An Update on Vermont's Shift To Combined Filing

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In July 2007 we reported on Vermont's shift from a separate company reporting system to a mandatory combined filing regime.[1] In doing so, we raised several questions that were unanswered at the time we issued our report. Now that the first combined filing season is coming to an end, our earlier report needs an update.

Vermont Combined Reporting Method Adopts 'California-Type' Calculation

Perhaps the most misunderstood aspect of the new combined regime for those outside New England was the method adopted by the Vermont Department of Taxes for reporting unitary members. Unlike "pure" combined filing states such as New Hampshire and Illinois, Vermont adopted a method for reporting unitary members' income and factors that is similar to California's. The Vermont method requires that the combined group's income be apportioned by each member's separate numerators over the group's combined denominators to arrive at each taxable member's separate Vermont tax liability.[2]

The written guidance for that computation is reflected in reg. section 1.5862(d)-7(d), (e). In early 2008, in an effort to help resolve any ambiguity regarding its combined filing method, the department placed an Excel spreadsheet with instructions on its Web site at http://www.state.vt.us/tax/majorvttaxescorporate.shtml (at the links "worksheet" and "instructions"). And in fall 2008, the department is expected to issue new unitary affiliate schedules for tax year 2008 that will consist of one form reporting the entire unitary group's income and Vermont tax liability (Form CO-411-U) and separate forms for each member of the unitary group that calculates each member's apportionment, Vermont taxable income, and Vermont tax liability (Form CO-421).

> ***It remains to be seen whether the department's limitation on availability of attributes to individual members as opposed to the entire combined group would be sustained if challenged.***

The department's method of combined reporting raises some interesting issues regarding exempt entities and net operating losses, as addressed below. Also, it remains to be seen whether the department's limitation on availability of attributes to individual members as opposed to the entire combined group would be sustained if challenged.[3]

Impact on 'Exempt Entities': Financial Institutions and Insurance Companies

From a tax policy standpoint, Vermont's method of combined reporting should have had its biggest impact on companies designated as exempt entities by the department — most importantly, primarily financial institutions and insurance companies. Before the implementation of the unitary regime, financial institutions and insurance companies were generally exempt from the Vermont corporate income tax. Section 5811 of Chapter 151, Title 32 of the Vermont Statutes (hereinafter V.S.A. section), which defines the term "corporation," expressly

[1]*See* our earlier report, "Vermont Goes Unitary in 2006 and Beyond," *State Tax Notes*, July 2, 2007, p. 59, *Doc 2007-14764*, or *2007 STT 128-27*.

[2]*See* Code of Vt. Rules (hereinafter reg.) sections 1.5862(d)-7(d), (e), and 1.5862(d)-12.

[3]*See* reg. section 1.5862(d)-9.

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exempts various types of insurance companies from the corporate income tax.[4] Similarly, 32 V.S.A. section 5836(g) exempts from the corporate income tax financial institutions that are subject to the Vermont franchise tax on financial institutions.[5]

The unitary legislation made no change to the foregoing statutory exemptions. The unitary legislation primarily amended 32 V.S.A. section 5862 to add subsection (d), which provides that "[a] taxable corporation which is part of an affiliated group engaged in a unitary business shall file a group return containing the combined net income of the affiliated group and other such informational returns as the commissioner shall require by rule." A fair reading of new section 5862(d), coupled with the existing exemption provisions (in sections 5811(3) and 5836(g)), would lead a reasonable tax practitioner to conclude that a Vermont unitary combined return would include only those corporations engaged in a unitary business that are not insurance companies or financial institutions, and that those exempt entities would not be required to file (or otherwise be part of) any Vermont corporate income tax return.

Despite the statutory exemption for insurance companies and financial institutions, the department has taken the position that the income and factors of those entities must be included in a unitary group.

Despite the retention of the statutory exemption for insurance companies and financial institutions from the corporate income tax, the department has taken the position that the income and factors of those entities must be included in a unitary group that has a filing obligation in Vermont. The unitary regulations identify, in a somewhat obscure manner, exempt corporations — namely, those corporations that are included in the combined group but are not subject to tax. Reg. section 1.5862(d)-4(b) states that, except for specified excluded corporations as described below in this article:

> a corporation that is not subject to Vermont corporate income tax is not excluded from the affiliated group. For example, banks, insurance companies, telephone companies electing to pay gross receipts tax, railroad companies are part of the affiliated group notwithstanding that the income allocated to them is not subject to Vermont income tax.

That provision means, for example, that an insurance company that has always been exempt from the Vermont corporate income tax now must include its preapportioned income in the combined group's tax base subject to apportionment by each member of the combined group. Also, the insurance company's payroll, property, and sales must be included in the denominator for each taxable member of the combined group. Although the insurance company member itself remains nontaxable under the Vermont method, its income and factors are nevertheless absorbed into each taxable member's calculation of Vermont tax liability.

An important distinction to note is that captive insurance companies are carved out from that treatment. In reg. section 1.5862(d)-4, the department identifies "excluded corporations," the income and factors of which are not included in the combined report. Excluded corporations are defined to include 80/20 companies, captive insurance companies, S corporations, and corporations not taxed federally.[6]

It remains to be seen whether Vermont's combined reporting method will produce distortive results for corporations engaged in those exempt industries, especially regional financial institutions and insurance companies. In other words, it is unclear whether the increase to the combined group's income with an offsetting dilution to the combined group's apportionment factor will properly reflect the unitary group's activity in Vermont. A subset of that issue is whether measuring an insurance company's activity by using a three-factor formula and not the more accepted premiums factor results in a fair representation of the amount of income generated in Vermont. The potential for distortion because of that apportionment method is perhaps even more pronounced in the financial industry. Of course, that issue is not unique to Vermont, and it is now coming to the forefront in the recently enacted Massachusetts unitary legislation.

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[4]*See* 32 V.S.A. sections 5811(3)(A), (B), and (C).
[5]*See* 32 V.S.A. section 5836(g).

[6]*See* reg. section 1.5862(d)-4(b). The exclusion for captive insurance companies is derived from reg. section 1.5862(d)-4(b)(2), which excludes "corporations taxable under section 6014 of title 8 of the Vermont Statutes Annotated; and captive insurance corporations domiciled outside Vermont whose activities do not exceed those permitted under chapter 141 of title 8." Chapter 141 of Title 8 applies to captive insurance companies operating in Vermont. Section 6014 of Title 8 addresses the tax on premiums collected by a captive insurance company subject to Title 8.

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However, other states imposing combined or consolidated regimes that tax those industries have recognized and remedied the potential distortion with alternative apportionment methods.[7]

Confusion Surrounding Retention of Consolidated Return/Member

One area of confusion that remains in Vermont's new combined reporting regime is the retention of the ability to elect to file as a consolidated group, a point that we raised in our 2007 report. The Vermont General Assembly should be encouraged to clean up that statutory language so that the references to affiliates in a consolidated group are separate and distinct from references to members of a combined (unitary) group.

In addition to that linguistic confusion, the retention of the consolidated election could result in two scenarios in the new unitary regime: the unlikely scenario wherein a federal consolidated group, or subgroup therein, that has nexus in Vermont but is not unitary is still permitted to elect to file on a consolidated basis; or the more likely scenario wherein a consolidated group that is unitary, at least in part, may elect to treat its Vermont taxpayer members as one consolidated member as part of a larger combined (unitary) group with nontaxpayer members (or taxpayer members that are not part of the same federal consolidated group).

In the latter scenario, the department has in effect permitted the statutory retention of the "consolidated" reference to be converted into a "consolidated member" concept. As clarified in the "Unitary Filing Instructions for 2006 and 2007 Tax Years," now on the department's Web site, the department has said the consolidated election provisions "remain intact but underneath the umbrella of 5862(d)." For most filers, the election to have a consolidated member within the combined group should have a neutral impact.

Net Operating Losses: The New 2007 Vermont NOL

To further complicate Vermont's transition, the department has had to address two fundamental changes to its net operating loss deduction in the past year. The first change resulted from the 2004 legislation that shifted Vermont to a combined filing regime, which took effect for tax years beginning on or after January 1, 2006.[8] In an attempt to provide guidance for the computation of NOLs for the first unitary year of 2006, the department issued Technical Bulletin No. TB-35 on March 13, 2007. TB-35 set forth the principle that federal NOLs incurred before 2006 and carried forward to 2006 are available to taxable corporations (those that have Vermont nexus) that file as part of a Vermont combined return. TB-35 attempted to clarify that Vermont was still in federal conformity in computing NOLs for the 2006 return, despite Vermont's shift from a separate regime to a unitary regime. Although TB-35 set forth a favorable policy that a taxpayer's preunitary NOLs will essentially be retained in the Vermont group, it left open many particulars as to the computation and limitations of the NOL in 2006.

The second fundamental NOL change resulted from the 2006 legislation that decoupled Vermont from the federal NOL provisions.[9] Under earlier law, the starting point for computing Vermont taxable income was federal taxable income after the federal NOL (Form 1120, line 30). Effective May 31, 2006, a new Vermont NOL was created with different carryforward provisions and transition rules. In an attempt to provide guidance for the conversion of NOLs into the 2007 tax year by the creation of the new Vermont NOL, the department issued TB-40 on January 7, 2008. TB-40 clarifies the conversion method of pre-2007 NOLs into an initial Vermont NOL with an eight-step schedule for separate filers and also addresses additional instructions for combined and consolidated filers. To determine the correct amount of available pre-2007 NOL to convert into a Vermont NOL for the 2007 return, step 6 of the schedule requires a taxpayer to use its Vermont apportionment percentage reported on its 2007 Vermont income tax return. It is important to remember that the conversion from the federal NOL into the initial Vermont NOL is a one-time event for the 2007 tax year.

A couple of issues are readily apparent from the instructions in TB-40. First, based on a plain reading of the text of TB-40 that addresses the method by which combined filers convert the federal NOL to

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[7]For example, California imposes a special apportionment regulation for unitary business groups that combine financial institutions with general corporations. *See* Cal. Code Regs. Tit. 18, section 25137-10(b)(4). Also, Florida has a rule for specialized industries such as insurance and transportation that are combined in the Florida consolidated group with other general corporations. Generally, the Florida statute requires that the numerators of the specialized member be determined by multiplying the denominators of each factor by the premiums or revenue miles factor applicable to that specialized member. Fla. Stat. section 220.131(5). The new Massachusetts legislation, effective for tax years beginning on or after January 1, 2009, combines members with different apportionment formulas and generally requires each member to impose its own formula in computing affiliated members' factors. *See* Mass. H 4904, enacted July 2, 2008.

[8]*See* L. 2004, H 784, Public Act No. 152 (eff. for tax years beginning on or after January 1, 2006); and reg. section 1.5862(d)-9.

[9]*See* L. 2006, H 843 (eff. May 31, 2006); 32 V.S.A. section 5811(25), 5888; and TB-35.

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the new Vermont NOL, combined filers should use the 2007 stand-alone apportionment factor of the loss generator in computing the step 6 conversion factor. That language is consistent with the legislative intent reflected in TB-35 that earlier NOLS would not be lost and that the 2007 conversion is permitted to help determine the portion of unused federal NOL that is attributable to Vermont.

> ***Combined filers should address all combined filing issues with the department, either informally or formally, before the filing of the 2007 return.***

Second, TB-40 appears to limit use of a loss generator member's Vermont NOL to offset other unitary members' income only if those members file as part of the same federal consolidated group. That restriction in application of the Vermont NOL to the federal consolidated group membership is also reflected in reg. section 1.5862(d)-9, which addresses attributes of separate corporations. The rationale for the limitation appears to relate back to former law that piggybacked on the federal NOL. The restriction also appears to be the result of the fact that the unitary regulations were drafted before the Vermont NOL guidance and adhere to the separate entity approach.

Where We Go From Here

As the department addresses the first round of combined returns this year, we expect to see all these issues clarified. In the meantime, combined filers should address all combined filing issues with the department, either informally or formally, before filing their 2007 return. If relief is sought formally, taxpayers must adhere to the strict timing requirements for requesting use of an alternative method, and they must do so before, and separately from, filing their returns.[10] It has been our experience that the department is willing to work with the taxpaying community to make this transition as smooth as possible. ✰

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[10]*See* VSA section 5833(b) and reg. section 1.5833-1(f) (relating to petitions for use of an alternative apportionment method); reg. section 1.5862(d)-13 (regarding petitions for use of an alternative method of reporting if combination leads to distortive results); and TB-40 (relating to petitions requesting a deviation from the 2007 conversion factor for Vermont NOLs).

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