

COMBINED REPORTING: MAKING SURE CORPORATIONS PAY THEIR FAIR SHARE OF TAXES

A Policy Brief by the Center for State Innovation

November 2008

DISCUSSION

Current tax systems in some states allow corporations to avoid their full tax burden. Corporations doing business in a state with a sound income tax system can avoid most or all tax by artificially assigning their profits to subsidiaries in low- or no-tax states. A 2003 Multistate Tax Commission report estimates that states lost upward of \$7.1 billion in revenue to domestic corporate income tax avoidance in 2001.

One of the primary reasons that state corporate income tax revenue has declined while other sources of state revenue have continued to grow is that large, multi-state corporations have become increasingly adept at artificially assigning their profits from states with reasonable tax rates to those with low rates. This transference can be achieved in a variety of ways. These include the use of entities such as “passive investment corporations” (PICs), management fees, consulting fees, royalty payments, or interest charges.

These corporations are frequently able to take advantage of the differences in tax systems among the states to avoid paying taxes at all. They are thus able to benefit from the public goods supplied by a state, like transportation infrastructure and the educational system, without having to pay for any of those benefits.

Combined reporting is a way to prevent corporate tax avoidance and increase state revenue. It allows a state to collect that state’s fair share of taxes from multi-state corporations. A Center for Budget and Policy Priorities report estimates that the adoption of combined reporting will likely increase corporate income tax revenue by approximately 10 to 25 percent.

Without combined reporting, every corporation is taxed individually. This is true even if corporations are related through ownership and do business with each other.

For example, a corporation making a profit in a state with reasonable tax rates can rent its stores from a wholly owned subsidiary in a low- or no-tax state. The rental agreement can be structured so that the parent corporation pays all of its profit to the subsidiary. The parent corporation would show no profit and would thus pay no income tax in its home state. The subsidiary corporation has a profit, but pays little or no income tax because of the tax rate in the state where the subsidiary is located.

Combined reporting treats multiple subsidiaries of a corporation operating in multiple states as a single, taxable entity. As a single entity, it does not matter what state the corporation says its profit came from. The locus of profitability is not the basis of the corporation’s tax; its basis is the share of business done in a given state. In this way, combined reporting helps states to reclaim the corporate tax revenue they would otherwise lose through profit shifting.

About CSI

The Center for State Innovation (CSI) believes every state can achieve shared prosperity, environmental sustainability, and efficient democratic government. We offer evidence-based, outcome-measured, fiscally prudent strategies for doing so.

A non-partisan, not-for-profit institution, CSI provides many types of assistance to state executives interested in implementing progressive policies.

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It is important to note that not all related corporations are taxed as a single entity. Only those corporations in affiliated groups that are engaged in a unitary business are taxed in this way. The terms “affiliated groups” and “unitary business” are defined by state tax law.

Combined reporting helps to fix the problem. By treating subsidiaries of multi-state corporations as a single taxpayer, requiring the single taxpayer to report all its profits, and then claiming a percentage of the firm’s total profits that corresponds with the firm’s business activity in the state, combined reporting removes the incentive to move profits across state lines.

COSTS

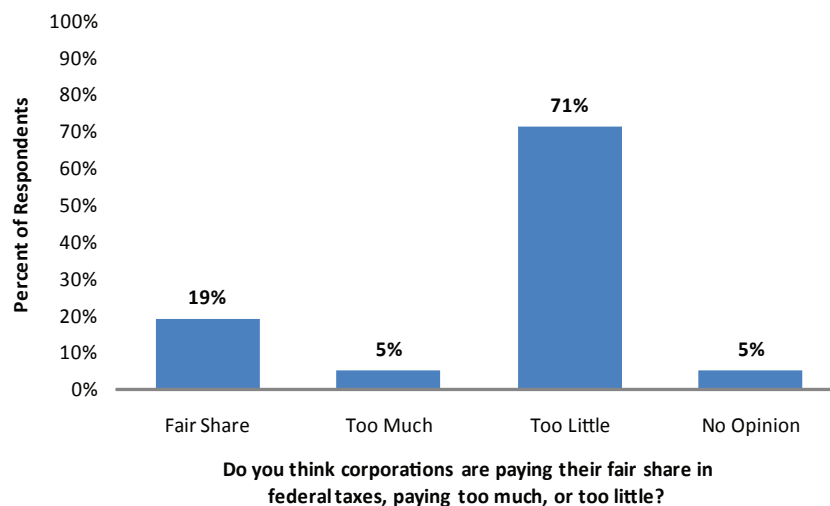
Combined reporting is meant to ensure that states are able to collect what is owed to them under existing laws. A report for the American Tax Policy Institute found that combined reporting increases the share of gross state product (GSP) subject to tax by approximately 25 percent. The cost of implementing combined reporting is small. The mechanisms for collection and enforcement are already in place as part of the existing tax collection system. States will incur some initial administrative costs around defining terms such as unitary business but these set-up costs will be minor compared to the increase in revenue that results from combined reporting. In addition, the corporate audits necessary under single entity reporting to ensure that transfers between affiliated corporations are legitimate will no longer be needed. Combined reporting may thus result in both increased revenue and increased administrative efficiency.

PUBLIC PERCEPTION

An overwhelming number of Americans feel that, at least at the federal level, corporations are not paying their fair share of taxes. In a 2008 Rockefeller Foundation Time poll, 72 percent of Americans surveyed favored increasing taxes on corporations. A 2007 Gallup survey indicated that 71 percent of respondents thought that corporations pay too little in federal taxes (see chart below).

CHART

Public Perception of Corporate Taxes



Source: Gallup Poll (April 2007)

TALKING POINTS

Doesn't combined reporting deter economic development?

No. In fact, there is evidence that combined reporting may promote economic growth. Combined reporting states have demonstrated disproportionate success in recent years. The Center on Budget and Policy Priorities reported that between 1990 and 2006, 9 of the 10 states that achieved net positive growth in manufacturing employment while levying corporate taxes had combined reporting in effect for the entire period. In terms of Gross State Product, manufacturing employment, and non-farm employment more generally, combined reporting states tend to grow at a rate comparable to, or greater than, states with separate-entity reporting.

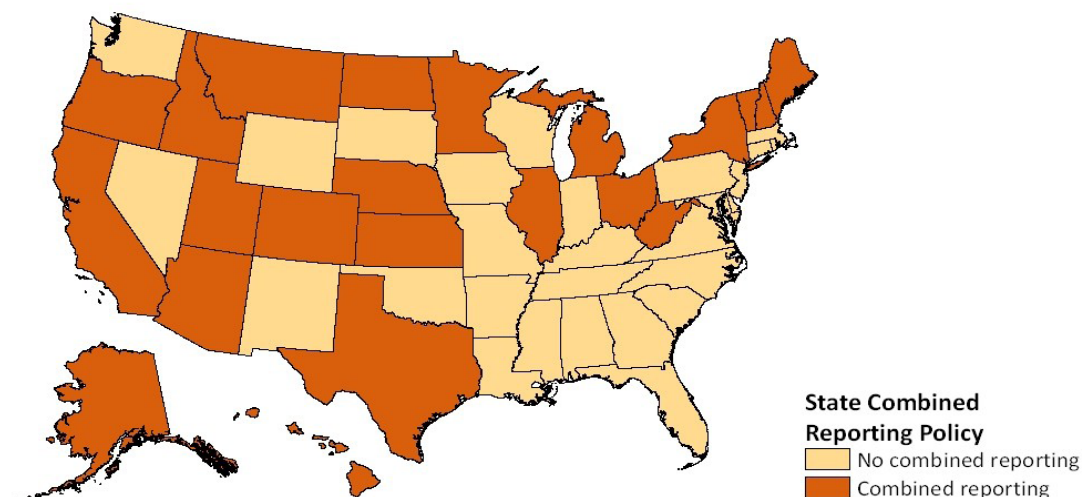
Why should states get tax revenues from businesses in other states?

Under combined reporting, states do not arbitrarily tax out-of-state businesses. A corporation that does business in multiple states would have its taxes apportioned among those states. The apportionment is the same under both combined reporting and single entity tax systems. What changes with combined reporting is that the state where a corporation does its business receives the tax, not the state where the income is said to have been earned after the income is transferred among affiliated corporations.

Corporations pay taxes in large measure because they derive benefits from the public services (e.g., education, transportation) provided by the states in which they are located. Through their ability to use subsidiary companies to shift profits to other states, many large corporations are in effect taking advantage of public benefits at an unfairly low cost. Combined reporting is as much about fairness as it is about revenue. The taxes corporations pay should be associated with the public benefits they receive, not their organizational structure.

WHO ELSE IS DOING IT?

According to CBPP, twenty-two states have adopted combined reporting: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Michigan, Minnesota, Montana, North Dakota, Nebraska, New Hampshire, New York, Ohio, Oregon, Texas, Utah, Vermont, and West Virginia.



SPOTLIGHT ON INNOVATION

New York: Former Governor Eliot Spitzer signed combined reporting legislation on April 1, 2007, as part of New York's 2007-2008 budget bill. The New York State Division of the Budget reports revenue gained from closing loopholes to promote tax fairness will be used to fund a range of business tax reductions better targeted to promote job creation.

WHAT CAN YOU DO?

Many governors have taken the lead in pushing for the adoption of combined reporting laws. In the past year alone, governors from Iowa, Massachusetts, Michigan, New York, North Carolina, and Pennsylvania have called for combined reporting, with legislation passing in both New York (as part of the 2007-2008 New York State Budget) and Michigan (included in the Michigan Business Tax - 2007 Michigan Act 36). For governors interested in proposing combined reporting laws, model legislation is available through the Multistate Tax Commission. In addition, for a more specific example of how combined reporting laws might be put in place, there is also a more detailed study published in the Louisiana Law Review, which outlines a plan for the development and implementation of combined reporting in Louisiana.

RESOURCES

Policy Reports

American Tax Policy Institute

- "The State Corporate Income Tax: Recent Trends for a Troubled Tax"
<http://www.americantaxpolicyinstitute.org/pdf/StateCorpTax%208-15-05%202.pdf>

Center on Budget and Policy Priorities

- "Closing Three Additional Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States"
<http://www.cbpp.org/4-9-02sfp.htm>
- "Growing Number of States Considering a Key Corporate Tax Reform"
<http://www.cbpp.org/4-5-07sfp.pdf>

Institute on Taxation and Economic Policy

- "Combined Reporting of State Corporate Income Taxes: A Primer"
<http://www.itepnet.org/pb24comb.pdf>
- "The ITEP Guide to Fair State and Local Tax Policy"
<http://www.itepnet.org/>

Michael J. McIntyre, Paul Mines, and Richard D. Pomp (Wayne State University Law School)

- "Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana"
http://www.law.wayne.edu/mcintyre/text/mcintyre_articles/Combined_reporting_LSU.pdf

Multistate Tax Commission

- "Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections"
http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Resources/Studies_and_Reports/Corporate_TaxSheltering/Tax%20Shelter%20Report.pdf

- Study: Corporate Tax Sheltering Linked to as much as \$12.4 Billion in Lost State Tax Revenues
http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Resources/Studies_and_Reports/Corporate_Tax_Sheltering/July%2015,%202003%20news%20release.pdf

Opinion Polls

Gallup

- Gallup Poll (April 2007)
<http://www.gallup.com/poll/27199/Americans-Say-Federal-Income-Taxes-Too-High-Unfair.aspx>

Rockefeller Foundation

- Campaign for American Workers Survey (July 2008)
http://www.rockfound.org/library/rf_time_data1.pdf

State Reports

Massachusetts

- “Combined Reporting: A Comprehensive Method of Closing Corporate Tax Loopholes”
http://www.massbudget.org/documentsearch/topic?top_code=TAX&top_name=Taxes&desiredPage=3
- “Building a Strong Economy: The Evidence of Combined Reporting, Public Investments, and Economic Growth”
http://www.massbudget.org/documentsearch/topic?top_code=TAX&top_name=Taxes&desiredPage=3

New York

- Enacted Budget Cuts Business Taxes
<http://www.ny.gov/governor/press/0401077.html>
- Closing Loopholes to Promote Tax Fairness
<http://www.budget.state.ny.us/pubs/archive/fy0708archive/fp0708/factsheet/loopholes.html>
- Business Tax Reductions
<http://www.budget.state.ny.us/pubs/archive/fy0708archive/fp0708/factsheet/businessstaxcuts.html>

State Legislation

Michigan

- 2007 Michigan Act 36
http://www.law.wayne.edu/mcintyre/text/Multistate_class/MI_business_tax_text.pdf

Multistate

Multistate Tax Commission

- Proposed Model Statute for Combined Reporting
http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/Adopted_Recommendations/Model_Statute_Updates_11-10/Combined%20Reporting%20-%20FINAL%20version.pdf

New York

- 2007-2008 Executive Budget
<http://www.budget.state.ny.us/pubs/archive/fy0708archive/fy0708artVIIbills/REVENUEConsBMwtoc.htm#SummaryO>