

Making Taxes More Certain: Iowa State Legislators' Guide to Combined Reporting

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ABSTRACT: State corporate-income-tax revenues are declining for several reasons, and amidst one of the worst economic climates in history, state policymakers are under pressure to reform the state corporate income tax to account for states' changing economies and corporations' multistate business structures. Proponents of reform advocate combined reporting as the best way to achieve a fair and accountable tax system. While individual businesses oppose combined reporting for a myriad of reasons, the general opposition to combined reporting from the business community at large stresses that when enacted hastily, combined reporting can cause enormous complexities and administrative burdens for taxpayers and state administrative agencies alike—and can end up defeating the very purpose of reform. Iowa's policymakers must examine several issues before making a final decision to enact combined reporting and consider whether combined reporting will keep Iowa competitive and attractive to businesses.

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I. INTRODUCTION

Benjamin Franklin once said, “[I]n this world nothing can be said to be certain, except death and taxes.”¹ Taxes certainly exist, but what they will look like and how much they will be for businesses is uncertain. The state corporate income tax (“CIT”) has been the subject of recent scrutiny in many states, as the changing and tightening economy forces states to look to new sources for more revenue. Politically, state policymakers are loath to raise taxes on individuals—those who are more prone to vote with their pocketbooks. Thus, the trend is for state lawmakers across the nation to propose CIT reform measures that would capitalize on the widely misunderstood and scorned corporate-tax structure.²

The situation is no different in Iowa, where relatively low costs of living and real-estate prices, low crime, and family-oriented policies make it an attractive place for a business to locate its operations. Because of rising unreliability, growing inequity, and expensive compliance and administration costs, Iowa’s CIT is in serious need of repair. Policymakers and corporate watchdogs strongly believe that some corporations—admittedly, a very small minority of U.S. corporations—have found ways to funnel a significant portion of their income into structures that enable such income to go tax-free. Something needs to be done—even those companies who have found ways to minimize their CIT liabilities to manageable levels agree. In the past few years, the Iowa General Assembly has considered several CIT reform proposals, and large deficits in the state budget will force the legislature to act soon.

If Iowa policymakers consider combined reporting as a tax-reform option, it is imperative that they take adequate time and use proper resources to review corporate-taxpayer concerns and features of existing combined reporting regimes. Combined reporting, on its face, seems like a simple reform, but as with anything related to tax law, hastily written laws and regulations can end up defeating the very purpose of reform. Part II of this Note explains the background and theory of the CIT, including the nuances that lead to states’ dilemmas today. Part II also describes combined reporting and how it works in comparison to other methods of reporting corporate-income-tax liability. Part III discusses why combined reporting garners so much attention from state-tax experts and reformers, including how laws governing corporate organization and structure give rise to activities that state departments of revenue decry. Part III also describes

1. 10 BENJAMIN FRANKLIN, THE WORKS OF BENJAMIN FRANKLIN 410 (Jared Sparks ed., Hillard Gray 1840).

2. William F. Fox, Matthew N. Murray & LeAnn Luna, *How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?*, 58 NAT’L TAX J. 139, 140 (2005) (“[A] form of fiscal illusion is created when taxes are collected by business enterprises (regardless of statutory burden or intent), as voters may underestimate the true costs of funding public services.”).

widely accepted principles of good tax policy and how combined reporting fulfills those principles.

Any investigation into combined reporting must also consider several key questions, which Part IV examines in detail. Simply subscribing to and enacting the theory is one feat, but actually practicing it can lead to several other problems if lawmakers and agency officials do not address particular issues, including: (1) which taxpayers comprise the unitary group; (2) how to combine the group's income; (3) how to treat intercompany transactions, net operating losses, credits and deductions, and nonbusiness income; (4) how to apportion income; and (5) how combined reporting's effects relate to Iowa's economic-development goals. From an economic-development perspective, policymakers have to answer subjective questions: Is combined reporting good for Iowa's existing and future companies? Will combined reporting lead Iowa in the direction its citizens want to go in the future?

Part V discusses how combined reporting affects economic development. The numerous, unknown, immeasurable, and often overlooked factors of combined reporting make its application inherently difficult. Part V argues that state policymakers must be vigilant of how combined reporting affects the economic vitality of their state, especially in examining revenue projections.

Finally, Part VI looks at the corporate-tax climate in Iowa and what previous tax-reform proposals have looked like. Part VI notes that Iowa's budgetary shortfalls are not necessarily rooted in corporate-tax evasion, and while taxpayers and tax collectors alike are calling for tax reform, policymakers would be wise to carefully consider shaky revenue estimates and other empirical data before reshaping Iowa's corporate income tax. Iowa policymakers must focus on reforming the CIT in a revenue-neutral way with fewer exceptions, which would enhance its predictability, equity, compliance and administration costs, and Iowa's competitiveness with other states. If Iowa's policymakers decide that combined reporting is the right CIT reform for Iowa, they are wise to consider the issues discussed here.

II. THE STATE TAX BACKGROUND

States have been taxing businesses' income for almost one hundred years.³ Income taxes were a major source of revenue and a way for states to spread costs of services between the businesses and individuals who used them. State governments' power to tax citizens and those who do business in a state is fundamental to our federalist system: states "need revenue to fund the services sought by their constituents."⁴ Forty-seven states impose taxes in

3. See *infra* notes 15–17 and accompanying text (describing the history of the CIT).

4. DAVID BRUNORI, STATE TAX POLICY: A POLITICAL PERSPECTIVE 4 (2d ed. 2005).

some form on corporate income.⁵ The CIT is the most widespread, albeit complicated and controversial, way that states raise revenue. This section gives a general overview of the CIT's and its purported purpose in most states, and describes combined reporting, the most recent and popular form of CIT reform.

A. WHAT IS THE STATE CORPORATE INCOME TAX?

The corporate income tax is a tax on corporate profits after subtracting allowable expenses and capital depreciation.⁶ States impose their own CIT, separate from that of the federal government, for a variety of reasons.⁷ One rationale for taxing business profits is the deficiencies in the state property tax.⁸ A more widely cited reason is to maintain the integrity of the personal income tax: "Without a levy on corporate income, taxpayers might have an incentive to shelter personal income in corporate holdings."⁹ Regardless, the increasing number of corporate-tax credits and exemptions allow corporations to reduce their taxable income, while other federal laws prevent taxpayers from using a corporate entity to shield personal income from taxation.¹⁰

The more convincing rationale for levying a state income tax on corporate profits is one of policy: corporations should reimburse states for the significant services they provide to the business community.¹¹ States are

5. *Id.* at 83; Scott A. Hodge, *U.S. States Lead the World in High Corporate Taxes*, FISCAL FACTS, Mar. 18, 2008, <http://www.taxfoundation.org/publications/show/22917.html>. Forty-four states impose a traditional CIT, while four states tax alternative tax bases—Michigan's Business Tax, Ohio's Commercial Activity Tax, Texas's Margins Tax, and Washington's Business and Occupancy Tax. *Id.* Three states—Nevada, South Dakota, and Wyoming—do not have a state-level corporate tax. *Id.*

6. THE URBAN INST. & BROOKINGS INST., TAX POLICY CTR., TAX TOPICS: THE FEDERAL BUDGET, <http://www.taxpolicycenter.org/taxtopics/budget/concepts.cfm#c> (last visited Nov. 6, 2009).

7. BRUNORI, *supra* note 4, at 85.

8. *Id.* Brunori further explains that the way the property tax is structured causes gross inequities in how much property tax businesses pay because the property tax does not differentiate between capital-intensive operations and labor-intensive companies. *Id.*

9. *Id.* at 86. However, some commentators argue that the opposite is taking place—that corporations are shielding their income in the form of passive-investment companies and other tax-avoidance schemes. See *infra* Part III.B (discussing passive investment companies as a current "loophole" in state CIT laws).

10. BRUNORI, *supra* note 4 at 86; see also Peter S. Fisher, *Revitalizing Iowa's Corporate Income Tax*, 40 ST. TAX NOTES 601, 605 (2006) (arguing that some of the state revenues lost from the state CIT are the result of more companies organizing themselves as subchapter S-corporations and limited liability companies ("LLCs"), which means that states tax more business income under the individual income tax).

11. BRUNORI, *supra* note 4, at 86–87. *But see* Fox, Murray & Luna, *supra* note 2, at 140. The authors cite two dominant justifications for taxing corporate income at the state level: the benefit principle and the source-based entitlement principle. *Id.* They argue, however, that the benefit principle is not a sufficient justification for state taxation because "under such a regime, taxes will be paid where corporate income is earned, not necessarily where the individual

providing more services than ever before—primarily in areas where the federal government used to dominate, such as welfare, Medicaid, Medicare, highway maintenance, and homeland security—and they need a way to pay for those services.¹² When corporations are not paying their “fair share” of taxes to a state, both the corporation and its shareholders are “free riders” of services for which they do not pay.¹³ Additionally, a more federalist rationale is that states should have the authority to impose a tax on income that originates in their jurisdiction.¹⁴

Corporate income taxes, as we recognize them today, can be traced back to Wisconsin’s Income Tax Law of 1911.¹⁵ By 1940, forty states had adopted CITs.¹⁶ In the early twentieth century, the nation’s and states’ economies were based primarily on manufacturing.¹⁷ Thus, CITs were based primarily on taxing corporations that manufactured tangible personal property.¹⁸ In addition, tax competition between states was not nearly as prevalent as it later became.¹⁹ While the economy and business climate has changed, the tax has remained the same: the national economy is now largely based on services and intellectual property, and businesses, notwithstanding their relative sizes, produce and sell in several states and

taxpayer receiving public service benefits resides.” *Id.* Importantly, the authors also note that “[i]n practice, a unique tax on corporations will not necessarily be borne by the owners of corporate capital but may instead be shifted to consumers or workers.” *Id.* at 141.

12. BRUNORI, *supra* note 4, at 2–3.

13. Fisher, *supra* note 10, at 612 (“Because a corporation’s ability to generate profits from Iowa operations depends on public services, corporations should pay their share of the cost of providing those services. Shareholders, the majority of whom reside outside the state, should not get a free ride.”); *see also* BRUNORI, *supra* note 4, at 86–87 (“Corporations use public services provided by the state as much as individuals and unincorporated businesses. . . . A corporation’s success depends on the adequate provision of these services.”). However, the Council on State Taxation (“COST”) released a February 2009 study, which found that state and local business taxes exceed the value of benefits provided to businesses by eighty-three percent. ANDREW PHILLIPS, ROBERT CLINE & THOMAS NEUBIG, TOTAL STATE AND LOCAL BUSINESS TAXES: 50 STATE ESTIMATES FOR FISCAL YEAR 2008, at 6 (2009).

14. Fox, Murray & Luna, *supra* note 2, at 141 (citing Peggy B. Musgrave, *Principles for Dividing the State Corporate Tax Base*, in THE STATE CORPORATE INCOME TAX 228–46 (Charles E. McLure ed., Hoover Inst. Press 1986)) (“Her argument is simple: states have the legal authority to impose and collect a tax on income that has its origin in the state, including income accruing to nonresidents.”).

15. Income Tax Law of 1911, 1911 Wis. Sess. Laws 989; BRUNORI, *supra* note 4, at 85.

16. BRUNORI, *supra* note 4, at 85.

17. *Id.*

18. *Id.*

19. *Id.* To keep their economies strong and viable, states compete for capital investment and jobs, which makes them somewhat “sensitive to assertions that business taxes are excessive and present a barrier to attracting capital investment.” Michael Vlasisavljevich, *State Business Taxes: The Policy and Research Agendas*, in THE UNFINISHED AGENDA FOR STATE TAX REFORM 177, 178 (Steven D. Gold ed., 1988).

around the world.²⁰ However, the CIT maintains its traditional form while the world around it has changed.

States' coffers are feeling the effects of their corporate income taxes bringing in less revenue than they once did. Revenues from state CITs declined 34% between 1980 and 2001.²¹ In Iowa, the CIT comprised only 2.4% of state revenue during 2001–2004, down from 6.9% of state revenue in the early 1980s.²² In 2005, CIT revenues comprised only 2.1% of total state revenues compared to general sales tax (13.0%) and property tax (16.6%).²³

Some tax-reform advocates blame tax-planning strategies, which skilled tax professionals devised to avoid state income taxes, for the decline in revenues.²⁴ However, several factors have contributed to the decline in the share of state revenues that CITs produce. A significant problem is that the structure of tax laws has stayed the same, while the structure of business entities and the way that they handle their money have changed.²⁵ More states are using apportionment formulas that place more weight on sales,²⁶ and inconsistencies among states allow multistate taxpayers to utilize legal tax planning to lower their tax burdens.

Despite this, taxpayers' activities are not solely to blame. State policymakers have crafted, perhaps inadvertently, the demise of a robust

20. BRUNORI, *supra* note 4, at 2.

21. MULTISTATE TAX COMM'N, CORPORATE TAX SHELTERING AND THE IMPACT ON STATE CORPORATE INCOME TAX REVENUE COLLECTIONS 1 (2003), available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Resources/Studies_and_Reports/Corporate_Tax_Sheltering/Tax%20Shelter%20Report.pdf.

22. Fisher, *supra* note 10, at 601. It should be noted that any figures covering a range of three years also reflect the trough of the economic cycle; given that the CIT is procyclical, this figure likely exaggerates the actual overall decline in CIT revenues relative to corporate income earned in the state.

23. NAT'L CONFERENCE OF STATE LEGISLATURES, PRINCIPLES OF A HIGH-QUALITY STATE REVENUE SYSTEM fig.1 (4th ed. 2007), available at <http://www.ncsl.org/programs/fiscal/fpphqrs.htm> [hereinafter NCSL, PRINCIPLES].

24. See generally MULTISTATE TAX COMM'N, *supra* note 21 (arguing that falling state revenues are the consequences of corporations taking advantage of "loopholes" in state tax laws to form and utilize tax shelters to avoid taxation); see also ROBERT CLINE, COST, COMBINED REPORTING: UNDERSTANDING THE REVENUE AND COMPETITIVE EFFECTS OF COMBINED REPORTING 3 (2008), available at <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=70000> ("[Proponents] argue that combined reporting is needed to offset erosion in the corporate income tax base attributed to tax planning strategies available to multistate corporations."). But see Gary Cornia, Kelly D. Edmiston, David L. Sjoquist & Sally Wallace, *The Disappearing State Corporate Income Tax*, 58 NAT'L TAX J. 115, 136 (2005) (concluding from a case study of Georgia state corporate-income taxpayers that there is "little evidence . . . that firms are shifting non-business income to low tax rate states, but . . . a significant number of firms [have changed] their forms of incorporation in Georgia, as evidenced by [the] link of C-corp and S-corp returns in the state").

25. BRUNORI, *supra* note 4, at 85.

26. NAT'L CONFERENCE OF STATE LEGISLATURES, TAX POLICY HANDBOOK FOR STATE LEGISLATORS 23 (2d ed. 2003) [hereinafter NCSL, TAX POLICY HANDBOOK].

CIT base. S-corporation and limited-liability-company laws enable corporations and partnerships to pass their tax liabilities onto their owners and partners, whose share of corporate profits are subject to the personal income tax as ordinary (or capital-gains) income.²⁷ Another major cause of declining state revenues from corporate income taxes is the wide availability of credits, incentives, and abatement that states offer to lure businesses and create jobs.²⁸ The number of holes in a state's CIT and resulting uncertainty create a case for CIT reform. This Note explains why it is imperative that policymakers enact reform responsibly.

B. WHAT IS COMBINED REPORTING?

States have the power to tax a corporation's income under a principle called "nexus." Nexus requires that a corporation have a "sufficient connection or sufficient relationship with the state" for the state to tax it.²⁹ The issues associated with the state combined reporting arise in the context of a corporation having related affiliates doing business in the same state. Two main methods determine how much of a corporation's income a state may tax: separate-entity reporting and combined reporting.³⁰ Under separate-entity reporting, the corporation reports only its own income on a separate return. Thus, the taxing state treats each corporation, even if it has related affiliates in the state, as a separate taxpayer.³¹

27. *Id.*

28. *Id.*

29. RICHARD D. POMP & OLIVER OLDMAN, *STATE & LOCAL TAXATION* 10-7 (3d ed. 1998). Public Law 86-272 determines when a state may tax the income of a business engaged in the interstate sale of personal tangible property. Act of Sept. 14, 1959, Pub. L. No. 86-272, § 101, 73 Stat. 555, 555 (codified at 15 U.S.C. §§ 381-384 (2000)); Mary C. McLaughlin, *Combined Filing and Federal Public Law 86-272*, CPA J., Dec. 2004, at 32, available at <http://www.nysscpa.org/cpapjournal/2004/1204/essentials/p32.htm>. McLaughlin explains the mechanics of Pub. L. 86-272:

The federal Interstate Income Tax Law (P.L. 86-272) prevents a state from imposing an income tax on income derived within the state from interstate commerce if the only business activity within the state is the solicitation of orders for tangible personal property, provided that the orders are approved and filled outside the state.

Id. The Supreme Court has considered the state-tax nexus issue in several important decisions, whose analysis is outside the scope of this Note. *See generally* *Container v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425 (1980), *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977); *Miller Bros. v. Maryland*, 347 U.S. 340 (1954).

30. POMP & OLDMAN, *supra* note 29, at 10-9 to -32 (describing each method in detail). A third method, specific allocation, is a less-common approach than the first two and is generally applied to income that is not apportionable to the activity of a corporation, specifically non-business income. *Id.* at 10-29.

31. *See* CLINE, *supra* note 24, at 1 (summarizing the differences between separate filing and combined reporting); Richard D. Pomp, *State Tax Reform: Proposals for Wisconsin*, 88 MARQ. L. REV. 45, 49-50 (2004) (citing POMP & OLDMAN, *supra* note 29, at 10-9) (describing the mechanics of the separate-accounting method).

Under either system, a multistate business uses a formula, known as formulary apportionment, to apportion income to a state. Formulary apportionment attributes a portion of the corporation's taxable income to each state in which it has business activities.³² The purpose of apportionment is to avoid multiple states taxing the same income.³³ The most common apportionment formula has three factors: payroll, property, and sales.³⁴ The basic apportionment formula reads:

$$ti_{state} = \frac{1}{3} \left(\frac{payroll_{state}}{payroll_{corp}} + \frac{property_{state}}{payroll_{corp}} + \frac{sales_{state}}{sales_{corp}} \right) ti_{state} \quad 35$$

Some states have altered their apportionment formulas to give the sales factor double or all of the weight, often based on the policy belief that favoring companies with high in-state payroll and property factors (relative to sales) will keep those companies from moving outside the state, thus keeping employment and the economy stable.³⁶ Their view is that "only sales generate income."³⁷ Iowa is one of eighteen states that use a single sales factor.³⁸

Allowing a state to apply its apportionment formula to a nonresident's income raises constitutional concerns. The Supreme Court has held that for a state to apply its apportionment formula to a taxpayer who is not domiciled in the state, thus taxing a nonresident's income, the taxpayer

32. Robert P. Strauss, *Apportionment*, in *ENCYCLOPEDIA OF TAXATION & TAX POLICY* 14, 14–15 (Joseph J. Cordes, Robert D. Ebel & Jane G. Gravelle eds., 2d ed. 2005); Pomp, *supra* note 31, at 51.

33. Strauss, *supra* note 32, at 14.

34. *Id.* at 15.

35. *Id.*

36. NCSL, *TAX POLICY HANDBOOK*, *supra* note 26, at 23; Mark J. Cowan & Clint Kakstys, *A Green Mountain Miracle and the Garden State Grab: Lessons from Vermont and New Jersey on State Corporate Tax Reform*, 60 *TAX LAW.* 351, 370 (2007); Strauss, *supra* note 32, at 15. Iowa, along with a few other states, double-weights the sales factor when apportioning income to multistate taxpayers. IOWA CODE § 422.33(2)(b)(4) (2008); JAY MUNSON & MICHAEL LIPSMAN, IOWA DEP'T OF REVENUE, *COMBINED REPORTING: AN OPTION FOR APPORTIONING IOWA CORPORATE INCOME TAX 7* (2007), available at <http://www.iowa.gov/tax/taxlaw/IDRCombinedReportingCorpTax.pdf>.

37. CLINE, *supra* note 24, at 3; see also ROGER M. NACKER, WIS. ECON. DEV. ASS'N, *WHITHER COMBINED REPORTING: AN ECONOMIC DEVELOPMENT VIEWPOINT 7* (2008), available at www.weda.org/about/legislative/pdf/WEDA_Combined_Reporting_02_20_08_Final.pdf ("The concept of a heavy-weighted sales factor for apportionment is politically popular because it normally benefits in-state companies." (citations omitted)).

38. IOWA CODE § 422.33(2)(b) (2008); CLINE, *supra* note 24, at 3; see also *infra* Part VI.A (describing Iowa's single sales factor). For more information, see generally THE PA. BUDGET & POLICY CTR., *CHRISTMAS IN AUGUST: SINGLE SALES FACTOR CREATES WINDFALL FOR A FEW, WORSENS STATE DEFICIT* (Aug. 5, 2009), http://pennbpc.org/sites/pennbpc.org/files/Single%20Sales%20Factor%20Policy%20Brief_0.pdf (arguing that single sales factor enforcement has worsened states' budget deficits).

must be part of a “unitary business.”³⁹ The unitary business principle requires a corporation’s out-of-state activities to have enough of a connection to its in-state activities for a state to apply its apportionment formula.⁴⁰ In defining a unitary business, the Supreme Court has focused on core factors that establish a connection between a corporation’s in-state and out-of-state activities: “unity of use and management of a business”;⁴¹ “functional integration, centralization of management, and economies of scale”;⁴² and “the out-of-state activities of the purported ‘unitary business’ must be related in some concrete way to the in-state activities.”⁴³

Combined reporting is an extension of the formulary apportionment method.⁴⁴ The taxpayer corporation, in this context, consists of a unitary group—a parent company and its subsidiaries or affiliates.⁴⁵ Combined reporting is a tax-reporting method that requires a unitary group to report the entire combined group’s corporate income instead of reporting the income from only those corporations that have a direct connection to the state.⁴⁶ In contrast to consolidated reporting, combined reporting requires corporations to include in the calculation of income out-of-state affiliates’ activities that are unitary with the corporation that is taxable in the state.⁴⁷ Essentially, states that require combined reporting “consider the activity of

39. *Mobil Oil Corp. v. Comm’r of Taxes*, 445 U.S. 425, 439 (1980) (“[T]he linchpin of apportionability in the field of state income taxation is the unitary business principle.”); Walter Hellerstein, *Unitary Taxation*, in *ENCYCLOPEDIA OF TAXATION & TAX POLICY* at 454, 455 (Joseph J. Cordes, Robert D. Ebel & Jane G. Gravelle eds., 2d ed. 2005).

40. Hellerstein, *supra* note 39, at 455.

41. *Butler Bros. v. McCollgan*, 315 U.S. 501, 508 (1942).

42. *Mobil Oil Corp.*, 445 U.S. at 438.

43. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 166 (1983).

44. Pomp, *supra* note 31, at 52–53.

45. *Income Taxes: Definition of a Unitary Business*, Tax Mgmt. Portfolios (BNA), No. 1110 § 07 (2007).

46. DAVID BRUNORI & JOSEPH J. CORDES, *AM. INST. OF TAX POLICY, THE STATE CORPORATE INCOME TAX: RECENT TRENDS FOR A TROUBLED TAX 20* (2005) (“Combined reporting is a legal requirement that all related corporations that are operated as a single business enterprise, any part of which is being conducted in the state, be treated as a single taxpayer for apportionment purposes.”); John E. Gaggini, John A. Biek & Theodore R. Bots, *State Tax Issues Arising from the Use of Pass-Through Entities to Structure Transactions*, in 8 *TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2008*, at 877, 933 (PLI Tax Law & Estate Planning, Course Handbook Series No. 14322, 2008) (“Combined reporting is merely a tax procedure where the income, expense, and apportionment factors of entities included in the group are combined or added together and reported as a single business.”).

47. JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *Application of the Unitary Principle to Multicorporate Enterprises*, in 1 *STATE TAXATION* ¶ 8.11(1) (3d ed. 1998). Consolidated reporting has its origins in federal income-tax provisions; state consolidated returns are usually elective, do not have a unitary requirement, and include only those affiliates that are taxable in the state. *Id.* A consolidated return is essentially all the individual returns for each affiliate in one bundle, and each affiliate may be held liable for the total tax due from the entire consolidated group. *Id.*

an entire unitary business with nexus in the state—disregarding the legal entities through which the business is operated.”⁴⁸ Combined reporting enables a state to tax the activities going on within its borders, regardless of the legal structures taxpayers have chosen, giving credence to substance over form.

III. THE RISE OF COMBINED REPORTING

On its face, combined reporting seems simple enough—it requires all companies and their subsidiaries that have minimum contacts with the taxing state (the “unitary group”) to file one tax return.⁴⁹ The group’s combined income is apportioned to the state using a relatively simple formula, which determines the group’s tax liability.⁵⁰ However, there is more to combined reporting than meets the eye. Opponents take issue with the means by which legislators and administrators choose to implement combined reporting. In a fifty-state system, where no state is a tax island, policymakers and state tax commissioners are wise to pay heed to a number of issues that, if unaddressed, can cause and have caused serious detriment to a state’s tax system and revenue collections.⁵¹

In considering combined reporting’s current significance, it is helpful to understand its history, supporting arguments, and whether it is good tax policy. Part A examines how and when combined reporting came about in the mid-twentieth century. Part B explains the modern push for combined reporting in light of corporate tax-planning methods that businesses use.

48. Cowan & Kakstys, *supra* note 36, at 364.

49. Timothy C. Kimmel, *An Overview of the Group Reporting Regimes in Use Today*, in *THE STORY BEHIND COMBINED REPORTING: A CRITICAL GUIDE FOR STATE TAX POLICY MAKERS, COPING TAXPAYERS AND U.S. NATIONAL AND FOREIGN GOVERNMENT TAX AUTHORITIES CONSIDERING FORMULARY APPORTIONMENT* 12, 35 (Georgetown Univ. Law Ctr., 2008).

50. MICHAEL MAZEROV, CTR. FOR BUDGET & POLICY PRIORITIES, *A MAJORITY OF STATES HAVE NOW ADOPTED A KEY CORPORATE TAX REFORM—“COMBINED REPORTING”* 4–6 (2009) available at <http://www.cbpp.org/4-5-07sfp.pdf> [hereinafter MAZEROV, *STATES ADOPTED KEY CORPORATE TAX REFORM*].

51. Giles Sutton & Nicholas E. Ford, *The Impact of Legal Entities on the Mechanics of Unitary Reporting*, in *TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS* 2008, at 117, 125 (PLI Tax Law and Estate Planning, Course Handbook Series No. 14322, 2008). Sutton and Ford highlight the increasing importance of policymakers’ understanding of unitary reporting issues:

As more states adopt or consider adopting unitary reporting, understanding the subtle issues that arise in the context of combined reporting and the nuances between the concept of the legal entity and a unitary business has become even more crucial. This is particularly true in a world where traditional separate entity state planning strategies have been colored by the press, state tax authorities, and the Multistate Tax Commission, as either “tax shelters” or “tax avoidance” transactions.

Id. (citations omitted).

Finally, Part C describes what tax policy experts consider “good” tax policy and how combined reporting fits within those principles.

A. WHEN DID COMBINED REPORTING BEGIN?

While combined reporting has become a trendy buzzword in legislative circles, it is not new. In the 1940s, California became the first state to enact combined reporting principles;⁵² the California Supreme Court approved California’s combined method of apportionment in *Edison California Stores, Inc. v. McColgan* in 1947.⁵³ California utilized combined reporting to stop film-production companies from moving their production centers to neighboring Utah to avoid their California tax burden.⁵⁴ Several other states, primarily in the West, followed California’s lead, and a few others joined them in the late 1970s and early 1980s.⁵⁵

In 2004, Vermont became the first state in over twenty years to enact combined reporting.⁵⁶ Since then, Texas, West Virginia, Michigan, New York, Massachusetts, and Wisconsin followed.⁵⁷ Originally, states proposed combined reporting to “achieve equity and fairness” by ensuring the same treatment to similarly situated taxpayers, regardless of their organizational form.⁵⁸ As of July 2009, twenty states had enacted mandatory unitary

52. HELLERSTEIN & HELLERSTEIN, *supra* note 47, ¶ 8.11.

53. *Edison Cal. Stores, Inc. v. McColgan*, 183 P.2d 16, 20 (Cal. 1947).

54. STACY MITCHELL, *BIG-BOX SWINDLE: THE TRUE COST OF MEGA-RETAILERS AND THE FIGHT FOR AMERICA’S INDEPENDENT BUSINESSES* 175 (2006).

55. Joe Huddleston & Shirley Sicilian, *History and Considerations for Combined Reporting: Will States Adopt a Model Combined Reporting Statute?*, 2008 ST. & LOC. TAX LAW. (forthcoming 2008) (manuscript at 13–14), available at <http://www.ncleg.net/DocumentSites/committees/revenuelaws/2007-2008/Meeting%20Documents/Meetings%20for%20Report%20to%202009%20Session/19%20November%202008/History%20and%20Considerations%20for%20Combined%20Reporting%20-%20MTC.pdf>.

56. H. 784, 2003–2004 Reg. Sess. (Vt. 2004) (codified in VT. STAT. ANN. tit. 32, §§ 5811, 5832, 5833(a), 5862(d), 8522(c) (2007)); Cowan & Kakstys, *supra* note 36, at 390.

57. N.Y. TAX LAW § 211(4)(a) (McKinney 2008); TEX. TAX CODE ANN. § 171.1014 (Vernon 2008); S.B. 62, 2009–2010 Reg. Sess. (Wis. 2009) (codified in WIS. STAT. § 71.255); H.R. 4904, 185th Gen. Court, Reg. Sess. (Mass. 2008); S.B. 94, 94th Leg., Reg. Sess. (Mich. 2007); S.B. 749, 77th Leg., Reg. Sess. (W. Va. 2007); MASSPIRG, *Testimony in Favor of Combined Reporting Legislation* (May 22, 2007), <http://www.masspirg.org/advocacy/testimony/archive/testimony-archive/testimony-in-favor-of-combined-reporting-legislation> (testimony of Phineas Baxandall, Senior Analyst for Tax and Budget Policy, MASSPIRG); Neil deMause, *Massachusetts Is Latest State to Chain Tax Loophole*, FORTUNE SMALL BUS., July 7, 2008, available at http://www.amiba.net/pressroom/chain_tax_loophole.html. States like Texas, Ohio, and Michigan have instituted tax reform that moves away from income-specific taxes in favor of gross-receipts taxes or other hybrid business taxes, which include combined reporting but have “dramatically different motivations and effects.” Council on State Taxation, *Testimony in Opposition to the Combined Reporting Provision of the Tax Reform Act of 2007*, <http://cost.org/WorkArea/DownloadAsset.aspx?id=67828> [hereinafter *Testimony of Crosby*] (testimony of Joseph R. Crosby, Legislative Director, Council on State Taxation).

58. BENJAMIN F. MILLER, *Principles for Sourcing of Multijurisdictional Income or “Slicing a Shadow,”* in THE STORY BEHIND COMBINED REPORTING: A CRITICAL GUIDE FOR STATE TAX POLICY

combined reporting.⁵⁹ Combined reporting is on the rise as states succumb to increasing pressure to reform their CITs and look for more revenue.

B. WHY ARE STATES PAYING ATTENTION NOW?

State policymakers have considered combined reporting for a variety of reasons, ranging from tax-policy goals to raising revenue (often under the guise of aggressive anti-corporation-tax planning motives).⁶⁰ Combined reporting advocates claim that combined reporting is a more accurate measure of a corporation's income because the "substance of the business activity conducted in the state controls the amount of income subject to apportionment," rather than the legal structure under which a business chooses to operate.⁶¹ Legal distinctions under separate accounting do not properly capture the features that make a business unitary, such as "synergies, interdependencies, and sharing of knowledge, know-how, and experiences."⁶² Related corporations that share these assets earn income for the entire group—thus, that income should be subject to taxation despite legal formalities.

State policymakers often ask what combined reporting means for businesses that are located wholly in one state. In-state businesses are ambivalent to combined reporting because it does not affect them.⁶³

MAKERS, COPING TAXPAYERS AND U.S. NATIONAL AND FOREIGN GOVERNMENT TAX AUTHORITIES CONSIDERING FORMULARY APPORTIONMENT 112, 167 (Georgetown Univ. Law Ctr., 2008).

59. Council on State Taxation, *Combined Reporting: July 2009* (on file with the Iowa Law Review) (showcasing, through a graphical map, states who have considered, adopted, or rejected combined reporting statutes as of July 2009).

60. Cowan & Kakstys, *supra* note 36, at 364 (highlighting the difference between Vermont's proposed tax reform and New Jersey's effort to raise more revenues quickly). See generally MICHAEL MAZEROV, STATE CORPORATE TAX SHELTERS AND THE NEED FOR "COMBINED REPORTING" (2007), available at <http://www.cbpp.org/10-26-07sfp.pdf> [hereinafter MAZEROV, STATE CORPORATE TAX SHELTERS] (arguing that combined reporting enables a state to halt corporate tax-avoidance strategies and ensure a "strong and fair corporate income tax"); Fisher, *supra* note 10 (arguing that the decline in Iowa's CIT revenues has been sharper than other states' declines because more companies in Iowa are using tax-avoidance strategies); Richard D. Pomp, *Ruminations on Reforming Aspects of Connecticut's Tax Structure*, 41 ST. TAX NOTES 647 (2006) (arguing that Connecticut's corporate income tax has remained unchanged and outdated while corporations have taken advantage of the "loopholes" that enable them to avoid taxation). But see COST Urges Massachusetts Study Commission Not to Recommend Combined Reporting in Final Report, 2007 ST. TAX TODAY 233-16 (Dec. 4, 2007) (arguing that combined reporting is "a tax system choice, not a means of increasing tax revenue"); Open Letter from the Coalition to Save Wisconsin Jobs to Wisconsin Legislators Regarding Opposition to Combined Reporting (Feb. 2, 2009), available at <http://cost.org/WorkArea/DownloadAsset.aspx?id=72230> [hereinafter Letter from Coalition to Save Wisconsin Jobs] ("Combined reporting is a new and different corporate income tax system; not merely a 'loophole closer'").

61. Huddleston & Sicilian, *supra* note 55 (manuscript at 18–19).

62. *Id.* (manuscript at 18 (citations omitted)).

63. Companies that are domiciled in only one state must report all of their income to that state and therefore do not have the opportunity to "plan" or "hide" their income in other states. Fisher, *supra* note 10, at 602.

Because a business that is located entirely within a state has no out-of-state affiliates that it could use to shelter income or assets, in-state businesses have no right to apportion their income. Often, when policymakers pursue combined reporting under a general policy goal of “corporate-tax reform,” states broaden the tax base (i.e., subject more businesses to the tax) but lower the tax rate, resulting in a tax cut for some corporations, including in-state businesses.⁶⁴

Combined reporting advocates claim it will forestall companies from using corporate-tax shelters or tax-avoidance strategies to hide corporate income.⁶⁵ In February 2007, combined reporting captured the public’s attention when an article in the *Wall Street Journal* “exposed” Wal-Mart’s alleged tax-evasion scheme.⁶⁶ Since then, the public has paid much attention to “closing loopholes” and advocating “tax fairness.”⁶⁷

Corporate watchdogs have identified three ways that retailers are taking advantage of “loopholes” in state CIT laws to hide their income and lower their tax liability: (1) real estate investment trust (“REIT”); (2) captive insurance company (“captive”); and (3) passive-investment company (“PIC”).⁶⁸ These three business structures all work in similar ways. Retailers set up certain types of subsidiaries that enable their stores to pay rent for their retail space to a REIT or pay fees for using the company’s name or logo to a PIC.⁶⁹ The corporation then deducts from its income the payments it made to the subsidiary owner as business expenses.⁷⁰ Corporations set up captives to insure the corporation against various risks—like losing a products-liability lawsuit—where that subsidiary is not subject to income tax,

64. CLINE, *supra* note 24, at 2 (“Combined reporting may increase, decrease, or leave unchanged the taxable income reporting on the combined return The result depends upon the . . . factors for the different corporations in the group.”); *see also* MUNSON & LIPSMAN, *supra* note 36, at 8 (describing a situation where a corporation’s tax liability in Iowa would decrease under combined reporting).

65. MAZEROV, STATES ADOPTED KEY CORPORATE TAX REFORM, *supra* note 50, at 4–6; Huddleston & Sicilian, *supra* note 55, (manuscript at 18–22); The Iowa Fiscal P’ship, *Loopholes in Tax Talk*, IOWA FISCAL P’SHIP BACKGROUNDER, Apr. 19, 2007, at 1–2, <http://www.iowafiscal.org/2007docs/070419-IFP-loopholes-bgd.pdf>.

66. Jesse Drucker, *Wal-Mart Cuts Taxes by Paying Rent to Itself*, WALL ST. J., Feb. 7, 2007, available at <http://www.realestatejournal.com/reits/20070205-drucker.html>.

67. Stacey Mitchell, *More States Close Tax Loophole That Gives Chains an Edge*, NEW RULES PROJECT (Minneapolis, Minn.), Mar. 6, 2008, http://www.newrules.org/retail/news_slug.php?slugid=369.

68. MAZEROV, STATE CORPORATE TAX SHELTERS, *supra* note 60, at 2 (identifying passive investment companies, real estate investment trusts, and captive insurance companies as the three common tax shelters that combined reporting would nullify if enacted); New Rules Project, Combined Reporting, <http://www.newrules.org/retail/taxfaircombined.html> (last visited Nov. 5, 2009).

69. New Rules Project, *supra* note 68.

70. *Id.*

as is common practice in most states.⁷¹ Most often, the profits from the trademark fees are never subject to tax, resulting in what tax-reform advocates have coined “nowhere income”—because some states, like Delaware, do not tax intangible assets.⁷² In the case of a REIT, the REIT’s income goes back to the company as a tax-free dividend because REITs are often set up in states, such as Delaware and Nevada, with no CIT on earnings from intangible assets.⁷³ In critics’ eyes, this “nowhere income” is a major cause of states’ shrinking revenues and should be subject to tax in at least one jurisdiction.⁷⁴

Although many of the tax-planning strategies under scrutiny comply with the law, many states, including Iowa, have used PICs, REITs, and captives as catalysts for reforming the CIT (without combined reporting). While they are legal, it is important to note that not every corporate taxpayer participates in these tax-planning methods. State policymakers have to consider whether it is appropriate to subject all of a state’s corporate taxpayers to tax reform aimed at curbing the actions of only a few.⁷⁵ Moreover, some states have opted to curb the use of intangible holding companies through the use of add-back statutes, which require the parent company to add back to its taxable income certain expenses it paid to a related member (i.e., an intangible holding company) that is not subject to tax in that state.⁷⁶ If a state already has a system in place to combat tax-planning strategies, combined reporting will provide significantly less additional revenue because “add back provisions achieve much of the same revenue effect as combined reporting.”⁷⁷

States are also considering combined reporting to assist a move toward a more uniform tax system.⁷⁸ As the issues of tax avoidance and double taxation become the same or similar for many states, tax-reform efforts in those states will move toward similar solutions like combined reporting.

71. MAZEROV, STATE CORPORATE TAX SHELTERS, *supra* note 60, at 2 (“[C]aptives are often set up for legitimate self-insurance purposes, with the potential for tax sheltering a secondary benefit.”).

72. DEL. CODE ANN. tit. 30, § 1902(b)(8) (2008); see Michael J. Semes, *Do Add-Back Statutes and State Budget Demands Create the Perfect Storm of State Tax Litigation?*, PRACTICAL U.S./DOMESTIC TAX STRATEGIES, Dec. 2005, at 1, available at <http://www.blankrome.com/siteFiles/Publications/DA34A5814DCCEA9C9DD82BE07A8B84BB.pdf> (discussing Delaware law and “nowhere income”).

73. New Rules Project, *supra* note 68.

74. *Restoring Fairness & Revenue*, IOWA FISCAL P’SHP POLICY BRIEF (The Iowa Fiscal P’ship, Iowa City, IA), Nov. 2006, <http://iowafiscal.org/2006docs/061128-ifp-CIT-2pgr.pdf>.

75. CLINE, *supra* note 24, at 2 (“Combined reporting cannot differentiate between real economic differences among taxpayers and the tax planning situations many intend for it to address. . . . [A] switch to combined reporting may have significant and unintended impacts on taxpayers and tax liabilities unrelated to tax planning.”).

76. Semes, *supra* note 72, at 2.

77. CLINE, *supra* note 24, at 2.

78. Huddleston & Sicilian, *supra* note 55 (manuscript at 23–24).

Multistate efforts have produced model legislation, like the Multistate Tax Commission's ("MTC") Proposed Model Statute for Combined Reporting.⁷⁹ As long as states use the same methodology for determining who is in the unitary group and what amount of a business's income is subject to tax, combined reporting is a move towards uniformity.⁸⁰ However, such harmony and simplicity is rarely the result after a combined reporting proposal makes it out of a state's legislative process.⁸¹

C. IS COMBINED REPORTING GOOD TAX POLICY?

While the function and definition of combined reporting are integral parts of the debate, the discussion really boils down to whether combined reporting serves general public-policy goals. Answering that question requires a review of what good tax policy is in the first place, which is detailed *infra* Part III.C.1, and an examination of how well combined reporting meets the principles of good tax policy, which is detailed in Subpart 2.

1. What Makes Good Tax Policy?

The National Conference of State Legislatures ("NCSL"), a bipartisan organization that provides legislators and staffs of the fifty states with research, technical assistance, and collaboration on pressing issues,⁸²

79. MULTISTATE TAX COMM'N, PROPOSED MODEL STATUTE FOR COMBINED REPORTING (2006), available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf. As a move toward uniformity among the states, the Multistate Tax Commission approved the Model Statute for Combined Reporting on August 17, 2006. *Id.* However, the Model Statute has met serious opposition from business and its supporters, especially from COST. See Letter from Douglas L. Lindholm, COST President & Executive Director, to the MTC Representative for each state (July 7, 2005), available at <http://statetax.org/WorkArea/DownloadAsset.aspx?id=67964> (urging MTC representatives to reject the Model Statute). COST took issue with "serious deficiencies" in the MTC Model Statute, including: (1) the fact that "the MTC ignores unitary theory when unitary theory benefits the taxpayer by lowering its tax liability" by choosing to apportion income and allocate credits, which is detrimental to a corporate taxpayer and allows the state to maximize revenue without "open legislative debate"; (2) a provision in the model statute that "attempts to return, through the back door, to mandatory worldwide combined reporting" by declaring that corporations that use tax havens must include that income in the water's-edge report, despite the fact that the states, at the urging of the federal government and multistate businesses, have provided a water's-edge election since the late 1980s; and (3) a provision in the model statute that requires corporations to include insurance companies in the unitary group—a provision that threatens to upset the national system of insurance taxation, in which the Commerce Clause does not protect the insurance industry and thus is subject to tax laws different from those that govern traditional corporate entities. *Id.*

80. Huddleston & Sicilian, *supra* note 55 (manuscript at 24).

81. See generally *infra* Part IV (describing the complications and nuances that can arise from the way state policymakers formulate combined reporting statutes).

82. Nat'l Conference of State Legislatures, NCSL Member Services, <http://ecom.ncsl.org/public/newmember/index.htm> (last visited Nov. 5, 2009).

compiled a list of the “best” principles for sound tax policy.⁸³ These principles provide a “conceptual framework for appraising the quality of state tax structures,” including reliability, equity, neutrality, fairness, accountability, and ease of administration and compliance.⁸⁴

Reliability involves stability, certainty, and sufficiency: that revenues will remain relatively constant over time; that additions and changes to the rules are kept at a minimum so that businesses may plan for the future; and that enough revenue is collected to facilitate spending.⁸⁵ Equity generally refers to taxpayers in similar economic circumstances having similar tax burdens.⁸⁶ A neutral tax system is one that has a minimal effect on the allocation of resources in the economy—one where taxes are not the primary motivation in business and economic decisions.⁸⁷ Similarly, ease of administration and compliance is important and also relates to fairness: compliance with a state’s tax code takes an enormous amount of time and resources for both the taxpayer and a state tax department; minimal compliance and administrative costs preserve state resources and result in higher compliance with the law.⁸⁸ In addition, tax burdens should be explicit, which means that state policymakers must review regularly anything in a state’s tax code that reduces revenue (e.g., credits and deductions) and should disclose any tax burden that can be passed onto consumers rather than paid directly by a taxpayer.⁸⁹

These six principles are especially appropriate for examining individual tax sources.⁹⁰ Policymakers should strive to incorporate these principles in any reform they consider.

2. How Does Combined Reporting Meet These Principles?

Combined reporting purports to make a tax system more equitable, at least in theory, because it makes obsolete certain tax-planning techniques that shield particular income from taxation. Additionally, combined reporting can be revenue-neutral if a low rate is applied to a broad tax base. However, the state CIT, whether under a separate-accounting method or a combined reporting method, calls several other principles into question.

83. NCSL, PRINCIPLES, *supra* note 23.

84. *Id.*; see also BRUNORI, *supra* note 4, at 11–24 (describing the background of the NCSL PRINCIPLES document and explaining five more common, widely agreed-upon principles: (1) raising adequate revenue; (2) neutrality; (3) fairness; (4) ease of administration and compliance; and (5) accountability).

85. NCSL, TAX POLICY HANDBOOK, *supra* note 26, at 7.

86. *Id.* at 7–8.

87. *Id.*

88. *Id.* at 8.

89. *Id.* at 8–9.

90. NCSL, TAX POLICY HANDBOOK, *supra* note 26, at 7.

Corporate profits are highly volatile and very vulnerable to economic cycles because of the nature of business operations and because of tax provisions that enable corporations to carry forward losses against future profits (known in the Internal Revenue Code as “net operating losses” or “NOLs”).⁹¹ Such volatility makes CIT revenue projections unstable, uncertain, potentially insufficient, and thus, unreliable. The CIT in most states creates high administration and compliance costs: varying definitions and regulations create major headaches for multistate taxpayers and often require a corporation to retain tax experts to decipher them.⁹² State departments of revenue must also spend a large share of their resources on compliance audits for these complicated regimes.⁹³ Finally, the CIT is not accountable to the public because consumers have no way of knowing what portion of the product’s price goes towards paying the CIT;⁹⁴ thus, the CIT is invisible to the public’s eye.

While combined reporting is usually implemented on a “mandatory” basis, most states that allow or require combined reporting include an “escape clause” in their combined reporting laws. The escape clause permits taxpayers to appeal to tax departments for permission to use separate accounting “under certain conditions ‘if the taxpayer shows that the apportionment method produces a manifestly unfair result.’”⁹⁵ The Supreme Court supported this opt-out clause as constitutional,⁹⁶ as does the Uniform Division of Income for Tax Purposes Act (“UDITPA”), a model act promulgated by the National Conference of Commissioners on Uniform State Laws, whose goal is to make uniform the way states tax net income.⁹⁷

Opponents of combined reporting often cite its complexity and administrative burdens as reasons why combined reporting is bad tax policy. The business community argues that combined reporting can chill a state’s business climate, that rules and regulations surrounding its implementation create innavigable complexity in a state’s tax system for both taxpayers and

91. *Id.* at 23–24.

92. *See, e.g.*, CLINE, *supra* note 24, at 19 (describing the additional compliance and audit burdens combined reporting could impose); Open Letter from Coalition to Save Wisconsin Jobs, *supra* note 60, at 2 (same).

93. NCSL, TAX POLICY HANDBOOK, *supra* note 26, at 24–25.

94. *Id.* at 25.

95. Michael J. McIntyre, Paull Mines & Richard D. Pomp, *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*, 61 LA. L. REV. 699, 703 (2001) (citing LA. REV. STAT. ANN. § 47:287.94(C) (2001)).

96. *Hans Rees’ Sons, Inc. v. N.C. ex rel. Maxwell*, 283 U.S. 123, 135–37 (1931) (allowing the taxpayer to challenge the apportionment resulting under a one-factor apportionment formula by introducing evidence that the formula produces an unreasonable and arbitrary result).

97. UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT § 18, 7A U.L.A. 331 (1985). The Act states: “If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer’s business activity in this state, the taxpayer may petition for . . . separate accounting . . . [or] the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer’s income.” *Id.*

state tax agencies, and that the combination of these issues causes costly and drawn-out litigation.⁹⁸ But many proponents of combined reporting argue that it is better tax policy than what exists in most states now.⁹⁹ For a state's combined reporting regime to be "good tax policy," policymakers should pay considerable attention to these principles and educate themselves about the nuances of the CIT.

IV. THE DEVIL IS ALWAYS IN THE DETAILS

While proponents of combined reporting claim that the main reason states have not adopted it is "business opposition,"¹⁰⁰ the business community generally advocates caution, not outright opposition.¹⁰¹ Combined reporting requirements vary across the states, even among those that have already instituted mandatory combined reporting,¹⁰² and this can (and does) cause confusion for taxpayers who file and pay taxes in multiple states.¹⁰³ If a state's true goals in reforming its CIT are simplicity and fairness, it is essential that states enact such reform only after vetting several issues that can cause (and have caused) confusion.

Combined reporting can add significant complexity and administrative burden to the state CIT filing process for both corporate tax departments and state revenue departments. Implementing combined reporting for state CITs involves several difficult determinations: (1) which affiliated companies

98. Cowan & Kakstys, *supra* note 36, at 367–69, 402–03. See generally CLINE, *supra* note 24 (bringing to light several issues and discrepancies in the figures and numbers that supporters use to advocate combined reporting).

99. David Brunori, *The Fight Against Combined Reporting*, 47 ST. TAX NOTES 451, 451 (2008) ("If states are going to tax corporate income, we need combined reporting").

100. Pomp, *supra* note 60, at 658.

101. *Testimony Before the S. Ways and Means Comm. on Mandatory Unitary Combined Reporting*, 81st Leg., Reg. Sess. (Iowa 2005) (statement of Joseph R. Crosby, Legislative Director, Council on State Taxation) (explaining that COST took no position on combined reporting but that "extensive experience[s]" in other states allowed COST to identify several issues that have created major problems for taxpayers and state administrative agencies that could have consequences adverse to the original motivations for adopting combined reporting). While groups with diverse business membership typically do not take a position on combined reporting because it can affect their members in a variety of ways in a variety of states, other state-specific business groups regularly oppose combined reporting. COST has since changed its position to oppose combined reporting. Testimony of Crosby, *supra* note 57; *Testimony of Associated Industries of Massachusetts Before H. Chairmen John J. Binienda, S. Chair Cynthia Stone Creem and Members of the Joint Comm. on Revenue in Opposition to H.4499, An Act Improving Tax Fairness and Business Competitiveness Filed by Governor Patrick*, 185th Gen. Ct. (Mass. 2008) (statement of Eileen McAnney, Senior Vice President & Associate General Counsel, Associate Industries of Massachusetts), available at http://www.aimnet.org/AM/Template.cfm?Section=Home_Page&template=/CM/HTMLDisplay.cfm&ContentID=13576 (explaining the position Associate Industries of Massachusetts took in opposition to the enactment of combined reporting).

102. HELLERSTEIN & HELLERSTEIN, *supra* note 47, ¶ 8.11(3).

103. See Cowan & Kakstys, *supra* note 36, at 368 ("As far as complexity is concerned, businesses do have a point").

compose a unitary group, (2) the unitary group's taxable income, and (3) "a state's share of the taxable income."¹⁰⁴

A. WHO IS IN THE UNITARY GROUP?

The unitary group is generally comprised of affiliated taxpayers—parent companies and subsidiaries engaged in a “unitary business.”¹⁰⁵ Determining who that actually *is* can be complicated. The Supreme Court has identified general indicia of a unitary business, including: “unity of use and management,” a concrete relationship between in- and out-of-state activities, “functional integration, centralization of management, economies of scale, substantial mutual interdependence, and some sharing or exchange of value not capable of precise identification of measurement.”¹⁰⁶ However, in practice, these indicia are not adequate for a corporation's tax preparer to determine who should be in its unitary group. Taxpayers rarely get additional guidance from state statutes or detailed regulations because the determination of whether a particular entity is unitary with another entity is inherently fact-specific.¹⁰⁷ Determining the unitary group's composition is a “complicated, subjective, and costly process” that involves re-examining the unitary relationship every year, in light of structural changes in a business.¹⁰⁸ It also involves examining entities that do not necessarily have nexus in the taxing state.¹⁰⁹

When corporations with a number of affiliates that are not in the same line of business attempt to determine their own unitary groups, taxpayers and tax administrators often clash over qualitative determinations of whether those businesses are truly unitary.¹¹⁰ These clashes expend valuable corporate and state resources, especially when they turn into costly audits, appeals, and litigation.¹¹¹ For state tax administrators (namely auditors) to determine effectively and accurately which affiliates are unitary, they must examine “how a taxpayer and its affiliates operate at a fairly detailed level.”¹¹² Taxpayers rarely find solace in the ability to appeal unitary determinations because the U.S. Supreme Court defers to state courts'

104. CLINE, *supra* note 24, at 19.

105. *Id.*

106. POMP & OLDMAN, *supra* note 29, at 10-26 to -27 (citations omitted); *see supra* notes 39-41 and accompanying text (explaining what is a unitary business).

107. CLINE, *supra* note 24, at 19.

108. *Id.* at 19-20. Structural changes in a business can include mergers, acquisitions, and divestitures. *Id.*

109. *Id.* at 20.

110. *Id.* at 19 (“[U]nitary determinations involve not only quantitative measures, but also qualitative dimensions.”).

111. Cowan & Kakstys, *supra* note 36, at 368 (“Since the unitary business concept is a flexible one, litigation can result between the state and taxpayers over which corporations should be in the combined return and which should not.”).

112. CLINE, *supra* note 24, at 19.

judgments on whether particular business activities constitute a unitary business using a type of rational-basis test.¹¹³ Thus, despite the constitutional limitations on imposing taxes on multistate taxpayers, the wide latitude that the Court allows states in defining “unitary business” leaves significant uncertainty for taxpayers on a day-to-day basis.

Combined reporting advocates suggest, however, that the complexity of instituting a new method of corporate taxation should be ignored because “combined reporting is nothing new.”¹¹⁴ They claim that because other states require combined reporting, corporations should have no problem figuring out what they have to do when a new state requires it.¹¹⁵ However, this justification is seriously flawed. The multitude of different state rules and regulations pertaining to combined reporting—with no uniformity or order—is exactly what businesses oppose.¹¹⁶ Keeping track of all the

113. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 175–76 (1983) (noting that the Court’s task is “to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment ‘was within the realm of permissible judgment’” (quoting *Norton Co. v. Dep’t of Revenue*, 340 U.S. 534, 538 (1951))).

114. Cowan & Kakstys, *supra* note 36, at 368. The authors continue that since “California has been using [combined reporting] since the Great Depression. . . . many multistate taxpayers are already accustomed to it.” *Id.*; cf. Ann Holley & Marianne Evans, *The Pros & Cons of Combined Reporting: A Compendium of Arguments For and Against Combined Reporting*, 2008 ST. & LOC. TAX LAW. (forthcoming 2008) (manuscript at 22) (citing N.M. BLUE RIBBON TAX REFORM COMM’N, OPTIONS FOR BUSINESS TAX REFORM AND RELIEF 6 (2003)) (“Simply moving from one tax regime to another involves complexities regardless of the merits of the old or new system.”).

115. Joe Huddleston & Shirley Sicilian, *Would States Adopt a Model Combined Reporting Statute?*, in *THE STORY BEHIND COMBINED REPORTING: A CRITICAL GUIDE FOR STATE TAX POLICY MAKERS, COPING TAXPAYERS AND U.S. NATIONAL AND FOREIGN GOVERNMENT TAX AUTHORITIES CONSIDERING FORMULARY APPORTIONMENT* 260, 265 (Georgetown Univ. Law Ctr., 2008) (noting that because “many states” require combined reporting, “many taxpayers now have extensive experience determining whether their various affiliates are unitary”).

116. *See Testimony Before the S. Ways and Means Comm. on Mandatory Unitary Combined Reporting*, *supra* note 101 (statement of Joseph R. Crosby, Legislative Director, Council on State Taxation) (“[M]any [combined reporting] states do not have adequate answers to these questions despite over 60 years of experience with unitary combined reporting.”); MILLER, *supra* note 58, at 127 (“It is the non-unitariness of state application of the unitary business principle that gives rise to many of the disparity of answers between the states and many of the issues involving state sourcing of income.”); *see also* BRUNORI, *supra* note 4, at 97. Brunori notes that tax reform is most effective when all states are working toward the same goal to achieve uniformity. Brunori states:

[S]trengthening the corporate income tax depends on all the states working toward this goal Uniformity in the tax base and apportionment formulas would reduce compliance and administrative costs. It would also remove the incentive to develop expensive tactics that take advantage of the myriad rules and regulations across states. Uniformity would ease the problems of double taxation and, most important, limit the opportunity of corporations to avoid their obligations of paying for the government services they receive.

Id. But *see* Huddleston & Sicilian, *supra* note 55, (manuscript at 28) (noting that determining a company’s unitary group for one state makes it easier to determine it for all other combined reporting states “because the determination of unity is largely governed by U.S. constitutional

different rules in the several states in which multistate corporations do business is costly and cumbersome. Businesses want to be sure that state lawmakers understand these issues.¹¹⁷

B. HOW IS INCOME COMBINED?

The complexity and administrative burdens do not end with determining who is in the unitary group. Once a corporation determines who is in its unitary group, it then has to calculate the group's combined income. In most separate-filing states, including Iowa, a corporation's state taxable income is based on its federal taxable income.¹¹⁸ But because most states use a different ownership test under combined reporting, the state unitary group differs considerably from the group included in the federal consolidated return.¹¹⁹ Put simply, there is no federal equivalent to the unitary business principle.¹²⁰ Even after a corporation's accountants are able to distinguish federal from state income, a unitary group's income may differ between states because of various state-specific requirements that contribute to the compliance costs and complexity of doing business in a combined reporting state.¹²¹

When laying out how a unitary group should combine its income, state policymakers must understand: (1) the difference between non-business income allocation and business income apportionment; (2) whether to include income from foreign affiliates; (3) how to treat intercompany transactions under combined reporting; and (4) how to treat multiple unitary businesses.

1. Allocation Versus Apportionment

Calculating a corporation's combined income involves properly distinguishing between apportionable business income and allocable nonbusiness income. Apportionment means divvying up income that is attributable to a corporation's activities in a particular state in order to tax it and avoid double taxation.¹²² Allocation is the practice of giving one state jurisdiction to tax certain receipts of a multistate business.¹²³ Non-business

principles, once a taxpayer has identified its unitary group for one state it has likely determined it for others").

117. Cowan & Kakstys, *supra* note 36, at 369. Cowan and Kakstys point out that while businesses' arguments against combined reporting are refutable, "[business opposition] cannot be ignored by the legislature." *Id.* Because of this, legislatures often end up enacting add-back statutes to fight tax shelters instead of enacting true corporate tax reform with combined reporting. *Id.*

118. MUNSON & LIPSMAN, *supra* note 36, at 3.

119. CLINE, *supra* note 24, at 20.

120. *Id.*

121. *Id.*

122. See *supra* text accompanying notes 32-35 (explaining apportionment).

123. Strauss, *supra* note 32, at 14.

income (or “allocable income”) is often interpreted as income accrued outside of the regular course of business, like the earnings from the sale of stocks and bonds held as part of a treasury-management function for a firm that produces and sells a product.¹²⁴ Such income is allocated entirely to a single state.¹²⁵

Non-business income, which can include both income from real property and intangible income like interest, dividends, rents, and royalties, is generally allocated because it is not thought to produce any part of the trading profit and can “be specifically allocated to [its] proper source[.]”¹²⁶ Under combined reporting, a taxpayer must determine what income to apportion and what income to allocate—not only for its affiliates that previously were separate filers in the state, but also for all corporations in the unitary group.¹²⁷ This is a costly, time-consuming practice that is not uniform across the states or even across those that mandate combined reporting.

2. Water’s-Edge Versus Worldwide Reporting

State policymakers must also consider whether they want to mandate “worldwide reporting” or “water’s-edge reporting.”¹²⁸ Worldwide combined reporting includes all of a corporation’s affiliates, regardless of the place of incorporation—including foreign affiliates—in the unitary group.¹²⁹ A water’s-edge report requires only income from affiliates incorporated in the United States, excluding affiliated foreign corporations from the combined report in that state.¹³⁰

Taxpayers often oppose worldwide combined reporting because of the additional complexity that gathering property, payroll, and sales information from a foreign company (often requiring translations and conversions) would add. The Multistate Tax Commission has long advocated worldwide combined reporting, codified in its Model Statute for Combined Reporting.¹³¹ Additionally, the U.S. Supreme Court has upheld California’s worldwide combined reporting practices.¹³² Despite the MTC’s support of and California’s legal victory for worldwide combined reporting, most states

124. Fox, Murray & Luna, *supra* note 2, at 150–51.

125. McIntyre, Mines & Pomp, *supra* note 95, at 725.

126. POMP & OLDMAN, *supra* note 29, at 10-29 to -30.

127. *Id.*

128. Michael G. Williams, Charles W. Swenson & Terry L. Lease, *Effects of Unitary vs. Nonunitary State Income Taxes on Interstate Resource Allocation: Some Analytical and Simulation Results*, J. AM. TAX’N ASS’N, Spring 2001, at 40.

129. POMP & OLDMAN, *supra* note 29, at 10-47.

130. Sutton & Ford, *supra* note 51, at 149; Williams, Swenson & Lease, *supra* note 128, at 40.

131. MULTISTATE TAX COMM’N, *supra* note 79, § 1(F)–(G), (I).

132. Barclays Bank P.L.C. v. Franchise Tax Bd., 512 U.S. 298, 303 (1994); Container Corp. v. Franchise Tax Bd., 463 U.S. 159, 159 (1983).

allow corporations to elect to use either combination method.¹³³ In reality, though, the water's-edge election varies considerably from state to state and generally includes certain foreign entities or elements of foreign income (e.g., Subpart-F income). The legal entities that a corporation includes in a unitary group depend on the taxing state's requirements for making the election.¹³⁴ Because of the uncertainty and confusion that often results from worldwide combined reporting, some state policymakers have found other ways to ensure that corporations do not abuse foreign affiliates when considering combined reporting proposals.¹³⁵

3. Intercompany Transactions

Another major issue in implementing combined reporting concerns transfer pricing. Transfer pricing is when a parent corporation sells its products to an out-of-state subsidiary, which in turn sells them to the final customers.¹³⁶ This is controversial because there is a perception among tax administrators that parent companies do not sell at arm's-length prices, allowing them to distort their taxable income.¹³⁷ Determining how to treat intercompany transactions, or transfer prices, is problematic because "only the inter-corporate transactions among the companies included in the unitary group are eliminated in determining combined income."¹³⁸ Issues still remain for transactions between companies in the unitary group and those outside the unitary group, though proponents argue that "combined

133. Williams, Swenson & Lease, *supra* note 128, 40–41 ("States rarely require the application of the worldwide method, typically allowing a choice between the two methods.").

134. Sutton & Ford, *supra* note 51, at 150–51 (describing California's requirements for making a water's-edge election and explaining that "with regard to water's-edge elections, combined reporting . . . looks to the commercial, and to a lesser extent, the legal domicile, of the legal entities in question while side-stepping the unitary business relationship of those entities").

135. PA. DEP'T OF REVENUE, PENNSYLVANIA BUSINESS TAX REFORM COMMISSION FINAL REPORT 3 (2004), available at http://www.revenue.state.pa.us/tax_reform/lib/tax_reform/04_final_report.pdf. The Commission explained:

[T]he Commission does not support mandatory worldwide combination. The Commission recommends the use of water's edge accounting coupled with a legislative prohibition of the inappropriate tax use of foreign affiliates. The Commission further recommends that taxpayers be permitted an election to use worldwide accounting. Any election should be binding for a reasonable period of time.

Id.

136. Fisher, *supra* note 10, at 608–09 & tbl.3; P.V. Smith, Annotation, *State Income Tax in Respect of Business That Extends into Other States*, 130 A.L.R. 1183, 1217–18 (2008).

137. MAZEROV, STATE CORPORATE TAX SHELTERS, *supra* note 60, at 4 (describing how parent companies use transfer pricing to manipulate taxable income by merely "solicit[ing] orders from its own subsidiary" and that "the parent has substantial leeway to manipulate the prices . . . at which it sells its products to the subsidiary in order to minimize its nationwide state corporate tax liability").

138. POMP & OLDMAN, *supra* note 29, at 10-29 to -30.

reporting eliminates the need to police transfer prices.”¹³⁹ This is because transfer prices will not affect the overall profits of the consolidated group, and the benefits of economies of scope and scale do not have to be estimated or distributed among firms.¹⁴⁰ However, opponents of combined reporting argue that separate reporting with arm’s-length transfer pricing is more accurate, especially with regard to in-state activities.¹⁴¹

Uncertainty over transfer pricing can be especially disconcerting for taxpayers when a statute does not change the state CIT scheme to combined reporting, but rather gives the state’s taxing authority broad discretion in state-tax matters. A New York statute gave a state official, like the tax commissioner, discretion to require or permit a company to file a combined report if that official suspected that some intercompany transaction did not properly reflect the tax liability of that company.¹⁴² Essentially, if the tax commissioner believed that intercompany transactions were not arm’s length, or that they would be in the open market, then he could determine that the company’s separate report reflected “distorted” income and require

139. *Id.* at 10-43 to -44. In a separate reporting system, a corporation that manufactures products in one state and stores them in another state must assign a transfer price to the products as if they were sold to an independent distributor (at arm’s length). *Id.* at 10-44. But in a combined reporting state, when the manufacturing functions are assigned to the parent company and the subsidiary receives those goods for storage and sale, the fiction that the company would have to create in a separate reporting system is explicit—that there was a tangible transaction between the parent and the subsidiary. *Id.*

140. Fox, Murray & Luna, *supra* note 2, at 147.

141. Holley & Evans, *supra* note 114 (manuscript at 13–14); *see also* Kimberley Reeder & Margaret Wilson, *Comments on Multistate Tax Commission Proposed Model Statute for Combined Reporting*, 36 ST. TAX NOTES 301, 303 (2005). Reeder and Wilson explain:

[S]o long as related taxpayers charge each other the same amounts that they would charge to an unrelated business for the same transaction, no distortion or improper reflection of income would result . . . in fact, when related corporations deal with one another on arm’s length terms, combination may actually result in distortion.

Id.

142. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 47, ¶ 8.11(3)(c)(i) (describing New York state law prior to January 1, 2007, which gave the tax commissioner discretion to “permit or require a corporation substantially all of whose capital stock is owned or controlled, directly or indirectly, by one or more other corporations, to file a combined report with the controlling corporation”). Essentially, if the tax commissioner determined that a company’s separate report distorted what he decided to be the corporation’s New York activities, business, or income, then he could require a corporation to file a combined report, ostensibly to force the corporation to incur a larger tax liability in the state of New York. *Id.* The statute read: “[T]he activities, business, income or capital of a taxpayer will be presumed to be distorted when the taxpayer reports on a separate basis if there are substantial intercorporate transactions among the corporations.” N.Y. COMP. CODES R. & REGS. tit. 20, § 6-2.3(a) (1998). However, New York changed its law for tax years beginning on or after January 1, 2007, to require combined reporting for corporations who had “substantial intercorporate transactions among the related corporations, regardless of the transfer price for such intercorporate transactions.” N.Y. TAX LAW § 211(4)(a) (McKinney Supp. 2009).

combined reporting.¹⁴³ This provision led to several state cases that questioned whether such discretion was appropriate,¹⁴⁴ but the New York courts settled on a line of reasoning that allowed taxpayers to refute the presumption of income distortion if the taxpayers could demonstrate that the affiliates employed arm's-length pricing.¹⁴⁵

4. Multiple Unitary Businesses

Policymakers should acknowledge that companies often operate several types of businesses that are independent of some businesses but unitary with others. If one unitary business operates in the taxing state and others operate outside that state, the state should only be entitled to require the taxpayer to include in its combined report income from the unitary business conducted in the state.¹⁴⁶ Where a corporation operates two distinct unitary businesses in the same taxing state, that state should calculate the taxable income of each unitary group separately¹⁴⁷—in effect, the state should ignore the two businesses' legal ties to each other for tax purposes.

* * *

These are not all the issues that exist with respect to combining the income of a unitary group. For example, how to treat income from members of a unitary group subject to other types of taxing schemes (like insurance and banking) is a very real concern—especially in Iowa, where the insurance industry makes up a major part of in-state business. Policymakers need to educate themselves on these other important issues and listen to business concerns.

C. HOW IS INCOME APPORTIONED?

After determining who is in the unitary group and its combined income, a corporation must apportion that income using the taxing state's apportionment formula. Applying a state's apportionment formula is not as easy as plugging numbers into a calculator.¹⁴⁸ Complications arise with respect to (1) sales among affiliated corporations who do not have nexus in the taxing state and (2) how members of a unitary group may use tax attributes.

143. HELLERSTEIN & HELLERSTEIN, *supra* note 47, ¶ 8.11(3)(c)(i).

144. *Id.*

145. *Id.*

146. McIntyre, Mines & Pomp, *supra* note 95, at 720–21.

147. *Id.* at 721; MILLER, *supra* note 58, at 175–76.

148. CLINE, *supra* note 24, at 20 (describing that calculating the apportionable income of a combined group is “considerably more complicated than simply basing the calculations on consolidated federal taxable income”).

1. How Is the Sales Factor Employed?

When a corporation makes a sale in a state in which the corporation itself is not taxable but other members of the unitary group are, one question that arises is to which state the sales should be attributed. California's experience with combined reporting reveals two main attribution methods: (1) the *Joyce* method and (2) the *Finnigan* method.¹⁴⁹ Under the *Joyce* method, sales of goods shipped from a corporation in the unitary group that does not have nexus in the state to customers in the taxing state are not included in that state's sales factor.¹⁵⁰ Under the *Finnigan* method, all firms in a unitary group that make sales in a state, regardless of whether they are taxable in that state, must include those sales in the sales factor for that state.¹⁵¹ Use of the *Finnigan* method can potentially cause sales made by an entity without nexus to be sourced to more than one state—once in the unitary group's sales factor in the *Finnigan* state and again in the non-nexus entity's state—defeating a rationale for the apportionment method in the first place.¹⁵² To avoid this, states should provide for the removal of sales income that is “thrown back” to its state of corporate location.¹⁵³

149. JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *Receipts or Sales Factors*, in 1 STATE TAXATION ¶ 9.18(1)(a)(ii) (3d ed. 1998) (citing Appeal of Joyce, Inc., No. 66-SBE-070, 1966 WL 1411, (Cal. State Bd. of Equaliz. Nov. 23, 1966), and Appeal of Finnigan, No. 88-SBE-022, 1990 WL 15164, (Cal. State Bd. of Equaliz. Jan 24, 1990)).

150. *Id.*; Fox, Murray & Luna, *supra* note 2, at 152.

151. Fox, Murray & Luna, *supra* note 2, at 154–55; HELLERSTEIN & HELLERSTEIN, *supra* note 149, ¶ 9.18(1)(a)(ii), at 9-187 to -190. The California State Board of Equalization effectively overruled *Joyce* when it ruled in *Finnigan*; however, in *In re the Appeal of Huffly Corp.*, No. 99-SBE-005, 1999 WL 386938 at *3 (Cal. State Bd. Equaliz. Apr. 22, 1999), the State Board of Equalization overruled *Finnigan* and reinstated *Joyce* as the correct law, stating that:

While there were theoretically good reasons for the initial implementation of the *Finnigan* . . . rule, the actual practice has resulted in the taxation of income which would not otherwise be taxed by the State of California. In order to promote uniformity of the UDITPA law, and to more fairly reflect the fundamental principles of combined reporting, this Board believes that its . . . decision in *Joyce* is the better law.

In re the Appeal of Huffly Corp., 1999 WL 386938, at *3 (citation omitted). States like Kansas and Wisconsin still employ the *Finnigan* method. Fox, Murray & Luna, *supra* note 2, at 154–55; Wis. STAT. § 71.255(5)(a) (2008). Fox, Murray, and Luna argue that the *Finnigan* method is “superior in promoting tax neutrality because it is likely to result in a broader set of firms being combined.” Fox, Murray & Luna, *supra* note 2, at 154–55

152. Fox, Murray & Luna, *supra* note 2, at 154–55 (noting that the *Finnigan* method exposes firms to double taxation).

153. *Id.* Twenty-five states have a throwback rule, which requires corporations to “throw back” to the taxing state sales income earned in states where the sales were made (“destination states”). New Rules Project, Throwback Rules, <http://www.newrules.org/retail/rules/level-playing-field-taxation/throwback-rules> (last visited Nov. 5, 2009).

2. What About Tax Attributes?

Of particular concern to taxpayers is how a state treats tax credits and NOLs—referred to as “tax attributes.” The issue is whether any member of the unitary group can use a tax credit or NOL, or whether the specific legal entity that “earned” the tax credit or NOL must use the attribute. Most states track tax attributes at the entity level and limit their utilization “to the legal entity which created the attribute.”¹⁵⁴ For example, Alabama allows a taxpayer to carry over to the affiliated group’s return a NOL incurred by members of the group, even if a member incurred the loss when it filed a separate return.¹⁵⁵ Wisconsin limits a group member’s use of credits, net business losses, and other post-apportionment deductions earned by one member prior to filing to that earning member; net business losses (but not credits) created by the unitary combined group may be shared among the group after apportionment.¹⁵⁶

However, California, in regulations promulgated by the Franchise Tax Board, utilizes “intrastate apportionment rules” and allows each member of the combined group to carry over its own NOL.¹⁵⁷ This practice, however, runs contrary to unitary theory and taxpayers find it hypocritical that states ignore their legal-entity distinctions to create taxable income, but recognize them for limiting attribute utilization.¹⁵⁸ Policymakers should abide by the premises of combined reporting on both sides of income—if a corporation’s legal distinctions are to be ignored when it earns profits, they should also be ignored when it loses profits.

V. HOW DOES COMBINED REPORTING AFFECT ECONOMIC DEVELOPMENT?

While proponents of combined reporting suggest that combined reporting does not have a profound effect on a state’s economy and

154. Sutton & Ford, *supra* note 51, at 146; Huddleston & Sicilian, *supra* note 55 (manuscript at 34) (explaining that most states treat the members of a unitary group as separate entities when calculating tax liabilities).

155. Craig B. Fields & Hollis L. Hyans, *Procedural Issues Raised by Combined Reporting and Formulary Apportionment*, in THE STORY BEHIND COMBINED REPORTING: A CRITICAL GUIDE FOR STATE TAX POLICY MAKERS, COPING TAXPAYERS AND U.S. NATIONAL AND FOREIGN GOVERNMENT TAX AUTHORITIES CONSIDERING FORMULARY APPORTIONMENT 230, 249 (Georgetown Univ. Law Ctr., 2008). While Alabama does not adhere to mandatory unitary combined reporting, its CIT laws employ some combined reporting practices. *See generally id.*

156. WIS. STAT. § 71.255(6)(a)–(b) (2009); *see also* Wis. Dep’t of Revenue, Summary of Act 28 Changes to Combined Reporting Law, Aug. 14, 2009, <http://www.dor.state.wi.us/combrep/summary.html> (last visited Nov. 11, 2009).

157. CAL. CODE REGS. tit. 18, § 25106.5(c)(1)(C), (e) (2009); FRANCHISE TAX BD., MULTISTATE AUDIT TECHNIQUE MANUAL § 8050 (2004), *available at* <http://www.ftb.ca.gov/aboutFTB/manuals/audit/matm/8000.pdf>.

158. Sutton & Ford, *supra* note 51, at 146–48.

competitiveness,¹⁵⁹ policymakers should be concerned about several unknown, and often immeasurable, factors that make proponents' assertions less certain. Global, national, state, and local economies are constantly changing, as are tax policies and other policy goals. These variables are difficult, if not impossible, to measure, and call into question any general assertions about how a policy change will affect a state's economic competitiveness.¹⁶⁰

Problems inherent in projecting revenue effects impede forecasting how combined reporting will affect a state's competitiveness. Despite reports from state departments of revenue that project revenue increases as a result of combined reporting,¹⁶¹ other studies have found that "[c]ombined reporting has uncertain effects on a state's revenues, making it very difficult to predict the revenue effect of combined reporting."¹⁶² Many factors affect revenue-impact reports, including all of those discussed above.¹⁶³ Additionally, some states opt to address controversial tax-planning techniques in other ways—including add-back statutes¹⁶⁴—and these other ways of curbing tax shelters significantly reduce the additional revenue a state may see from combined reporting. State studies show that "[e]ach state's experience is unique" because of the unique features of each state's tax system and tax compliance programs.¹⁶⁵

Proponents argue that combined reporting is a revenue-neutral tax reform, not a way to shake the piggy banks of corporations for more money;

159. *E.g.*, MAZEROV, STATES ADOPTED KEY CORPORATE TAX REFORM, *supra* note 50, at 7–8 (“[T]he burden of proof ought to lie with combined reporting opponents to demonstrate that the policy has a negative impact on state economic growth.”); *Testimony Before the H. Fin. Comm.*, 2005 Pa. Legis. Serv. (testimony of Gregory C. Fajt, Secretary, Pa. Dep’t of Rev.) (“There is no evidence that adoption of combined reporting has a negative effect on a state’s ability to attract employers. In fact, by some measures combined reporting states have actually done better economically than separate company states.”).

160. CLINE, *supra* note 24, at 14.

161. MUNSON & LIPSMAN, *supra* note 36; N.M. BLUE RIBBON TAX REFORM COMM’N, OPTIONS FOR BUSINESS TAX REFORM AND RELIEF 7 (2003), available at <http://legis.state.nm.us/LCS/bluetaxdocs/BusinessTax.pdf>; PA. DEP’T OF REVENUE, *supra* note 135, at 3.

162. CLINE, *supra* note 24, at 2; *see also* POMP & OLDMAN, *supra* note 29, at 10-40 (“A combined report does not systematically lead to a higher or lower tax than would separate entity reporting. Both a corporation’s taxable income and its apportionment percentage will change. Whether these changes will lead to a higher or lower amount of tax cannot be predicted a priori.”). Brunori and Cordes offer an alternative perspective. They argue that:

[W]hen the performance of states with combined reporting is compared with that of states without this requirement, we find that the latter group of states had high performing state corporate taxes in 37 percent of the possible trials, and low performing state corporate taxes in 50 percent of the possible trials.

BRUNORI & CORDES, *supra* note 46, at 20.

163. *See supra* Parts IV.A–C.

164. CLINE, *supra* note 24, at 11.

165. *Id.* at 13.

however, they still trumpet its ability to raise revenue through reform as a convenient side effect.¹⁶⁶ In arguing that the implementation of combined reporting does not affect businesses' willingness to locate operations in a particular state, advocates cite anecdotal evidence businesses that remained in California during the Silicon Valley expansion in the 1990s, businesses that continued operations in other states that implemented combined reporting, and the seemingly small tax-liability increase that combined reporting causes.¹⁶⁷ While this may be an accurate representation of business attitude in the aggregate, individual taxpayers argue that, indeed, taxes *do* matter to their business-location decisions, even if taxes are not a necessary deciding factor.¹⁶⁸ Policymakers considering combined reporting must always keep sound tax-policy principles at the forefront of their efforts.

VI. COMBINED REPORTING IN IOWA

While some of Iowa's geographic neighbors have considered and adopted combined reporting,¹⁶⁹ Iowa's legislature has not enacted combined reporting despite several proposals in the past few years. This section examines what Iowa's CIT looks like right now and what past combined reporting proposals have included. It concludes with a

166. Huddleston & Sicilian, *supra* note 55 (manuscript at 20) ("Although the tax effect of combined reporting is neutral in principle, . . . [it] is likely to have a positive impact on tax revenue."); Pomp, *supra* note 60, at 657 ("A combined report is not biased against taxpayers and does not systematically lead to a higher tax than would separate-entity reporting Nonetheless, . . . its adoption would almost certainly raise revenue.") .

167. MAZEROV, STATES ADOPTED KEY CORPORATE TAX REFORM, *supra* note 50, at 7–8.

168. CLINE, *supra* note 24, at 14–15; NACKER, *supra* note 37 at 8–9. One businessman noted:

"[B]usiness and investors alike generally tend to favor states that do not [sic] require combined reporting. . . . Draconian decisions, such as completely pulling out of state altogether are not the real issue. Over time, simple decisions to allocate more resources to other locations or outsource sub-processes have a dramatic and cumulative negative impact on local jobs and the economy."

Id.

169. Currently, Illinois, Kansas, Minnesota, Nebraska, North Dakota, and Wisconsin all have mandatory unitary combined reporting regimes in place. 35 ILL. COMP. STAT. 5/304(e) (2009); KAN. STAT. ANN. § 79-3279 (2008); MINN. STAT. §§ 290.34(2), 290.17(4)(j) (2008); NEB. REV. STAT. § 77-2734.01(3) (2008); N.D. CENT. CODE § 57-38-14 (2008); WIS. STAT. § 71.255 (2009); ILL. ADMIN. CODE tit. 86, § 100.5200 (2008); N.D. ADMIN. CODE 81-03-05.2 (2008); *Pioneer Container Corp. v. Dir. of Taxation*, 684 P.2d 396, 404 (Kan. 1984) (holding that combined reporting is a natural and consistent extension of the provisions giving the tax director authority to allocate a corporation's income among certain factors). Missouri, Louisiana, Alabama, Tennessee, Florida, New Mexico, and Delaware, in addition to Iowa, all rejected combined reporting legislation in 2009. Council on State Taxation, *Combined Reporting: July 2009* (on file with the Iowa Law Review) (showcasing, through a graphical map, states who have considered, adopted, or rejected combined reporting statutes as of July 2009). South Dakota does not levy a corporate income tax. See S.D. Governor's Office of Econ. Dev., Ready to Work, Step 9: South Dakota State Taxes, <http://www.sreadytowork.com/DBISD/Startup/step9.asp> (last visited Nov. 5, 2009) (stating that South Dakota has no corporate income tax).

recommendation of how Iowa should approach tax-reform proposals regarding combined reporting.

A. IOWA'S CORPORATE INCOME TAX RIGHT NOW

Currently, Iowa imposes an income tax on corporate entities that have sales, income, and a physical presence (nexus) in Iowa.¹⁷⁰ Iowa allows those corporate entities to file separately or as part of a consolidated group according to the federal consolidated-reporting method.¹⁷¹ While most states use a three-factor formula to apportion a business's income that relates to its activities in the state,¹⁷² Iowa uses single-sales-factor apportionment, which means that it taxes only a business's income from sales in the state and ignores income from property and payroll.¹⁷³ This gives a low-tax advantage to companies in industries like manufacturing, which have high property and payroll factors and relatively low sales income.

Iowa does not have an add-back statute, so some commentators suspect that corporations exploit the goods and services that Iowa provides them and allocate all their sales income to states in which they have no tax nexus (and thus no tax liability).¹⁷⁴ This "nowhere income" is a driving force behind calls for corporate tax reform in Iowa despite the fact that in 1995, Iowa law changed to subject Delaware holding companies to taxation, as they are often blamed for shielding corporate income from the Iowa CIT.¹⁷⁵ The Iowa Department of Revenue ("IDOR") reports that "[f]irms have responded to the Iowa tax environment by shifting income to other members of the affiliation that are not subject to Iowa corporate income tax"¹⁷⁶ The IDOR's report speculates that companies in Iowa are using tax-planning methods similar to those that companies are using in other states, such as holding companies, PICs, and transfer-pricing schemes.¹⁷⁷

170. IOWA CODE § 422.33 (2008).

171. MUNSON & LIPSMAN, *supra* note 36, at 3. Currently, multistate firms using either filing status may include in their Iowa income-tax returns only those corporations actually doing business in Iowa and having an Iowa presence. *Id.*

172. *See supra* Part IV.C.

173. IOWA CODE § 422.33(2)(b) (2008); MUNSON & LIPSMAN, *supra* note 36, at 7. The apportionment factor is called the business activities ratio ("BAR") and includes other receipts, such as royalties. The Iowa BAR is Iowa sales divided by total sales of all affiliated corporations doing business in Iowa. *Id.*

174. Fisher, *supra* note 10, at 610–11; *see also supra* Part III.B (explaining add-back statutes).

175. MUNSON & LIPSMAN, *supra* note 36, at 4–5. The report notes, however, "compliance with this law has been spotty, and most of the assessments—approximately \$20 million—the Department has issued on this issue are currently under appeal." *Id.*; *see also supra* Part III.B (explaining corporate-tax shelters that prompt states to reform their CIT).

176. MUNSON & LIPSMAN, *supra* note 36, at 4 (describing some "common examples" of how Iowa corporations have shifted their income to avoid taxation).

177. *Id.*

The Iowa General Assembly also utilizes several tax credits and abatements to keep businesses from leaving the state or to lure new businesses into the state.¹⁷⁸ According to one Iowa think tank, these credits cost the state \$108 million between 2001 and 2004.¹⁷⁹ The Iowa General Assembly is not required to approve tax credits, and there is no annual cost cap on most tax credits.¹⁸⁰ Such credits and abatements deprive the state of a large chunk of untracked and unmonitored potential revenue. There is no clear evidence that these tax credits are worth their cost in terms of loss of revenues to Iowa.

Iowa's current CIT calls into question several tax-policy principles, such as reliability, equity, compliance, accountability, and interstate and international competition. The General Assembly needs to update the CIT to reflect Iowa's modern economy and the competitive business climate in which other states operate.

B. CALLS FOR COMBINED REPORTING

Citing evidence that Iowa's CIT is not performing the way it should, policymakers, economists, and taxpayers alike have called for CIT reform in Iowa. Proposals from the governor's office and the IDOR have made headlines, caught the public's attention,¹⁸¹ and will likely keep the issue at the forefront of the Iowa General Assembly's to-do list.

Iowa lawmakers have considered several combined reporting proposals over the past few years.¹⁸² In his 2008 State-of-the-State Address, Governor Chet Culver proposed combined reporting to "[l]evel the playing field for Iowa small businesses" by "clos[ing] a tax loophole allowing multi-billion dollar corporations that do tens of millions of dollars of business in Iowa

178. IOWA CODE § 422 *passim* (2008); *see also* Fisher, *supra* note 10, at 606 tbl.2 (detailing the various credits available to Iowa businesses).

179. Fisher, *supra* note 10, at 601; *Restoring Fairness & Revenue*, *supra* note 74.

180. Fisher, *supra* note 10, at 607. In November 2009, in response to concern over budget constraints and how corporations use tax credits, Governor Culver ordered the six state agencies that oversee tax-credit programs to review their respective tax-credit programs. Press Release, Office of Governor Chet Culver & Lieutenant Governor Patty Judge, Governor Culver Orders Review of State Tax Credits (Nov. 19, 2009), available at <http://www.governor.iowa.gov/index.php/m/pr/194/>. The directors of each of those agencies are to advise the Governor as to the oversight, accountability, transparency, public reporting, cost-benefit, and which programs should be continued, curtailed, or eliminated. *Id.*

181. *See* 21st Century Taxation, State Corporate Tax Reform—Combined Reporting, <http://21stcenturytaxation.blogspot.com/2008/01/state-corporate-tax-reform-combined.html> (Jan. 22, 2008, 06:15 AM) (reacting to Iowa Governor Chet Culver's call to implement combined reporting); Tax Update Blog, Combined Corporate Returns: A Gold Mine for Iowa?, <http://www.rothcpa.com/archives/000207.php> (Feb. 14, 2003) (same).

182. S.F. 211, 83d Gen. Assem., Reg. Sess. (Iowa 2009); H.F. 326, 82d Gen. Assem., Reg. Sess. (Iowa 2007) (same as S.S.B. 1242); H.F. 2556, 80th Gen. Assem., Reg. Sess. (Iowa 2004); S.F. 2298, 80th Gen. Assem., Reg. Sess. (Iowa 2004).

[to] avoid paying Iowa income taxes.”¹⁸³ In his fiscal-year 2009 budget recommendations, Governor Culver included a proposal for mandatory combined reporting that he estimated to raise \$75 million¹⁸⁴—a 16.7% increase over the projected 2008 CIT revenues.¹⁸⁵ Governor Culver explained his recommendation to implement combined reporting “as a matter of fairness for small business owners.”¹⁸⁶ Proponents claim that because combined reporting nullifies the tax savings multistate corporations receive in using tax shelters—which taxpayers who operate solely in the state cannot use because they rarely have the resources to set them up—combined reporting would level the playing field between large and small companies and would ultimately benefit Iowa’s economy by allowing small companies to remain competitive.¹⁸⁷ However, the fact that most small businesses are organized as pass-through entities and thus pay no entity-level tax undercuts these assertions.

Scholars and policymakers are also paying close attention to Iowa’s combined reporting proposals. Several reports have attempted to describe the need for corporate tax reform in Iowa and the need for that reform to be combined reporting.¹⁸⁸ The IDOR report on combined reporting notes that the basic structure of Iowa’s CIT has not changed since 1934, that “significant economic changes” make the Iowa CIT unfair and inefficient, that the CIT is easy to avoid, and that it is an “economic development liability.”¹⁸⁹ The report suggests that combined reporting would “increase the equity of Iowa’s corporate income tax system” and that it is “simply . . . used to determine the amount of income of a unitary business that is attributable to the operations within a particular state.”¹⁹⁰ However,

183. Press Release, Office of Governor Chet Culver & Lieutenant Governor Patty Judge, Governor Culver: “The Condition of the State Is Strong!” (Jan. 15, 2008), available at http://www.governor.iowa.gov/news/2008/01/15_1.php.

184. IOWA DEP’T OF MGMT., IOWA FISCAL YEAR 2009 REPORT 38 (2008) [hereinafter IOWA F.Y. 2009 REPORT] (on file with the Iowa Law Review). While the report was originally a public document, Gov. Culver subsequently revised it after fallout from the economic crisis forced him to revisit particular budgetary line items.

185. CLINE, *supra* note 24, at 24.

186. IOWA F.Y. 2009 REPORT, *supra* note 182 at 30.

187. KATHERINE LIRA & MICHAEL MAZEROV, CTR. ON BUDGET & POLICY PRIORITIES, ALMOST ALL LARGE IOWA MANUFACTURERS ARE ALREADY SUBJECT TO “COMBINED REPORTING” IN OTHER STATES: FEARS OF JOB FLIGHT FROM REDUCING CORPORATE TAX AVOIDANCE ARE UNWARRANTED 5–6 (2008), available at <http://www.cbpp.org/files/4-3-08sfp.pdf>.

188. See generally LIRA & MAZEROV, *supra* note 187 (arguing that Iowa policymakers need to revamp the CIT); MUNSON & LIPSMAN, *supra* note 36 (same); Fisher, *supra* note 10 (same); *Restoring Fairness & Revenue*, *supra* note 74 (same). Cf. TYSON SLOCUM ET AL., INST. ON TAXATION & ECON. POLICY, CHOICES FOR IOWA: BUILDING A BETTER TAX SYSTEM (1998) (arguing that the decline in revenues from the CIT necessitates CIT reform).

189. Michael A. Lipsman, Iowa Dep’t of Revenue, Iowa Corporate Income Tax: Where Did All the Money Come From and When Will It Stop? (Sept. 18, 2007), http://www.taxadmin.org/FTA/Meet/07rev_est/papers/lipsman.pdf.

190. MUNSON & LIPSMAN, *supra* note 36, at 5.

combined reporting is anything but simple.¹⁹¹ The IDOR report suggests that the apportionment factor should include “the business activity of all affiliated firms”; specifically, it suggests that the numerator should include “all business activity of companies having Iowa nexus.”¹⁹² The report also states that “common ownership” would be the guiding principle for defining which companies comprise a unitary group.¹⁹³ That statement is unsupported, however, as the ownership is a necessary but constitutionally insufficient criterion for the finding of a unitary relationship. Another report advocating for combined reporting in Iowa suggests that, in addition to adopting combined reporting, Iowa should also adopt the MTC’s definition of “unitary group” and an additional requirement that a corporation include any subsidiaries listed on a combined return in another state in the corporation’s Iowa combined return.¹⁹⁴

Iowa policymakers seem confident that combined reporting will increase the net-income base and decrease the apportionment factor, resulting in an increase in Iowa taxable income, despite the tax-policy principle of neutrality.¹⁹⁵ If Iowa policymakers are truly interested in doing what is best for Iowa citizens, including its corporate citizens, it is imperative that they pay attention to the very real concerns that businesses point out.

C. WHAT SHOULD IOWA DO?

Calls for reform are coming from all sides, but what should Iowa’s policymakers do with all this information? “Nowhere income” and tax-evading companies are not the sole causes of Iowa’s falling CIT revenues. In fact, falling revenues could be the result of the executive and legislative affinity for giving tax cuts to keep businesses in Iowa.¹⁹⁶ Scholars have looked at the dilemma on a national level and found that several factors contribute to the decline of CIT revenues, depending on the state.¹⁹⁷

Iowa’s apportionment formula, which relies solely on a company’s sales in the state, could be partly to blame.¹⁹⁸ A corporation’s income in a state like Iowa is earned not only from sales, but also from its property and payroll factors. Single sales factor apportionment under combined reporting would

191. See *supra* Part IV (describing the complications that can arise when attempting to practice combined reporting).

192. MUNSON & LIPSMAN, *supra* note 36, at 7.

193. *Id.*

194. Fisher, *supra* note 10, at 614.

195. *Id.*; David Brunori, *Combined Reporting Dies in Iowa*, 47 ST. TAX NOTES 626, 626 (Feb. 25, 2008) (“Iowa Gov. Chet Culver (D) proposed adopting combined reporting. He was not so much interested in the integrity of the corporate tax structure as in the need to find revenue.”).

196. See *supra* Part VI.A (discussing the wide availability and alleged cost of tax credits).

197. See CLINE, *supra* note 24, at 2, 13 (describing varied results among states).

198. BRUNORI & CORDES, *supra* note 46, at 22–23 (finding that combined reporting can have negative effects on a state’s revenues).

discriminate against corporations without property or payroll in the state and favor those corporations with low sales income and high payroll or property factors. If the goal is to make Iowa's tax system more equitable, then the income tax should reach all forms of income.

While the IDOR has devoted a considerable amount of time and resources to investigating corporate tax reform in the state, policymakers should pay attention to the uncertainty of the data upon which the IDOR based its reports. In giving examples to "prove" the benefits of combined reporting in Iowa, the IDOR noted that "this is not necessarily the case for all corporations" and that the examples were "extremely simplified" and several complicating factors were ignored.¹⁹⁹ By ignoring the details that have proven to complicate the implementation of combined reporting in other states, the IDOR is, in effect, misrepresenting the true complexity and glossing over the implications of combined reporting in Iowa. Any combined reporting language should embody the goals of reform and clarity. Legislators should not focus on the straw-man argument that some proponents of combined reporting rely on—that corporations are avoiding paying Iowa taxes and that instituting combined reporting will stop such activity. The numbers the IDOR provides are unreliable. Therefore, any combined reporting proposal should not be driven by a promise of more revenue, but by a promise of more predictability and reliability.

If Iowa wants to remain competitive in attracting and retaining businesses, it is essential for any tax reform to adhere to the NCSL's nine tax-reform principles. Any revision of the Iowa CIT should simultaneously include repealing the plethora of tax credits available to businesses. Demanding more money does not achieve the same result as demanding fairness and honesty from a state's corporate citizens.

VII. CONCLUSION

As economies and business practices evolve, tax reform is the buzzword for state tax administrators and policymakers everywhere. As other states consider and adopt combined reporting, and corporate watchdogs decry tax-sheltering practices that they claim deprive Iowa of tax revenue it has a right to receive, the pressure is mounting on Iowa's leaders to do something. Iowa policymakers should strive for reform that is revenue-neutral without exceptions or "loopholes." If the Iowa General Assembly decides that combined reporting is the appropriate tax reform for Iowa's CIT, then there are several factors that legislators must consider to ensure that what takes place is truly reform, and not more unnecessarily complicated tax rules and regulations.

199. MUNSON & LIPSMAN, *supra* note 36, at 8.