

POLICY BRIEF

Combined Reporting: Restoring Fairness by Reducing Tax Avoidance

Large corporations have become increasingly sophisticated in using subsidiaries and complex accounting strategies to move profits into states where they can't be taxed. As a result, many large and very profitable corporations that do business in Wisconsin pay little or no income tax in our state.

These tax avoidance strategies contribute to the state's huge deficit, and they give the largest corporations a competitive advantage over smaller Wisconsin-based corporations that can't employ the same tactics to move their profits out of state.

This paper briefly describes a different and fairer way of taxing corporations, known as combined reporting, which is used by almost half of the 45 states that levy corporate income taxes.

Past estimates indicated that combined reporting would generate an additional \$75 million per year for Wisconsin. Although we think those estimates were much too low, the current recession is reducing corporate profits, which means that the revenue potential in the short-term will be less.

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:

- Some Wisconsin banks transferred their investments to subsidiaries in Nevada, which does not have a corporate tax, to try to avoid paying taxes on the income from those investments.
- Wisconsin retailers shifted their trademarks to 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.

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 22 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. Combined reporting is used in Wisconsin's neighboring states of Illinois, Michigan and Minnesota, and although corporations may adjust practices related to this reporting, there is no evidence that it results in corporations leaving the state(s). Michigan is one of six states that have adopted combined reporting since 2004 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 taxes they should be paying to the state, but which they may not currently be paying 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 responsibility for contributing to 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. 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, multi-state 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. A study done a few years ago found that ten states had positive growth in manufacturing employment between 1979 (when manufacturing employment in the United States peaked) and 2001. Nine of the ten 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 could generate \$75 million per year at a time when the state faces a huge budget deficit – revenue that could help to maintain 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.