Implementing Major Tax Policy Changes: Combined Reporting

September 24, 2019

State of Rhode Island
Division of Taxation
DEPARTMENT OF REVENUE

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Introductions

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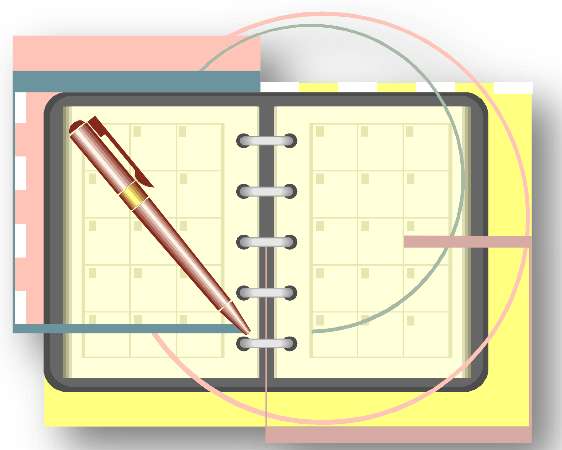
Agenda

- History/Timeline
- Pro Forma Study
- Corporate Tax Overhaul
- Methodology
- Impact of Combined Reporting
- Lessons Learned
- Next Steps
- Q&A



History/Timeline

2013-2017: Modernization of Tax System Completed

June 30, 2011

Statute Mandating Pro Forma Combined Reporting Study Enacted

December 31, 2011

Pro Forma Study Final Regulations

Tax Year 2011 and 2012 : Corp

Returns: Pro Forma CRS Schedule

2013

Pro Forma CRS Schedules for TY 2011 and 2012 Processing and Analysis

March 2014

Combined Reporting Study Completed and Presented to Legislature

June 19, 2014

Comprehensive Corporate Tax Changes enacted: Combined Reporting, Rate Reduction, Franchise Tax Repeal, Single Sales Factor Apportionment, Market Based Sourcing: Study Due March 2018

December 2015 Nexus, Apportionment Regulations Finalize,

March 2016 Combined Reporting Regulation Finalized

2016 CRS Schedule Development, Staff Training,

Modernization of Tax System Concluded 2017.

March 2018

Final Combined Reporting Study

Combined Reporting Pro Forma Study

- This study submitted on March 15, 2014 analyzed the fiscal impact of changing the business corporation tax statute to a "combined reporting" method
- Corporations were required to submit a *pro forma* combined report for two tax years (2011 & 2012)
  - Under combined reporting a Rhode Island corporation reports its own income and the combined income of the other corporations, or affiliates that are under common ownership
  - They then use a formula to apportion the amount of the combined income
  - Approx. **1,621** combined groups filed *pro forma* combined reports
- The study found that regardless of methodology the state would have gained more in revenue had Rhode Island adopted combined reporting

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Pro Forma Study Results

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Range of aggregate increase in Rhode Island corporate tax ***(pro forma)***

	With three-factor apportionment	With single-sales-factor apportionment
Tax year 2011	$23.4M to $25.3M	$49.5M to $54.7M
Tax year 2012	$21.5M to $23.1M	$38.6M to $44.4M

Dollar figures are in millions. First dollar figure in each row calculated under Joyce method, second under Finnigan.
Source: Rhode Island Division of Taxation

Corporations with tax change, no tax change, due to combined reporting ***(pro forma)***

	% increase in tax	% decrease in tax	% no change
Tax year 2011			
Three-factor apportionment (Joyce)	29%	10%	61%
Three-factor apportionment (Finnigan)	31%	9%	60%
Single-sales-factor apportionment (Joyce)	35%	5%	60%
Single-sales-factor apportionment (Finnigan)	37%	5%	58%
Tax year 2012			
Three-factor apportionment (Joyce)	21%	8%	71%
Three-factor apportionment (Finnigan)	22%	8%	70%
Single-sales-factor apportionment (Joyce)	27%	4%	69%
Single-sales-factor apportionment (Finnigan)	28%	4%	68%

For details about the difference between the Joyce and Finnigan methods, please see following section.

Pro Forma Study Results: Limitations and Conclusions

- Data that was compiled was based solely on unaudited tax returns as filed by corporations.
- Combined reporting measures only included tax years 2011 and 2012, broadly speaking after businesses were recovering from recession.
- Study focused tax returns filed as if combined reporting were a law, not taking into account what actions corporations took once it became law. (i.e. reorganize as pass-through entities and/or locate affiliates offshore)
- Study was unable to determine impact of combined reporting by industry as it was not mandated by statute to include NAICS code on RI return.
- Single sales factor apportionment study encompassed only those corporations subject to proforma combined reporting (most corporations are not subject to proforma combined reporting).
- Some taxpayers did not fully understand all the requirements despite extensive outreach and education by the Division of Taxation.
- Not all software providers supported the required schedule for the study.
- No penalty for not attaching CRS Schedule.

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Corporate Tax Overhaul

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June 19, 2014: Rhode Island adopted a combined reporting methodology for tax years beginning on January 1, 2015, changing four main components

New law vs. old law – explanation at a glance*

	Old law	New law
Corporate tax rate:	9%	7%
Reporting method:	Separate entity	Combined reporting
Apportionment formula:	Three-factor**	Single factor**
Sourcing method for sales:	Cost of performance	Market-based sourcing

*"Old law" in effect for 2014 tax year, "new law" in effect for tax years beginning on or after January 1, 2015.
** Three-factor apportionment relied on sales, payroll, and property. Single-factor apportionment relies on one factor: sales.

March 15 2018: Report on the effect of legislative changes due

http://www.tax.ri.gov/reports/Report_on_corporate_tax_changes_03_15_18.pdf

Methodology

- Calculated the taxes which were or would have been owed under the old and new policy regimes for all corporations which filed using Combined Reporting in tax year 2015

- 2,012 Unitary Group filings, comprised of 27,022 member corporations (1,147 groups filed electronically, 865 filed on paper)

- To estimate the marginal effects of each portion of the policy change, taxes were computed for each permutation of the four applicable main component changes

- Tax Year 2016 was not used due to the number of filers on extension

Base Calculation

1 Federal Taxable Income
Total taxable income of the entire "Unitary Group"

−

2 Deductions
NOL deduction/carryforward, special deductions, foreign dividends, bonus depreciation, etc.

+

3 Additions
Interest, corporate taxes, bonus depreciation, domestic production activity

×

4 Apportionment Ratio
Finnigan: Rhode Island receipts divided by everywhere receipts

−

5 Adjustments
R&D, pollution, capital investment

×

6 Tax Calculation
Whichever is greater:
A. RI adjusted taxable income *.07
B. If nexus, $500

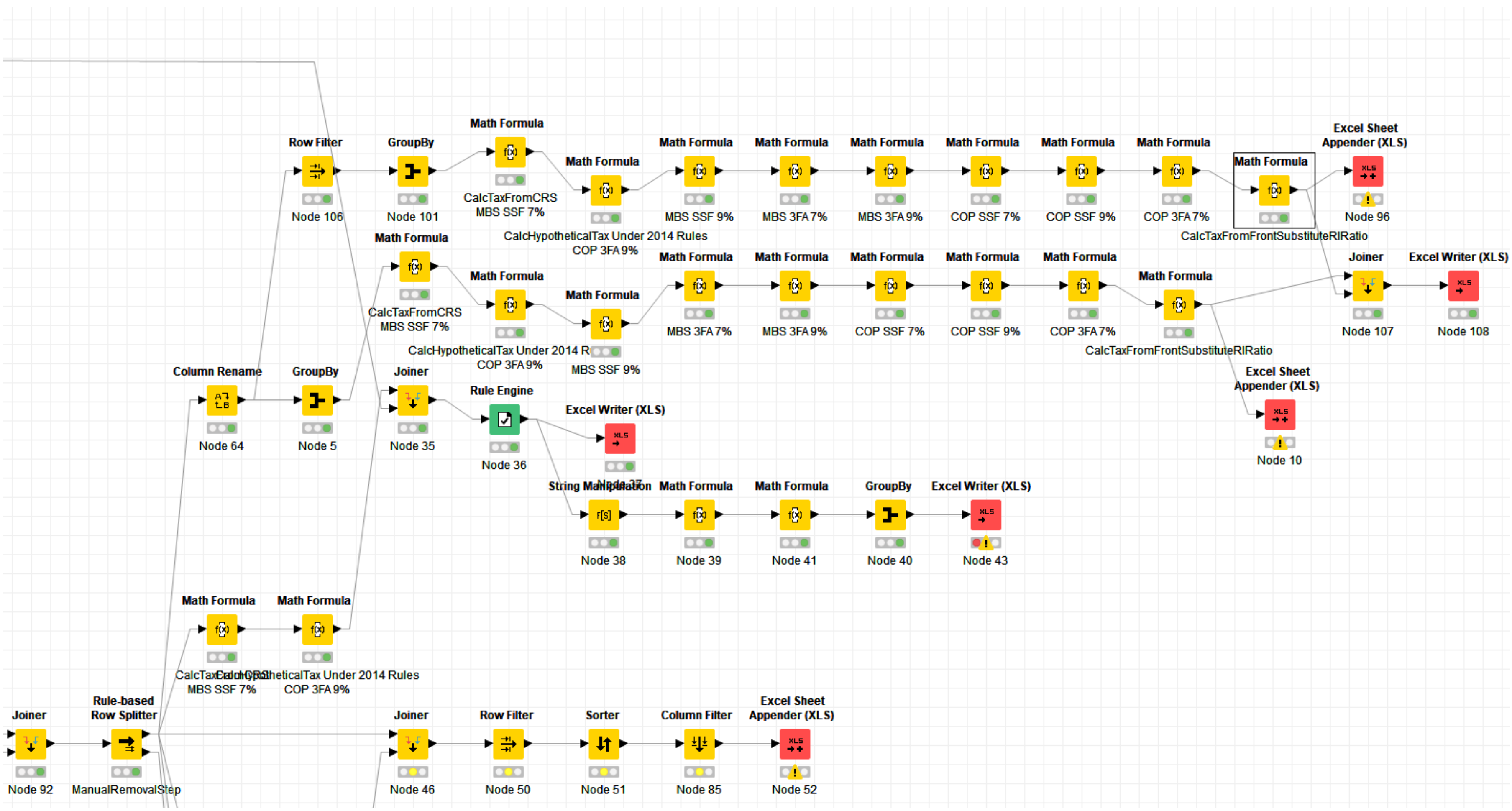
=

7 Total Tax
After carryforwards, credit recapture, etc.

Techniques

- Analytical Cleaning techniques used
  - Eliminated duplicate schedules (e.g. parent puts themselves on the child schedule)
  - Remove "bad" data, predominantly corporations improperly included of where there were only partial data sets
- Too much data to do manually, so knime was used to string together pieces and generate different outputs
  - Was able to correct data in ITS system, and then re-run model in a matter of minutes

Usage of Knime for Analysis



Caveat on Impact Analysis

- This is the quantitative impact without analysis on non-return based factors
- The Rhode Island tax base of C Corp filers is limited, hence limiting the data evaluated
- Rhode Island has a relatively small number of businesses in certain industries
- Taxpayers' segmentation and financial figures are mostly self-reported
- The Sum is not equal to the sum of the parts in component impact analysis

Impact on RI Summary

As a result of the aforementioned examination and calculations for tax year 2015, the Division estimated that the combined groups had approximately $62.4 million in tax due under the new law, compared with approximately $89.2 million under the old law.

In other words, the Division estimates that the combined groups saved – and Rhode Island relinquished in revenue – approximately $26.8 million, a 30 percent reduction.

Fiscal impact: New law vs. old law

	Tax year 2015
New law*	$ 62,426,195
Old law**	$ 89,231,564
Difference	($ 26,805,369)

* New law includes 7% corporate tax rate, combined reporting, single-factor apportionment (sales), and market-based sourcing

** Old law includes 9 percent corporate tax rate, single-entity reporting, three-factor apportionment (sales, property, payroll), and cost-of-performance sourcing.

Impact on RI
Marginal Effect of Components

- The effect on combined groups, in the aggregate, of the lowering of the corporate tax rate (from 9 percent to 7 percent) was a reduction in tax due of approximately $20.3 million.

Impact of lowering corporate tax rate (to 7%)
Difference
($ 20,281,836)

- The effect on combined groups, in the aggregate, of the change in the apportionment formula (from three-factor apportionment to single-sales-factor apportionment) was a reduction in tax due of approximately $47.2 million.

Impact of change in apportionment formula (to single factor: sales)
Difference
($ 47,178,994)

- The effect on combined groups, in the aggregate, of the change in the sourcing method used to determine how to treat a corporation's sales of services and/or intangible personal property (from cost-of-performance sourcing to market-based sourcing) was an increase in tax due of approximately $1.7 million.

Impact of change in sourcing method (to market-based sourcing)
Difference
$ 1,722,883

- The effect, in the aggregate, of the change from separate-entity reporting to mandatory unitary combined reporting was an increase in tax due of approximately $37.8 million.

Impact of change in reporting method (to combined reporting)
Difference
$ 37,771,117

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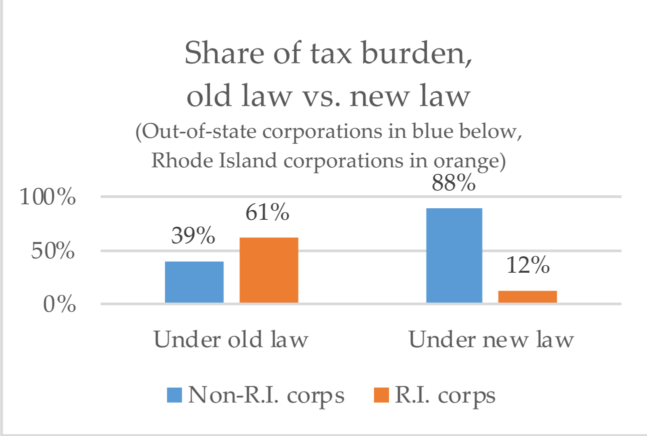
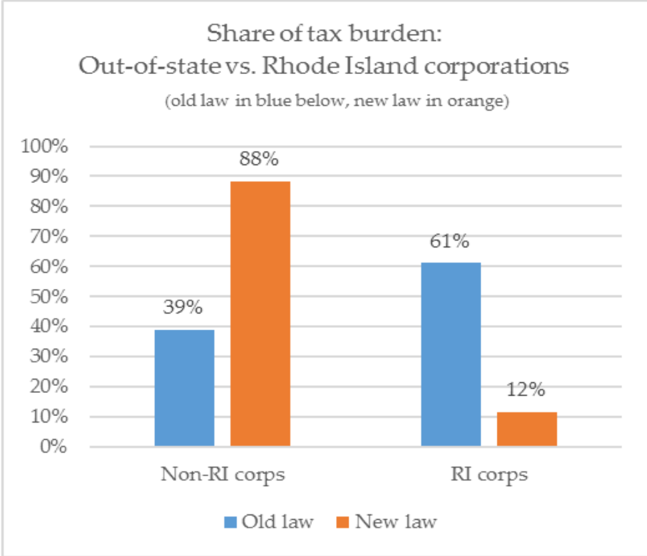
Fiscal impact TY 2015: Out-of-state vs. Rhode Island corporations		
	Out-of-state corps	**Rhode Island corps**
New law*	$ 55,086,805	$ 7,252,893
Old law**	$ 34,714,730	$ 54,416,931
Difference (in dollars)	$ 20,372,075	($ 47,164,038)
Difference (%)	58.7%	-86.7%

* New law includes 7% corporate tax rate, single-factor apportionment (sales), market-based sourcing for the sales factor, and mandatory unitary combined reporting.
** Old law includes 9% corporate tax rate, three-factor apportionment (sales, property, and payroll), cost-of-performance sourcing for the sales factor, and separate-entity (single-entity) reporting.



Fiscal impact of four key changes in tax policy:* Out-of-state vs. Rhode Island corporations		
Tax increase (or decrease) due to specific changes to corporate tax regime		
	Out-of-state corps	**Rhode Island corps**
Lowering of corporate tax rate	($ 12,312,101)	($ 7,969,735)
Change in apportionment formula:	($ 6,771,568)	($ 40,407,426)
Change in sourcing method:	$ 1,387,048	$ 335,835
Change in reporting method:	$ 36,967,365	$ 803,752

* Prior law included 9 percent corporate tax rate, three-factor apportionment (sales, property, and payroll), cost-of-performance sourcing, and single-entity reporting. New law includes 7% corporate tax rate, single-factor apportionment (sales), market-based sourcing, and combined reporting.



Impact on RI
Size of Business

Increase or decrease is calculated as the effect of moving from the tax as computed under the old policy to tax as computed under the new policy.

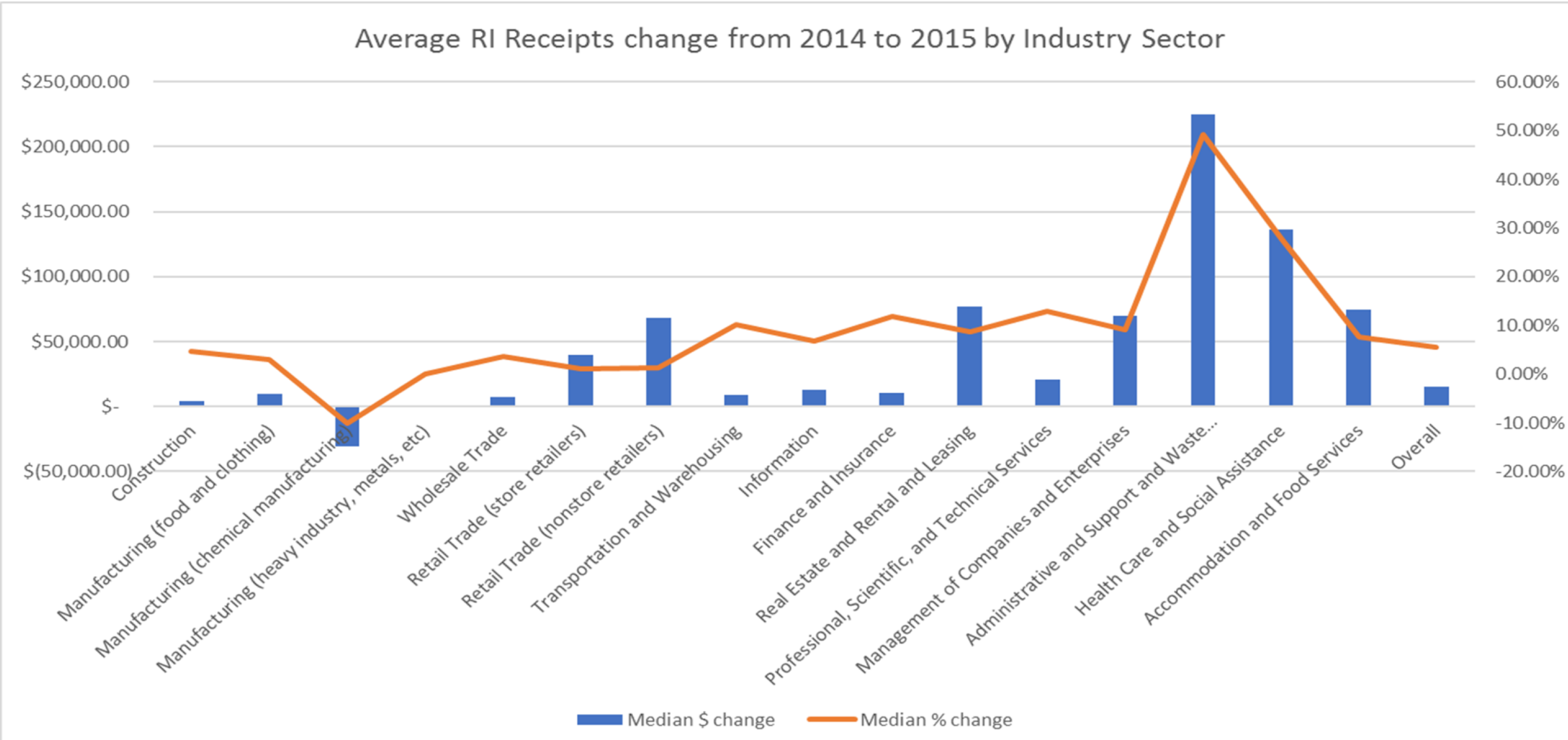
Number of businesses in analysis				
	Tax increase	No change	Tax decrease	Total
Large businesses:	706	3,176	295	4,177
Small businesses:	187	9,141	114	9,442
Could not evaluate size:	1,633	11,180	590	13,403
Total:	**2,526**	**23,497**	**999**	**27,022**

- Using the US Small Business Association defines a "small business" in different ways depending on industry. Some, such as most manufacturing businesses, are classified by number of employees, while others, such as most retailers, are classified by total revenue.

- Where possible, the Division of Taxation has classified businesses. However, a plurality of member organizations could not be classified, either due to missing or inaccurate data, or because the total number of employees was not available outside of those reporting income in the State of Rhode Island.

- For the majority of instances where a corporation fit the definition of a small business, their taxes were unchanged by this policy.

Impact on RI
NAICS Code analysis



Impact on RI
Change in Sourcing

Change in sourcing method: Increase/decrease in Rhode Island receipts		
Industry	**NAICS code**	**Change in R.I. receipts**
Administrative, support, and waste management	56	49.1%
Health care and social assistance	62	28.1%
Professional, scientific, and technical services	54	12.9%
Finance and insurance	52	11.9%
Transportation and warehousing	48	10.1%
Management of companies and enterprises	55	9.0%
Real estate and rental and leasing	53	8.6%
Accommodation and food services	72	7.6%
Information	51	6.8%
All others (various)	Various	5.5%
Construction	23	4.7%
Wholesale trade	42	3.7%
Manufacturing (food and clothing)	31	3.0%
Retail trade (non-store retailers)	45	1.4%
Retail trade (store retailers)	44	1.1%
Manufacturing (heavy industry, metals, etc.)	33	0.0%
Manufacturing (chemical manufacturing)	32	-10.10%

Industries are listed in order, based on change in receipts (starting with greatest percentage increase). Store retailers operate fixed point-of-sale locations, located and designed to attract a high volume of walk-in customers. Non-store retailers, like store retailers, are organized to serve the general public, but their retailing methods differ: They may reach customers and market merchandise with methods such as the broadcasting of "infomercials", the broadcasting and publishing of direct-response advertising, the publishing of paper and electronic catalogs, or other means.

Lessons Learned from Analysis

- ✓ Data Quality: Garbage in ensures Garbage out
  - Tried to mitigate by designing form to reference 1120
  - Combined Reporting forced a shift to proactive evaluation
- ✓ Sheer size of the corporations provided challenging to verify in one sitting
  - Difficulties in keeping track of what is recorded for each entity
  - having to keep track of which have been recorded before
- ✓ Confusion over segmentation
  - What is a Small Business?
  - How do you define a “local business”?
- ✓ Taxpayer miseducation may lead to incorrect reporting and underreporting

What's Next?

- Refine the schedule further to only capture needed information, since report is complete
  - More Fields = Less Compliance
  - Leveraged Paid Preparers to understand where the pain points lay in filing the return
- Work with taxpayers to understand the administration of combined groups and educate where needed
- Train auditors and Models as the tax regime comes into the commonly selected audit period

Questions?