FACTS AT A GLANCE

FEBRUARY 2007

Combined Reporting: What It Is and How It Works

What is the Problem that Combined Reporting Aims to Solve?

Large companies with subsidiaries operating in different states can reduce their state tax liability by using accounting strategies that reduce the taxable income that they report in particular states. Because different states tax corporations in different ways, corporations can develop accounting strategies to shift income into states in which they will pay little or no tax on it.

For example, one such strategy that Massachusetts sought to prohibit four years ago related to what is called "passive investment income," such as income earned by licensing the use of a trademark. In some states this income is not taxed. Multi-state companies learned that they could place the rights to the company name in a subsidiary in a state that doesn't tax passive investment income and then have their subsidiaries that operate in other states pay a fee to the subsidiary that owns the name for using that name. Because of this additional "expense" the income of the subsidiaries operating in other states would be reduced and therefore they would pay less in taxes in those states. The subsidiary that received the income wouldn't be taxed on it because it operated in a state that didn't tax passive investment income.

Another example involves the use of Real Estate Investment Trusts (REITs). A REIT is an entity that allows several investors to pool their resources to invest in real estate. The REIT does not generally pay taxes on the income it earns. It distributes its profits as dividends to its shareholders and under federal tax law those owners are taxed on that income when they receive it. The problem is that corporations can use REITs that they own ("Captive REITs") to avoid paying state taxes. They are able to do this because many states do not tax the dividends that corporations receive from entities they own. So if the REIT is owned by a subsidiary in a state that doesn't tax these dividends, then the money that is earned in the REIT can avoid state taxation entirely. For example, the Wall Street Journal recently reported that, as states began to try to close the passive investment loophole, Wal-Mart found another way to shelter income. It created a REIT to operate as the landlord for many of its stores. The article reported that Wal-Mart stores pay rent to this REIT and those payments reduce the taxable income of the stores making the payments. But the REIT receiving the payment isn't taxed on that income and neither is the subsidiary that owns the REIT and receives the dividend payment, so a portion of Wal-Mart's income can escape state taxation entirely.[i]

How can States Respond to Aggressive Tax Avoidance Strategies?

One method for reducing tax avoidance is for states to try to prohibit particular tax avoidance strategies as they become aware of them. That is what Massachusetts did when it passed a law aimed at ending the use of the passive investment company loophole. The problem is that when a particular loophole is closed, companies that are aggressive about tax avoidance can often find new variations on the loophole, or completely new strategies for shifting money around among subsidiaries to reduce their state tax liabilities. The REIT strategy is one such tactic that has recently come to light.

Many states use a different approach to corporate taxation to eliminate the ability of companies to reduce their tax liability by shifting income around among subsidiaries. This method, called combined reporting, is currently used by seventeen states, including major states like California and Illinois and our neighbors in Maine, New Hampshire, and Vermont. It has also recently been proposed by the Governors of New York, Pennsylvania, and Iowa. This method of corporate taxation requires companies to file with the department of revenue a combined report of all of the income earned by any set of subsidiaries that operate together as a unitary business.

Rather than this method, Massachusetts currently uses what is called the "separate entity accounting" approach. This means that the state determines the Massachusetts taxable profits of each separate subsidiary of a multi-state business by apportioning the total profits of the subsidiary among the states in which it operates. It does this by using a formula that looks at the share of the subsidiary's property, payroll and sales that are within each state.[ii] Under the combined reporting approach, the state would combine the profits of all subsidiaries that operate together as one business and apply the apportionment formula to the total, rather than applying the formula separately to each subsidiary. This solves the problem of companies shifting income among subsidiaries to reduce state tax liability.

In the long term, combined reporting may be the only effective way of reducing corporate tax avoidance and is therefore often recommended by tax policy experts.

For example, 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."[iii] Richard Pomp, the Loiselle Professor of Law at the University of Connecticut explains that "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."[iv]

What is the Annual Cost to the Commonwealth of Not Requiring Combined Reporting?

Projections made by the Wisconsin Legislative Fiscal Bureau, the Iowa Department of Revenue and Finance, and the Maryland Department of Legislative services have estimated that combined reporting would increase corporate tax collections by 13% (Wisconsin) to 19.6% (Maryland).[v]

In 2006 Massachusetts took in $1.39 billion in corporate income taxes. Applying the estimates from other states to this number generates an estimate of $180 million to $270 million for Massachusetts. The revenue gain could be somewhat less in the first year of implementation and, to the extent that companies have not found new loopholes to replace those that have been closed, some of this savings may already have been achieved by the enactment of legislation to close specific loopholes. On the other hand, the baseline value is likely greater now than in 2006 as the economy has grown.

---

[i] Drucker, Jesse, "Wal-Mart Cuts Taxes By Paying Rent to Itself," *The Wall Street Journal*, February 1, 2007, Page A1.
[ii] For manufacturing and mutual fund companies Massachusetts uses a different formula that is based only on sales.
[iii] 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.
[iv] 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.
[v] *Combined Reporting: A Comprehensive Method of Closing Corporate Tax Loopholes*, Massachusetts Budget and Policy Center, March 27, 2003, p. 5. Available at http://www.massbudget.org/combined_reporting.pdf