

Rhode Island enacts combined reporting, corporate rate reduction, tax haven legislation, and other changes

June 20, 2014

In brief

Signed on June 19, 2014, and applicable to tax years beginning on or after January 1, 2015, [H.B. 7133](#) implements the following changes into Rhode Island's Business Corporation Tax: (1) a tax rate reduction from 9% to 7%, (2) mandatory unitary combined reporting, (3) special treatment for entities organized in tax haven countries, (4) single sales factor apportionment, and (5) the repeal of related party expense addbacks. Additionally, H.B. 7133 repeals the state's franchise tax for tax years beginning on or after January 1, 2015. The bill also requires the establishment of an independent appeals process to resolve alternative apportionment disputes.

In detail

Tax rate reduced to 7%

For tax years beginning on or after January 1, 2015, Rhode Island's Business Corporation Tax rate is decreased from 9% to 7% of net income.

Combined unitary reporting required in 2015

For tax years beginning on or after January 1, 2015, each C corporation that is part of a unitary business with one or more other corporations must file a combined group return. The following definitions are instructive:

- **Combined group** means a group of two or more corporations in which more than 50% of the voting stock of each member corporation is directly or indirectly owned by a common owner or owners, either corporate or non-corporate, or by one or more of the member corporations, and that are engaged in a unitary business.
- **Unitary business** means the activities of a group of two or more corporations under common ownership that are sufficiently interdependent, integrated,

or interrelated through their activities so as to provide mutual benefit and produce a significant sharing or exchange of value among them or a significant flow of value between the separate parts. The term unitary business shall be construed to the broadest extent permitted under the United States Constitution.

Federal consolidated group five-year election

A taxpayer may make an election to file a Rhode Island combined group return that consists of its federal consolidated group members. The election is binding for five

years unless revocation is approved by the tax administrator.

Treatment of foreign entities – 80/20 companies excluded

A non-US incorporated entity with 80% or more of its sales (as defined under sales factor apportionment treatment) outside the US may not be included in a combined group.

Treatment of foreign entities – Treaty exception

A non-US incorporated entity included in a combined report (e.g., if it has more than 20% of its sales inside the US) may have certain attributes that are treaty protected. To the extent that the included non-US incorporated entity's income is subject to the provisions of a federal income tax treaty, such income and associated expenses and apportionment factors are excluded from a combined return ("Treaty Protected Attributes").

Treatment of foreign entities – Tax haven inclusion and safe harbors

Treaty Protected Attributes that are protected because the treaty is with a 'tax haven' country are included in a combined return.

However, a **tax haven exception** provides that Treaty Protected Attributes may be excluded from a combined return if the "tax administrator determines" that the non-US incorporated entity is organized in a tax haven country that has a federal income tax treaty with the US and:

- the transactions conducted between such non-US corporation and other members of the combined group are done on an arm's length basis and not with the principal purpose to avoid the payment of Rhode Island taxes, or

- the member establishes that the inclusion of such net income in combined group net income is unreasonable.

A 'tax haven' is defined as a jurisdiction that, during the tax year in question has no or nominal effective tax on the relevant income and

- has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime
- has a tax regime that lacks transparency A tax regime lacks transparency if the details of legislative, legal or administrative provisions are not open and apparent or are not consistently applied among similarly situated taxpayers, or if the information needed by tax authorities to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation is not adequately available.
- facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy
- explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime benefits or prohibits enterprisers that benefit from the regime form operating in the jurisdiction's domestic market, or
- has created a tax regime that is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether

the jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy.

Finnigan apportionment

Each unitary group member includes all Rhode Island receipts in its sales factor regardless of whether the member has nexus with the state.

Net operating losses, five-year carryforward

Net operating losses (NOLs) created in tax years beginning before 2015 are allowed to offset only the income of the corporation that created the net operating loss. No deduction is allowed for an NOL sustained during a tax year in which a taxpayer was not subject to the Business Corporation Tax.

For NOLs created in tax years beginning on or after January 1, 2015, such loss allowed shall be the same as the net operating loss deduction allowed under I.R.C. sec. 172 for the combined group except that:

- any net operating loss included in determining the deduction shall be adjusted to reflect Rhode Island inclusions and exclusions from entire net income
- the deduction shall not include any net operating loss sustained during any taxable year in which the member was not subject to the Business Corporation Tax
- the deduction shall not exceed the deduction for the taxable year allowable under I.R.C. sec. 172; provided, however, that the deduction for a taxable year may not be carried back to any other taxable year for Rhode Island purposes but shall only be allowable on a carry forward basis

for the five succeeding taxable years.

Tax credits

Tax credits earned in tax years beginning before 2015 can be used to offset only the tax liability of the corporation that earned the credits. Credits earned in tax years beginning after 2014 may be applied to other members of the group.

Single sales factor apportionment, services sourced to where benefit received

Rhode Island requires that multistate taxpayers apportion their income on the basis of an equally weighted three-factor apportionment formula. Additionally, service income is sourced to where the service is 'performed.'

Effective for tax years beginning on or after January 1, 2015, the state requires apportionment based on a single sales factor. The sales factor is generally computed in the same manner as before H.B. 7133, except that service receipts are sourced to a state "to the extent the recipient receives benefit of the service" in the state.

Related party expense addbacks repealed

Rhode Island requires an addback to net income for related party (1) intangible expenses and costs and (2) interest relating to intangibles. Effective for tax years beginning on or after January 1, 2015, these addbacks are repealed.

Franchise tax repealed

Effective for tax years beginning on or after January 1, 2015, the state's franchise tax is repealed.

S Corporations subject to the \$500 minimum tax

For tax years beginning on or after January 1, 2015, S corporations are subject to Rhode Island's \$500 minimum tax. S corporations remain exempt from the Business Corporation Tax.

Alternative apportionment appeals process

Rhode Island generally allows the tax administrator to apply "any other method of allocation that is equitable" when the tax administrator (on his or her own motion or acting upon a taxpayer complaint) determines that the provided allocation methods are inequitable.

Applicable to tax years beginning on or after January 1, 2015, the Division of Taxation will establish an independent appeals process to attempt to resolve disputes between the tax administrator and the taxpayer with respect to the method of allocation applied. The resulting decision will not prohibit either party from pursuing any available legal remedy "if the issue is not resolved as a result of the appeal process."

The takeaway

While the details of Rhode Island's new mandatory unitary combined legislation may be addressed over time, there are several elements of H.B. 7133 that taxpayers should be aware of.

Rhode Island incorporates a 'tax haven' *definition* similar to how the Multistate Tax Commission, D.C. and West Virginia define tax havens. However, Rhode Island's *treatment* of 'tax havens' is unique. Other states generally provide that an entity incorporated in or doing business in a 'tax haven' jurisdiction is included in a

water's edge report. For Rhode Island purposes, a non-US entity is not included in a combined group solely because it is incorporated in a 'tax haven.' Only when a non-US entity is otherwise included in a combined group will the application of tax haven rules impact whether certain income is included or excluded from the Rhode Island group's return.

Also of note is the repeal of the state's related party addback rules. This change may not be relevant to many taxpayers because intercompany transactions will be eliminated in combined reporting, thus rendering addbacks moot. However, taxpayers that would otherwise add back related party expenses to entities outside the combined group may realize a benefit.

The independent appeals process to resolve alternative apportionment disputes is unique among states. The process may provide taxpayers opportunities to receive alternative apportionment treatment denied by the tax administrator without having to resort to litigation.

Pursuant to the state's 2011-2013 combined reporting study, Rhode Island issued regulations providing taxpayers guidance regarding how to complete their pro forma informational combined returns. It is unclear whether these regulations will have any application to the state's mandatory combined reporting regime for tax years beginning on or after January 1, 2015.

Although the combined reporting changes are applicable to "tax years beginning January 1, 2015," we expect this technical defect to be corrected and the combined reporting provisions of H.B. 7133 to be applicable for tax years beginning on or after January 1, 2015.

Let's talk

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