A Cursory Analysis of the Impact Of Combined Reporting in the District

by Eric Cook

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In this article, Cook analyzes whether combined reporting had a significant impact on taxpayers' filings by reviewing the effects combined reporting had on District of Columbia taxpayers that had at least a 25 percent increase in gross receipts in tax year 2011 over tax year 2010.

Introduction

The District of Columbia enacted combined reporting beginning in tax year 2011. It is anticipated that combined reporting should help enforce corporate tax compliance and raise about $20 million annually.

This article analyzes the impact that combined reporting had on the top 4,196 District taxpayers by tax year 2011 gross receipts in both tax year 2010 and 2011. This analysis is cursory in the sense that a proxy was used to determine whether combined reporting had a significant impact on a taxpayer's filing. Specifically, I analyzed the effect that combined reporting had on taxpayers that reported at least a 25 percent increase in gross receipts in tax year 2011 over 2010. A more rigorous analysis was not possible because of the lack of data necessary to thoroughly analyze specific taxpayer filings.

My analysis confirms that the additional revenue collected from combined reporting for tax year 2011 was a net $21.3 million ($24.7 million in tax increases and $3.4 million in tax decreases), largely explained by a small number of taxpayers. I also discovered that there are only a few taxpayers in my sample that were significantly affected by combined reporting that would also receive an IRC section 482 tax adjustment.

I believe that the takeaways from this exercise are as follows:

- The 2011 tax liability results indicate that there are a few more of my sample taxpayers in the highest gross receipts classes paying more in tax in the aggregate.
- My findings are consistent with the District's revenue estimate of combined reporting raising an additional $20 million per year.
- The number of "minimum" large taxpayers in tax year 2011 was down significantly compared with those in 2010 (37.5 percent versus 83.3 percent).
- Most of the impact of combined reporting is accounted for by a small number of taxpayers.
- There are very few taxpayers that received a tax increase from combined reporting that would also receive an IRC section 482 tax adjustment.
- Both combined reporting and the application of an IRC section 482 tax analysis are effective methods of achieving tax compliance, but there is very little overlap in the results from the two methods.

Enactment of Combined Reporting in the District

Combined reporting became effective on September 14, 2011, in the Fiscal Year 2012 Budget Support Act of 2011 (D.C. Law 19-21; 58 DCR 6226), which requires combined reporting in the District for tax years beginning after December 31, 2010. The combined reporting provisions were incorporated into the Income and Franchise Taxes statutes, Chapter 18 of Title 47 of the District of Columbia Official Code.

Combined reporting is a method of apportioning the income of corporations among the states in which they do business. Under combined reporting, the related corporations that are part of a unitary group are generally treated as one entity for tax purposes. Supporters of combined reporting say that this grouping of corporations reduces distortions and tax planning opportunities caused by intercompany transactions, whether legitimate or otherwise, within the group. Opponents say that combined reporting creates other distortions by attributing income to the wrong jurisdiction because the calculation simply averages the income and apportionment of all the businesses that actually have different economic profitability.

As a result of the combining of apportionment fractions and income, as well as the opportunity of blending losses, the combined reporting calculation will produce increased tax liability for some corporate groups and decreased tax liability for others.

Most large corporations consist of a parent corporation and its subsidiaries. If the subsidiaries are located within the United States, combined reporting effectively treats the

parent and most or all of its subsidiaries as a single corporation for state income tax purposes. In doing so, combined reporting can nullify a wide variety of tax avoidance strategies that large multistate corporations have devised to artificially move profits out of the states in which they are earned and onto the books of subsidiaries located in states that will tax the income at a lower rate — or not at all. Many states have lost substantial revenue to these strategies.

General Profile of the District's Corporate Income Tax

Below, I present discussions of minimum tax taxpayers and tax liability in tax years 2010 and 2011.

Minimum Tax. One of the key characteristics of the District's corporate income tax is the number of taxpayers that pay the "minimum tax." For tax year 2010, the minimum tax was $100. For tax years 2011 and beyond, the minimum tax is $250 if District gross receipts are $1 million or less and $1,000 if District gross receipts are greater than $1 million. Table 1 presents the number of minimum tax taxpayers by gross receipts for tax year 2010 for the 4,196 taxpayers in my sample. This table shows that 55.1 percent of these taxpayers were minimum tax taxpayers in tax year 2010. In fact, the percentage of minimum tax taxpayers is actually higher for those taxpayers with the highest gross receipts.

Table 1.
Tax Year 2010 Under Single-Entity Reporting

Total Receipts (in billions)	Total Taxpayers	Minimum Tax Taxpayers	Percent of Total
$0 to $1	3,738	2,034	54.4%
$1 to $10	378	226	59.8%
$10 to $50	69	43	62.3%
$50 to $100	5	3	60.0%
Greater than $100	6	5	83.3%
Total	**4,196**	**2,311**	**55.1%**

Of the 662 related-party taxpayers in 2010, 398 were minimum tax taxpayers (60.1 percent). It should be clear that many of the District's largest taxpayers, as measured by gross receipts, are minimum tax taxpayers. Eight of the 11 largest taxpayers were minimum tax taxpayers. This phenomenon holds true for tax years leading up to tax year 2010 as well.

The results for tax year 2011 under combined filing are not significantly different from the results for tax year 2010's single-entity filings. Table 2 shows the number of minimum tax taxpayers by gross receipts for 2011 for the 4,196 taxpayers in my sample. Although the total number as measured by percent is slightly higher for 2011 (57.7 percent versus 55.1 percent), the percent of the total for the largest taxpayers was down significantly compared with 2010 (37.5 percent versus 83.3 percent).

Table 2.
Tax Year 2011 Under Combined Reporting

Gross Receipts (in billions)	Total Taxpayers	Minimum Tax Taxpayers	Percent of Total
$0 to $1	3,675	2,166	58.9%
$1 to $10	409	214	52.3%
$10 to $50	93	37	39.8%
$50 to $100	11	3	27.3%
Greater than $100	8	3	37.5%
Total	**4,196**	**2,423**	**57.7%**

Tax Liability. Table 3 presents the 2010 tax liability for my sample of 4,196 taxpayers by gross receipts. The large majority of tax liability is highly concentrated in the lowest gross receipts classes, with 81.8 percent of the tax liability associated with taxpayers having less than $10 billion in gross receipts.

Table 3.
Tax Liability
Tax Year 2010 Under Single-Entity Reporting

Gross Receipts (in billions)	Total Taxpayers	Tax	Percent of Total
$0 to $1	3,738	$38,144,228	50.1%
$1 to $10	377	$24,170,297	31.7%
$10 to $50	70	$11,850,573	15.6%
$50 to $100	5	$295,315	0.4%
Greater than $100	6	$1,713,219	2.2%
Total	**4,196**	**$76,173,633**	**100%**

Table 4 presents the tax liability results for the same sample of taxpayers by gross receipts class under combined filing. The 2011 tax liability results indicate that there are a few more of my sample taxpayers in the highest gross receipts classes paying more in tax in the aggregate.

Table 4.
Tax Liability
Tax Year 2011 Under Combined Reporting

Gross Receipts (in billions)	Total Taxpayers	Tax	Percent of Total
$0 to $1	3,675	$445,770,324	54.3%
$1 to $10	409	$17,390,008	20.6%
$10 to $50	93	$15,109,802	17.9%
$50 to $100	11	$4,266,856	5.1%
Greater than $100	8	$1,747,102	2.1%
Total	**4,196**	**$84,284,092**	**100%**

These aggregate results for my sample do not tell the whole story. I wanted to examine what happened to a

specific group of my sample taxpayers in order to determine the impact of combined filing, other than the total revenue effect. Some taxpayers experience no significant change, some experience tax increases, and some experience tax decreases.

Method for Analyzing the Impact of Combined Filing

The method for analyzing the impact of combined filing in the District compares the same taxpayers over a two-year period covering tax years 2010 (which was the tax year just before implementation of combined filing) and 2011 (the first tax year of implementation). This analysis is not intended to be a thorough and detailed analysis of the impact on specific taxpayers but rather a general analysis of the impact of combined filing on a specific group of taxpayers over the two-year period.

Database Development. All corporate D-20 returns were evaluated for tax years 2010 and 2011. Returns that had an overall apportionment factor of less than 1 with total gross receipts greater than $10 million were examined. All other D-20 tax returns were eliminated from the analysis. The resulting D-20 tax returns were assembled into logical records that consisted of all related tax returns using the following fields to determine relationship: employer identification number, company name, and address. All returns that shared one or more of the above criteria were grouped together while preserving the integrity of each individual return that was added to the logical record. The final result was a sample of 4,196 taxpayers for both 2010 and 2011. There were 662 related-party, separate-entity taxpayers for 2010.

Each D-20 tax return added to its logical record was evaluated for the possible presence of Standard and Poor's Compustat data, which contains corporate financial data reported by businesses as part of the SEC. The Compustat data was added to the logical record for the respective return if it matched the name or EIN of the tax return. After all data was processed, each logical record contained total values by year for fields such as sales and cost of goods sold. This was accomplished by summing those values for every return added to the logical record respective to the return year.

All logical records that possess data for both years were then output for review. For each respective year, the logical record output all related returns on a single line. For example, if Company One had four related returns (sharing federal EIN and/or name and/or address), the first field details how many returns are present, followed by all fields for return one, followed by return two and so on. A totals file was also produced for each entity totaling all returns per taxpayer per year. The order is uniform across the files. For example, if Company One's output is on line 267 in the 2010 file, the same line would be used for the 2011 and total files.

Analysis of the Impact of Combined Reporting

As stated above, the following analysis is cursory in the sense that proxies are used to determine whether the implementation of combined filing in the District for tax year 2011 significantly affected the filing for that year. A rigorous analysis of combined reporting would require more data than was available to perform the analysis.

The proxies that I initially used to determine whether combined filing affected the 2011 return were the percentage changes in gross receipts and the apportionment factors from 2010 to 2011. I determined that the percentage change in apportionment did not represent a good proxy for a significant impact of combined reporting on a taxpayer's filings. The percentage change in gross receipts, on the other hand, did serve as a fairly strong proxy in determining that a taxpayer's filing was significantly affected because of the imposition of combined reporting.

The selection of a specific threshold for the percentage change in gross receipts is somewhat arbitrary. After performing a general sensitivity analysis to the selection of different thresholds, the threshold that was selected was 25 percent. Thus, if a taxpayer's gross receipts increased by 25 percent or more from 2010 to 2011, this proxy would indicate that combined reporting had a significant impact on its filings.

It is generally accepted that it is indeterminate whether the impact of combined reporting on a taxpayer's tax liability is a tax increase or decrease. It is my understanding that when the District enacted combined reporting, the District's tax analyst estimated the revenue impact to be approximately a $20 million tax increase annually, and my findings are consistent with that estimate. Table 5 provides estimates of taxpayers from my sample with tax increases by the level of tax increase resulting from combined reporting. Table 6 provides estimates of taxpayers from my sample with tax decreases by the level of tax decrease resulting from combined reporting.

Table 5 presents a very interesting result — 32.6 percent of the total tax increases are accounted for by four taxpayers, and 61.1 percent of the total tax increases are accounted for by 18 taxpayers. Only 371 taxpayers out of my sample 4,196 experienced tax increases because of combined filing. A similar outcome can be gleaned from Table 6 in that 78.6 percent of the total tax decreases are accounted for by 10 taxpayers, and only 89 taxpayers experienced tax decreases. Thus, for my sample, most of the impact of combined reporting is accounted for by a small number of taxpayers.

Table 7 provides estimates of taxpayers with tax increases resulting from combined reporting by the level of gross receipts. Table 8 below provides estimates of taxpayers with tax decreases resulting from combined reporting by the level of gross receipts.

Of the $24.7 million in tax increases, 89.7 percent was accounted for by taxpayers with gross receipts of less than

Table 5.
Tax Increases Under Combined Reporting by Size of Tax Increase

Total Tax Increases	Total Taxpayers	Tax Increase	Average Increase	Percent of Total
$0.0 to $10,000	192	$621,918	$3,239	2.5%
$10,000 to $100,000	133	$4,522,942	$34,007	18.3%
$100,000 to $250,000	28	$4,459,671	$159,274	18.0%
$250,0000 to $1,000,000	14	$7,049,675	$503,548	28.5%
Greater than $1,000,000	4	$8,058,132	$2,014,533	32.6%
Total	**371**	**$24,712,338**	**$66,610**	**100.0%**

Table 6.
Tax Decreases Under Combined Reporting by Size of Tax Decrease

Total Tax Decrease	Total Taxpayers	Tax Decrease	Average Decrease	Percent of Total
$0.0 to $10,000	54	145,094	2,687	4.2%
$10,000 to $100,000	25	593,306	23,732	17.3%
$100,000 to $250,000	6	1,040,437	173,406	30.3%
$250,000 to $1,000,000	4	1,658,662	414,666	48.3%
Greater than $1,000,000	—	—	—	0.0%
Total	**89**	**3,437,500**	**38,624**	**100.0%**

Table 7.
Tax Increases Under Combined Reporting by Gross Receipts

Gross Receipts (in billions)	Total Taxpayers	Tax Increase	Average Increase	Percent of Total
$0 to $1	224	$8,996,264	$40,162	36.4%
$1 to $10	107	$5,929,235	$55,413	24.0%
$10 to $50	31	$7,234,182	$233,361	29.3%
$50 to $100	5	$1,622,717	$324,543	6.6%
Greater than $100	4	$929,938	$232,485	3.8%
Total	**371**	**$24,712,338**	**$66,610**	**100.0%**

$50 billion. Of the $3.4 million in tax decreases, 93.6 percent was accounted for by taxpayers with gross receipts of less than $50 billion.

Of the 4,196 taxpayers in the sample, 371 taxpayers received tax increases, whereas 89 taxpayers received tax cuts. Of the six taxpayers with gross receipts in excess of $100 billion, four received tax increases, while one received a tax decrease. Similarly, of the 11 taxpayers with gross receipts in excess of $50 billion but less than $100 billion, five received tax increases, while two received tax cuts.

Intersection of Combined Reporting and an IRC Section 482 Analysis

One of the more interesting aspects from the analysis of the impact of combined reporting is its intersection with an IRC section 482 analysis. Generally, the IRC section 482 analysis is an economic analysis that identifies taxpayers that are consistently not paying a sufficient amount of tax. One would expect that if combined reporting is effective in enhancing tax compliance, the IRC section 482 analysis would not intersect significantly with combined reporting.

Since the passage of combined reporting in the District, a taxpayer's filing is essentially the same as a taxpayer's filing at the federal level. At the federal level, IRC section 482 and the associated regulations were developed to provide a mechanism to enforce tax compliance. Essentially, if the federal government has transfer pricing issues and uses IRC section 482 to enforce tax compliance, it stands to reason that the District will also have transfer pricing issues and can continue to use IRC section 482 to enforce tax compliance. For example, if a taxpayer has intercompany transactions with foreign subsidiaries excluded from the combined return, the income reported to the District may or may not be consistent with the arm's-length standard. The determination of whether a taxpayer's reported income is consistent with the arm's-length standard may be made using the comparable profits method under IRC section 482, which (generally) compares the reported income on the tax return with the operating profit of comparable companies. If the reported income on the tax return is below the arm's-length range, an income adjustment may be warranted.

The application of an IRC section 482 analysis to the 4,196 taxpayers in the sample resulted in 311 taxpayers with IRC section 482 tax adjustments totaling $15.5 million. As previously reported, there were 371 taxpayers that received significant tax increases from combined reporting totaling

Table 8.
Tax Decreases Under Combined Reporting by Gross Receipts

Gross Receipts (in billions)	Total Taxpayers	Tax Decrease	Average Decrease	Percent of Total
$0 to $1	51	$852,314	$16,712	24.8%
$1 to $10	22	$827,527	$37,615	24.1%
$10 to $50	13	$1,537,515	$118,270	44.7%
$50 to $100	2	$82,585	$41,292	2.4%
Greater than $100	1	$137,559	$137,559	4.0%
Total	**89**	**$3,437,500**	**$38,624**	**100.0%**

$24.7 million. Of these taxpayers, only 30 received both a tax increase from combined reporting and an IRC section 482 tax adjustment. These 30 taxpayers represent less than a 10 percent intersection between the IRC section 482 analysis and combined reporting. Thus, as one would expect, very few taxpayers received a tax increase from combined reporting and an IRC section 482 tax adjustment.

It is noteworthy that of the 311 receiving IRC section 482 tax adjustments, 271 were not affected by combined reporting. Most of the IRC section 482 tax adjustments, or $13.7 million, was associated with these 271 taxpayers. The key point is that both combined reporting and the application of an IRC section 482 tax analysis are effective methods for achieving tax compliance, but there is very little overlap in the two methods.

Conclusion

The analysis of the impact of combined reporting on a sample of the largest taxpayers in the District suggests that there were significant increases in tax that resulted from its implementation. While some taxpayers received tax cuts from combined reporting, most of the taxpayers that were significantly affected received tax increases. The net aggregate tax increase for my sample is $21.3 million.

Of the 4,196 taxpayers in the sample, only 460 were significantly affected by the imposition of combined reporting. A key finding of this analysis, however, was that the majority of taxpayers in the District pay its minimum tax. This is true both before combined reporting and after its implementation.

Finally, another key finding from the preceding analysis is that there is very little intersection of the impact of combined reporting with any IRC section 482 tax adjustments. Both are effective methods for achieving increased tax compliance. ☆