

## Vermont Goes Unitary in 2006 and Beyond

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Vermont has enacted several significant statutory changes to Vermont's corporate income tax regime beginning with the 2006 tax year. The most noteworthy change is Vermont's shift from requiring separate company filing to mandatory combined filing for unitary affiliates. In the wake of those sweeping changes, the Vermont Department of Taxes has promulgated new regulations, changed its form instructions, and issued technical bulletins addressing the new rules. Despite the foregoing guidance, several questions remain unanswered for taxpayers facing the new regime.

### Overview of Changes

For tax years beginning before January 1, 2006, Vermont required corporations to file on a separate company basis and permitted affiliated corporations with nexus in Vermont to elect to file a Vermont consolidated return. Vt. Stat. Ann. 32 section 5862. For tax years beginning on or after January 1, 2006, Vermont requires affiliated corporations engaged in a unitary business to file a combined Vermont return. See L. 2004, H. 784, P.A. No. 152 (effective for tax years beginning on or after January 1, 2006); Vt. Stat. Ann. 32 sections 5811, 5862; Code of Vt. Rules 1.5862(d)-1 through -14 (effective for tax years beginning on or after January 1, 2006).

In addition to the foregoing, Vermont amended its net operating loss provisions. The new NOL provisions generally:

- create a new Vermont NOL that is no longer based on the federal NOL;
- change the NOL carryforward provisions; and
- create a transition rule for years 2007 through 2009 for federal NOLs that were carried back.

See L. 2006, H. 843 (effective May 31, 2006); Vt. Stat. Ann. 32 sections 5811(25), 5888; Vermont Technical Bulletin TB-35 (Mar. 13, 2007).

### Highlights of New Regime

## **New Hampshire Unitary Test Adopted**

Vermont's unitary business definition is based on the existence of the three unities (of ownership, operation, and use) or the interdependence in functions among affiliates. The "three unities" and "interdependence" tests are identical to the New Hampshire statutory unitary test for purposes of the business profits tax. Vt. Stat. Ann. 32 section 5811; Code of Vt. Rules section 1.5862(d)-6. However, unlike the New Hampshire test, the unity of ownership prong is based on a 50 percent ownership test under department regulations. Code of Vt. Rules section 1.5862(d)-6(d)(1) and 1.5862(d)-4(c). Taxpayers should consider their multistate unitary filing positions because the department will favor consistency with unitary determinations of other states to the extent compatible with Vermont law. Code of Vt. Rules section 1.5862(d)-6(a).

## **Unitary Group Limited to Water's Edge**

The unitary business group is a water's-edge group that excludes "overseas business organizations" (80/20 companies). Vt. Stat. Ann. section 5811; Code of Vt. Rules section 1.5862(d)-4, (d)-5.

## **Unitary Group Excludes Specialized Entities**

Previous law exempting from the corporate income tax some specialized companies -- such as financial institutions, insurance companies (including captive insurance companies), and railroads remains intact. Vt. Stat. Ann. 32 sections 5811(3) and 5836; Vt. Stat. Ann. 8 section 6014. Implementing those exemptions in the unitary context should pose challenges and potential planning opportunities.

## **Intercompany Transactions Follow Federal**

For purposes of computing the Vermont tax base and apportionment factor, transactions between unitary members are deferred in a manner similar to the federal consolidated return regulations. Vermont Technical Bulletin TB-36 (Mar. 16, 2007) (citing Code of Vt. Rules section 1.5862(d)-7(e)(5) and 26 CFR 1.1502-13).

## **Sales Factor Shifts to Double-Weighted**

The evenly weighted three-factor apportionment formula is changed to one with a double-weighted sales factor. Vt. Stat. Ann. 32 section 5833(a).

## **Joyce Rule Adopted for Throwback Sales**

Throwback sales are added to the sales factor numerator. The *Joyce* rule has been adopted, requiring throwback of sales to the Vermont numerator even if another member of the group has nexus in the state of destination. Code of Vt. Rules 1.5862(d)-8(a).

## **Factor Relief for Foreign Dividends**

Vermont provides for factor relief of dividends received by the unitary group from overseas business organizations. Code of Vt. Rules 1.5862(d)-8(b); 2006 Vermont

Corporate Income Tax Form CO-419 (“Apportionment of Foreign Dividends”) and Form CO-420 (“Foreign Dividend Factor Increments”). That provision is similar to the factor relief provision in New Hampshire.

### **Net Operating Losses Revised**

As summarized above, the new rules address the computation and limitation of NOLs in a combined return. The NOL legislation was silent on the treatment of NOLs created before 2007. However, Vermont TB-35 provides favorable treatment for taxpayers, indicating that the department will allow taxpayers to retain their pre-2007 federal NOLs by converting them to an initial Vermont NOL that may be carried forward 10 years. See L. 2006, H 843 (effective May 31, 2006); Vt. Stat. Ann. 32 sections 5811(25), 5888; Vermont Technical Bulletin TB-35 (Mar. 13, 2007); Code of Vt. Rules 1.5862(d)-9; 2006 Vermont corporate income tax return instructions to Form CO-411.

### **Holding Companies Included in Group**

Under prior law, passive holding companies (as defined in repealed Vt. Stat. Ann. 32 section 5837) were generally permitted to pay a \$250 minimum tax on a separate company basis, even if a consolidated return was elected. Under the new provisions, unitary holding companies are now required to be included in the combined return as any other corporation and no minimum tax applies. Vt. Stat. Ann. 32 section 5832; L. 2004, P.A. No. 152 (repealing Vt. Stat. Ann. 32 section 5837); Vermont Technical Bulletin TB-22 (June 22, 2000) (addressing prior law). Thus, the new law will effectively subject to Vermont income tax an affiliated group's passive investment company, whereas it previously would have been excluded or subject to a \$250 tax. Also, the new rules specifically state that an intermediary holding company will not negate a unitary finding. Code of Vt. Rules 1.5862(d)-6(e). That may result in distortive taxation of holding companies in specialized industries that are exempt from the corporate income tax.

### **Open Issues Remain**

The new provisions raise many open issues and questions that have not yet been answered or are otherwise unclear from a cumulative reading of the legislation, statutes, regulations, 2006 return instructions, and 2007 technical bulletins.

### **Why Retain the Consolidated Election?**

Despite the adoption of mandatory combined filing for unitary business groups, the statute, regulations, and form instructions still retain the election to file on a consolidated basis. The election would apply only to a small group of taxpayers; that is, for nonunitary members of a consolidated group. The department's new regulations provide that a corporation required to be included in a unitary business group may nonetheless be included in a consolidated return, provided the members of the consolidated group have the same fiscal year. See Code of Vt. Rules 1.5862(d)-14. Although that language appears to be directly contradictory to the mandatory combined filing requirements set forth in the statute, the regulation should be interpreted to mean that such consolidated election is available only in the absence of unity. For the small

number of taxpayers that will be permitted to file on a consolidated basis, it should be noted that a holding company with Vermont nexus must now be included in the group because of the repeal of Vt. Stat. Ann. 32 section 5837.

### **Combined Versus Consolidated: Which Is It?**

The retention of a consolidated return election has caused further confusion because the statute, regulations, and form instructions inconsistently and interchangeably use the terms “affiliated,” “group,” “consolidated,” and “combined.” For instance, Vermont TB-35 addresses NOLs in unitary combined reporting, but refers to consolidated return situations. Also, Code of Vt. Rules 1.5862(d)-4 addresses the affiliated group, suggesting that overseas business organizations are excluded from the group under the new rules, whereas that term should refer to the “combined” (unitary) group. Thus, taxpayers should be cautious in interpreting the new unitary rules, because the department still needs to clarify the consolidated return references in the regulations because differences exist between consolidated and combined filings, including the use of particular tax attributes.

### **Confusion Remains in Computing NOLs**

Vermont TB-35 was issued to provide guidance to taxpayers in computing NOLs, given the creation of the new Vermont NOL and the change from separate (or consolidated) reporting to combined reporting. However, open issues remain, namely:



- Although existing guidance is unclear on specific issues regarding application and apportionment of pre-2006 NOLs in the context of a unitary combined return, it appears that the drafters contemplate that taxpayers will prepare their combination schedules (see below) in a manner consistent with the apparent intent of the existing guidance, so that those “pre-effective date” attributes are taken into account.
- The department's technical bulletin addressing NOLs suggests that the department will promulgate formal regulations addressing the application of pre-2007 NOLs. Taxpayers should watch for the issuance of the department's regulations in this area.
- As noted above, there remains some confusion caused by the variable use of the “combined” and “consolidated” terminology, which may be addressed in future clarifying guidance.
- No specific guidance exists regarding other NOL issues that have been addressed in other combined filing states -- that is, treatment of NOLs on members joining or leaving the group.

### **Lack of Combination Schedules**

The lack of regulatory guidance is compounded by the absence of department-created return schedules for computing income, NOLs, apportionment, or

tax on a combined basis. Rather, the form instructions generally require the taxpayer to create its own workpapers and consolidating schedules that show individual member attributes, factors, and liability. See instructions to forms CO-411 and BA-402; Code of Vt. Rules 1.5862(d)-11 (listing seven items that must be reported on a taxpayer-created form).

### **Before You File . . .**

In light of those sweeping changes in Vermont, taxpayers should take several steps to review the filing positions for their 2006 returns, including an assessment of the unitary (or nonunitary) position, the effect of the apportionment change, and combination issues relating to tax attributes.