

Testimony Supporting
S.B. No. 807, An Act Concerning Combined Reporting
for the Purposes of the Corporation Business Tax
Testimony of Jeffrey M. Tebbs*
To the Committee on Finance, Revenue, and Bonding
February 9, 2009

Senator Daily, Representative Staples, and distinguished Members of the Finance, Revenue, and Bonding Committee,

I am testifying today on behalf of Connecticut Voices for Children, a research-based public education and advocacy organization that works statewide to promote the well-being of Connecticut's children, youth, and families. I submit this testimony because the manner in which Connecticut raises and spends its revenues is of great importance to the state's children and families, just as it is to Connecticut's businesses.

Connecticut Voices for Children supports SB 807, An Act Concerning Combined Reporting for the Purposes of the Corporation Business Tax.

1. Connecticut's current system of single entity reporting leaves it exposed to "aggressive" corporate tax planning by multi-state and multi-national corporations.

As Charles McLure, a Senior Fellow at the Hoover Institution and former Reagan Administration Treasury Department official famously stated, single entity reporting is "an open invitation to tax avoidance."¹

Under Connecticut's current system of predominantly single entity reporting,² multi-state corporations are able to artificially shift profits to subsidiaries operating in states that do not tax businesses.³ Mandatory combined reporting remedies this problem by treating parent corporations and certain subsidiaries and affiliates as a single corporation for tax purposes.⁴ With combined (unitary) reporting, "the profits and losses of all entities in a unitary group are combined" for the purposes of apportionment. This combination renders the existence of multiple entities and any transfers between those related entities irrelevant.⁵ Combined treatment of the parent corporation and its affiliates therefore counteracts the erosion of a state's corporate tax base that occurs under aggressive corporate tax planning.⁶

* This testimony was prepared through the Yale Law School Legislative Advocacy Clinic under the supervision of J.L. Pottenger, Jr., Nathan Baker Clinical Professor of Law, Shelley Geballe, Distinguished Senior Fellow at Connecticut Voices for Children, and Douglas Hall, Acting Managing Director of Connecticut Voices for Children.

In recent years, multi-state corporations have artificially shifted profits across jurisdictions through a host of sophisticated tax planning mechanisms, including:

- Assigning income to a subsidiary in a tax haven (e.g., royalty income, licensing income);
- Transferring appreciated assets to a subsidiary in a tax haven;
- Avoiding the inclusion of a subsidiary's employees in state apportionment formulas through the use of "captive employee leasing compan[ies]";
- Selling account receivables at a substantial "loss" to subsidiaries in a tax haven; and
- Creating a rental deduction through the use of Captive Real Estate Investment Trusts (REITs).⁷

Wal-Mart's aggressive tax strategies over the past fifteen years provide a high-profile illustration of the myriad techniques multi-state and multi-national corporations employ to avoid taxation in single-entity reporting states.⁸ In the early 1990s, Wal-Mart created an "intangibles holding company" in Delaware into which it deposited the ownership to the brand names of the corporation. Subsidiaries operating in various single-entity reporting states then issued payments to the Delaware holding company for use of these intangibles, thereby enabling them to deduct these expenses from their taxable income.⁹ When this approach eventually encountered resistance from state authorities, Wal-Mart shifted to a tax strategy involving REITs. Much of Wal-Mart's real estate was deposited in a REIT. Subsidiaries in various states then paid rent to the REIT, which the subsidiaries could deduct from their taxes. Simultaneously, however, the REIT's rental income was non-taxable, provided it paid out a specified percentage of its income to shareholders as dividends. This tax shelter shaved an estimated \$230 million from Wal-Mart's assessed taxes over a four-year time frame.¹⁰

2. Combined reporting prevents the need to close loopholes on a case-by-case basis.

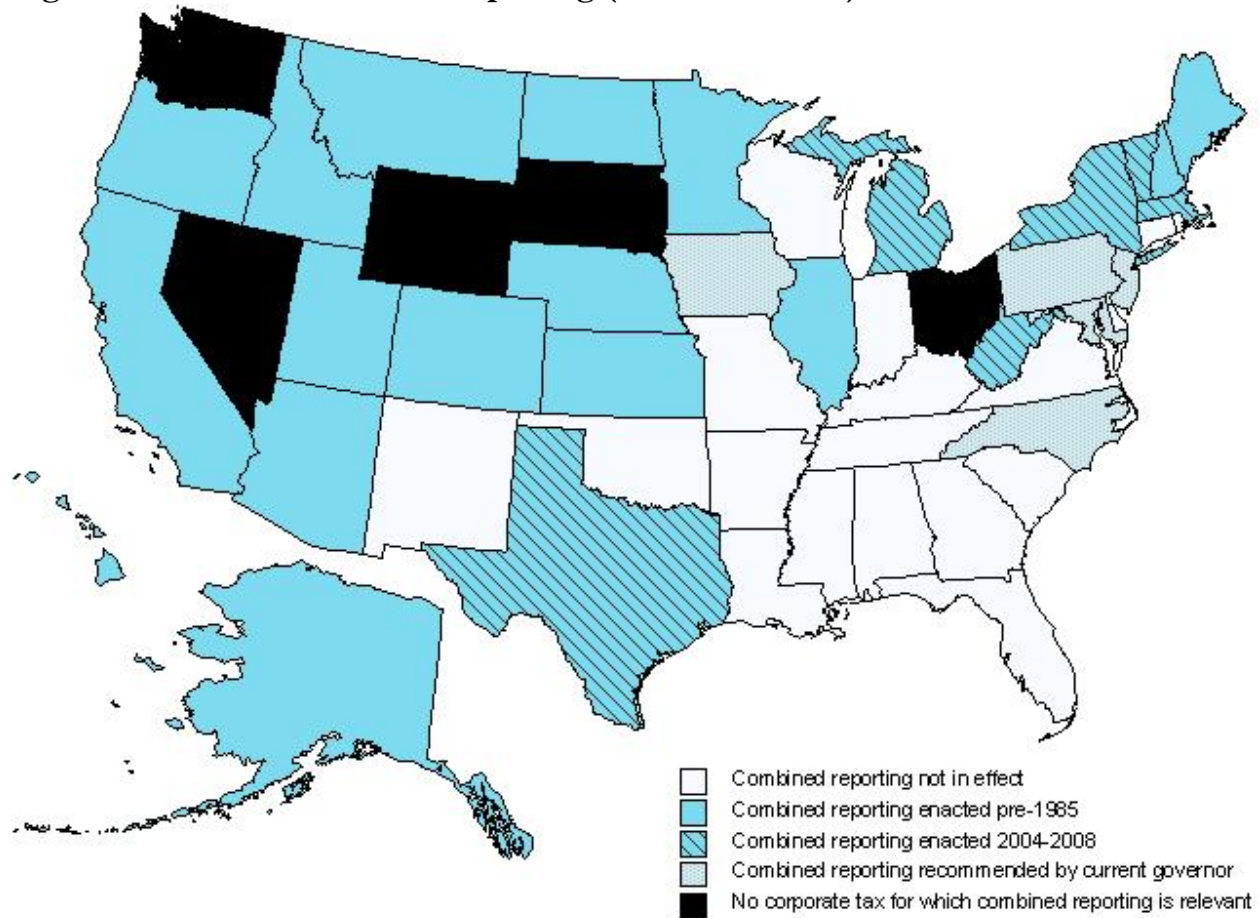
Single entity reporting states have managed to close certain corporate loopholes on a case-by-case basis. Indeed, in 1998, Connecticut passed legislation restricting the circumstances under which certain intangible expenses and related interest expenses are deductible from the corporation business tax.¹¹ The principal difficulty with this piecemeal approach "is that in the absence of combined reporting, multi-state corporations will always be able to develop new methods of transferring profits" to states and foreign countries that lack a corporate tax.¹² Combined reporting represents an approach to enforcement that is resistant to innovations in corporate tax avoidance. Under a combined reporting regime, the Commissioner of Revenue will no longer be forced to waste precious resources litigating individual cases of abusive tax avoidance.

3. Combined reporting has been successfully implemented in multiple jurisdictions across the nation.

At least twenty-two states now require combined reporting for corporate tax returns.¹³ Sixteen states have effectively administered combined reporting regimes for more than two decades, and six additional states have adopted combined

reporting in the past five years.¹⁴ In the past, the Connecticut Business & Industry Association has opposed mandatory combined reporting because “[m]ost of our competitor states in this region do not have unitary reporting methods.”¹⁵ However, today, “peer” states in the Northeast have adopted combined reporting, including New York, Massachusetts, New Hampshire, Vermont, and Maine. Rhode Island is actively considering combined reporting,¹⁶ and the Governors of New Jersey, Pennsylvania, and Maryland all recommend the adoption of combined reporting (Figure 1). New York and Massachusetts, in fact, have adopted mandatory combined reporting in the past two years.

Figure 1. Status of Combined Reporting (November 2008).



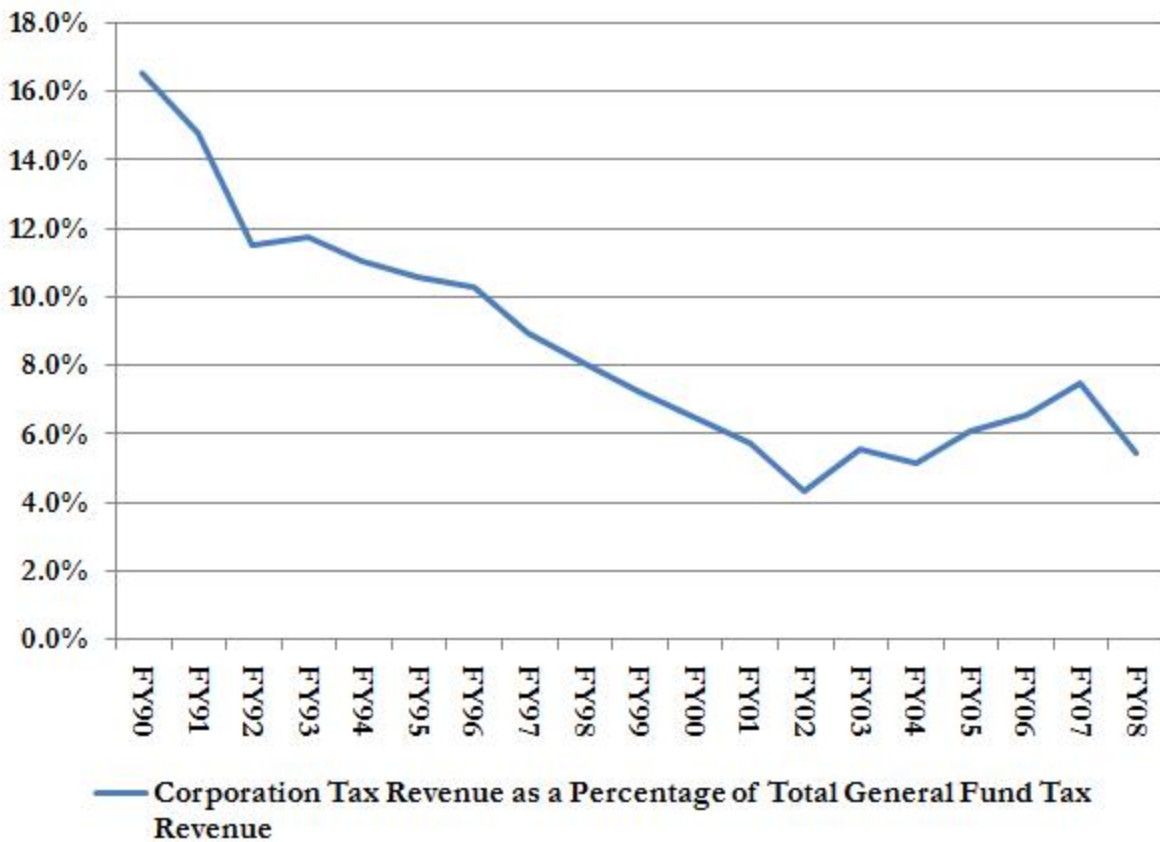
Source: Center on Budget and Policy Priorities (2009).

4. Failing to require combined reporting costs Connecticut between 10 and 20 percent of revenue from the corporation business tax. The latest revenue estimates released by the General Assembly’s Office of Fiscal Analysis on February 2, 2009 indicate that corporate taxes are estimated to generate \$584.1 million in revenue in the current fiscal year and \$525.7 million in revenue in both FY 2010 and FY 2011.¹⁷ Official revenue estimates conducted in other states that have recently adopted, or considered, combined reporting (Iowa, Maryland, Massachusetts, New York, and Wisconsin) indicate that the

adoption of combined reporting increases net corporate tax revenue by an average of 16.6 percent.¹⁸ The adoption of combined reporting in Connecticut would provide critical revenues in the midst of a rapidly deteriorating fiscal situation. Assuring adequate revenues will allow Connecticut to maintain essential services during this recession and avoid cuts in state spending that exacerbate the economic downturn.

A bit of context is important. As Figure 2 below illustrates, the share of General Fund tax revenues flowing from the corporation business tax fell dramatically starting in FY 1991; Connecticut’s adoption of a broad-based personal income tax enabled the corporation business tax rate to be markedly reduced, new tax credits to be adopted, and certain types of corporations to be wholly exempted from the tax. As a result, corporate tax revenues have continued to slide over the past seventeen years.

Figure 2. Corporate Tax Revenue as a Share of GF Tax Revenue (FY 1990-2008)



Sources: Historical budget data derived from Office of Fiscal Analysis, *Connecticut Revenue and Budget Facts*, February 27, 2006, pp.6, 38; Governor's Midterm Budget Adjustments (FY2006-2007); Governor's Biennial Budget (FY2008 - FY2009); Governor's Budget Adjustments (FY 2009 Midterm).

5. Combined reporting does not impede economic growth or development. A joint report between the Economic Policy Institute and the Massachusetts Budget and Policy Center concluded that states that have adopted combined reporting have experienced

comparable, if not superior, economic growth than states that have failed to adopt combined reporting. Indeed, five of the seven fastest growing states from 1990 to 2005 employed combined reporting, and the average annual growth in state domestic product was higher in combined reporting states (3.3 percent) than the average growth in states without combined reporting (3.1 percent).¹⁹ The results are similar with regard to employment growth: four of the five states with the fastest employment growth from 1992 to 2005 required combined reporting.²⁰

These findings even extend to trends in manufacturing employment. In theory, manufacturers have a greater ability to relocate than retail and service businesses. In January 2009, Michael Mazerov of the Center on Budget & Policy Priorities released an analysis demonstrating that seven of the eight states that experienced growth in manufacturing employment from 1990 through 2007 had combined reporting in effect throughout the period.²¹

As additional states have adopted mandatory combined reporting, the compliance cost of preparing a unitary return has fallen dramatically. At present, states with mandatory combined reporting are responsible for 51 percent of the national economy.²² Many, if not most, multi-state corporations conducting business in Connecticut already prepare combined returns as a consequence of their operations in combined reporting states.

6. Combined reporting would level the playing field for Connecticut-centered businesses competing against multi-state and multi-national corporations. At present, Connecticut businesses that lack related subsidiaries operating in other states cannot engage in the elaborate tax avoidance schemes available to large, multi-national corporations that combined reporting is designed to combat. To argue that combined reporting would be detrimental to the economic health of Connecticut requires the assumption that equitably applying the tax law to both local businesses and multi-national corporations would impede economic growth. *All* businesses operating in Connecticut seek a well-trained workforce, as well as a well-functioning infrastructure. It is a clear violation of the principle of tax fairness to allow large multi-state corporations to avoid paying their fair share of the costs of these business essentials at the expense of smaller Connecticut businesses.

¹ Charles E. McLure, Jr., *The Nuttiness of State and Local Taxes – and the Nuttiness of Responses Thereto*, STATE TAX NOTES, September 16, 2002, 851.

² Connecticut law currently *allows* corporations that file a federal consolidated return to file a combined return in Connecticut; the combined Connecticut tax liability is determined after each corporation in the combined return individually apportions its income to Connecticut (i.e., the return is in the nature of a state consolidated return). Connecticut imposes a preference tax on corporations that choose to file a combined state return that is equal to the difference between the tax that would have been due if the entities had filed separately and the total tax due under the combined return, up to a maximum of \$250,000. In income year 2006, 1,014 corporations elected to file combined returns. Had these corporations filed single entity returns, the corporation tax due would have been \$557.0 million. By electing to file combined returns, the total tax due was reduced to \$348.6 million (including \$27.1 million in the preference tax). Notably, more than a third of the voluntary combined returns (366 of 1,014) reported only \$250 in tax due, i.e., Connecticut's minimum corporate tax. Connecticut law also allows certain corporations to file unitary returns, as of right or with the permission of the Department of Revenue Services. In such cases, the combined net income of the unitary group is apportioned to Connecticut as if it were one corporation. *See* State of Connecticut, Department of Revenue Services, Annual Report Fiscal Year 2007-2008, pp. 18-20.

³ MICHAEL MAZEROV, CTR. ON BUDGET & POL'Y PRIORITIES, STATE CORPORATE TAX SHELTERS AND THE NEED FOR "COMBINED REPORTING" (2007), <http://www.cbpp.org/10-26-07sfp.pdf>

⁴ MAZEROV, *supra* note 3. Connecticut currently allows combined reporting at the election of corporate taxpayers that file a federal consolidated return (see note 2). The bill under consideration (SB 807) would require combined reporting if a company is part of a group of related companies that meets specified criteria (e.g., fifty percent or more of the taxpayer's gross income is derived from "transacting or conducting any business with one or more affiliated corporations or related entities"). The Multistate Tax Commission has prepared a Model Statute for Combined Reporting that the Finance Committee should consider carefully. The Model Statute provides the state commissioner of revenue with the discretion to require, by regulation, combined reporting by persons or entities not otherwise covered under the Act. *See* MULTISTATE TAX COMM'N, PROPOSED MODEL STATUTE FOR COMBINED REPORTING (2006), http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf; MULTISTATE TAX COMM'N, REPORT OF THE HEARING OFFICER REGARDING THE PROPOSED MODEL STATUTE FOR COMBINED REPORTING (2005), http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/CR%20HO%20Report.pdf.

⁵ William F. Fox, LeAnn Luca, & Matthew N. Murray, *Emerging State Business Tax Policy: More of the Same, or Fundamental Change?*, STATE TAX NOTES, May 2007, at 393, 394..

⁶ Fox, Luca, & Murray, *supra* note 5.

⁷ For a detailed description of the tax avoidance strategies discussed here, see ROBERT G. LYNCH, ET AL., MASS. BUDGET & POL'Y CTR. & ECON. POL'Y INST., BUILDING A STRONG ECONOMY: THE EVIDENCE ON COMBINED REPORTING, PUBLIC INVESTMENTS, AND ECONOMIC GROWTH (2007), http://www.massbudget.org/file_storage/documents/BuildingStrongEconomyJune07.pdf.

⁸ Jesse Drucker, *Inside Wal-Mart's Bid to Slash State Taxes; Ernst & Young Devises Complex Strategies; California Pushes Back*, WALL ST. J., Oct. 23, 2007, at A1.

⁹ *Id.*

¹⁰ *Id.*

¹¹ Pub. L. No. 98-110, § 20, (codified at CONN. GEN. STAT. ANN. § 12-218c (Westlaw 2009)).

¹² INST. ON TAXATION & ECON. POL'Y, COMBINED REPORTING OF STATE CORPORATE INCOME TAXES: A PRIMER (2008), <http://www.itepnet.org/pb24comb.pdf>.

¹³ *See* Mazerov, *supra* note 3 (reporting that twenty-one states require combined reporting); Press Release, Governor of Massachusetts, Governor Patrick Signs Law to Close Corporate Loopholes (July 3, 2008), http://www.mass.gov/?pageID=gov3pressrelease&L=1&L0=Home&sid=Agov3&b=pressrelease&f=080703_taxfairness&csid=Agov3 (announcing Massachusetts' adoption of combined reporting).

¹⁴ MICHAEL MAZEROV, CTR. ON BUDGET & POLICY PRIORITIES, MOST LARGE NORTH CAROLINA MANUFACTURERS ARE ALREADY SUBJECT TO "COMBINED REPORTING" IN OTHER STATES 2 (2009), <http://www.cbpp.org/1-15-09sfp.pdf>

¹⁵ Testimony of Joseph Brennan, Senior Vice President of Public Policy, Connecticut Business & Industry Association, Hearing before the Committee on Finance, Revenue, and Bonding, March 28, 2005.

¹⁶ Neil Downing, *Rhode Island Tax Reform Panel Agrees on Individual Income Tax Proposal*, STATE TAX TODAY, Jan. 22, 2009 (noting that a panel appointed by Rhode Island Gov. Don Carcieri remains divided on whether to recommend combined reporting)

¹⁷Conn. Gen. Assembly, Office of Fiscal Analysis, FY 09 - FY 12 General Fund and Transportation Fund Budget Projections, Feb. 2., 2009, http://www.cga.ct.gov/OFA/Documents/Statements/2009/Feb_2_2009_Statement.pdf

¹⁸ In New York, the Division of the Budget estimated that combined reporting would generate \$328 million in additional corporate franchise tax revenue for FY 2007-08. A few months earlier, the Division of the Budget projected baseline corporate franchise revenue (in the absence of combined reporting) of \$4,080 million. The combined reporting initiative was thus expected to increase corporate franchise tax revenue by 8.0%. In Massachusetts, the Department of Revenue estimated that combined reporting would generate \$313 million in additional revenue on an annual basis, although only \$188 million would be collected in FY 2009 since combined reporting was slated to begin mid-way through the tax year.¹⁸ Compared to a corporate tax baseline of \$1,216 million, the combined reporting initiative was expected to increase corporate tax revenue by 25.7%. Finally, the Wisconsin Legislative Fiscal Bureau, the Iowa Department of Revenue and Finance, and the Maryland Department of Legislative Services have issued projections in recent years that range from 13.0% to 19.6% gains in corporate tax revenue from combined reporting. The gold standard for estimating the impact of a combined reporting requirement has been established by the Pennsylvania Department of Revenue, which reviewed the combined returns filed by Pennsylvania corporations in another state with a unitary reporting requirement.

¹⁹ LYNCH, ET AL, *supra* note 7.

²⁰ *Id.* at 14.

²¹ MAZEROV, *supra* note 14.

²² Author's calculations from Bureau of Economic Analysis, Gross Domestic Product by State (accessed February 9, 2009). GDP data are current through the close of 2007.