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Tell It Like It Is: Combined Reporting Improves DC's Tax System By Making Corporations Disclose Their Profits and Pay Their Fair Share

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Mayor Fenty and the DC Council recently approved an important reform to the District's corporate income tax which will prevent large corporations from avoiding taxes. The law, known as "combined reporting," is recognized by economists and tax experts as the most comprehensive way for states to stop corporations from abusing tax shelters. A majority of states with corporate income taxes already practice combined reporting; many have had this provision in place for more than 20 years. DC's Chief Financial Officer has concluded the law, which will go into effect in January 2011, will raise roughly $20 million in revenue annually.

Not surprisingly, combined reporting often faces business opposition. This likely reflects its effectiveness at closing corporate tax loopholes. Since the District's adoption of combined reporting this summer, the DC law has been attacked by organizations such as the DC Chamber of Commerce and the Council on State Taxation, a trade association of multistate corporations, as well as by individual corporations such as Verizon, Pfizer, and Home Depot.

Combined reporting is important because it promotes tax fairness for the city's small businesses, which are far less likely than large, nationwide businesses to use tax shelters and other tax avoidance schemes. The new law should be defended for several reasons:

- **Combined reporting levels the tax-paying field between national and local companies.** Without combined reporting, large national and multinationals have a tax advantage by shifting profits earned in DC to states with lower taxes—or no taxes at all. While small businesses and local companies that operate only in DC have to pay their fair share of taxes, larger corporations often don't.

- **Combined reporting will not hurt the District's business climate.** Of the 45 states with a corporate income tax, 23 already have adopted combined reporting. Sixteen have operated with combined reporting for more than 20 years, including California and Illinois. Studies suggest that combined reporting has not affected their economic competitiveness.

- **Combined reporting builds on previous DC efforts to close corporate tax shelters.** Elected officials took steps in 2004 and 2009 to close a corporate tax shelter known as the Delaware Holding Company. Using this tax scheme, businesses shift profits to a shell company in the state of Delaware, a state with no corporate income tax. Combined reporting helps close other shelters that are not addressed by previous legislation.

- **A move to eliminate combined reporting would unbalance DC's budget.** Getting rid of combined reporting would create a $20 million budget gap in FY 2012 and beyond. Recent budget deliberations in the District have focused on the city's long-term budget problems stemming from the recession, and the need to adopt policies that provide long-term fiscal stability. Eliminating combined reporting would require cutting local services or raising other local taxes, while keeping taxes low for large national corporations.

Combined Reporting Promotes Tax Fairness

Should a locally-owned clothing store be taxed more than a branch of a national retailer? Of course, the answer is no.

Yet without combined reporting, national retailers and other corporations often have a distinct tax advantage over local DC businesses. Many national and multinational companies engage in complicated tax-avoidance strategies that artificially shift profits out of jurisdictions where they are earned and put them in states where the business tax rate is lower—or where a corporate income tax doesn't exist at all.

This occurs because most large multistate corporations are composed of a "parent" corporation and a number of "subsidiary" corporations owned by the parent. Some major retailers, such as Wal-Mart and Toys R Us, have shifted profits earned by subsidiaries to reduce their taxes.

Combined reporting addresses this practice by treating the parent company and its fully-owned subsidiaries as one corporation for state income tax purposes. In other words, the profits made by the parent and subsidiaries are combined and added up together. In a state with combined reporting, the corporate tax is determined by a formula based on the percentage of business operations that take place in that state compared to activity in other states.

The tax avoidance strategies that occur in states without combined reporting are unfair in several ways. They rob states of tax dollars needed to finance roads that customers might travel to stores, schools that educate workers, police and fire departments that provide public safety protection, and other services.

So who picks up the slack when large corporations hide profits by using tax shelters? Individual taxpayers and smaller, locally owned companies who can't stow away their profits in a different state.

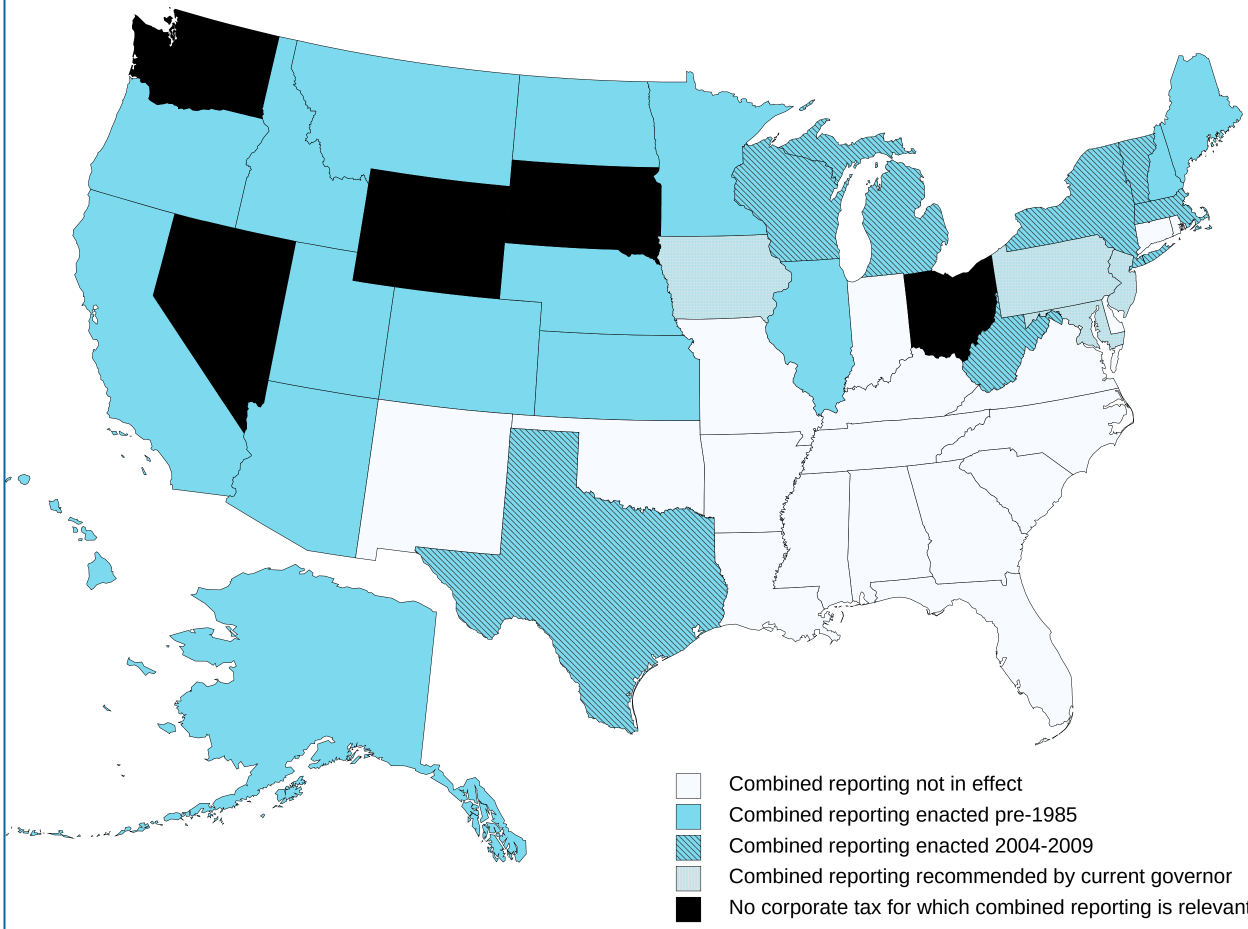
Combined reporting creates a level-playing field, so that large and small, local and national, all pay their fair share. States that adopt combined reporting are following advice long offered by state corporate tax policy experts, who argue that the failure to enact combined reporting is an invitation for businesses to engage in tax avoidance.[i]

States with Combined Reporting Remain Economically Competitive

By adopting combined reporting, DC joined 23 states which already have chosen to implement this key reform. (Forty-five states have a corporate income tax.) Sixteen of these states have

FIGURE 1

Current Status of Combined Reporting



required combined reporting for decades. Recently, momentum has been growing among other states to expand this policy. Since 2004, seven states — West Virginia, New York, Massachusetts, Wisconsin, Michigan, Texas, and Vermont — have adopted combined reporting.

Despite the long existence of combined reporting, corporate interests often warn that adopting this policy will harm a state's economic prospects.

The evidence proves otherwise. States with combined reporting include some of the most economically-powerful in the country. Of the eight states with corporate income taxes that have seen growth in manufacturing since 1990, seven had combined reporting in effect the entire time, according to a study by the Center on Budget and Policy Priorities. The next two best-performing states, Oregon and Minnesota, also are combined-reporting states.[ii]

Moreover, recent studies by three states considering combined reporting examined the location decisions of large companies in their states. The studies found that a majority of these businesses maintain facilities in other states with combined reporting. The fact that these companies have chosen to locate in states with combined reporting suggests that they would not move their locations from a jurisdiction that newly adopts combined reporting. [iii]

Finally, corporate income taxes represent a relatively small share of business expenses—usually less than one percent, whether or not a corporation is located in a combined reporting state. A state's decision to adopt combined reporting increases that small corporate tax load only slightly. Not surprisingly, a recent study by economists Robert Tannenwald and George Plesko, which measured interstate differences in overall state and local tax costs for corporations, found no statistically significant correlation between those costs and state success in attracting business investment.[iv]

In other words, higher state and local business taxes did not impede business investment.

Combined Reporting Extends DC's Efforts to Close Corporate Tax Loopholes

The District of Columbia already has taken steps to close corporate tax shelters. Adopting combined reporting allows it to close such shelters more tightly.

In 2004, DC adopted legislation to nullify an abusive corporate tax shelter frequently referred to as the "Delaware Trademark Holding Company" or "Passive Investment Company" (PIC) shelter. Updated legislation to close the same tax shelter was adopted in 2009.

This is how this tax scheme works: A corporation transfers ownership of its trademarks and patents to a subsidiary corporation located in a state that does not tax royalties such as Delaware or Nevada. The out of state profits are disguised as royalty fees paid for the use of the trademark or patent in the Delaware corporation. For example, Toys R Us created a separate entity for its logo that was incorporated in Delaware. All Toys R Us stores paid royalties to the Delaware corporation, shifting profits away from the states where they were earned.

DC and some states have taken steps to close this specific tax shelter, but combined reporting is needed to address such profit-shifting strategies more comprehensively. If states were to rely on closing only the Delaware Holding Company, they remain susceptible to other tax shelters abuses. [v]

Conclusion: Combined Reporting Asks Business to Pay Its Fair Share and Provide Revenue for Critical Services

At its essence, combined reporting closes a gaping corporate tax loophole.

It's about fairness. If companies don't pay their full tax burden, there's less money to fund critical city services these businesses rely on to create a healthy business climate, as well as money for other services that residents need.

For these reasons, the District should retain the combined reporting requirement it passed in July.

[i] Michael Mazerov, A *Majority of States Have Now Adopted a Key Corporate Tax Reform — "Combined Reporting"*, Center on Budget and Policy Priorities, Revised April 3, 2009.

[ii] See: Michael Mazerov, "Most Large North Carolina Manufacturers Are Already Subject to 'Combined Reporting' in Other States," Center on Budget and Policy Priorities, January 2008, Table 1, p. 6. Available at www.cbpp.org/1-15-09sfp.pdf.

[iii] See the study cited in Note ii. See also: Michael Mazerov, "Almost All Large Iowa Manufacturers Are Already Subject to 'Combined Reporting' in Other States; Fears of Job Flight from Reducing Corporate Tax Avoidance Are Unwarranted," Center on Budget and Policy Priorities, April 2008, available at www.cbpp.org/4-3-08sfp.pdf. See also: Jack Norman, "Combined Reporting: How Closing Corporate Loopholes Benefits Wisconsin," Institute for Wisconsin's Future, February 2009, available at www.wisconsinsfuture.org/publications/taxes/IWF_combined%20reporting_Feb09.pdf.

[iv] George A. Plesko and Robert Tannenwald, *Measuring the Incentive Effects of State Tax Policies Toward Capital Investment*, Federal Reserve Bank of Boston Working Paper 01-4, December 3, 2001.

[v] For example, businesses can set up a tax shelter, known as a "captive real estate investment trust," that acts in many likes like the Delaware Holding Company shelter. Yet legislation to close the Delaware Holding Company shelter would not affect that captive real estate investment trust shelter.