Combined Reporting: A Key Element in West Virginia Tax Modernization

"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 Assist. 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

Introduction

Over the past several decades, state corporate income taxes have declined markedly. From 1989 to 2003, West Virginia has seen its corporate income tax revenue fall by 47 percent as a share of gross state product.[4] On the national level, corporate taxes are at their lowest levels since the 1930s. One of the factors contributing to this decline has been aggressive tax avoidance on the part of large, multi-state corporations; a 2003 study by the Multistate Tax Commission (MTC) suggests that states in the aggregate lost as much as $7.1 billion in corporate income tax revenue in fiscal year (FY) 2001 due to such activities.[5] This report also estimated that West Virginia lost 57.8 percent of its corporate income tax collections (as a share of revenue) in 2001 due to tax shelters, the highest in the nation.[6] The estimated revenue lost due to domestic tax sheltering was between $17 and $36 million in 2001, according to the report.[7] The most effective approach to combating corporate tax avoidance is the use of combined reporting, a method of taxation currently employed in 17 states. Moreover, the governors of Iowa and New York have included provisions to institute combined reporting in their FY 2008 budget proposals, while commissions in several states, including Pennsylvania and Kentucky, have recommended its adoption in recent years. The

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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)
[4] Robert S. McIntyre and T.D. Coo Nguyen, "State Corporate Income Taxes 2001-2003," *Institute for Taxation and Economic Policy & Citizens for Tax Justice*, February 2005 http://www.ctj.org/pdf/corp0205an.pdf
[5] Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections, *Multistate Tax Commission*, July 15, 2003 http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Resources/Studies_and_Reports/Corporate_Tax_Sheltering/Tax%20Shelter%20Report.pdf
[6] Ibid
[7] Ibid

2006 Report of the West Virginia Tax Modernization Project stated that combined reporting was one of two options worth pursing in order to "revise the Corporate Net Income Tax structure to increase fairness and improve administration" and help "solve some of the problems associated with the Corporate Net Income Tax."[8]

Combined reporting would require multi-state corporations to report profits from related entities, including any subsidiaries. Currently in West Virginia corporate taxpayers use "separate accounting," where businesses report profits only to the extent the business is located in the state. This limitation creates a tax loophole for tax planning techniques that shift income to low tax states.

According to testimony given by Mark Muchow to the Finance Subcommittee B on December 11, 2006, mandating combined reporting could boost income tax receipts by $25-$35 million in West Virginia over the long-term. While combined reporting will not solve all problems associated with corporate tax avoidance, it's the single best short-term option available to lawmakers that will not only give the state additional revenue without raising taxes, but make the corporate tax more equitable. This policy brief explains how combined reporting works and assesses its advantages for West Virginia.

How Combined Reporting Works

For corporations that only do business in one state, paying corporate income taxes can be pretty simple – all of their profits are taxable in the state in which they are located. For corporations with subsidiaries in multiple states, the task of determining the amount of profits subject to taxation is more complicated. There are broadly two ways of doing this: **combined reporting**, which requires a multi-state corporation to add together the profits of all of its subsidiaries, regardless of their location, into one report, and **separate accounting**, which allows companies to report the profit of each of its subsidiaries independently. For example, if the Acme Corporation has three subsidiaries in three different states, a combined reporting state would require Acme to report the profits of the four parts of the corporation as one total, on the grounds that each of the parts of the corporation contribute to its profitability. In contrast, a separate accounting state would require only those parts of the Acme Corporation that have "nexus" in that state – that is, enough in-state economic activity to be subject to the state's corporate income tax – to report their profits, even if the out-of-state parts of the corporation are responsible for the bulk of Acme's overall profits.

How Businesses Abuse Separate Accounting

In addition to allowing companies to structure their operations so that some subsidiaries avoid taxation, separate accounting enables corporations to use certain gimmicks to shift their profits from high-tax states to low-tax states. The most notorious example of such a gimmick is the passive investment company (PIC) loophole. One of the most popular examples of a PIC is Geoffrey Inc., a subsidiary of Toys "R" Us.

Geoffrey Inc. is one of over 600 corporations that have their headquarters in a not very large building in Wilmington, Delaware. These are shell corporations. They have no real staff, and

[8] The West Virginia Tax Modernization Project Final Report, November 2006, p. 134

their only function is to serve as a tax-free haven for corporate profits. Geoffrey, Inc, for example, owns the Toys "R" Us trademark, and its only purpose is to collect royalties on that trademark from Toys "R" Us stores across the country. The amount Geoffrey can charge for royalties is not determined in an "arms-length" transaction; it is an arbitrary amount, and the only real constraint is the fear that too blatant use of the device could trigger serous counter-measures by the states.

Here's how the tax loophole works. Toys "R" Us is required to pay West Virginia corporate income taxes on the profits it makes from its stores in West Virginia. Toys "R" Us deducts from its profits the royalties its West Virginia stores pay to Geoffrey for use of the Toys "R" Us name. Thus, part of the Toys "R" Us profits earned in West Virginia disappear, and part of its West Virginia tax burden goes with it. Geoffrey Inc. and hundreds of other PICs have been established in Delaware, where they can shift profits that would have been taxable in West Virginia and many other states. In Delaware, those profits go tax free because Delaware does not tax royalty income earned by a company whose activities are limited to managing intangible assets.27 Toys "R" Us is not the only culprit here.

Table 1 lists some of the other large, multistate businesses that the Wall Street Journal identified as using these loopholes in at least some states in which they do business. This practice not only deprives the West Virginia treasury, but also is unfair to local businesses that compete with these companies for sales, and to other national corporations doing business in West Virginia that have not resorted to the PIC device to avoid state taxes. Local businesses pay taxes on all their profits; they have nowhere to shift them.

Table 3: Examples of Firms Using the 'Geoffrey Loophole'

American Greetings - Budget Rent-A-Car - Burger King – CompUSA - ConAgra Foods - Dress Barn – Gap - Home Depot - Honeywell International - K-Mart – Kohls - Long John Silver's - Marsh Supermarkets - Payless Shoes - Radio Shack - Sherwin-Williams - Stanley Works - The Limited Brands - Tyson Foods - Circuit City Stores - Staples

Source: The Wall Street Journal

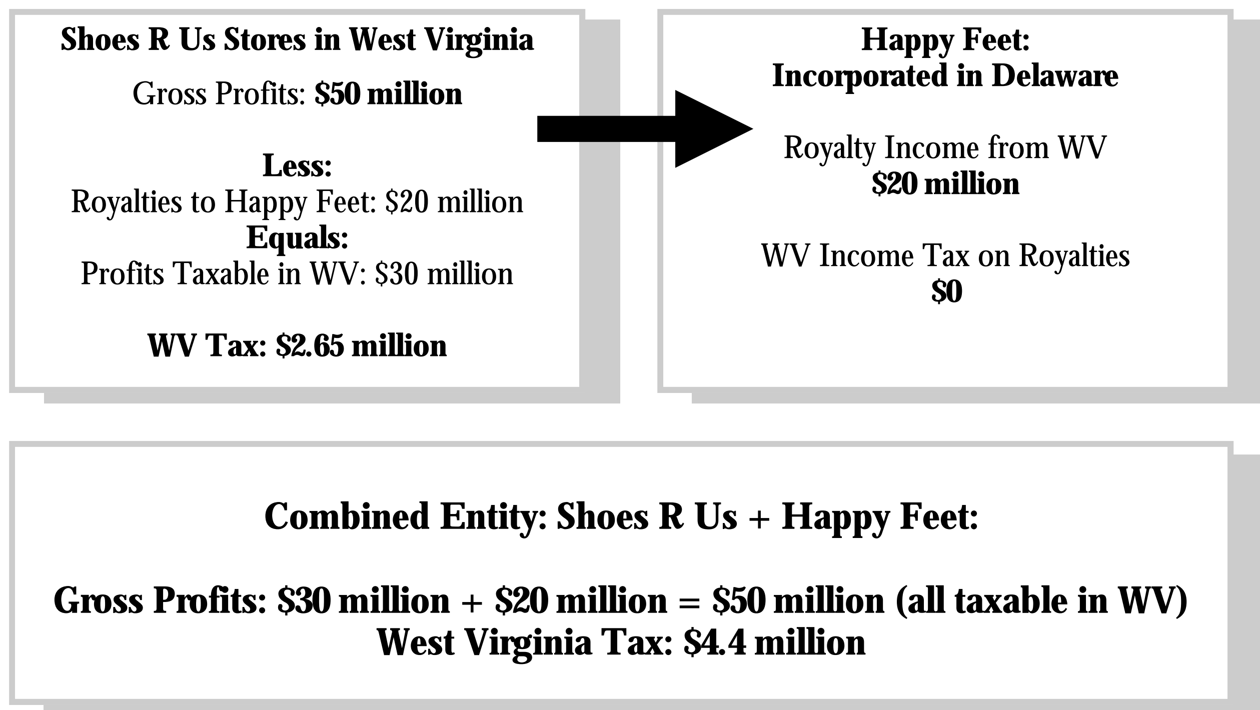
Unfortunately, the PIC loophole is one of just many tax avoidance techniques available to corporations operating in separate accounting states. For example, a February 2007 *Wall Street Journal* article notes that Wal-Mart may have been able to avoid as much as $350 million in state corporate income taxes between 1998 and 2001 due to another, similar loophole know as "captive real estate investment trusts (REITs)".[9]

Adopting Combined Reporting

As stated above, 17 states have closed the PIC or Geoffrey loophole by requiring "combined reporting" of profits. Under combined reporting, all profits from the in-state business (such as the Toys "R" Us stores) and any out-of-state subsidiaries (such as Geoffrey Inc.) must be combined and reported on the West Virginia return, including any royalties earned by the

[9] Jesse Drucker, "Friendly Landlord: Wal-Mart Cuts Taxes By Paying Rent to Itself," *Wall Street Journal*, February 1, 2007.

PIC subsidiaries. The royalty deduction no longer reduces the company's taxable profits because it is added back in as income for the subsidiary. Toys "R" Us then is taxed fairly on the legitimate profits made in the state. An imaginary example of how the PIC loophole shifts profits and reduces taxes, and how this benefit is eliminated through combined reporting, is shown below:



Combined reporting also eliminates the gains from other methods of profit shifting. The shifting of profits from a West Virginia subsidiary to an out-of-state parent through the charging of interest on loans from the parent to the subsidiary, or the charging of high rents on West Virginia facilities owned by the parent, or charging management fees to the subsidiary, would no longer be advantageous. The interest or rental income or management fees gained by the out-of-state firm would now be part of the profits of the combined corporation, and part of that combined income would be apportioned to West Virginia.

Myths & Realities on Combined Reporting

Myth #1: Combined reporting will be bad for the state's economy.

There is no evidence that adoption of combined reporting has a negative effect on a state's ability to attract employers. In fact, by some measures combined reporting states have actually done better economically than separate company states. Since manufacturing employment peaked in 1979, combined reporting states constituted:[10]

- Four of the top five states in manufacturing job growth
- Eight of the top ten states in manufacturing job growth

[10] Source: Data presented to Finance Subcommittee B on December 11, 2006 by Michael Mazerov, Senior Fellow, Center on Budget and Policy Priorities.

- 10 of the 17 states with positive manufacturing job growth, even though only 16 states used combined reporting during this period.

To cite a few examples of this trend, during the decade of the 1990s, manufacturing jobs in New Hampshire, a combined reporting state, grew 1%, while manufacturing jobs in Massachusetts, a separate company reporting state, fell 16%. Illinois implemented combined reporting in 1982 and since that time jobs have grown by 24% in Illinois. Finally, California became the high tech capital of the country, even though it is by general consensus the most aggressive practitioner of combined reporting. If combined reporting were such an impediment to economic development, then these states should be economic laggards, but they are among the fastest growing states in the country. The truth is that combined reporting has no effect on economic development; it is a fair and neutral method of calculating corporate net income.

While many opponents of combined reporting might argue that it will lead to higher business costs and thus impair efforts to stimulate the economy, the evidence doesn't support these claims. While business costs do matter, 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. Moreover, as Lynch notes:

> 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]

Robert Tannenwald, Assistant Vice President and Economist at the Federal Reserve Bank of Boston, has concluded that corporate tax structure plays at best a marginal role in capital spending:

> This study of the impact of state and local tax burden on business's capital spending in 1991 found a small effect that was statistically insignificant. This finding buttresses existing empirical evidence that the effectiveness of state and local tax policy as an instrument of economic development is uncertain. While tax characteristics may affect a state's competitiveness, policymakers should view with caution claims that changes in tax policy

[11] Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*, Economic Policy Institute, March 2004, p. 4.
[12] Lynch, p. 6

> will dramatically improve their state's economy. Enhancing public services valued by firms may be a more effective economic development strategy."[13]

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.

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.[14]

In November 2006, a report by the U.S. Small Business Association on "State Tax Policy and Entrepreneurial Activity" concluded that "states with combined reporting and throwback rules as part of their corporate income taxes tend to have higher entrepreneurship rates."[15]

The experience with combined reporting to date has been sufficiently attractive – and the scope of corporate tax avoidance has grown so greatly – that two Governors - Chet Culver of Iowa and Elliot Spitzer of New York – have included a proposal to adopt combined reporting in there FY 2007-8 budget.[16] 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."[17]

Myth #2: Combined reporting will lead to excessive litigation and controversy.

This myth springs from California's experience with worldwide combination. When combined reporting was first adopted in California, their definition of a unitary business was unclear and led to litigation. In fact, they took a very hard line in litigation and pushed many issues into the US Supreme Court. In effect, California allowed the courts to write their

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[13] Robert Tannenwald, "State Business Tax Climate: How should it be measured and how important is it?," *New England Economic Review*, January February 1996.
[14] Lynch, p. 11
[15] U.S. Small Business Association, "State Tax Policy and Entrepreneurial Activity," November 2006 http://www.sba.gov/advo/research/rs284tot.pdf
[16] http://www.dom.state.ia.us/state/budget_proposals/files/fy08/FY08_Iowa_Budget_Report.pdf http://publications.budget.state.ny.us/fy0708artVIIbills/REVENUEConsBMwtoc.htm

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

definitions. In contrast, West Virginia would set out a specific definition of a unitary business based on the prior decisions of the court.

In addition, some opponents of combined reporting have noted that Florida repealed their combined reporting statute a year after they adopted it. It's important to recognize that it 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 would use a different version of the policy, known as "water's edge" reporting. In the 15 years since the last state switched to water's edge combination, there has been very little controversy surrounding combined reporting.

Unfortunately, some have argued that combined reporting will be just like California's experience. To the contrary, if West Virginia adopted the Multistate Tax Commissions Model Legislation it would avoid the difficulty of worldwide combination, and specifically defines the important terms in the legislation. 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.

Myth #3: Combined reporting is too difficult to comply with.

First, it's important to recognize that almost all corporate groups already file a consolidated federal tax return. In addition, many businesses operate in combined reporting states and already know how to file a combined state report. It is certainly true that filing a combined report will be different than filing a CNI return under current law. However there is no reason to think that the mechanics of the reporting will be too hard to comply with.

To put this in perspective, we should consider the lengths to which businesses have been willing to go to avoid tax under current law. The establishment of thousands of token offices in Delaware or a foreign tax haven country, frequent meetings in those locations, and expensive legal or accounting advice about tax planning, are all considered the cost of doing business. A recent report from the US Congress entitled, "The Role Of Professional Firms In The U.S. Tax Shelter Industry" uncovers the enormous efforts at the premier national accounting and law firms currently devoted to avoiding both state and federal income tax. This 144-page report details the complex schemes invented by such firms and the large fees charged to clients who wish to avoid the income tax. Clearly, combined reporting cannot possibly be as difficult as the tax evasion schemes some taxpayers are willing to employ under current law.

If the West Virginia State Tax Department needs help to change to a combined reporting system, the Multistate Tax Commission's Joint Audit Program may be able to assist. According to the Multistate Tax Commission:

> The Joint Audit Program helps states learn of any inconsistent reporting to different states by multistate taxpayers. In cases in which settlements of disputes are negotiated, the states' position is improved by their joining together; by the same

token, corporate taxpayers sometimes find it less burdensome to negotiate with one representative than with numerous individual state tax agencies. States also use the program as a tool for adapting existing laws to new circumstances and industry practices that arise continuously in a dynamic market economy. By working together through the Commission, several states can simultaneously gain experience in addressing these new circumstances and can apply that experience in their individual state audit programs.

Conclusion

Tax reform strategies that broaden the tax base by eliminating unfair and expensive loopholes can help offset any lost revenue due to tax cuts and help West Virginia balance its budget without requiring unpopular increases in tax rates — and requiring combined reporting is the single best option available to lawmakers seeking to stamp out tax avoidance strategies by multi-state corporations.

For more information about the content of this policy brief please contact Ted Boettner at ted@mserf.org or 304.346.8928.