Proposed Wisconsin Combined Reporting Regulations

- 10/15/2009

October 15, 2009

On February 19, 2009, Governor Jim Doyle signed legislation mandating the use of combined reporting for unitary businesses doing business in Wisconsin effective for tax years ending after December 31, 2008. The Wisconsin legislature passed a set of technical amendments to those combined reporting provisions, which were signed into law on June 29, 2009. On August 31, 2009, the Wisconsin Department of Revenue ("Department") published and sought comment on proposed regulations interpreting various components of the combined reporting statute ("Proposed Regulations"). Tax Executives Institute is pleased to submit the following comments to the Proposed Regulations.

Combined reporting represents a significant shift in the method Wisconsin taxpayers use to compute their corporate income tax liabilities. Historically, that computation was accomplished by each corporation filing a separate return based solely on its activities in the State. Because of the magnitude of the change, clear guidance in the Proposed Regulations on the scope and application of many provisions in the combined reporting statute is critically important to the successful implementation of combined reporting in Wisconsin.

Our comments focus on five areas: (1) the basis of assets owned by corporations that have not previously filed Wisconsin corporate income tax returns; (2) the calculation and sharing of research credits and carryforwards between members of a combined group; (3) the sharing of net business loss carryforwards between members of a combined group; (4) the mechanics of the controlled group election; and (5) the selection of a designated agent for a combined group. Additionally, TEI commends the Department for providing language in the Proposed Regulations that helps conform the concepts in Wisconsin tax law to the principles of U.S. federal income tax treaties.

I. Tax Executives Institute

Tax Executives Institute is the preeminent association of business tax executives in North America. Today, the organization has 54 chapters in North America, Europe, and Asia, including two in Wisconsin. Our 7,000 members represent 3,200 of the largest companies in the world, many of which are either resident or do business in Wisconsin. TEI represents a cross-section of the business community, and is dedicated to developing and effectively implementing sound tax policy, promoting the uniform and equitable enforcement of the tax laws, and reducing the cost and burden of administration and compliance to the benefit of taxpayers and governments alike. As a professional association, TEI is firmly committed to maintaining a tax system that works – one that is administrable and with which taxpayers can comply in a cost-efficient manner.

Members of TEI are responsible for managing the tax affairs of their companies and must contend daily with the provisions of the tax law relating to the operation of business enterprises. We believe that the diversity and professional training of our members enable us to bring a balanced and practical perspective to the issues raised by the Proposed Regulations.

II. Background

Wisconsin's combined reporting statute requires corporations constituting a unitary business to file a combined report with the Department for all tax years ending after December 31, 2008.1 A unitary business group generally includes corporations connected by stock ownership of more than 50 percent and "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."2 No requirement exists that all members of a unitary business group have nexus with Wisconsin individually to be included in a Wisconsin combined report. Consequently, many corporations that do not have nexus in Wisconsin individually must now file Wisconsin returns as a result of being included in a unitary business group that includes other members that do have nexus.

III. Treatment of Depreciable Property

The Proposed Regulations require corporations that have never filed Wisconsin tax returns to use the federal basis of their depreciable assets for purposes of calculating depreciation deductions and gain and loss on the sale or disposition of those assets rather than the Wisconsin basis. Specifically, section 2.61(6)(a)(3) provides that, "[t]he Wisconsin basis of a corporation's depreciable property for the first year the corporation becomes taxable in Wisconsin equals its federal basis as of the beginning of the taxable year in which the corporation becomes taxable in Wisconsin, as required under s. 71.265 Stats."3

As a result of Wisconsin's decision not to conform to federal "bonus" depreciation provisions,4 section 2.61(6)(a)(3) discriminates against new Wisconsin filers because a corporation's basis in depreciable property for federal purposes can vary significantly from its basis for Wisconsin purposes. For example, if a corporation took advantage of the federal 50% bonus depreciation available in 2008 for certain assets, its federal basis in those assets would be approximately half of its Wisconsin basis in 2009. The result of the variation is that a company will lose large depreciation deductions, and recognize more gain upon the sale of affected assets, simply because the company has not historically done business in Wisconsin.

While the Proposed Regulations aver that Wis. Stat. § 71.265 requires the use of a corporation's federal basis upon its initial Wisconsin corporate income tax filing, that statute applies only to corporations that lose their "exemption" from Wisconsin tax. The use of the word "exemption" in the statute assumes that a corporation has previously qualified for an exemption from Wisconsin tax rather than never having been within Wisconsin's taxing jurisdiction.

Since Wis. Stat. § 71.265 does not necessarily apply to corporations coming within the reach of Wisconsin's corporate income tax, the Department is not required to follow the treatment of depreciable assets outlined there. The language of the combined reporting statute supports that interpretation since it states that "[t]he business income of a combined group is the sum of the income of each member of the combined group as determined under the Internal Revenue Code, as modified under s. 71.26 (which provides that "a corporation shall compute amortization and depreciation under the federal Internal Revenue Code as amended to December 31, 2000").

Section 2.61(6)(a)(3) of the Proposed Regulations also arguably discriminates against interstate commerce in violation of the Commerce Clause of the U.S. Constitution by providing a direct commercial advantage to businesses whose property is located in the state of Wisconsin. The Supreme Court has defined "discrimination" for Commerce Clause purposes as "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." *Oregon Waste Systems, Inc. v. Department of Environmental Quality of Oregon*, 511 U.S. 93, 99 (1994). Forcing corporations to measure depreciation and amortization, as well as gain or loss, on a less favorable basis solely as a result of not having property located in Wisconsin or engaging in business in Wisconsin would subject the State to unnecessary risk of litigation challenging the constitutionality of section 2.61(6)(a)(3).

When Massachusetts faced this issue upon its adoption of mandatory combined reporting effective for tax years beginning after December 31, 2009, the Massachusetts Department of Revenue avoided this type of discrimination by adding a mitigating provision to its combined reporting regulations. That provision allows taxpayers to elect the use of Massachusetts-adjusted basis for all assets brought into the combined group.5 Likewise here, to minimize exposure to constitutional challenges and to better reflect the intent of the recent combined reporting legislation, the Department should revise section 2.61(6)(a)(3) to provide an election for corporations newly subject to Wisconsin taxation to elect use of the Wisconsin basis for depreciable assets they own.

IV. Research Credits

A. Credit Calculation

Wisconsin provides a tax credit to businesses that engage in research and development in the State.6 The calculation of the credit is based in large part on the federal research and experimentation credit found in section 41 of the Internal Revenue Code. To calculate the credit, taxpayers take their total "qualified research expenses" ("QREs") for the current tax year less a "base amount" multiplied by 5%. Taxpayers may only include 65% of their contract research expenses in determining their QREs. Contract research expenses include payments to third parties who conduct research on behalf of the taxpayers.

For purposes of computing the federal research and development credit, the applicable Treasury Regulations treat a consolidated group as a single entity.7 Thus, when one corporation in the consolidated group pays another corporation in the same group to perform research on their behalf, the research expenses of the corporation performing the research are treated as QREs of the group and not as a contract research expense subject to the 65% limitation. In Wisconsin, however, corporations included in a combined group retain their separate existence as filing entities within the combined return for purposes of business loss carryforwards and credit computations. Consequently, the 65% limitation could apply even when one corporation contracts with another group member to provide research services.

To ameliorate this problem, the Proposed Regulations provide an "exception for funded research" in section 2.61(10)(d). Under that exception, in a situation where one entity in the group performs research for another member of the same group, the corporation actually performing the research would be able to treat its research expenses as QREs eligible to be included in the calculation of its own credit. Since the corporation actually doing the research uses its expenses in the calculation of the credit, the 65% limitation will not apply to those expenses.

Because the exception for funded research included in the Proposed Regulations reflects a significant change from the way contract research expenses were previously treated, TEI recommends inserting the following example into the Proposed Regulations at the end of section 2.61(10)(d) to clarify this concept:

> Corporation A and Corporation B file as part of Wisconsin combined group ABCD. Corporation A funds research completed by Corporation B. The payment made by Corporation A to Corporation B will not be included in the calculation of either corporation's Wisconsin research credit. Corporation B will include the qualified research expenses associated with the research activities performed for Corporation A in its Wisconsin research credit calculation.

B. Credit Sharing Among Controlled Group Members

Even though each entity must calculate its own research credit on a separate company basis (notwithstanding the requirement to file a combined Wisconsin return), the Proposed Regulations allow members of a combined group to share a portion of their research credits with other members of the group. The Proposed Regulations provide that a group "member may, after using the available credit *to offset its own tax liability*, share a portion or all of the remaining credit with the other members." (Emphasis added.) In certain circumstances, a group member with an available credit may not have "its own tax liability." For example, a group member may offset all of its taxable income with a net business loss or have no Wisconsin apportionment either before or after elimination of intercompany sales. To clarify that a group member in this situation may still share its available credits, section 2.61(10)(c) of the Proposed Regulations should be revised by adding the underlined words as follows: "the member may, after using the available credit to offset its own tax liability (<u>if any</u>), share a portion of all or the remaining credit with the other members." (New language underscored.)

The Proposed Regulations also permit corporations within a combined group to elect not to share otherwise shareable credits. No guidance is provided, however, regarding whether the election applies to future years or only to the year in which the election is made. TEI recommends that the following language be added to the end of section 2.61(10)(c)2.:

> Any election not to share an otherwise shareable credit shall be effective only for the year in which the election is made and shall have no effect on the ability to share such credits or credit carryforwards in future years.

IV. Net Operating Losses

Corporations within a Wisconsin combined group must also calculate net business losses on a separate company basis. Corporations may, however, share a portion of their net business losses generated during tax years beginning after December 31, 2008 with other members of their combined group. Section 2.61(9)(h) of the Proposed Regulations also permits corporations to elect not to share otherwise shareable net business losses with other members of the group. The Proposed Regulations do not state, however, whether that election applies to future years or only the year in which the election is made. To clarify this point, the following language should be added to section 2.61(9)(h)2. of the Proposed Regulations:

> Any election not to share an otherwise shareable net business loss or net business loss carryforward shall be effective only for the year in which the election is made and

> shall have no effect on the ability to share such net business loss carryforwards in future years.

V. Controlled Group Elections

The new Wisconsin combined reporting statute permits taxpayers to elect to file a combined return that includes all members of a commonly controlled group even if all entities within the commonly controlled group do not meet the definition of a unitary business.8 For example, if a holding company owns two corporations engaged in separate and independent lines of business that do not constitute a unitary business, those corporations would file separate company returns in Wisconsin notwithstanding the new mandatory combined return rules (because the new rules require that a unitary business exist before combined returns become mandatory). If this group were to file a controlled group election under Wis. Stat. § 71.255(2m), the holding company and its two subsidiaries could file a combined return without constituting a unitary business.

Section 2.63(3)(a) of the Proposed Regulations provides that the controlled group election "is also binding on any corporations that join the commonly controlled group during the period the election is in effect." This provision ostensibly interprets Wis. Stat. § 71.255(2m)(b), which provides that "[a]ny corporation that becomes includable in the commonly controlled group subsequent to the year of election shall have waived any objection to its inclusion in the combined report." Pursuant to these rules, if the holding company and its two subsidiaries in the above example make a controlled group election and subsequently acquire a new subsidiary, the new subsidiary will join the combined report with the holding company and its subsidiaries (*i.e.*, the newly acquired subsidiary is bound by the controlled group election made by the acquiring group).

Regrettably, however, neither Wis. Stat. § 71.255(2m) nor the Proposed Regulations address the situation where a combined group that has not made a controlled group election purchases the stock of the parent of a group that has made the election. Consider the following situation. A multinational business with numerous subsidiaries falling into two separate unitary groups files two combined Wisconsin corporate income tax returns for 2009 and does not make a controlled group election. This business agrees to purchase all of the stock of the holding company used in our earlier example. If the multinational business is considered as bound by the acquired group's controlled group election under section 2.63(3)(a), the multinational corporation would be required to include both of its separate unitary businesses with the acquired group in a single combined return simply as a result of acquiring a much smaller business in a routine transaction.

To clarify the application of this rule, TEI suggests the following language be added to section 2.63(3)(a):

> When a merger or acquisition occurs between two combined groups of corporations, and the book value of total assets or fair market value of the acquiring group is greater than that of a target controlled group on the date of the transaction, the controlled group election of the target group terminates.

VI. Designated Agent of Combined Group

Wis. Stat. § 71.255(7) requires each combined group to select a designated agent to act on behalf of the group. Section 2.65(2)(c) of the Proposed Regulations provides that the selection of a designated agent is binding for future years with three exceptions: (1) when the designated agent leaves the combined group; (2) when the designated agent ceases to exist; and (3) when the designated agent submits a written request for another member to become the designated agent. None of these options addresses the designated agent consequences when one combined group is acquired by another combined group doing business in Wisconsin. In that case, the designated agent of the acquired group does not leave its combined group; it merely becomes a new member of the acquiring group.

To eliminate any confusion in this area, the following sentence should be added to section 2.65(2)(c)(1):

> In the event one combined group (or a portion of a combined group that includes the designated agent) is acquired by a second combined group, the corporation which files, or will file, the first combined return after the date of the acquisition is deemed to be appointed as the new designated agent.

Conclusion

Tax Executives Institute appreciates this opportunity to present its views on the Proposed Regulations. If you have any questions, please do not hesitate to call Cathleen Stevens, chair of TEI's State and Local Tax Committee, at (847) 735-4672 or cathleen.stevens@brunswick.com; or Daniel B. De Jong of the Institute's professional staff at 202.638.5601 or ddejong@tei.org.

Respectfully submitted,

TAX EXECUTIVES INSTITUTE, INC.

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1 Wis. Stat. § 71.255(2)(a).

2 Wis. Stat. § 71.255(1)(n).

3 "The Wisconsin adjusted basis of the property of any corporation that has, in any taxable year before it ceases to be exempt from tax under this chapter, taken depreciation or amortization of depreciable property for federal income tax purposes shall be the adjusted basis of that property as computed for federal income tax purposes as of the beginning of the taxable year in which the corporation ceases to be exempt. The corporation may continue, after it ceases to be exempt, to depreciate that property under the method used previously for federal income tax purposes." Wis. Stat. § 71.265 was enacted by L. 1987, Act 399; amended by L. 1987, Act 411, § 33; Stats. 1987.

4 Under Wis. Stat. § 71.26(2)(y), taxpayers must depreciate assets using the rules of the Internal Revenue Code in effect as amended to December 31, 2001 – except for certain property first placed in service on or after January 1, 1983, but before January 1, 1987.

5 *See* Massachusetts Statutes 830 CMR 63.32B.2(6)(d).

6 Wis. Stat. § 71.47(4).

7 Treas. Reg. §§ 1.41-6(b)(1) and -6(i)(1).

8 Wis. Stat. § 71.255(2m).