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SETTING THE RECORD STRAIGHT ON COMBINED REPORTING

"A state that does not require related corporations conducting a unitary business to file a combined report is at the mercy of its corporate taxpayers."[1]

– Richard Pomp, Loiselle Professor of Law, University of Connecticut

[the failure to use combined reporting is] "an open invitation to tax avoidance"[2]

– Charles McLure, Senior Fellow, Hoover Institution;
Deputy Assistant Secretary of the Treasury during the Reagan Administration

[combined reporting] "has been a success in every state that has adopted it."[3]

– Michael McIntyre, Professor of Law, Wayne State University

On March 29, 2004, the Associated Industries of Massachusetts (AIM) distributed to the General Court a document that attempts to rebut the March 2003 MBPC report *Combined Reporting: A Comprehensive Means of Closing Corporate Tax Loopholes*. AIM's document makes a set of unsupported claims concerning Massachusetts' corporate income tax, corporate tax avoidance, and the effect that combined reporting would have on each. The following reviews the claims put forward in the AIM document, providing additional information about the research that the MBPC and others have conducted in order to set the record straight on combined reporting.

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[1] Pomp, Richard D., "The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer," in David Brunori, *The Future of State Taxation* (Washington: Urban Institute Press, 1998), p. 62.
[2] McLure, Charles E., Jr., "The Nuttiness of State and Local Taxes – and the Nuttiness of Responses Thereto," *State Tax Notes*, September 16, 2002, p. 851.
[3] McIntyre, Michael J., "Thoughts on the Future of the State Corporate Income Tax," 25 *State Tax Notes* 931-947 (September 23, 2002).

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From AIM's March 29th document:

MBPC ASSERTION: "*Declining corporate tax revenue, due in no small part to the widespread use of tax avoidance schemes devised by corporate accountants and lawyers has contributed … (to the deterioration of the state's tax base).*"

FACT: Tax avoidance schemes did not cause the deterioration in our tax base. The drop in revenues in 2002 was due to the acknowledged and painful downturn in the national economy that hit local industries particularly hard, and nothing else. It goes without saying that tax revenues go down when employers have less income to be taxed in bad economic times. To assert that "tax avoidance" is the cause is not only misleading, it is insulting to the tens of thousands of Massachusetts businesses who are good corporate citizens and contribute to the community in countless ways in addition to paying their fair share of taxes each and every year.

MBPC ASSERTION *"The corporate income tax provided just four percent of total state tax revenue in 2002."*

FACT: The MBPC chose cleverly to make this statement. It uses the year in which the Commonwealth saw the most precipitous drop in corporate excise revenues in 40 years as the benchmark of corporate tax collections, ensuring the comparison would be skewed. Not only is the statement misleading, it fails to reflect the total tax burden borne by employers, as corporate excise payments represent only 10 percent of the total taxes businesses pay. Employers pay nearly 40 percent of state and local revenues in Massachusetts.

Setting the record straight:

As Figure 1 – adapted from the MBPC's January 2003 *Gone With the Wind* report – shows, the decline in Massachusetts corporate income tax is a long-term trend. In FY 1968, the corporate income tax comprised 16.3 percent of all taxes collected by the Commonwealth. That same year, the corporate income tax amounted to 0.74 percent of personal income, a measure that AIM and other organizations have used as a proxy for corporate profits.[4] By FY 2003, the corporate income tax had fallen precipitously by both measures; in FY03, it constituted 5.3 percent of all taxes and equaled 0.32 percent of personal income. Consequently, while it is true that FY 2002 represented a roughly thirty-year nadir for the corporate income tax, it is equally true that FY 2002 simply reflects a much a larger trend. Moreover, part of the reason Figure 1 shows an up tick for FY03 is that Governor Romney and the Legislature decided to take steps to halt this downward trend. Senate No. 1949, signed into law on March 5, 2003, closed a number of fairly egregious tax loopholes, including those relating to passive investment companies and to real estate investment trusts and generated over $140 million in additional revenue in FY03.

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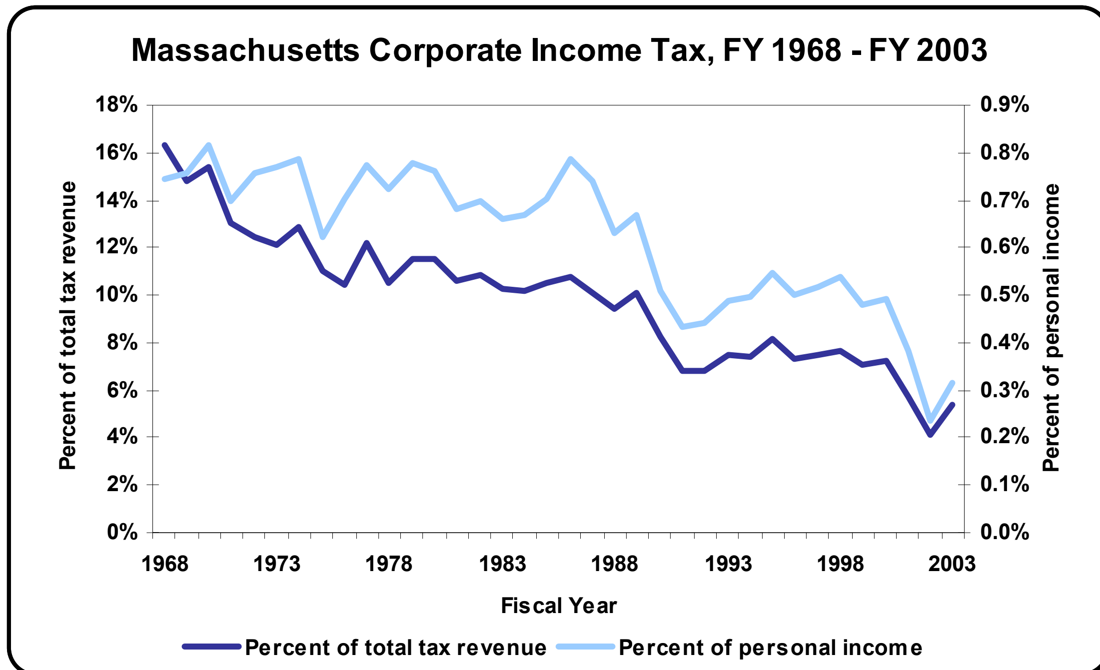
[4] *Fragile Progress: Reining in Massachusetts' High Business Costs*, Massachusetts Taxpayers Foundation, February 2003, p. 27.

Figure 1.



While some of the decline seen in Figure 1 may, in recent years, be attributable to the sluggish economy, heightened corporate tax avoidance has unequivocally contributed as well. In a report released last July, the Multistate Tax Commission, a non-partisan, joint agency of state governments dedicated to improving the fairness, efficiency and effectiveness of state tax systems, found that:

> State corporate income taxes as a proportion of corporate profits declined by 34 percent – from approximately 9.0 percent during the period from 1980 to 1989 to 5.9 percent in 2001. This reduction in the effective tax rate on corporate income can be attributed in part to tax sheltering and in part to state tax policy changes . . .
>
> The lost revenue attributable to domestic and international income tax sheltering is adding to the size of state budget deficits while undermining the equity and integrity of state tax systems. It is not enough to say that state corporate tax revenues are declining just because of federal tax law changes or state tax-cutting during the 1990's. It is apparent that various corporations are increasingly taking advantage of structural weaknesses and loopholes in the state corporate tax systems.

Indeed, Governor Romney himself acknowledges both the problems that tax avoidance strategies pose for the Commonwealth and the need to address them. When the Governor filed House No. 4485, "An Act to Clarify Certain Tax Provisions and Improve Various Activities of the Department of Revenue," he transmitted a letter to the members of the House of Representatives and the Senate summarizing the provisions of the bill and making the case for their adoption. One passage of that letter is especially noteworthy. It reads: "flaws in the tax code cost the Commonwealth millions of dollars a year in lost revenue by permitting corporations to shelter certain activities that were intended to be subject to taxation. Given the fiscal challenges confronting the Commonwealth, these costly weaknesses in the tax code warrant swift correction."[5]

Finally, the MBPC has in fact examined, in a separate report, arguments that the total tax burden borne by employers is the more important statistic to consider in evaluating Massachusetts tax policy. In *Massachusetts' Business Taxes: "High and Rising" or Comparatively Low and Falling?*, the MBPC used data from a study conducted by the accounting firm Ernst & Young for the AIM Foundation and determined that:

- since businesses' capacity to pay their taxes has grown substantially in the last decade – as reflected in the growth of personal income in Massachusetts – the burden that those taxes pose has fallen over the last ten years. Specifically, taxes paid by businesses in Massachusetts – which includes the corporate income tax, as well as businesses' share of property, sales, and other taxes – have dropped from 4.5 percent of personal income in FY92 to 4.1 percent in FY02.

- when compared to the total taxes paid by businesses across the country, taxes paid by businesses in Massachusetts are lower than the national average.

Another Ernst & Young study – prepared in January 2004 for the Council on State Taxation (COST), a Washington, DC-based trade association that represents 550 multistate and multinational corporations – confirms Massachusetts' fairly low standing, in terms of total tax burden, relative to other states.[6] While that study suffers from methodological flaws that tend to overstate business tax burdens, it nevertheless finds that the total business tax burden in Massachusetts in FY 2003 ranked:

- 42nd in the country when measured as a share of all taxes;
- 27th when measured per employee;
- 46th when measured as a share of private sector business activity; and
- 38th when measured as a share of capital income.

[5] Letter to the Honorable Senate and House of Representatives, January 28, 2004

[6] Cline, Robert; Fox, William; Neubig, Tom; and Phillips, Andrew, *Total State and Local Business Taxes: A 50-State Study of the Taxes Paid by Business in FY2003*, Ernst & Young, January 2004.

From AIM's March 29th document:

MBPC ASSERTION: *"Because combined reporting would put an end to a variety of tax avoidance schemes, it would generate additional tax revenue and help to forestall cuts to vital public services."*

FACT: This MBPC statement is perhaps the most disingenuous assertion of all! It represents a hope of the proponents masquerading as fact. In truth, combined reporting could reduce rather than increase revenue for the state because corporate taxpayers using unitary reporting (the underlying tax concept for "combined reporting") can import losses they have elsewhere on to their Massachusetts tax return, reducing tax liability here. The Commissioner of Revenue has stated publicly on numerous occasions that the revenue impact of this proposal is difficult to ascertain. Promises of increased revenues are sketchy at best. Combined reporting will not provide a new revenue stream in the short term if at all and will not forestall cuts to public programs.

FACT: Combined reporting does not provide a reliable revenue stream and cannot be sold to the Legislature as a funding source for social programs. As the dramatic cyclical nature of capital gains tax revenue proved to our horror in 2001, the experience with combined reporting could follow suit. Combined reporting would make the revenue stream from corporate excise tax reflect the ups and downs of the business cycle, as all of the losses of a corporation and its affiliates would be factored in to determining the Massachusetts excise owed. If the volatility and loss of capital gains revenue was bad, corporate excise tax under combined reporting could be worse.

FACT: Money realized from combined reporting, if any, is often collected years after the initial assessment, after prolonged administrative and legal proceedings, because the determination of what constitutes a unitary business is highly subjective.

Setting the record straight:

In its March 2003 report on combined reporting, the MBPC reviewed analyses that governmental entities in three separate states – Wisconsin, Iowa, and Maryland – had conducted concerning combined reporting and the fiscal impact it would have if adopted in those states.[7] Since that time, governmental entities in two other states – Florida and Vermont – have produced similar analyses.[8] **Each of these analyses finds that, once fully implemented, combined reporting would have a significant and positive effect on revenue collections.** Figure 2 below summarizes the findings of those analyses.

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[7] "Corporate Income and Franchise Tax – Combined Reporting," Wisconsin Legislative Fiscal Bureau, Joint Committee on Finance, Paper #112, June 7, 1999.

Issue Brief – Combined Reporting, Iowa Department of Revenue and Finance, January 2003.

SB 398 - Fiscal and Policy Note, Department of Legislative Services, Maryland General Assembly, 2003 Session.

[8] *Why Did Florida's Corporate Income Tax Revenue Fall While Corporate Profits Rose?*, Florida Senate, Committee on Finance and Taxation, Report Number 2004-137, November 2003.

Analysis of the Governor's General Fund Tax Equity Proposals, Vermont Joint Fiscal Office, January 23, 2004.

Figure 2.[9]

	Projected Dollar Increase in Corporate Income Tax Revenue Due to Combined Reporting (in millions)	Projected Percent Increase in Corporate Income Tax Revenue Due to Combined Reporting
Wisconsin	70	13.0%
Iowa	25	13.5%
Vermont	5	14.2%
Maryland	85	19.6%
Florida	238	24.8%

From AIM's March 29th document:

ASSERTION: *"Combined reporting has been a success in every state that has adopted it."*

FACT: Florida, one of our major competitors, enacted combined reporting 20 years ago and repealed it because of the adverse impact it had on the state's business climate.

FACT: Connecticut adopted combined reporting last year and repealed it a week later because of the damage it was doing to the state's economic position.

FACT: Iowa was seriously considering combined reporting in FY 2004 until they did a revenue estimate and determined they would lose $30 million.

FACT: Only 16 out of fifty states have combined reporting — Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon and Utah — few of these are considered industrial or high tech states and competitors of ours. However if you like California's situation, combined reporting works — it is one of the ways California got into its multi-billion dollar fiscal problem.

Setting the record straight:

It is true that Florida adopted combined reporting in 1983, only to repeal it in 1984. However, the measure was repealed not because of its allegedly "adverse impact on the state's business climate," but in response to pressure that the federal government, at the time, was exerting on states to abandon "worldwide" combined reporting. Proposals to institute combined reporting currently before the General Court would use a different version of the policy, known as "water's edge" reporting.

[9] The data for Iowa in Figure 2 reflect estimates included in Governor Tom Vilsack's FY 2005 budget proposal, rather than the original estimates contained in the Issue Brief prepared by the Iowa Department of Revenue and Finance in January 2003.

Furthermore, the notion that Iowa will lose $30 million by adopting combined reporting will likely come as a surprise to the Iowa Department of Management, since it recently estimated that a proposal to mandate combined reporting, included in Governor Tom Vilsack's FY 2005 budget proposal, will generate $25 million in FY05.[10]

Lastly, with regard to the states that do utilize combined reporting, employment data from the past fifteen years suggest that it has hardly posed an impediment to economic growth. Between the peaks of the last two economic cycles – that is, from July 1990 to March 2001 – total payroll employment in states that mandate combined reporting grew, on average, by 28.5 percent; the comparable figure for the remaining 34 states was noticeably lower – 21.3 percent. Conversely, since the start of the national recession in March 2001 until December of last year, total payroll employment fell by just 0.3 percent, on average, in the combined reporting states, while the average decline for states without combined reporting is 1.3 percent. It is also worth noting that California has used combined reporting since 1937; in that time, the California economy has become larger than that in all but five of the world's nations. Obviously, this is not meant to imply that the presence of combined reporting stimulates employment growth. It is simply meant to show that state corporate income taxes have little effect one way or the other on economic development

AIM's Ultimate Claim: Closing Corporate Tax Loopholes is Bad for Business

The final section of AIM's March 29th document makes a variety of claims concerning the effects that combined reporting would have on the Massachusetts economy. Expressed succinctly, the AIM document argues that combined reporting will, one, lead to higher business costs and thus impair efforts to stimulate the economy and, two, create the perception that Massachusetts is inhospitable to business.

Taking these arguments in turn, business costs do matter, as the AIM document points out. However, state corporate income taxes comprise an exceptionally small fraction of such costs. A recent study by Robert G. Lynch, the Chairman of the Department of Economics at Washington College, finds that "after federal deductibility, ***all*** state and local taxes paid by businesses … accounted for only 0.8 percent of their costs."[emphasis added].[11] State corporate income taxes, in turn, constitute only a small share of all state and local taxes paid by businesses, as AIM, Ernst & Young, and COST have observed. Moreover, as Lynch notes:

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[10] *Iowa Budget Report, Fiscal Year 2005*, prepared for Governor Tom Vilsack and Lieutenant Governor Sally Pederson by the Department of Management, January 2004.
[11] Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*, Economic Policy Institute, March 2004, p. 4.

> differences in tax burdens across states are so modest that they are unlikely to outweigh the differences across states in the other costs of conducting business. These other 'costs of conducting business' are the most important factors affecting business investment decisions and include the cost and quality of labor, the proximity to markets for output (particularly for service industries), the access to raw materials and supplies that firms need, the access to quality transportation networks and infrastructure (e.g., roads, highways, airports, railroad systems, and sewer system.), quality-of-life factors (e.g., good schools, quality institutes of higher education, health services, recreational facilities, low crime, affordable housing, and good weather), and utility costs.[12]

In short, the availability of quality public services is an important determinant of business investment decisions. Therefore, adopting combined reporting to ensure that the corporate income tax helps to provide the revenue necessary to finance these public services would not result in a material deterioration of companies' bottom lines over the long run.

Turning to the second argument, while business costs and other objective, measurable criteria do matter in attracting and retaining businesses, perceptions should not. Again, as Robert Lynch argues:

> … it is unlikely that business decision makers are apt to be persuaded by 'perceptions' rather than by the facts of business costs and benefits. In any case, firms that are driven appreciably by perception and less attuned to the facts about costs and benefits are likely to be unsuccessful and few in number, as they tend to get driven out of business by their more savvy competitors. Attempts to attract such businesses by giving them tax breaks is probably not a wise investment on the part of state and local governments.[13]

In any event, at least one of the leading business-oriented organizations in the country perceives the tax climate in Massachusetts to be relatively favorable. As noted previously, on behalf of the Council on State Taxation, Ernst & Young produced a study in January 2004 that attempted to assess the business tax burden in each of the fifty states; by three of the four measures used in that study, Massachusetts' business taxes ranked in the lowest third of states. While that study suffers from methodological flaws that tend to overstate the business tax burden, it nonetheless can be taken as a sign of how some in the business community view Massachusetts.

[12] Lynch, p. 6
[13] Lynch, p. 11