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GROWING NUMBER OF STATES CONSIDERING A KEY CORPORATE TAX REFORM

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A growing number of states are giving serious consideration to a major reform in their corporate income taxes long advocated by state tax experts. The governors of six states — Iowa, Massachusetts, Michigan, New York, North Carolina, and Pennsylvania — all recommended in 2007 that their states implement this policy, which is known as "combined reporting." New York enacted combined reporting legislation retroactive to the beginning of 2007 as part of the state's budget bill for FY2007-08. Michigan included combined reporting in its newly-enacted "Michigan Business Tax," which will take effect in 2008. And West Virginia enacted combined reporting as well, effective with the 2009 tax year.

Most large multistate corporations are composed of a "parent" corporation and a number of "subsidiary" corporations owned by the parent. Combined reporting essentially treats the parent and most subsidiaries as one corporation for state income tax purposes. Their nationwide profits are combined — that is, added together — and the state then taxes a share of that combined income. The share is calculated by a formula that takes into account the corporate group's level of activity in the state as compared to its activity in other states.

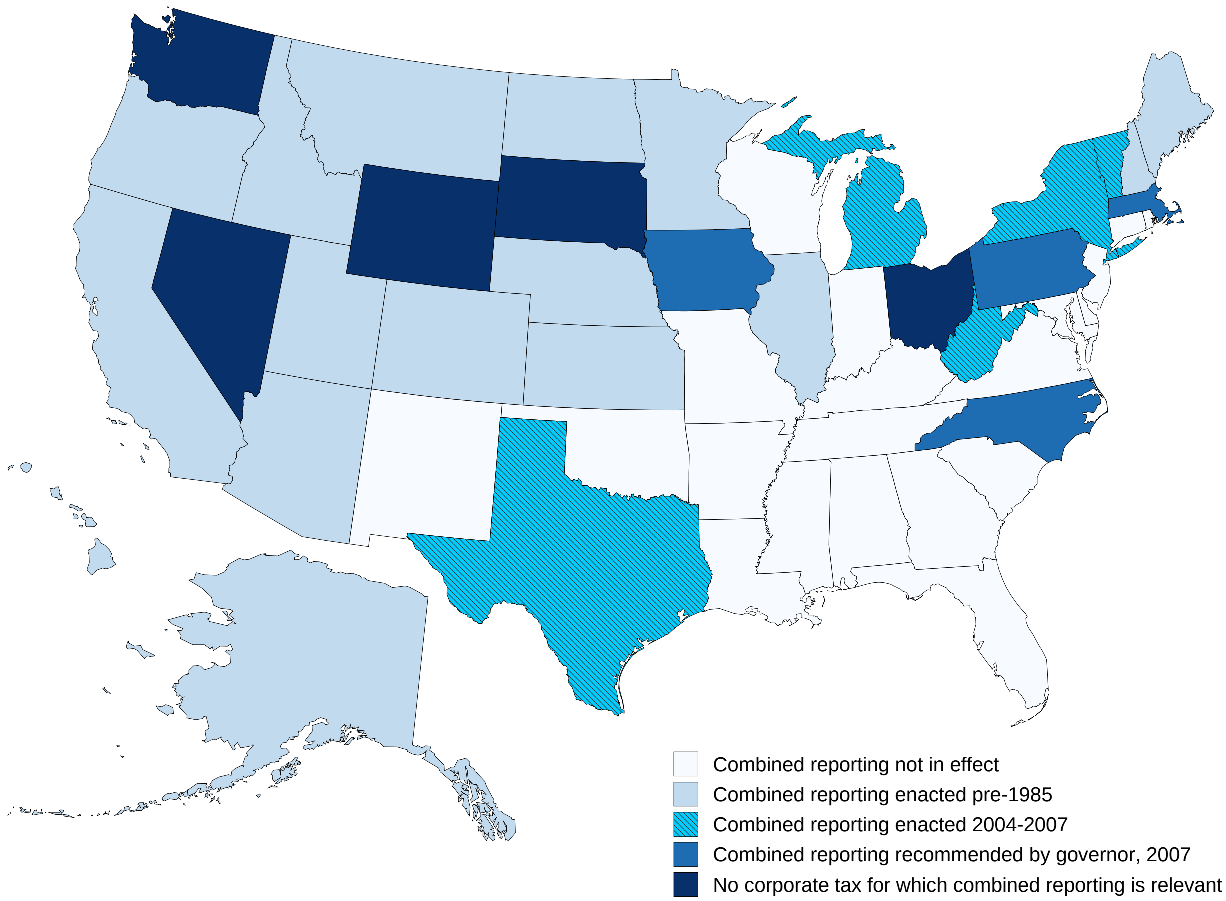
KEY FINDINGS

- **The governors of Iowa, Massachusetts, Michigan, New York, North Carolina, and Pennsylvania all recommended in 2007 that their states implement a key corporate income tax reform known as "combined reporting."**
- **West Virginia, New York, and Michigan enacted combined reporting legislation in 2007, bringing to 21 the number of states that have adopted this policy.**
- **Combined reporting nullifies a variety of abusive corporate income tax avoidance strategies, including Wal-Mart's "captive REIT" tax shelter featured in a front-page *Wall Street Journal* story in February 2007.**

By requiring corporate parents and subsidiaries to add their profits together, combined reporting states are able to nullify a variety of tax-avoidance strategies large multistate corporations have devised to artificially move profits out of the states in which they are earned and into states in which they will be taxed at lower rates — or not at all. These strategies cost the non-combined reporting states billions of dollars of lost corporate income tax revenue they need to finance essential public services, like education and health care. Households and small businesses, which do not have the opportunities or resources to engage in interstate income-shifting, end up paying higher taxes than necessary to make up for the taxes that large corporations are able to avoid.

FIGURE 1

Current Status of Combined Reporting



Growing Consideration of Combined Reporting

Sixteen states — slightly more than one third of the states with corporate income taxes — have mandated and successfully used combined reporting for decades. (See Figure 1.) Until recently, however, that group had not expanded at all — not even after the U.S. Supreme Court ruled in 1983 that combined reporting was a fair and constitutional method of taxing multinational (and, by extension, multistate) corporations.

That inertia is now being overcome. Five states have enacted combined reporting legislation in the past three years, and serious consideration of combined reporting is occurring in a number of other states:

- In 2004, Vermont became the first state in more than 20 years to adopt combined reporting, effective in 2006.

- In adopting a new general business tax in 2006 to substitute for its corporate income tax, Texas also mandated combined reporting (effective 2008). Although the new tax differs in significant ways from a traditional income tax, the decision to require combined reporting was based on the same basic understanding that underlies the inclusion of combined reporting in state corporate income tax structures — that failure to do so gives corporations free rein to artificially shift taxable income out of the state.

- In March 2007, the West Virginia legislature adopted combined reporting, effective with the 2009 tax year.

- As part of the state budget bill approved in April 2007, the New York legislature accepted Governor Eliot Spitzer's recommendation that the state require combined reporting, retroactive to the beginning of 2007.

- In July 2007, Michigan Governor Jennifer Granholm signed into law a new "Michigan Business Tax" to replace the state's former "Single Business Tax." The new tax is a hybrid tax on corporate gross receipts and corporate profits and mandates the use of combined reporting.

- Four other governors — Governor Michael Easley of North Carolina, Governor Chet Culver of Iowa, Governor Deval Patrick of Massachusetts, and Governor Edward Rendell of Pennsylvania — all recommended as part of their FY08 tax and budget packages that their states adopt combined reporting. In Massachusetts, combined reporting remains under consideration by a business taxation study commission that is expected to issue its recommendations before the end of 2007.

There has also been serious discussion or consideration of combined reporting in a number of other states in recent years:

- The 2003 Blue Ribbon Tax Reform Commission in New Mexico recommended that the state adopt combined reporting.[3]

- In a November 2003 report, the Florida Senate Committee on Finance and Taxation wrote: "There are several changes in the Florida Income Tax Code that the legislature should consider to prevent further erosion from tax avoidance strategies by corporations that are taxable under current law: 1. Adopt combined reporting to nullify the use of passive investment companies and other corporate tax avoidance strategies. . . ."[4]

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[3] New Mexico Blue Ribbon Tax Reform Commission, table of recommendations, available at legis.state.nm.us/LCS/bluetaxdocs/BRTRCTableofRecommendations.pdf.

[4] Florida Senate Committee on Finance and Taxation, *Why Did Florida's Corporate Income Tax Revenue Fall While Corporate Profits Rose?* Available at www.flsenate.gov/data/Publications/2004/Senate/reports/interim_reports/pdf/2004-137ft.pdf.

- In a March 2003 report, the Ohio Committee to Study State and Local Taxes identified combined reporting as a policy option for the state worthy of further consideration. It stated: "Unitary taxation [another term for combined reporting] is a constitutionally sanctioned tax system that treats corporate groups as a single business enterprise for income tax purposes. The result is a more fair tax picture for a business enterprise. This approach reduces many of the tax planning opportunities that affect the current Ohio tax."[5]

- Bills to mandate the use of combined reporting were introduced in 2007 legislative sessions in at least two states in addition to the six in which the governor recommended it, Maryland (HB 553/SB 393) and New Mexico (HB 535).

Corporate Tax Shelters and the Need for Combined Reporting

Renewed discussion of combined reporting was sparked approximately five years ago by a rash of court cases in which non-combined reporting states sought to nullify an abusive corporate tax shelter to which they are vulnerable. That tax shelter is frequently referred to as the "Delaware Holding Company" or "Passive Investment Company" (PIC). It is based on a corporation's transferring ownership of its trademarks and patents to a subsidiary corporation located in a state that does not tax royalties, interest, or similar types of "intangible income," such as Delaware and Nevada. Profits of the operational part of a business that otherwise would be taxable by the state(s) in which the company is located are siphoned out of such states by having the tax-haven subsidiary charge a royalty to the rest of the business for the use of the trademark or patent. The royalty is a deductible expense for the corporation paying it, and so reduces the amount of profit such a corporation has in the states in which it does business and is taxable. Moreover, the profits of the Passive Investment Company often are loaned back to the rest of the corporation, and a secondary siphoning of income occurs through the payment of deductible interest on the loan. Of course, the royalties and interest received by the PIC are not taxed; Delaware has a special income tax exemption for corporations whose activities are limited to owning and collecting income from intangible assets, and Nevada does not have a corporate income tax at all.

Combined reporting nullifies the PIC tax shelter because the profits of the subsidiary are added to the profits of the operational part(s) of the corporate group, eliminating any tax benefit of shifting profits on paper from the latter to the former. Only Vermont, Texas, New York, and West Virginia chose to address the PIC problem through combined reporting, however. All of the remaining states that enacted legislation to attack PICs chose limited, targeted approaches focusing on just this particular tax shelter. Many of those bills were so watered-down in the legislative process by business objections that there is a real question as to whether they will be effective at all. The answer to this won't be known for several years until state corporate tax audits covering the years when the laws went into effect reveal whether corporations have, as the laws require, stopped deducting their royalty payments to their PICs.[6]

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[5] *Report of the Committee to Study State and Local Taxes,* March 1, 2003. Available at tax.ohio.gov/channels/research/documents/CSSLT%20Final%20Draft.pdf. The Ohio corporate income tax is scheduled to be phased out.

[6] Some 100 corporations were still deducting royalty payments to PICs more than two years after a Maryland law clamped down on the deductions. See: Kathleen Johnston Jarboe, "Loophole Still Used Even After Closure," *Daily Record*, May 6, 2006.

A recent front-page article in the *Wall Street Journal* underscores the need to take a comprehensive rather than piecemeal approach to the corporate tax avoidance strategies to which non-combined reporting states are vulnerable.[7] The article discusses a tax shelter established by Wal-Mart that is analogous to the PIC but that would not be nullified by the targeted anti-PIC legislation that some states enacted. Indeed, the article revealed that Wal-Mart set up this shelter, known as a "captive Real Estate Investment Trust" (REIT), at approximately the same time it was liquidating its conventional PIC (perhaps because PICs had become a red flag for state auditors).[8] Wal-Mart transferred ownership of all its stores to its REIT subsidiary, and the stores paid tax-deductible rent to the REIT for use of the buildings they occupied. As with royalty payments for the use of trademarks, the rent payments had the effect of reducing taxable profits of the stores and shifting the profits to the REIT. Virtually all states effectively treat the REIT as a tax-exempt entity — just as the federal government does. And the other Wal-Mart subsidiary that owned the REIT was only taxable in the state in which it was based, so the states where Wal-Mart's stores were located couldn't reach the REIT's profits when those were passed on in the form of dividends to the REIT's owner, either.

The Wal-Mart REIT example suggests that when the comprehensive solution of combined reporting is available, it is simply not optimal for states to seek to shore-up their corporate income taxes through targeted attacks on specific tax shelters. The case-by-case approach is inferior to combined reporting for at least three reasons:

- Highly-skilled and highly-compensated tax attorneys and accountants are likely to remain at least one step ahead of under-staffed state revenue departments in devising new mechanisms multistate corporations can use to minimize their state income taxes in non-combined reporting states. For example, a recent newsletter from the BDO Seidman accounting firm that discussed a (rare) New York State court victory against a PIC assured its clients that:

  > BDO Seidman can facilitate the replacement of your current Delaware Holding Company with state tax reducing strategies to fit naturally around your business operations. Examples of BDO Seidman's most popular state tax reducing strategies include:
  >
  > - 197 Strategy,
  > - Embedded Royalty Company, and
  > - Effective Use of Transfer Pricing.[9]

- It is labor-intensive, time-consuming, and costly for states to address these problems on a case-by-case basis. For example, after the Wisconsin legislature rejected the 1999 call by former Governor Tommy Thompson to mandate combined reporting, the state revenue department was compelled to engage in a four-year-long (and still ongoing) process of auditing and then negotiating individual agreements with 175 banks to stop tax avoidance based on the use of

[7] Jesse Drucker, "Wal-mart Cuts Taxes by Paying Rent to Itself" *Wall Street Journal*, February 1, 2007.

[8] According to the article cited in the previous note, Wal-Mart set up its captive REIT structure in the second half of 1996 and liquidated its PIC in February 1997.

[9] BDO Seidman, LLP, *State Tax Alert*, May 2005.

PICs located in Nevada.[10]

- Some of the targeted legislation aimed at nullifying particular tax shelters that non-combined reporting states are vulnerable to may be subject to legal challenge. Several articles have been written by corporate tax attorneys advising their clients how to attack these laws on the grounds that they discriminate against interstate commerce; a test case in Alabama already went against that state.[11] In contrast, the legality of combined reporting has been upheld twice by the U.S. Supreme Court.[12]

The corporate income taxes of states that do not mandate combined reporting are fundamentally flawed because they permit intra-corporate transactions to affect how much income tax a corporation owes to a particular state. Attacking specific tax shelters that exploit this flaw is akin to treating the symptoms of a disease rather than the underlying defect that causes it.

State Corporate Tax Experts and Newspaper Editorial Boards Support Combined Reporting

In giving serious consideration to combined reporting, states are following advice long offered by state corporate tax policy experts. For example:

- Economist Charles McLure, Deputy Assistant Secretary of the Treasury Department in the Reagan Administration, has written: "Failure to require unitary combination is an open invitation to tax avoidance. (Or — to the extent transfer prices are misstated — is it tax evasion?) The advent of electronic commerce exacerbates the potential problems of economic interdependence and manipulation of transfer prices."[13]

- In a recent paper, George Washington University professors David Brunori and Joseph J. Cordes wrote: "Our research shows that requiring combined reporting would help the corporate income tax become a more significant source of revenue. . . The combined reporting requirement would severely limit the ability of corporations to use tax planning techniques such as creating nowhere income and establishing passive investment companies to avoid state corporate tax liability. . . ."[14]

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[10] Paul Gores, "Bankers Fear Doyle Cold Shoulder, Some Still Smarting Over Tax Shelter Issue," *Milwaukee Journal Sentinel,* November 15, 2006.

[11] See, for example: Thomas H. Steele and Pilar M. Sansone, "Surveying Constitutional Theories for Challenges to Add Back Statutes," web site of the Morrison and Foerster law firm, February 23, 2005. The Alabama case, which was not decided on constitutional grounds, is discussed in Matthew S. Houser, Christopher R. Grissom, and Bruce P. Ely, "Alabama Judge Rules for Jeans Manufacturer in Addback Case," *State Tax Notes*, January 29, 2007.

[12] The cases were *Container Corporation of America* v. *California Franchise Tax Board* (1983) and *Barclays Bank* v. *California Franchise Tax Board* (1994).

[13] Charles E. McLure, "The Nuttiness of State and Local Taxes and the Nuttiness of Responses Thereto," *State Tax Notes*, September 11, 2002, p. 851.

[14] David Brunori and Joseph J. Cordes, "The State Corporate Income Tax: Recent Trends for a Troubled Tax," unpublished paper submitted to the American Institute of Tax Policy, August 15, 2005.

- In an article in the prestigious *National Tax Journal*, Economists William F. Fox, Matthew N. Murray, and LeAnn Luna wrote: "[W]e argue for combined reporting in all states. This conclusion is based in part on economic considerations that are independent of any tax planning opportunities, such as the practical problems associated with measuring economies of scope across related firms. But combined reporting can also lessen tax planning distortions based only on corporate form that waste resources through avoidance and government oversight activities."[15]

Major newspapers have also editorialized in support of combined reporting. For example:

- According to the *Wisconsin State Journal*: "Wisconsin should require combined reporting, which demands that a corporation add together the profits of all subsidiaries in one report so that taxable profits can be attributed to the states where they belong. Seventeen states, including neighboring Minnesota and Illinois, require combined reporting. It's time for Wisconsin to update its tax laws so that the state budget is not again left with a multi-million-dollar hole.[16]

- According to the *Des Moines Register*: "The appropriate tax rate of business certainly is debatable, but everyone should agree those companies should pay the full taxes they owe, and multistate corporations shouldn't have a tax advantage over wholly local corporations. Last year [former Governor] Vilsack proposed combined reporting to lawmakers, but it didn't get anywhere. . . . That's unfortunate. . . . Ensuring taxes are collected by closing a loophole that's unfair to Iowa-based businesses should be a bipartisan no-brainer."[17]

Combined Reporting Is Primarily About Fairness, Not Revenue

The *Des Moines Register* editorial just cited alludes to an important issue. The primary goal of combined reporting is to create a level playing field for all businesses. It seeks to ensure that large multistate corporations cannot end up paying income tax at a lower effective tax rate than small businesses by subdividing themselves into separate corporations and then manipulating transactions within the overall corporate group.

Because such manipulations appear to be widespread and because combined reporting nullifies their tax effects, most states that have studied the fiscal impact of combined reporting have concluded that its adoption would raise some additional revenue. In states that need new revenue sources, requiring combined reporting could certainly make a modest contribution toward that objective. Most states that have prepared estimates conclude that the adoption of combined reporting would increase corporate income tax receipts on the order of 10 to 25 percent.

If a state is considering combined reporting at a time when it does not need additional revenue, and if it wishes to maintain the current balance of taxes between businesses and households, it can

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[15] William F. Fox, Matthew N. Murray, and LeAnn Luna, "How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?" *National Tax Journal*, March 2005.

[16] "Heed Warning to Update Tax Laws," *Wisconsin State Journal*, February 2, 2007.

[17] "First, Close Loopholes," *Des Moines Register*, February 20, 2004.

use the revenue gained from combined reporting to make offsetting changes in other business tax provisions to ensure that the overall impact is revenue neutral. Even if other business tax changes are made to keep combined reporting revenue-neutral in the short run, its adoption will help to preserve the long-run revenue-generating capacity of the corporate income tax by nullifying a wide variety of corporate tax-avoidance techniques.

Combined Reporting and State Economic Development

As is often the case when changes in tax policy are put forward that would have the effect of increasing tax payments by some businesses, the widespread consideration of combined reporting that is now occurring has brought forth warnings from corporate interests that implementing the policy would harm the economic prospects of any state doing so.

In fact, combined reporting states are well-represented among the most economically-successful states in the country. Since 1990, for example, only 10 states that levy corporate income taxes have managed to achieve net positive growth in manufacturing employment. Nine of those ten states — Arizona, Idaho, Kansas, Montana, Minnesota, Nebraska, North Dakota, Oregon, and Utah — had combined reporting in effect throughout the 1990-2006 period. The governor of the tenth state, Iowa, has proposed adoption of combined reporting.

Being the state that has used combined reporting the longest and enforces it most aggressively was not a barrier to California's giving birth to Silicon Valley in the 1990s. The presence of combined reporting has not been a barrier to Intel Corporation's maintenance of its headquarters in California and its decision to place the bulk of its expensive chip fabrication plants in Oregon, Arizona, and Colorado — all combined reporting states. Such anecdotes and the data on manufacturing employment cited above suggest that the burden of proof ought to lie with combined reporting opponents to demonstrate that the policy has a negative impact on state economic growth.

All state and local taxes paid by corporations represent approximately two to four percent of their expenses on average, and the state corporate income tax represents on average less than 10 percent of that 2-4 percent. A state's decision to adopt combined reporting increases that small corporate tax load only slightly. The potential influence on corporate location decisions of state corporate tax policies is simply overwhelmed in most cases by interstate differences in labor, energy, and transportation costs, which comprise a much greater share of corporate costs than state corporate income taxes do and often vary more among the states than effective rates of corporate taxation. It comes as no surprise, then, that a recent study by economists Robert Tannenwald and George Plesko, which measured interstate differences in overall state and local tax costs for corporations in a particularly rigorous way, found that there was not a statistically-significant (inverse) correlation between those costs and state success in attracting business investment.[18] In other words, higher state and local taxes did not impede business investment.

[18] George A. Plesko and Robert Tannenwald, *Measuring the Incentive Effects of State Tax Policies Toward Capital Investment*, Federal Reserve Bank of Boston Working Paper 01-4, December 3, 2001.

Making the Transition to Combined Reporting

Adopting combined reporting is a significant change in corporate tax policy and necessitates some effort to educate state personnel and taxpayers alike in the ways in which it differs from the "separate entity" approach to corporate taxation that still prevails in a majority of states.[19] Fortunately, assistance is available to states that wish to make the change to combined reporting from the Multistate Tax Commission. The MTC is an organization of state revenue departments whose members include most of the existing combined reporting states. In recent years, the MTC has promulgated a model statute for the implementation of combined reporting and a model regulation spelling out in considerable detail which corporate subsidiaries do and do not constitute parts of a "unitary business" that therefore must be included in a combined report.[20] The MTC also has a staff of corporate income tax auditors who audit large multistate corporations on behalf of numerous states simultaneously. They are quite familiar with auditing under combined reporting regimes. A state new to combined reporting could supplement its auditing efforts with MTC auditors as its audit staff familiarizes itself with the new approach. States do not need to be members of the MTC to participate in its Joint Audit Program.

Conclusion

With six governors simultaneously recommending the adoption of combined reporting and three states enacting it, 2007 could be a breakthrough year in state corporate tax reform efforts. As policymakers in non-combined reporting states ponder their states' ongoing vulnerability to a variety of aggressive corporate tax shelters — such as Wal-Mart's "captive REIT" — and objectively examine the decades-long experience of 16 states with this policy, the number of states requiring combined reporting seems likely to grow.

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[19] The key differences between combined reporting and the "separate entity" approach to state corporate income taxation are discussed in Appendix B of Michael Mazerov, *State Corporate Tax Disclosure: The Next Step in Corporate Income Tax Reform*, February 2007. Available at www.cbpp.org/2-13-07sfp.pdf.

[20] The MTC's model combined reporting statute is available at www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf. The MTC's model definition of a "unitary business" for combined reporting purposes is available on pp. 5-14 of the following document www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocationandApportionmentReg.pdf.