MASSACHUSETTS BUDGET AND POLICY CENTER

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COMBINED REPORTING:
A COMPREHENSIVE METHOD OF CLOSING CORPORATE TAX LOOPHOLES

Massachusetts is facing a budget shortfall that has been estimated at $3 billion for FY 2004, the direct result of the deterioration of the state's tax base during the last decade. While much of that deterioration can be attributed to personal income tax reductions adopted during the 1990s, 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 as well. The corporate income tax provided just four percent of total state tax revenue in 2002 – one half of the share it comprised in 1990, about one third of the share it produced in 1980, and a little more than one quarter of the share it constituted in 1970.

In recent weeks, both Governor Romney and the Legislature have effectively acknowledged that corporate tax avoidance has exacerbated the state's fiscal problems. The deficit reduction bill proposed by the Governor in late January and then approved – in slightly different form – by the Legislature at the end of February closes several loopholes in the state's corporate income tax and impairs businesses' ability to shift profits out of Massachusetts in order to avoid their fair share of the state tax burden. This paper examines a more comprehensive approach to closing corporate tax loopholes – namely, combined reporting. It describes what combined reporting is, explains the impact it would have in Massachusetts, and discusses the success other states have enjoyed in using combined reporting.

What Is Combined Reporting?

To understand what combined reporting is, it is first necessary to understand how the Massachusetts corporate income tax – or corporate excise, as it is formally known – currently functions. In its simplest form, the process by which corporations operating in Massachusetts determine their corporate income tax liability consists of three steps:

1. First, they determine the amount of profits subject to apportionment, generally following federal definitions for taxable income but also making modifications specified under Massachusetts law.

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2. They then apply the Massachusetts apportionment formula to determine Massachusetts taxable income.

   - Corporations that operate in multiple states do not pay taxes on all of their profits in each state; if they did, they would be taxed multiple times on the same profits.

   - Instead, states have reached an agreement that a given corporation's profits should be distributed – or apportioned – among the states in which it operates based on readily measurable factors. That agreement is premised on the notion that states that provide services to a corporation's property and workers, as well as states that provide a market for the corporation's output, should be able to tax a portion of the corporation's profits. It is also based on the recognition that, in taxing corporations that operate in more than one state, it would be all but impossible to determine *which* activities in *which* state lead to *which* profits. Thus, states use a formula to apportion, in an objective fashion, the profits multi-state corporations earn.

   - The apportionment formula that states have traditionally used relies on three factors to decide taxable income: the share of a corporation's total property that is situated in a state, the share of a corporation's total payroll that is located in a state, and the share of a corporation's total sales that are made in a state. In fact, every state uses an apportionment formula that takes at least one of these factors into account

   - In Massachusetts, manufacturers and mutual fund companies use an apportionment formula that is based solely on their sales in the Commonwealth, while other companies use an apportionment formula that gives disproportionate weight to sales, but still incorporates the property and payroll factors.

3. Finally, corporations multiply their Massachusetts taxable income by the corporate income tax rate of 9.5 percent and, of course, subtract any applicable tax credits to calculate their tax liability.[1]

[1]Obviously, this explanation ignores many of the details that affect the taxes that corporations pay in Massachusetts. For instance, corporations must also pay a non-income excise, equal to $2.60 per $1,000 of either tangible property or net worth. What's more, financial institutions, insurers, and public utilities are not subject to the corporate excise; they are subject to different forms of taxation. Finally, only C corporations are subject to the 9.5 percent rate; S corporations pay a different rate. For more information on how the corporate excise is calculated, refer to either the Executive Office for Administration and Finance's annual Tax Expenditure Budget or the Department of Revenue's reports on corporate excise returns. All are available at http://www.dor.state.ma.us/stats/stats.htm.

Combined reporting would modify the first two of these three steps, so that the taxes corporations ultimately pay would more accurately reflect both the total profits they earn and the location of the factors they use to generate those profits. More specifically, combined reporting would require corporations, when filing their tax returns, to list all of the profits they have earned – including the profits earned by any subsidiary with which they are engaged in a unitary business – and to calculate their profits subject to apportionment based on that total.[2] In addition, combined reporting would require corporations and the subsidiaries with which they are engaged in a unitary business to combine their apportionment factors – i.e. the shares of payroll, property, and sales that they have in Massachusetts – to determine their tax liability here. These modifications, in turn, would ensure that corporate accountants' decisions about allocating income to various subsidiaries can not be used as a tool to avoid paying the appropriate level of taxes.

The adoption of combined reporting would, naturally, represent a change in tax policy for Massachusetts, but it would not change the weighting of the state's apportionment formula, nor would it alter the corporate income tax rate. Rather, it would eliminate an entire set of corporate tax loopholes by requiring corporations to report their profits more accurately. In short, the aim of combined reporting is to ensure that form – specifically, the form in which corporations choose to organize themselves, which, in turn, is often manipulated to reduce their tax liabilities – does not triumph over substance – namely, the true level of economic activity in which corporations operating in Massachusetts are engaged.

What Impact Would Combined Reporting Have in Massachusetts?

Simply put, the adoption of combined reporting in Massachusetts would make it more difficult for corporations to shift profits out of the Commonwealth and to reduce their tax liability inappropriately. Indeed, Charles McLure, a Senior Fellow at the Hoover Institution and a leading Treasury Department official in the Reagan Administration, has called the failure to use combined reporting "an open invitation to tax avoidance."[3]

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[2] The definition of a unitary business varies among the states that employ combined reporting; however, three of the country's leading scholars in this area recommend defining it as "a common enterprise undertaken by one or more commonly controlled entities in pursuit of business profits," with, among other characteristics, "the participants in the enterprise [contributing] in a nontrivial way to each other's profitability" or "its activities managed by some central authority of the enterprise." For more information, see Michael J. McIntyre, Paull Mines, and Richard D. Pomp, "Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana," 61 *Louisiana Law Review* 699 (2001).

[3] 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.

Similarly, Richard Pomp, the Loiselle Professor of Law at the University of Connecticut and a nationally respected expert on state tax systems, has remarked, "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."[4]

Policymakers in Massachusetts have recently made an effort to combat corporate tax avoidance. In late January, Governor Romney proposed legislation that, among other things, would deny corporations a tax deduction for any royalty payments they may make to related subsidiaries and would thus stop them from using one of the more egregious tax avoidance schemes currently available to them – namely, passive investment corporations. The same legislation would strengthen an existing law designed to prevent the manipulation of transfer prices – that is, the prices of transactions among a corporation and its subsidiaries – in order to reduce the corporation's taxable income. At the end of February, both the House of Representatives and the Senate approved S. 1949, a modified version of this legislation; the Governor signed S. 1949 into law in early March.

While these changes start to close corporate tax loopholes, they nonetheless represent specific responses to a general threat. Passive investment corporations and transfer pricing schemes are just two of several techniques that corporations can employ to shift profits out of Massachusetts and into states where they are either not taxed at all or taxed at a significantly reduced rate. For instance, the bill offered by the Governor and enacted by the Legislature would not stop corporations from avoiding taxes by structuring their operations to maximize the extent to which activities that generate profits within Massachusetts appear to occur outside the Commonwealth.

Combined reporting would provide a general response to this general threat. It would deny corporations any advantage from shifting profits around by accounting for all of the profits realized by corporations doing business in Massachusetts as well as by their subsidiaries. Moreover, combined reporting would address problems such as passive investment corporations and transfer pricing schemes even more effectively than the legislation recently signed by the Governor, since it would not require the constant policing of transactions among corporations and their subsidiaries.

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. Official estimates of the impact that combined reporting would have on corporate income tax revenue in Massachusetts are not yet available, but studies from several other states

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[4] 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.

suggest that it could be substantial. A 1999 study conducted by the Wisconsin Legislative Fiscal Bureau estimated that combined reporting would yield $70 million in additional corporate tax revenue for Wisconsin in FY 2001, an amount that equates to 13 percent of Wisconsin corporate tax revenue that year.[5] An issue brief released earlier this year by the Iowa Department of Revenue and Finance projected that combined reporting would produce $40 million per year in additional corporate income taxes once fully implemented; this amount represents 16.6 percent of anticipated corporate income tax revenue in Iowa for FY 2004.[6] Lastly, the Maryland Department of Legislative Services recently indicated that combined reporting would yield anywhere from $20 million to $150 million annually, with a mid-point estimate of $85 million once it is in effect for a full fiscal year. As Maryland is expected to collect about $434 million in corporate income taxes in FY 2004, this would suggest a nearly 20 percent jump in corporate tax revenue.[7]

Figure 1.

		Potential Revenue Impact in Massachusetts (in millions of dollars)	
	Projected Percent Increase in Corporate Income Tax Revenue Due to Combined Reporting	Base = FY2002	Base = FY1993-FY2002 Average
Wisconsin	13.0%	76.5	130.3
Iowa	16.6%	97.3	165.8
Maryland	19.6%	114.9	195.8

Corporate tax revenue in Massachusetts was $587 million in FY 2002 and averaged $1 billion per year (in inflation-adjusted dollars) for the FY 1993 through FY 2002 period. Therefore, as Figure 1 shows, if combined reporting produced a percentage change in corporate tax revenue within the range estimated by these three states, its adoption in Massachusetts would mean an additional $76.5 million to $195.8 million in corporate tax revenue each year.

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

[6] *Issue Brief – Combined Reporting*, Iowa Department of Revenue and Finance, January 2003. The *Iowa Financial Summary – FY 2004,* produced by the Office of the Governor, projects that corporate income tax revenue in Iowa will total $241.2 million in FY 2004.

[7] *SB 398 - Fiscal and Policy Note*, Department of Legislative Services, Maryland General Assembly, 2003 Session. March 11, 2003 data from the Maryland Board of Revenue Estimates indicates that corporate income tax revenue for Maryland's General Fund will be $330.1 million in FY 2004. As only 76 percent of corporate income tax revenue is dedicated to the General Fund, the full amount of corporate income tax collections is $434.2 million.

Several factors should be considered in evaluating these estimates and the likelihood that combined reporting in Massachusetts would produce an effect within the range proscribed above. First, corporate tax receipts in Massachusetts reached a more than thirty-year low in FY 2002. While this is due, in part, to greater corporate tax avoidance and the passage of eight major corporate tax cuts during the 1990s, it is also the result of the ongoing national recession. Consequently, once the economy recovers, it is likely that corporate tax receipts will grow and the impact of combined reporting will expand along with them. Second, the Iowa Department of Revenue and Finance estimates noted above are simply the aggregate effect of combined reporting on just 50 large corporations in that state. It is likely that, if the Department's analysis were extended to all corporations subject to the corporate income tax in Iowa, the projected percent increase would be larger. As a result, the corresponding impact in Massachusetts would be larger as well. Lastly, as noted earlier, at the beginning of March, the Governor approved a bill – S. 1949 – that attempts to close a number of corporate tax loopholes. If that bill is successful in permanently curbing the use of passive investment corporations (or PIC's, as they are also called), it will necessarily reduce the amount of revenue that combined reporting would otherwise generate. However, if the effect of the bill is only temporary – that is, if corporations ultimately devise other income-shifting alternatives to PIC's – then the bill will have little impact on the above estimates.

What Has Been the Experience in Other States?

Sixteen states currently require corporations to use combined reporting, as Figure 2 indicates. The first state to adopt it was California, which began employing it administratively in 1937. The California Supreme Court upheld the practice in 1947, while the U.S. Supreme Court has twice affirmed its legality, most recently in 1994.

Figure 2.

States Requiring the Use of Combined Reporting

Alaska	Maine
Arizona	Minnesota
California	Montana
Colorado	Nebraska
Hawaii	New Hampshire
Idaho	North Dakota
Illinois	Oregon
Kansas	Utah

In the words of Michael McIntyre, a professor of law at Wayne State University, combined reporting "has been a success in every state that has adopted it."[8] Recent evidence certainly bears out McIntyre's conclusion, as states that mandate combined reporting are "disproportionately among the most economically successful" in recent years. Of the states with combined reporting, four were among the top five states in terms of manufacturing job growth over the 1995-2000 period; eight placed in the top ten in terms of manufacturing job growth.[9]

The experience with combined reporting to date has been sufficiently attractive – and the scope of corporate tax avoidance has grown so greatly – that one Governor – Tom Vilsack of Iowa – has gone so far as to include a proposal to adopt combined reporting in his FY 2004 budget. As one advocate of closing corporate tax loopholes, Governor Bob Holden of Missouri, has pointed out, "When working families and most . . . businesses who pay their taxes see the breaks and perks and tax shelters that have been carved out for a few, their confidence in the fairness of government is eroded."[10]

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[8] McIntyre, Michael J., "Thoughts on the Future of the State Corporate Income Tax," 25 *State Tax Notes* 931-947 (September 23, 2002).

[9] Mazerov, Michael. "Two Key State Corporate Income Tax Reforms: Mandating 'Combined Reporting' and Bolstering State Corporate Minimum Taxes," Presentation to the 10th Annual Funding State Services Conference, December 8, 2002.

[10] *Holden Holds Fair Share Budget Summit, Seeks Support for Education*, Press Release – Office of the Governor, November 26, 2002.