, forms, schedules and statements filed with the federal consolidated return, including IRS Form 851, and all IRS Forms 1122; and
- Supporting statements for each corporation included on the federal consolidated return, including, for each such corporation, columns showing items of gross income and deduction, as well as a computation of taxable income.

Insights

- Rhode Island is one of several states that has recently adopted combined reporting (e.g., Connecticut, District of Columbia, Wisconsin, and West Virginia) – a trend among states, like single sales factor apportionment and market-sourcing for receipts from sales of other than tangible personal property, which Rhode Island has also adopted.
- Rhode Island's combined reporting regulation is comprehensive and provides many examples to assist taxpayers with the application of the combined reporting rules – especially as it pertains to the inclusion/exclusion of entities, computation of combined income, and utilization and tracing of NOLs.
- The regulations related to the pro forma combined return requirement asked taxpayers to calculate a Financial Accounting Standard 109 (or FAS 109) deduction. The deduction is not allowed for purposes of mandatory unitary combined reporting.