

**Testimony Supporting  
H.B. 6628's Proposed Enactment of Mandatory Combined Reporting**  
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Committee on Finance, Revenue, and Bonding  
March 28, 2011

Senator Daily, Representative Widlitz, and Members of the Finance, Revenue and Bonding Committee:

I am a member of the Legislative Advocacy Clinic at Yale Law School, 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 in support of enacting mandatory combined reporting.

I commend the General Assembly on its willingness to consider revenue-generating proposals, rather than closing Connecticut's deficit only through service cuts and state employee concessions. Consistent with the principle of "shared sacrifice," the enactment of mandatory combined reporting as presented in H.B. 6628 would be a fair way of seeking contributions from the business community, adding balance to the Governor's revenue proposals, which currently are disproportionately borne by individuals. Sharing the responsibility for the State's recovery is the fairest way for Connecticut to raise revenue, and a more effective way for the state to structure necessary fiscal policy reform. Enacting mandatory combined reporting also furthers the goal of creating a more equitable tax structure, by helping to close loopholes through which large multi-state companies can intentionally avoid taxation by Connecticut. This will help level the playing field so that Connecticut's small and local businesses can effectively compete. With this in mind, Connecticut Voices for Children offers its full support for the proposed enactment of mandatory combined reporting, as other states in our region, including our neighboring states of New York and Massachusetts - recently have done.

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<sup>1</sup>Sarah Kopman-Fried is a second-year student at Yale Law School. This testimony was prepared through the Law School's 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 Clinical Visiting Lecturer at Yale Law School, and Jamey Bell, Executive Director of Connecticut Voices for Children. A significant contribution to this testimony was made by Jeffrey Tebbs, a 2010 graduate of Yale Law School and former extern at Connecticut Voices for Children.

**In the midst of a major budget crisis, Connecticut can no longer afford to forfeit much-needed corporate tax revenue.** Our current system of single entity reporting leaves the state 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.”<sup>ii</sup> The sort of tax avoidance to which McLure is referring already exists in Connecticut, and it is costing the state tens of millions of dollars annually.<sup>ii</sup>

Under Connecticut’s current system of predominantly single entity reporting,<sup>iii</sup> multi-state corporations are able to artificially shift profits to subsidiaries operating in states that do not tax businesses.<sup>iv</sup> Tax experts believe the practice is costing states billions of dollars in lost revenue.<sup>v</sup> It has also given multi-state businesses an unfair advantage over smaller, locally owned businesses, which must pay state income tax on all of their Connecticut earnings and cannot engage in the elaborate tax avoidance schemes available to larger multi-state companies.

To combat this form of tax avoidance, twenty-three states (including Massachusetts and New York) have adopted a system of mandatory combined reporting, which has since been upheld by the Supreme Court.<sup>vi</sup> Mandatory combined reporting remedies this problem by treating parent corporations and certain subsidiaries and affiliates as a single corporation for tax purposes.<sup>vii</sup> With combined reporting, the profits and losses of every entity 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.<sup>viii</sup> Combined treatment of the parent corporation and its subsidiaries and affiliates therefore impedes the usage of these types of tax shelters, thereby counteracting the erosion of Connecticut’s corporate tax base.<sup>ix</sup>

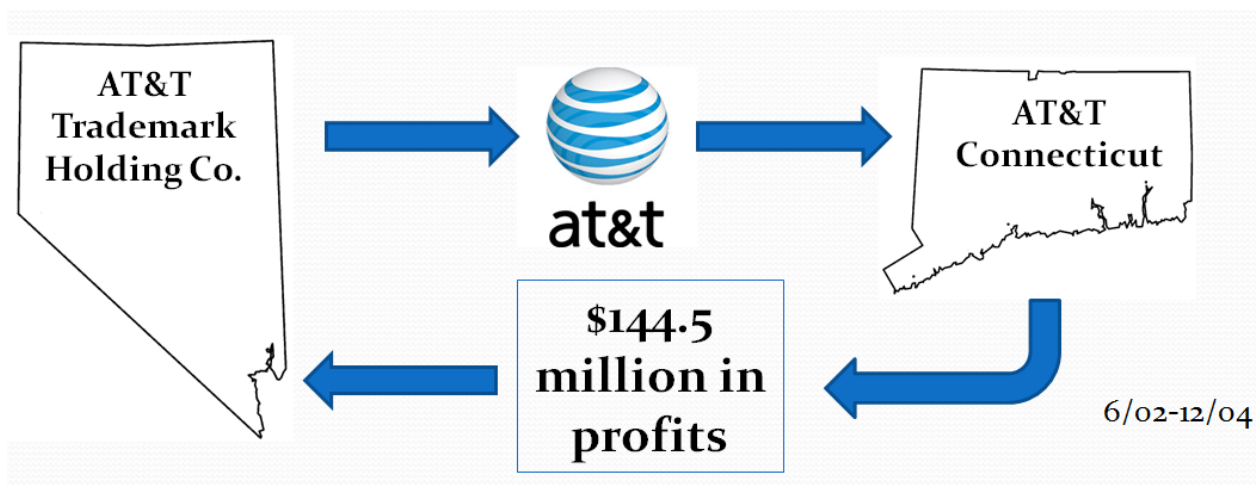
Two recent examples illustrate the manner in which single entity reporting permits significant tax avoidance by multi-state corporations.

**(a) The Trademark Holding Company Strategy.** Under a trademark holding company strategy, a multi-state corporation creates a subsidiary in a state that does not assess corporate taxes on holding companies, such as Nevada. The corporation then deposits the right to its trademarks in this subsidiary. An affiliated corporation in Connecticut issues royalty payments to the trademark holding company in exchange for the right to use the corporate enterprise’s logo and brand name. The Connecticut affiliate deducts the royalty payment from its net income as an expense, thereby eliminating any Connecticut tax on that income. Concurrently, the out-of-state trademark holding company is not subject to tax on the royalty payments transferred to it in the state in which it is incorporated. Under Connecticut’s single entity reporting system, Connecticut’s Department of Revenue Services is required to ignore the out-of-state trademark holding company, even though it shares a common owner with the Connecticut affiliate. To be clear, from an economic perspective,

these maneuvers are meaningless, as the revenue is merely being shifted from one subsidiary of a large corporation to another. Yet, through these sham transactions, from a tax standpoint, the income vanishes.

In 2009, Connecticut's Department of Public Utility Control conducted a routine audit of the financial statements of AT&T's Connecticut operations and discovered that AT&T was attempting to use this well-known tax avoidance strategy.<sup>x</sup> According to the audit produced by the Barrington-Wellesley Group, Inc., AT&T's Connecticut subsidiary made royalty payments of \$144.5 million to a Nevada trademark holding company for the use of the AT&T logo on the company's Connecticut buildings and on bills sent to Connecticut customers over a two-and-a-half year period (June 2002 to December 2004).<sup>xi</sup> Subsequent reporting revealed that AT&T's Connecticut subsidiary persists in this practice, shielding \$46.7 million in intercompany royalty payments that would otherwise have been taxed in Connecticut.<sup>xii</sup>

**Figure 1. Illustration of AT&T's Trademark Holding Company Strategy**



Since corporate tax returns currently are private, Connecticut residents rarely catch a glimpse of the complex legal maneuvering in which multi-state corporations engage to avoid Connecticut taxes. Although these glimpses are rare, the use of complicated tax avoidance strategies is not. According to the same audit report, the trademark holding strategy is exploited by numerous companies with household names including Limited Brands, Toys 'R' Us, ConAgra Foods, Home Depot, Kmart, Gap, Sherwin-Williams, Stanley Works, Staples, and Burger King.<sup>xiii</sup>

## **(b) The Captive Real Estate Investment Trusts (REITs) Strategy.**

Established in the 1960s by Congress, REITs are exempt from paying taxes on dividends paid to their investors. Chain retailers have taken advantage of this by setting up their own REITs (often called "captive REITs"), which own the land and buildings that house their stores. The chain then pays rent to the REIT and deducts the rent as a business expense from its state tax returns. The REIT's income is then paid back to the chain as a tax-free dividend.

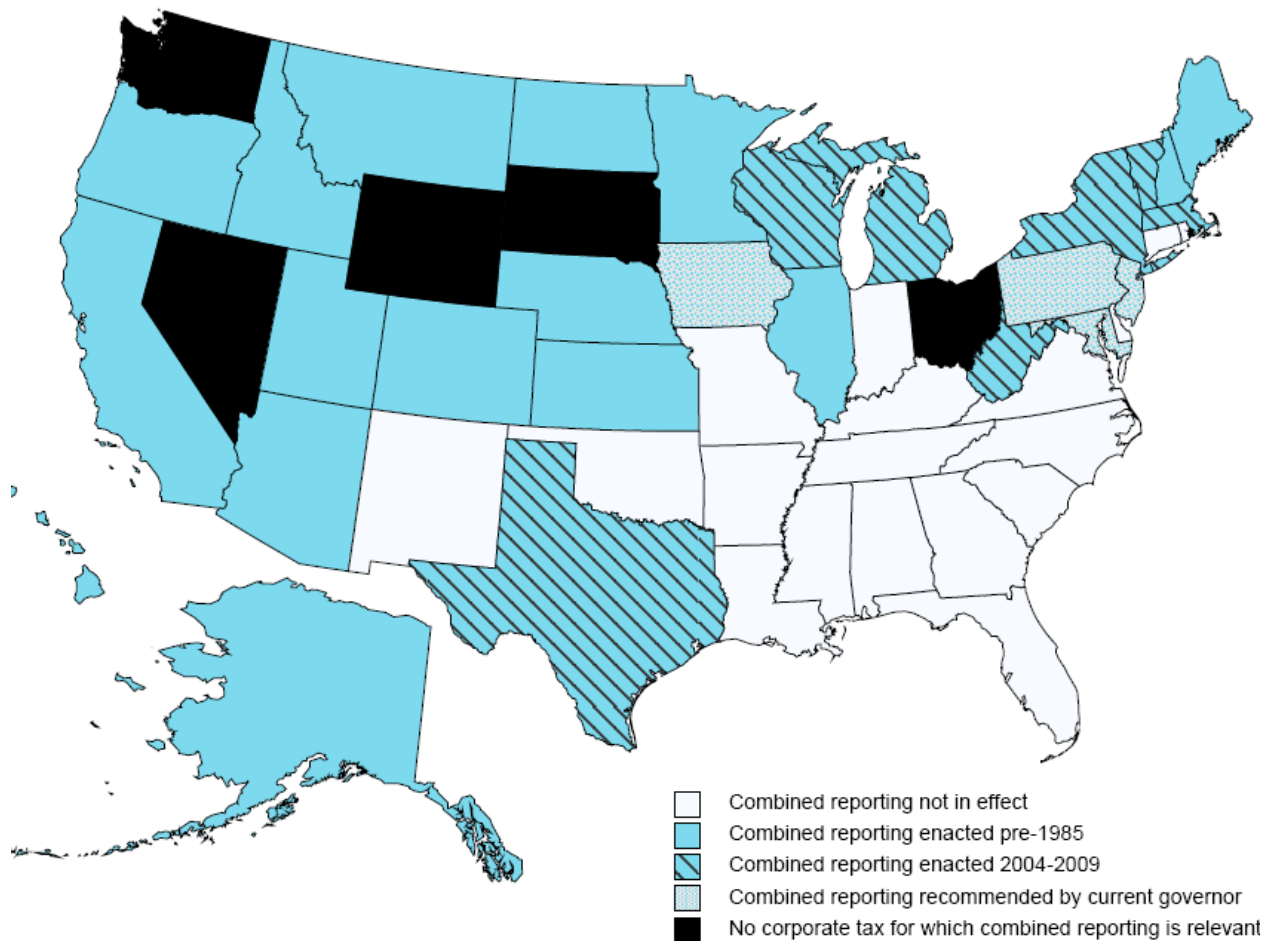
Former Department of Revenue Services Commissioner Richard Nicholson previously described the "captive REIT" strategy as "allow[ing] a company to pay rent to itself, take a deduction for the rental expenses and receive the rent back through a nontaxable dividend. The circular flow of funds allows a company to save significant corporation taxes . . . ."<sup>xiv</sup>

Wal-Mart's aggressive tax strategies over the past fifteen years provide a high-profile illustration of how the captive REIT strategy operates.<sup>xv</sup> 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 taxable income. 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.<sup>xvi</sup>

In addition to the two examples discussed above, multi-state corporations artificially shift profits across jurisdictions through a host of other tax planning mechanisms, including: 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]"; and selling account receivables at a substantial "loss" to subsidiaries in a tax haven.<sup>xvii</sup>

**Combined reporting is already the most commonly used standard by states with a corporate income tax.** Twenty-three states and the District of Columbia now require combined reporting for corporate tax returns.<sup>xviii</sup> Sixteen states have effectively administered combined reporting regimes for more than two decades, and seven additional states have adopted combined reporting in the past five years.<sup>xix</sup> Today, “peer” states in the Northeast including New York, Massachusetts, New Hampshire, Vermont, and Maine all require combined reporting,

**Figure 2. Status of Combined Reporting (April 2009).**



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

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 53 percent of the national economy.<sup>xx</sup> Many, if not most, multi-state corporations conducting business in Connecticut already prepare combined returns as a consequence of their operations in states that mandate combined reporting.

A study done last year by Connecticut Voices for Children determined that the vast majority of Connecticut's largest employers already file combined tax returns in one or more states where combined reporting is required.<sup>xxi</sup> This study is included as an appendix to this written testimony, but the key findings are important to highlight here:

- Connecticut has 37 for-profit companies with at least 1,000 employees. 32 of these companies (86%) already operate in other states with mandatory combined reporting. 27 of these companies operate in 5 or more combined reporting states.
- In 2007, 18 Connecticut companies had more than \$2.5 billion in worldwide sales. All 18 of these companies currently operate in at least one combined reporting state.

Notably, 30 of the 37 largest Connecticut employers and 17 of the 18 Connecticut companies with more than \$2.5 billion in annual sales have facilities in at least one state that enacted mandatory combined reporting *prior to* 1985.<sup>xxii</sup> This strongly suggests that the administrative costs and additional tax liability that may be associated with mandatory combined reporting are not so substantial as to persuade these firms to relocate their facilities. Leading Connecticut companies continue to willingly conduct operations in one or more of these mandatory combined reporting states, and have done so *for decades*.

**Connecticut forfeits up to 20 percent of its corporate income tax revenue because it doesn't mandate combined reporting.** The latest revenue estimates released by the General Assembly's Office of Fiscal Analysis on January 14, 2011 indicate that corporate taxes are estimated to generate \$660.5 million in revenue in the current fiscal year and \$649.4 million in revenue in FY 2012.<sup>xxiii</sup> 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 mandatory combined reporting increases net corporate tax revenue by an average of 16.6 percent.<sup>xxiv</sup> When Connecticut enacted and immediately repealed combined reporting in 2003,<sup>xxv</sup> the Office of Fiscal Analysis estimated that the legislation would generate \$40 million in additional revenue in FY 04<sup>xxvi</sup> or 7.7% of actual collections (\$518 million).<sup>xxvii</sup>

**Mandatory combined reporting does not impede economic growth or development.** A joint report by 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 mandatory combined reporting. Indeed, five of the seven fastest growing states from 1990 to 2005 required 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).<sup>xxviii</sup> 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.<sup>xxix</sup>

These findings even extend to trends in manufacturing employment. In theory, manufacturers have a greater ability to relocate than retail and service businesses. Yet, 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 required combined reporting throughout the period.<sup>xxx</sup>

**Mandatory Combined Reporting Works as a Complement to the Throwback Rule.** Although both of these strategies attempt to change how Connecticut allocates the taxable income of multi-state businesses to the jurisdictions in which they operate, **each addresses a separate problem in multi-state taxation.** A “throwback rule,” as presented in S.B. 1007, would improve tax equity by repatriating income back to Connecticut that otherwise could not be taxed by any jurisdiction (“nowhere income”). The tax advantage owed to this “nowhere income” disproportionately benefits large multi-state companies and therefore works to the detriment of small, local Connecticut businesses. “Mandatory combined reporting” on the other hand would close a tax avoidance loophole and address business practices adopted for the sole purpose of tax avoidance. Therefore, a major difference between “mandatory combined reporting” and a “throwback rule” is that the former relates to intentional rather than inadvertent leakage of taxable income from a state’s jurisdiction.

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

<sup>ii</sup> Estimates of the revenue that could be regained by enacting mandatory combined reporting range. In 2003, when Connecticut adopted (and then immediately repealed) mandatory combined reporting, the Office of Fiscal Analysis estimated that the legislation would generate \$40 million in additional revenue. The fiscal note for the 2003 combined reporting bill can be found through the Connecticut General Assembly’s “Advanced Legislative Document Search.” See <http://search.cga.state.ct.us/> (search for “combined reporting” under “Fiscal Notes.”).

<sup>iii</sup> 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

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separately and the total tax due under the combined return, up to a maximum of \$500,000. In income year 2006, 1,014 corporations elected to file combined returns (the preference tax in that year was \$250,000). 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 before credits 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, at 18-20.

<sup>iv</sup> 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>

<sup>v</sup> Because companies are not required to publicly disclose these transfers, it is not possible to determine exactly how much profit is being sheltered from state income tax. However, tax experts believe these schemes are costing states billions of dollars in lost revenue and likely account for a sizeable share of the decline in state corporate income tax receipts that has occurred in recent years. In 1977, corporate income taxes accounted for 9.7 percent of total state tax revenue. By 2001, their share had fallen to 5.7 percent and had dropped to an estimated five percent by 2004 (see [http://www.americantaxpolicyinstitute.org/pdf/StateCorpTax\\_8-15-05\\_2\\_.pdf](http://www.americantaxpolicyinstitute.org/pdf/StateCorpTax_8-15-05_2_.pdf)). In Connecticut, corporate income taxation accounts for about 4 percent of state revenue. Court cases filed by a few states have forced some chains to disclose evidence about the extent of their own tax avoidance. One case revealed that Toys "R" Us shifted \$55 million to a Delaware subsidiary, Geoffrey, Inc., in 1990 alone. Between 1992 and 1994, Limited Brands transferred more than \$1.2 billion from its stores to Delaware subsidiaries. Kmart shifted \$1.25 billion into its Michigan subsidiary, Kmart Properties, Inc., from 1991 to 1995.

<sup>vi</sup> MICHAEL MAZEROV, CTR. ON BUDGET & POL'Y PRIORITIES, A MAJORITY OF STATES HAVE NOW ADOPTED A KEY CORPORATE TAX REFORM – "COMBINED REPORTING" (2009), <http://www.cbpp.org/files/4-5-07sfp.pdf>.

<sup>vii</sup> 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>. Connecticut currently allows combined reporting at the election of corporate taxpayers that file a federal consolidated return.

<sup>viii</sup> 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.

<sup>ix</sup> *Id.*

<sup>x</sup> *See* Lynn Doan, *Corporations Dodge State Tax Payments*, HARTFORD COURANT, July 5, 2009, at A1; Lynn Doan, *AT&T Investigated for Avoiding Connecticut Taxes; Trademark Royalties*, HARTFORD COURANT, June 17, 2009, at A10; Luther Turmelle, *SBC Avoided Paying Taxes to State on \$144.5M: Sent Money to Nevada Affiliate for 2 1/2 Years, Audit Shows*, NEW HAVEN REGISTER, June 16, 2009.

<sup>xi</sup> Barrington-Wellesley Group, Inc., *An Audit of the Southern New England Telephone Company's Affiliate Transactions for the Department of Public Utility Control*, Mar. 1, 2007, at 78-79 *available at* [http://www.dpuc.state.ct.us/dpucinfo.nsf/3fcf2cde5ae350e98525742e004bf71e/aa6424b86eb823f885257297004be169/\\$FILE/Final%20Report%20to%20DPUC%203.2.07final.pdf](http://www.dpuc.state.ct.us/dpucinfo.nsf/3fcf2cde5ae350e98525742e004bf71e/aa6424b86eb823f885257297004be169/$FILE/Final%20Report%20to%20DPUC%203.2.07final.pdf).

<sup>xii</sup> *Id.*

<sup>xiii</sup> Barrington-Wellesley Group, Inc., *supra* not xi, at 78.

<sup>xiv</sup> Written Testimony of Richard D. Nicholson, Comm'r, Dep't of Revenue Servs., Hearing before the Committee on Finance, Revenue, and Bonding, Mar. 15, 2010, at 2.

<sup>xv</sup> 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.

<sup>xvi</sup> *Id.*

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<sup>xvii</sup> 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](http://www.massbudget.org/file_storage/documents/BuildingStrongEconomyJune07.pdf).

<sup>xviii</sup> MICHAEL MAZEROV, CTR. ON BUDGET & POL'Y PRIORITIES, A MAJORITY OF STATES HAVE NOW ADOPTED A KEY CORPORATE TAX REFORM – “COMBINED REPORTING” (2009), <http://www.cbpp.org/files/4-5-07sfp.pdf>.

<sup>xix</sup> *Id.* See also MICHAEL MAZEROV, CTR. ON BUDGET & POL'Y 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>

<sup>xx</sup> Author's calculations from Bureau of Economic Analysis, Gross Domestic Product by State, <http://www.bea.gov/regional/gsp/> (accessed Mar. 20, 2010). GDP data are for calendar year 2008.

<sup>xxi</sup> JEFFREY M. TEBBS ET AL., CONN. VOICES FOR CHILDREN, MOST OF CONNECTICUT'S TOP EMPLOYERS ARE ALREADY SUBJECT TO MANDATORY COMBINED REPORTING IN OTHER STATES (2010), *available at* <http://www.ctkidslink.org/publications/bud10combinedreporting.pdf>.

<sup>xxii</sup> The sixteen states adopting mandatory combined reporting prior to 1985 are Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, and Utah. The seven states adopting mandatory combined reporting in more recent years are Massachusetts, Michigan, New York, Texas, Vermont, West Virginia, and Wisconsin.

<sup>xxiii</sup> OFFICE OF FISCAL ANALYSIS, FY 11 –FY 14 CONSENSUS REVENUE ESTIMATES, (January 15, 2011) [http://www.cga.ct.gov/ofa/Documents/year/CR/2011CR-20110115\\_January%2015,%202011%20Consensus%20Revenue%20Estimates%20FY%202011%20-%20FY%202014.pdf](http://www.cga.ct.gov/ofa/Documents/year/CR/2011CR-20110115_January%2015,%202011%20Consensus%20Revenue%20Estimates%20FY%202011%20-%20FY%202014.pdf)

<sup>xxiv</sup> 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 \$4.08 billion. 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.<sup>xxiv</sup> 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.

<sup>xxv</sup> In 2003, Connecticut actually adopted mandatory combined reporting, Pub. Act No. 03-1, §§ 90-91, but the success was short-lived. Combined reporting was repealed shortly thereafter by the budget implementation bill. Pub. Act No. 03-6, §§ 78-81, 244.

<sup>xxvi</sup> See *supra* note ii.

<sup>xxvii</sup> OFFICE OF FISCAL ANALYSIS, REVENUE AND BUDGET DATA 52 (2009).

<sup>xxviii</sup> LYNCH, ET AL., *supra* note xv. Here, growth refers to growth in state GDP.

<sup>xxix</sup> *Id.* at 14.

<sup>xxx</sup> MICHAEL MAZEROV, CTR. ON BUDGET & POL'Y 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>.