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Vermont Wishes You All And Your Affiliates A "Happy New Year" While Ushering In A Hangover-Inducing Draft Regulation On Combined Reporting

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I. A New Year, A New Resolution For Vermont[1]

As we let go of our New Year's resolutions one by one, we may take comfort in watching the pains of others who continue to pursue their resolutions. Vermont's New Year's resolution may provide comfort to some and pain to others. Vermont has joined the list of states requiring combined unitary reporting[2] in order to put "all corporations doing business in Vermont on an equal income tax footing, and with the revenue from the expanded and more accurate tax base, to lower Vermont's corporate income tax rate."[3] Expect a few "hiccups" and "hangovers" from the reporting system change particularly considering the ambiguities in Vermont's draft regulation.

II. Last Year: Vermont Asserted Separate Reporting Made Geoffrey The Giraffe Look More Like Miss Piggy

For tax years beginning before January 1, 2006, Vermont generally required separate reporting. Corporations included in a federal consolidated group were permitted to file a state consolidated return as long as the corporation could demonstrate to the Vermont Commissioner that consolidated reporting would not significantly reduce their corporate income tax liability.[4] As corporate income taxes began to represent a smaller portion of the General Fund revenues, legislators sought to broaden the tax base by becoming the first state in nearly 20 years to change to the combined reporting method.

[1] Making New Year's resolutions dates back around 4000 years to the early Babylonians. Popular modern resolutions might include the promise to lose weight or quit smoking. The early Babylonian's most popular resolution was to return borrowed farm equipment. *See* http://wilstar.com/holidays/newyear.htm.

[2] 16 states have adopted combined reporting. California was the first in 1937. *See* Massachusetts Budget and Policy Center Report: Facts at a Glance, March 2005, *available at* http://massbudget.org/combrpt_faq.pdf.

[3] *See* Section 1 of House Bill 784, 2004 Vt. Acts & Resolves 152.

[4] Vt. Stat. Ann. tit. 32, § 5862 (pre-2006); Vt. Regs. § 1.5862-2.

III. New Year: Out With The Old In With The New . . . And Any Excuse To Raise Our Glasses One More Time

A. New Legislation and Lower Rates Take Effect; Time to Pass the Champagne?

Several important provisions of House Bill 784, which was approved June 7, 2004, became effective as of January 1, 2006.

Vermont Statute §§ 5811 and 5862(d) were amended to provide for mandatory combined reporting by any taxable corporation that is part of an "affiliated group" engaged in a "unitary business."[5] An "affiliated group" is defined as "two or more corporations in which more than 50 percent of the voting stock of each member corporation is directly or indirectly owned by a common owner or owners, either corporate or noncorporate, or by one or more of the member corporations."[6] The definition excludes overseas business organizations and captive insurance companies. A "unitary business" is defined as "one or more related business organizations engaged in business activity both within and without the state among which there exists a unity of ownership, operation, and use; or an interdependence in their functions."[7]

Vermont Statute § 5832 is amended to lower the corporate income tax rates. Effective for the 2006 calendar year, tax rates on corporate net income have been reduced across all tax brackets.[8] Beginning in 2007, the highest marginal tax bracket is eliminated and there is a further reduction of tax imposed--the new highest marginal tax rate is reduced by an additional 0.25%.[9] This calls for at least a drop of bubbly!

B. Draft Regulation Takes Effect; Time For A Little Hair-Of-The-Dog![10]

Vermont's Draft Regulation § 1.5862(d), which was issued for public comment on September 8, 2005, is effective for tax years beginning on or after January 1, 2006.[11]

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[5] Vt. Stat. Ann. tit. 32, §§ 5862(d) ("a taxable corporation which is part of an affiliated group engaged in a unitary business shall file a group return containing the combined net income of the affiliated group and such other informational returns as the commissioner shall require by rule"); 5811(18)(c) ("for a taxable corporation that is a member of an affiliated group and that is engaged in a unitary business with one or more other members of that affiliated group, "Vermont net income" is the allocable share of the combined net income of the group").

[6] Vt. Stat. Ann. tit. 32, § 5811(22).

[7] Vt. Stat. Ann. tit. 32, § 5811(23).

[8] For example, in the highest marginal tax bracket, the tax rate for net income in excess of $250,000 has been reduced to 8.9% from 9.75%.

[9] In 2007, the highest tax rate will be 8.5% on net income in excess of $25,000.

[10] A home remedy for hangovers that contains a little of the alcohol consumed the night before (drinking "the hair of the dog that bit you"). The phrase harkens back to the middle ages when it was believed that the cure for what ails you (a dog bite) is a little more of what ails you (the hair of the dog that bit you). *See* http://urbanlegends.about.com/od/medical/a/hair_of_the_dog.htm. Not that the authors are admitting to having tested this remedy themselves, but we doubt that the success rate for curing a hangover with another drink is much better than the success rate for curing rabies with dog hair.

[11] Draft Regulation § 1.5862(d)-1.

As of the date of publishing this article, Vermont has not issued a "final" version of the draft regulation. Discussions with Vermont Department of Taxation indicate that a revised version of the regulation will likely be submitted to the Legislative Committee on Administrative Rules some time in February. While revisions will primarily be stylistic in nature, the next draft is expected to provide some clarification regarding the treatment of net operating losses and credits by the combined group.

Draft Regulation § 1.5862(d) attempts to provide guidance on the recent amendments to Vermont Statute §§ 5811 and 5862(d) regarding the transition to and implementation of combined return reporting in Vermont. Since the draft regulation is too lengthy to reproduce in its entirely in this article, we will focus our comment on several of its interesting and/or controversial provisions.

1. Trouble Ahead: Inventing A New "Unitary Business" Test

The draft regulation's definition of "unitary business" is similar to that contained in the statute, and equally as troubling.[12] Vermont Statute § 5811(23), as interpreted by Draft Regulation § 1.5862(d)-6, provides two tests for establishing a unitary business. The first test is the three unities test: unity of ownership, operation, and use. The three unities test, first articulated by California, has a long history of interpretive state court decisions. The second test for establishing a unitary business in Vermont is the "interdependence in their functions" test.

The latter test lacks a clear definition and has no judicial precedent. The draft regulation states that in order to satisfy the "interdependence in their functions" test, "the operations of the entities must contribute to one another but need not be essential to the operations of one another."[13] While the draft regulation attempts to align the "interdependence in their functions" test to the more traditional "contribution and dependency" test, the differing texts creates inherent uncertainty. In determining whether there is sufficient interdependence, the draft regulation sets forth general rules and presumptions discussed below.

2. Increased Taxpayer Burden: Rebuttable Presumptions

The draft regulation lists general rules and rebuttable presumptions applicable when determining unity of operations, unity of use, or interdependence of functions.[14] Among the factors listed are the engagement in the same general line of business, vertically structured business, strong centralized management, non-arm's length prices, benefits from joint, shared or common activity, and exercise of control. The use of presumptions

[12] Vt. Stat. Ann. tit. 32, § 5811(23) (defines a "Unitary Business" as "one or more related business organizations engaged in business activity both within and without the state among which there exists a unity of ownership, operation, and use; or an interdependence in their functions"); Draft Regulation § 1.5862(d)-6(a) (defines "unitary business" as "one or more related business organizations doing business both within and without the State where there is a unity of ownership, operation, and use. It can also exist where there is an interdependence in their functions").

[13] Draft Regulation § 1.5862(d)-6(g).

[14] Draft Regulation § 1.5862(d)-6(e)

adds yet another layer to the analysis, increases the taxpayer's burden of proof, and potentially leads to inaccurate results. Some of the presumptions are too broad, contradict existing case law, and invite litigation.

3. Muddy Waters: The Treatment Of Pass-Through Entities

The draft regulation "clarifies" who may be included in an affiliated group, but fails to address the treatment of distributable income from a pass-through entity. The draft regulation expressly excludes S corporations and tax-exempt corporations from the affiliated group. It also provides that "[e]ntities not organized as corporations, such as partnerships and limited liability companies taxed as partnerships under federal law, are outside the scope of combined reporting."[15] The draft regulation is silent, however, regarding how distributable income from pass-through entities should be treated on the combined report. Should these items of potentially taxable income be treated like inter-company expenses and credits? The lack of clarity on this issue is troubling.

4. Confusion And Opportunity: Tax Attributes

The draft regulation addresses the use of tax credits and net operating losses ("NOLs") generated by a single member of the unitary group.[16] For purposes of determining the use of *credits*, the draft regulation provides that credits "shall apply against the corporate income tax liability of the individual member of the group as calculated in Reg. § 1.5862(d)-12."[17] Application of Draft Regulation § 1.5862(d)-12 essentially limits the utilization of the credits to the corporation that generated them. The provision is unclear, however, whether a similar rule should be applied to limit the use of *NOLs*.[18] If it does not apply for purposes of NOL utilization, the combined group may be free to allocate tax liability among its members as they choose (e.g., through a tax allocation agreement). Alternatively, under a California-type approach, a corporation's use of NOLs may be limited to the offset of its assigned portion of the unitary combined NOL against its assigned portion of future unitary combined income. [19] [

[15] Draft Regulation § 1.5862(d)-4(b).

[16] Draft Regulation §§ 1.5862(d)-9 and 1.5862(d)-12.

[17] Draft Regulation § 1.5862(d)-9(b).

[18] Draft Regulation § 1.5862(d)-9(a), which discusses the rules with respect to NOLs, does not reference Draft Regulation § 1.5862(d)-12. Further, Draft Regulation § 1.5862(d)-12 makes no reference to NOLs. It is, therefore, unclear whether Draft Regulation § 1.5862(d)-12 is the required method for allocating tax liability among combined group members for all purposes or just for tax credit purposes.

[19] The full text of Draft Regulation § 1.5862(d)-9(a) reads: "If the taxable income computed pursuant to Reg. § 1.5862(d) - 3 results in a loss for a taxable corporation that is a member of the group, that corporation has a Vermont net operating loss, subject to the net operating loss limitations of the Internal Revenue Code and the carryback and carryforward provisions of 32 V.S.A. § 5888(4)(B). Vermont law does not allow refunds from the operation of a net operating loss carryback. Such net operating loss is applied as a deduction in a subsequent year only if the loss was not absorbed as a net operating loss carryback on a federal return and that corporation has Vermont source positive net income."

As previously, the upcoming version of this regulation is expected to clarify the process by which NOLs and credits may be utilized by the members of the combined group.

5. Helpful Provision: The Ownership Of Voting Verses Nonvoting Stock.

In an effort to end our summary of the draft regulations on a positive note, we find the regulation's provision regarding the ownership of voting stock to be helpful. Significantly, the draft regulation recognizes that control over the subsidiary/affiliate is the key to inclusion within the affiliated group. Specifically, the draft regulation notes that voting stock

refers only to those shares of voting stock having the power to elect the corporation's board of directors. If the power otherwise held in corporate stock to vote the membership of the board is transferred to another, the holder of that power will be considered to be the owner of that stock to the exclusion of the transferor of such power.[20]

Such provision recognizes the possibility of an ASARCO-like situation, in which one corporation may have the potential to control another, but through some contractual means limited its ability to exert actual control.[21]

IV. Will Vermont And Its Taxpayers Be Wishing For Auld Lang Syne?[22]

Ultimately, Vermont anticipates that unitary combined reporting will provide a more accurate reflection of the income of a taxpayer's business attributable to Vermont and, incidentally, should create a greater tax base from which to draw revenues for the State. While the new system may create a larger tax base, the end effect on the taxes paid by a taxpayer will vary. Some corporations may benefit from the new system because they are able to offset Vermont income with losses incurred in other states. Other corporations will have a higher tax bill because of inclusion of entities that would not have otherwise paid tax in Vermont.

Unfortunately, Vermont failed to take full advantage of the experience of other states that have implemented combined reporting. The vague language and undefined terms in Vermont's draft regulation will likely lead to tax litigation that may have taxpayers and tax administrators alike wishing for "Auld Lang Syne." Only Father Time[23] can tell.■

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[20] Draft Regulation § 1.5862(d)-4(e).

[21] *See ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 322 (1982).

[22] The traditional Scotch song "Auld Lang Syne" was penned at least in part by Robert Burns. "Auld Lang Syne" literally means "old long ago," or simply, "the good old days." *See* http://wilstar.com/holidays/newyear.htm

[23] And the tradition of Father Time? Since you have surely tired of our useless New Year trivia, we'll spare you from any further references to traditions … other than to wish all our readers a Happy New Year!

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