
Closing Corporate Tax Loopholes to Fund Programs for Families

Many state policy makers responded to news of the \$652 million deficit in the current state budget with calls for cuts in spending. However, revenue options should be considered if they provide a fair, progressive alternative to program cuts that would hurt Wisconsin's most vulnerable children and families.

One option is combined reporting, a corporate income tax change that would combat efforts by some corporations to avoid the tax. Combined reporting would generate about \$90 million a year. It would also protect the integrity of the corporate income tax.

Separate accounting, Wisconsin's current tax filing system, gives corporations an unintended incentive to avoid paying income taxes. Under separate accounting, each corporation reports its own income and expenses separately, without regard to the income and expenses of corporations with which it is affiliated.

Because a parent corporation and each of its subsidiaries file separate returns under separate accounting—even though they are part of a single, unified business—corporations have an incentive to shift income to subsidiaries outside of Wisconsin in order to avoid the tax. For example:

- Wisconsin banks transferred their investments to subsidiaries in Nevada, which does not have a corporate tax, to try to avoid being taxed on the income from those investments.
- Wisconsin retailers shifted their trademarks in Delaware holding companies and claimed a Wisconsin tax deduction for royalties paid for the use of the trademarks. Those deductions lowered Wisconsin income and tax, and the holding companies were not subject to tax in Delaware.
- Wisconsin companies placed ownership of their land and buildings in subsidiaries called real estate investment trusts. They claimed a

deduction for rents paid to these entities, thus reducing Wisconsin income and tax. REITs are not subject to federal or state tax when they distribute their income to their shareholders as dividends. Wisconsin does not tax the dividends a REIT pays to a parent corporation that owns at least 70 percent of the REIT.

The result is that many of the largest and most profitable corporations doing business in Wisconsin avoid paying any income taxes here.

These strategies are improper -- they have been successfully challenged as lacking business purpose by state tax auditors. But auditing is a case-by-case approach that succeeds only when firms are audited, auditors are able to identify improper activities and their assessments of additional tax, interest and penalties stand up in court. Often, substantial audit resources are devoted to combating the practices of a few companies, and many improper activities go undiscovered.

Combined reporting, which requires a corporation and its subsidiaries to file a combined report of their income and expenses, is a comprehensive, effective solution to tax avoidance.

This filing regime, adopted by 21 of the 45 states with a tax on corporations, eliminates much of the exploitation that occurs under separate accounting because it disallows improper shifting of income to other states. States with combined reporting include Wisconsin's neighbors of Illinois, Michigan and Minnesota. Michigan is one of 5 states that have adopted combined reporting in the past 3 years to combat corporate tax avoidance.

Because it raises revenue, critics label it a tax increase—but combined reporting would not raise the tax rate or eliminate exemptions, deductions or credits. Rather, it ensures that corporations pay tax to the state that they should pay, but may not pay now because of improper tax avoidance strategies.

By combating improper manipulation of corporate structure and accounting practices, combined reporting would make Wisconsin's tax system fairer. Currently, some businesses skirt their responsibilities for paying for public services. That's not fair to other taxpayers, both corporations and households, who have to pay higher taxes, and it's not fair to citizens who are deprived of the services they need because of a lack of revenue.

Combined reporting would also make it more likely that corporations will voluntarily comply with the law, rather than giving them an incentive to avoid the tax.

Combined reporting would not hurt economic growth in Wisconsin. There is little evidence that the corporate income tax depresses economic growth—not surprising since the tax is small relative to other costs of doing business. Further, combined reporting does not raise the corporate tax rate or eliminate exemptions, deductions or credits, changes that one might argue would hurt growth. It simply closes off strategies that a few corporations, mostly large, multistate companies, use to avoid paying their fair share of tax.

There is good evidence that combined reporting is not harmful to a state's business climate. Between 1979, when manufacturing employment in the U.S. reached its peak, and 2001, nine of the ten states with positive growth in manufacturing employment were states that required combined reporting.

Conclusion

Wisconsin should ensure the integrity of its corporate income tax by enacting combined reporting. Because of separate accounting, corporations currently have an incentive to engage in tax avoidance practices. As a result, some corporations pay less than their fair share. In addition, combined reporting would generate an additional \$90 million per year at a time when the state faces a budget deficit – revenue that could help to support programs for Wisconsin's needy families and children.

Though it raises revenue, combined reporting does not raise the tax rate or eliminate exemptions, deductions or credits. Rather, it eliminates tax avoidance strategies that are costing the state treasury significant amounts of money.

Take Action to Support Programs for Wisconsin's Most Vulnerable Families

Legislators and the Governor need to hear that you support protecting programs that help Wisconsin's most vulnerable citizens from budget cuts when fair, progressive alternatives, like closing corporate tax loopholes, are available to fund them. You can contact the Governor's office by calling (608) 266-1212, or use their online e-mail form at: <http://www.wisgov.state.wi.us/contact.asp?locid=19>.

To get the name or the contact information for your state Representative and Senator, go to the e-mail address below. It will give you their phone numbers, as well as a way to reach them by e-mail: <http://waml.legis.state.wi.us/>