

COMBINED REPORTING

UNDERSTANDING THE REVENUE AND COMPETITIVE EFFECTS OF COMBINED REPORTING

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EXECUTIVE SUMMARY

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and corporate taxpayers is how a state should determine the corporate income tax base for multistate corporations with multiple businesses and entities. The debate is framed as a choice between two distinctly different corporate income tax systems used by states to answer this question: separate filing and combined reporting.

The first approach to determining the income of a multi-state enterprise, separate filing, treats each corporation as a separate taxpayer. Under separate filing, each corporation includes only its income on the corporate tax return it files. The second approach, combined reporting, treats affiliated taxpayers (parents and subsidiaries) engaged in a unitary business as a single group for purposes of determining taxable income.¹ In the process of determining tax liabilities of the members of the combined group, the separate incomes of the members are added together or “combined.” In effect, combined reporting treats the members of the unitary business as though they were a single company in determining their income. Under both systems, the income of the taxpayer or group is then distributed (apportioned) by a formula to a specific state. States vary widely both on the composition of the combined group and the apportionment formula.

Prior to Vermont's adoption of combined reporting beginning in 2006, no state had adopted combined reporting for two decades. West Virginia and Michigan followed Vermont in adopting combined reporting for their business income taxes, and New York recently expanded its combined filing requirements. Additional states are considering the switch from separate filing to combined reporting. Proponents

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maintain that the switch will increase state corporate tax collections and reduce tax base shifting attributable to tax planning by multistate firms. Opponents assert that combined reporting decreases a state's economic competitiveness and may result in a state taxing more or less income than is justified based on the taxpayer's actual in-state activities. This study provides additional information that should help legislators and policymakers better understand the complex issues involved in this debate.

Key study findings

- Combined reporting may increase, decrease or leave unchanged the taxable income reported on the combined return compared to the sum of the taxable incomes for the separate taxpayers, assuming that corporations in the combined group are already taxpayers in a state. The result depends upon the difference in profitability per dollar of U.S. payroll, property and/or sales ("factors") for the different corporations in the group.
- Combined reporting has uncertain effects on a state's revenues, making it very difficult to predict the revenue effect of adopting combined reporting. This is due to the fact that combined reporting assumes that all members of the group have the same profitability per dollar of factors. This assumption contradicts both economic theory and business experience. The assumption is invalid for almost all taxpayers, not just corporations using tax planning strategies.
- Combined reporting replaces one set of distortions with another set of distortions. Combined reporting may reduce distortions in reported taxable income among related companies due to tax planning. However, combined reporting will simultaneously create new distortions related to the averaging effect for a large number of taxpayers with different profitability across businesses, with no tax planning. This fact should not be ignored in the evaluation of the benefits and costs of adopting combined reporting.
- Combined reporting cannot differentiate between real economic differences among taxpayers and the tax planning situations many intend for it to address. For this reason, a switch to combined reporting may have significant and unintended impacts on taxpayers and tax liabilities unrelated to tax planning.
- The type of filing system a state uses does not provide an explanation for the presence of zero or minimum tax filers. Proponents of combined reporting have frequently argued that combined reporting is justified by the significant percentage of corporate income taxpayers that pay no tax or pay only a state's minimum tax unrelated to corporate profits. The study finds that a high percentage of companies in both separate and combined filing states paid no corporate income taxes in excess of the minimum tax for the years reported.
- Reliably estimating the state revenue impact of adopting combined reporting is a very challenging task. Considerable uncertainty surrounds combined reporting estimates due to: the lack of needed information on separate filing returns, inability to identify members of the unitary group, absence of information on carryover net operating losses and unused credits into the new system, insufficient data to estimate changes in apportionment formulas, and the interaction of combined reporting with addback statutes and other measures previously enacted to address income shifting in many separate filing states.
- A review of past state revenue estimates of combined reporting reveals a wide range of expected impacts reflecting the high degree of uncertainty in the estimation process. States that looked at current tax return information as a starting point in the estimating process found lower impacts. The short-run impact of adopting combined reporting may be a relatively small increase or even no change in corporate income tax revenue. The one state that actually reviewed the initial estimates after implementation, Minnesota, concluded that combined reporting did not increase revenues at all in the short- or intermediate-run.
- States that have already enacted addback provisions can expect significantly reduced additional revenue from combined reporting. Addback provisions achieve much of the same revenue effect as combined reporting.
- Economic theory, empirical studies and economic simulation modeling all suggest that switching from separate filing to combined reporting will have a negative impact on a state's economy. If combined reporting increases tax revenues, it will also increase effective corporate income tax rates, on average, for the states' taxpayers. In response, firms will reduce the level of investment and jobs in states adopting combined reporting.
- Simple comparisons of aggregate state job growth rates, when adjusted to reflect population changes, show that separate filing states are doing no worse or slightly better than combined reporting states. Data on recent large investment projects across the states reinforce this conclusion. Comparisons of separate filing and combined reporting states show that the ratio of project-related jobs to gross state product is substantially higher for separate filing states.
- The additional compliance, administrative and litigation costs associated with combined reporting should be in-

cluded in a balanced evaluation of the benefits and costs of adopting combined reporting.

The analysis in this paper suggests that combined reporting is not a panacea for addressing the problem of how to determine accurately multistate business income that is attributable to economic activity in a state. From a business taxpayer perspective there is a significant risk that combined reporting will arbitrarily attribute more income to a state than is justified by the level of a corporation's real economic activity in the state. This will occur simultaneously with any gains from reducing tax planning opportunities.

State legislators should carefully evaluate the revenue, economic development, and tax policy impacts before adopting combined reporting. The revenue and economic impacts are complex and, in some cases, uncertain. Given this uncertainty, legislators should consider the range of options available for achieving their corporate tax policy objectives at a lower cost, while minimizing the unintended and negative consequences from combined reporting.

I. INTRODUCTION

Overview

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and corporate taxpayers is how a state should determine the multistate corporate income tax base. This complex and controversial tax policy question has two separate, but closely related, issues that are central to this debate. The first is determining the total income attributable to the taxpayer and the second is determining the state's share of that total income.

Answering the first question is relatively straightforward in the case of a single, unaffiliated company doing business in a single state or in multiple states. The total income of the company is the tax base distributed across the states where the taxpayer is operating. It becomes more complex, however, when a parent company operates with a number of affiliates with economic activity in multiple states. In this case, states have historically taken two distinct approaches to determining income: separate filing and combined reporting.

In separate filing states, the parent company and affiliates are treated as separate companies in determining income. Each of the companies that a state is permitted to tax (companies with "nexus") files a tax return that includes only the income and factors of that company. In determining income, there is no merging of income or factors of the related companies.

In contrast, combined reporting states disregard separate legal business entities in determining income for corporate tax purposes.² The parent corporation and its affiliates that are engaged in a unitary business are treated as a single group in determining income.³ In the process, the nationwide income

and factors of the members of the unitary group are combined, as though they were operating as a single company.

The second key question, how should the total tax base be divided among these states, is answered using an apportionment formula that includes measurable, state-specific "factors" (payroll, property and sales) assumed to reflect where the firm's economic activity generating the income is located. For a single company, a weighted average of a state's shares of the taxpayer's factors (for example, instate payroll divided by U.S.-wide payroll) is applied to the taxpayer's business income to determine each state's share of the tax base. The apportionment formula approach is used for taxpayers with multistate business income in both separate and combined filing states.

Even with a single company as the taxpayer, there is some controversy and disagreement among the states over the measurement and weighting of the factors. For example, 18 states have adopted (or are phasing in) an apportionment formula that uses only the sales factor. In effect, these states take the view that only sales generate income. At the other extreme, 11 states have "traditional" apportionment formulas that apply a weight of one-third to the sales factor and two-thirds to the payroll and property factors combined. These states view payroll and property together as the most important determinants of where income is generated.

In the states with combined reporting, the apportionment formula is applied to the combined income of the unitary group to determine the distribution of nationwide income to a state. Compared to the separate filing method, the combined reporting apportionment formula includes the nationwide factors of the combined group in determining the state's share of factors. For example, with two affiliated corporations in a combined group, each company's share of payroll is calculated by dividing the company's instate payroll by the sum of the nationwide payroll for both members of the unitary group, rather than only the nationwide factors for one firm as calculated under separate filing. Each firm's weighted average of the apportionment factors is then multiplied by the group's combined income to determine each company's taxable income in a state. The sum of the taxable income amounts for the two firms equals the group's total income.

Issues related to combined reporting

The proponents of combined reporting focus on the combination of income dimension of mandatory combined reporting.⁴ They argue that combined reporting is needed to offset erosion in the corporate income tax base attributed to tax planning strategies available to multistate corporations. Proponents argue that these strategies, such as the use of passive investment companies to manage intangible assets or the distortions in prices charged by one firm to other firms in the group (transfer prices), allow multistate corporations to

lower their tax liabilities by shifting income to affiliates in low-tax or no corporate income tax states. By combining income of affiliated companies in a unitary group, the adoption of combined reporting is viewed as one method of negating these shifts and making the group's tax liability independent of business structure.

The proponents of combined reporting also argue that it provides increased uniformity in the effective tax rates paid by companies that operate as multiple divisions rather than multiple corporations. Proponents expect single-company corporations to have fewer tax planning opportunities that reduce tax liabilities. It is also argued that combined reporting will reduce the administrative and compliance costs associated with monitoring transfer prices under separate filing systems.

While the proponents focus on expanding the taxable income of an affiliated group of taxpayers, there is less discussion or even awareness of the impacts of combining factors in moving from separate filing to combined reporting. Issues related to factor combination (the second question of how to distribute income among the states) introduce additional controversy into the debate that goes beyond the issue of how to define the taxpayer group and how to combine income. As discussed in this paper, these two issues are integrally inter-related.

The interaction of the two issues creates significant challenges and uncertainty in estimating the revenue impacts of adopting combined reporting and magnifies the potential negative impact on a state's economy from adopting combined reporting. More fundamentally, the interaction creates an actual or perceived disconnect in the link between the location of measurable, state-specific factors and the attribution of income to a state. This distortion adds even more controversy to the debate; while combined reporting is advocated as a method of more reliably measuring the income of a unitary business, it may not attribute this income to the state in which the economic activities that actually generated the income occur.

While the proponents focus on expanding the taxable income of an affiliated group of taxpayers, there is less discussion or even awareness of the impacts of combining factors in moving from separate filing to combined reporting.

Examples of the possible effects of combined reporting on state tax liabilities

The example provided in Table 1 may help to clarify this point by illustrating how combined reporting works. Company 1 and Company 2 are commonly-owned multistate corporations engaged in a unitary business operating in State A, which apportions multistate income based on an equally weighted, three-factor formula using payroll, property and sales.⁵ Also assume that for non-tax reasons the two companies are operated as separate legal entities. Both companies have \$10 million of annual sales and \$1 million of net income.

Under *separate filing*, both firms file separate tax returns in State A as follows:

- Company 1 has 5 percent of each factor (payroll, property, and sales) in state A. With an equally weighted apportionment formula, the apportionment factor is also 5 percent. After apportionment, Company 1 has 5% of its \$1 million of U.S. income or \$50,000 taxable in the state.

Table 1
Example of Combined Reporting Reducing State Taxes
(dollars in thousands)

A. Separate filers			
Company 1	US-wide	In-state	In-state share
Sales	\$10,000	\$500	5.0%
Payroll	5,000	250	5.0
Property	5,000	250	5.0
Apportionment factor			5.0%
Taxable income	\$1,000	\$50	
Company 2			
Sales	\$10,000	\$5,000	50.0%
Payroll	1,000	500	50.0
Property	1,000	500	50.0
Apportionment factor			50.0%
Taxable income	\$1,000	\$500	
Total taxable income: separate		\$550	
B. Combined report			
Sales	\$20,000	\$5,500	27.5%
Payroll	6,000	750	12.5
Property	6,000	750	12.5
Apportionment factor			17.5%
Taxable income: combined	\$2,000	\$350	
Change in taxable income			
Company 1		\$22	
Company 2		-\$222	
Total change		-\$200	

- Company 2 has 50% of each factor in State A; after apportionment, \$500,000 (50 percent) of its U.S. income is taxable in State A.
- The sum of the incomes taxable in State A is \$550,000 under separate filing.

Assume that State A adopts combined reporting and Company 1 and Company 2 are members of a unitary group. (To simplify the example, assume that they do not have inter-company sales.) The combined nationwide income of the unitary group is \$2 million, the sum of the separate company incomes. To determine each company's taxable income in State A, the in-state payroll, property and sales for each firm is divided by the total of the U.S.-wide factors summed over both firms, \$20 million of sales and \$6 million each for payroll and property. After weighting each factor by one-third, the combined apportionment factor is 17.5%. Multiplying the combined income of \$2 million by 17.5% results in total income subject to tax in State A of \$350,000, a reduction of \$200,000.

The 36% reduction in taxable income from \$550,000 to \$350,000 can be explained in terms of the mechanics of combined reporting. When the two companies are combined two things happen: 1) they must include the combined income for both firms on their tax returns (\$2,000 in this example), and 2) their apportionment factor is lowered significantly as the U.S.-wide factors of both firms are included in the denominator of the apportionment factors.⁶ In both cases the income they report increases by 100 percent because each has the same amount of U.S. income. If the apportionment factor for both companies were reduced by exactly 50 percent, there would be no change in income apportioned to State A.

However, in this example Company 1 is bigger than Company 2 as measured by U.S. factors. As a result, when the two firms are combined, the apportionment factor for Company 2 falls by 72 percent. Because it falls by more than 50 percent, it more than offsets the doubling of income to be apportioned and Company 2's taxable income in State A falls by 44 percent to \$278,000. In contrast, Company 1, because it has larger U.S.-wide factors, only experiences a 28 percent decrease in the apportionment factor following combination. This is too small a decrease to offset the doubling of U.S.-wide income, so taxable income for Company 1 rises by 44 percent to \$72,000.⁷ In effect, combination significantly "dilutes" the apportionment percentage for both companies by increasing the denominators of the factors, but the Company 2 reduction is 2.6 times larger. Because Company 2 has 50 percent of its factors in State A, compared to only 5 percent

for Company 1, the 44 percent decrease in taxable income for Company 2 results in a greater dollar reduction in taxable income than the increase for Company 1 and total taxable income goes down under combined reporting.

Another way to understand why combined taxable income fell is to note that Company 2 is approximately 66 percent more profitable, per dollar of total U.S. factors, than Company 1. Because of the averaging of income per dollar of factors under combined reporting, the combination of the two firms lowers the income per dollar of in-state factors for Company 2 by 25 percent, while increasing the income per dollar of in-state factors for Company 1 by 25 percent. Because Company 2 accounts for 86 percent of the in-state factors, combined reporting lowers total taxable income attributed to State A.

There are a number of reasons why profits per dollar of factors vary across firms and states. The most important source of variation is the difference in ratios of value added to sales across companies and states. Value added is the additional value that a company adds to the products and services that it purchases from other companies. It measures the contribution of the companies' labor and capital to production.⁸ Firms with high value added, such as manufacturers using significant amounts of real, personal and intangible capital, tend to have high ratios of income to factors. In contrast, retailers will have low value added (and income) relative to sales and other factors. This is why retailers are often referred to as low-margin businesses. There are also competitive and economic factors that influence the ratio of income to factors in different regions of the country.

Table 2 provides an example where combined reporting would have no impact on state taxes compared to a separate filing system. In this situation, the ratios of income to U.S. factors included in the apportionment formula are the same for both companies. Under combined reporting, the income apportioned to the state on the combined return is the same as the combined income of the separate filers even though their in-state apportionment factors are different because there is no change in income per dollar of in-state factors. In this example, the combined income to be apportioned is doubled and the apportionment factor for both companies is reduced by 50 percent. As a result, there is no change in State A taxable income. Combined reporting will not change taxable income (and taxes) attributable to these two firms overall. It will increase the tax on Company 1 and reduce the tax on company 2.

Table 2
Example of Combined Reporting with no
Change in State Taxes
(dollars in thousands)

A. Separate filers			
Company 1	U.S.-wide	In-state	In-state share
Sales	\$10,000	\$500	5.0%
Payroll	5,000	250	5.0
Property	5,000	250	5.0
Apportionment factor			5.0%
Taxable Income	\$1,000	\$50	
Company 2			
Sales	10,000	5,000	50.0%
Payroll	5,000	2,500	50.0
Property	5,000	2,500	50.0
Apportionment factor			50.0%
Taxable income	\$1,000	\$500	
Total taxable income: separate		\$550	
B. Combined Report			
Sales	\$20,000	\$5,500	27.5%
Payroll	10,000	2,750	27.5
Property	10,000	2,750	27.5
Apportionment factor			27.5%
Taxable Income: combined	\$2,000	\$550	
Change in taxable income			
Company 1		\$0	
Company 2		\$0	
Total change		\$0	

Table 3 provides an example of the situation where combined reporting would increase taxable income apportioned to State A. In this case, Company 1 has significantly higher profits per dollar of U.S. factors than Company 2. In moving to combined reporting, the income each company is apportioning doubles. Because Company 1 is smaller (in terms of U.S. payroll and property), combination reduces its apportionment factor by 72 percent more than offsetting the higher income and reducing State A taxable income. In contrast, Company 2's apportionment factor only falls by 28 percent, resulting in a significant increase in Company 2's taxable income apportioned to the state. Because Company 2 has significantly larger in-state factors, the taxable income on the combined report increases. In this example, combination increases corporate income attributable to State A by \$200,000 or 36 percent.

The example in Table 3 is generally the one that proponents of combined reporting have in mind when they present the case for switching from separate filing to combined reporting. Proponents often describe the more extreme case where Company 1 has no physical presence (as compared to a

relatively small presence shown in Table 3) in State A, and therefore, is not a taxpayer in the state. This firm is often described as a Delaware intangible holding company receiving royalties from Company 2 for the use of intangible property. Combined reporting then results in Company 1's income being included on the return for Company 2, and the sum of the U.S. factors for both companies being included in the denominators of Company 2's apportionment factors. In this situation, combined reporting doubles the income reported on Company 2's return but only reduces Company 2's apportionment factor by 28 percent.⁹ The net result is a 44 percent increase in Company 2's income apportioned to State A.

The proponents of combined reporting might argue that even in the situation shown in Table 3 (both companies are taxpayers) the profits per dollar of factors for Company 2 might be artificially reduced due to improper transfer pricing adjustments or other tax planning techniques. Conversely, they might argue that the income per dollar of factors is artificially inflated for Company 2. By combining income, any income shift between affiliates due to tax planning might be negated.

Table 3
Example of Combined Reporting Increasing
State Taxes
(dollars in thousands)

A. Separate filers			
Company 1	US-wide	In-state	In-state share
Sales	\$10,000	\$500	5.0%
Payroll	1,000	50	5.0%
Property	1,000	50	5.0%
Apportionment factor			5.0%
Taxable income	\$1,000	\$50	
Company 2			
Sales	\$10,000	\$5,000	50.0%
Payroll	5,000	2,500	50.0%
Property	5,000	2,500	50.0%
Apportionment factor			50.0%
Taxable income	\$1,000	\$500	
Total taxable income: separate		\$550	
B. Combined report			
Sales	\$20,000	\$5,500	27.5%
Payroll	6,000	2,550	42.5%
Property	6,000	2,550	42.5%
Apportionment factor			37.5%
Taxable income: combined	\$2,000	\$750	
Change in taxable income			
Company 1		-\$22	
Company 2		\$222	
Total change		\$200	

However, it is also possible that the income-factor differences actually reflect differences in relative profitability based on the economics of the two businesses with no tax planning involved. In the case where the differences are “real” (not created by tax planning opportunities), combined reporting will distort the distribution of taxable income and taxpayers could assert that by adopting combined reporting State A is arbitrarily attributing a portion of the income earned by factors and economic activity in other states to State A. This fundamental difference in perspective on the relationship between real economic activity, reported income and the mechanism for attributing multistate income to different states is one of the reasons why many taxpayers with diverse businesses strongly oppose the concept of combined reporting.

This fundamental difference in perspective on the relationship between real economic activity, reported income and the mechanism for attributing multistate income to different states is one of the reasons why many taxpayers with diverse businesses strongly oppose the concept of combined reporting.

It is also apparent that some state tax administrators and legislators do understand the different impacts on state corporate tax collections under combined reporting illustrated in the three examples. This understanding is evident in a bill introduced this legislative session in Alabama.¹⁰ The bill would give the Commissioner of Revenue the authority to require a corporation to file a combined return if the ratio of the taxpayers profits (under separate filing) to profits of the combined unitary group is less than 50 percent of the taxpayers factors (payroll, property and sales) relative to the factors of the group. This arbitrary rule would have the effect of ensuring that the average income (profits) per dollar of in-state factor is increased with combination.

The exercise of this authority will increase Alabama tax collections, regardless of the presence of intercompany transactions, income shifting or economic differences in profitability among members of the unitary group. Because the bill does not allow taxpayers to elect combined reporting, it avoids any revenue losses from the example illustrated in Table 1 where the firm added to the group decreases both income per dollar of in-state factors and taxable income apportioned to the

state. The bill is designed to raise revenue, not to create a fairer attribution of multistate taxable income to Alabama.

Insights provided by the three simple examples include:

- Independent of any intercompany transactions that could distort taxable income between the two companies, the examples show that under different circumstances mandatory combined reporting could result in reduced, unchanged, or increased income taxable in a state. The outcome is dependent on the level of each company’s income, total U.S. apportionment factors, and state apportionment percentages under separate filing. Changes in the relative levels of these factors can result in seemingly arbitrary assignment of income to a particular state.
- The example that shows combined reporting reducing a state’s taxable income (and taxes) may not be intuitively obvious, but it is a result of the fundamental assumption underlying combined reporting. The assumption is that both of the companies in the combined group are equally profitable for each dollar of their factors. In other words, each dollar of capital equipment (property), labor costs (payroll) or sales is assumed to generate the same level of profits in both companies.

The proponents of combined reporting argue that this is a reasonable assumption because it is not possible to determine where corporate net income is generated for a group of unitary companies. However, economists would assert that income, a payment for the use of capital, varies depending upon the amount of equity capital used in each company. The combined reporting assumption that the profitability of the two firms is the same, when economic theory and fact conclude otherwise, illustrates the disconnect between economic reality and the operation of the state corporate income tax system.¹¹

In effect, combined reporting based on this averaging assumption creates distortions in the distribution of taxable income among firms and across states that are unrelated to business economics. This is a result similar to the situation where distortions in transfer prices may result in the distribution of income across states unrelated to real economics. While combined reporting may reduce distortions related to tax planning, it will have the effect of creating new distortions related to the averaging effect. This fact should not be ignored in the evaluation of the benefits and costs of adopting combined reporting.

The key point is that combined reporting cannot differentiate between the examples reflecting real economic differences and the tax planning situations it intends to address. For this reason, a shift to combined reporting

The combined reporting assumption that the profitability of the two firms is the same, when economic theory and fact conclude otherwise, illustrates the disconnect between economic reality and the operation of the state corporate income tax system.

may have significant and unintended impacts on taxpayers and tax liabilities unrelated to tax planning. Legislators need to be aware of this problem and consider alternatives for dealing with the shifting of income through tax planning opportunities that do not have these unintended consequences caused by combined reporting.

- To estimate reliably the revenue impact of adopting combined reporting, estimators would have to know which companies would be combined and all details related to their apportionment factors and incomes. For example, in Tables 1-3, if Company 2 was not a taxpayer in State A under separate filing, the needed information would not be available from State A tax return information. This helps explain why estimating the revenue impact of combined reporting is so difficult. (This is discussed in detail in a later section.)

... a shift to combined reporting may have significant and unintended impacts on taxpayers and tax liabilities unrelated to tax planning.

No-tax or minimum-tax returns

Proponents of combined reporting have frequently argued that combined reporting is justified by the significant percentage of corporate income taxpayers that pay no tax or pay only a state's minimum fee or tax. To many legislators, these appear to be surprisingly large numbers of taxpayers. It is often suggested by proponents of combined filing that this results from tax planning opportunities in separate filing states. What has been overlooked is how many taxpayers in combined reporting states also pay no tax based on income or only minimum taxes unrelated to a taxpayer's income.

Table 4 provides a broader perspective on the issue of taxpayers that have no positive income tax liabilities beyond minimum taxes. Collection information on the components

of corporate tax liabilities that address this issue is available from a number of state tax agencies. Table 4 presents information on the number of returns that have zero or only minimum tax liabilities in both separate filing and unitary combined filing states. Minimum taxes may be, for example, fixed dollar amounts, sliding scale taxes based on the level of factors (payroll, property and sales), or other non-income measures. The table also shows the tax year for the reported data.

In order to make interstate comparisons, the last column reports the percentage of total corporate income tax returns that report zero or only minimum tax liabilities. The interesting insight from the percentages shown in the last column of Table 4 is the similarity in the range of percentages for combined and separate return states. The combined reporting states have zero or only minimum tax percentages that range between 44.5 and 71.2 percent; the range for separate return states is 50.1 to 71.9 percent. The percentages in Table 4 show that at least 45 percent of the taxpayers in both separate and combined filing states paid no corporate income taxes in excess of the minimum fee for the years reported, including the years of significant corporate tax growth following the 2001 recession. Note that Utah, a unitary state, and Pennsylvania, a separate filing state, both have no-or-minimum tax percentages exceeding 71 percent.¹²

Table 4
State Corporate Income Tax Returns with State No Liability or Only Minimum Taxes

State	Year	Returns with minimum tax or no income tax	
		Number	% of total
I. Combined returns			
California	2005	163,712	49.0%
Kansas	2005	17,645	56.7
Minnesota	2001	23,321	44.5
Nebraska	2005	11,342	56.3
Utah	2005	14,981	71.2
II. Separate returns			
Massachusetts	2004	32,645	53.5%
North Carolina	2004	52,788	65.5
Ohio	2006	45,353	50.1
Pennsylvania	2002	100,448	71.9
Virginia	2005	46,998	63.3
Wisconsin	2004	33,883	65.1

While the simple average percentage of taxpayers paying no more than the minimum fee is slightly higher in the separate filing states, it still exceeds 55 percent in combined reporting states. Clearly, this commonly high level of taxpayers with only zero or minimum payments cannot be explained by tax

planning opportunities in either type of reporting system.¹³ Instead, they are explained by economic and other tax system features including the presence of significant carryforward losses, a large number of inactive corporations in all the states, regulatory registration requirements, and the share of businesses with income less than state exclusions and deductions and with before-credit tax liabilities less than credits. The exclusions, deductions and credits that reduce or eliminate regular tax liabilities have been adopted by legislators to achieve non-revenue objectives, including stimulating capital investment and new job creation in a state.

Clearly, this commonly high level of taxpayers with only zero or minimum payments cannot be explained by tax planning opportunities in either type of reporting system.

The important point for emphasis in the corporate income tax policy debate is that a majority of corporations in the states included in Table 4 (excluding Minnesota and California) do not have income tax liabilities in excess of minimum taxes. State tax agencies could do a better job of explaining to legislators the reason for these apparently high percentages that are independent of the type of state filing system.

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II. REVENUE EFFECTS FROM ADOPTING COMBINED REPORTING

This section looks at the experience of state revenue estimators in tackling the very challenging task of estimating the revenue effects of switching from separate to combined reporting. The central problem is that corporate tax returns in separate filing states do not contain sufficient information to estimate reliably the revenue impacts of adopting mandatory combined reporting. In separate filing states, only the U.S.-wide net income and apportionment factors of the separate multistate taxpayers are available from state tax return information. In many cases even the data that is reported on corporate tax returns is not captured during the processing

of corporate returns because of resource limitations in state tax agencies.

Given this lack of information from state tax returns, revenue estimators must supplement actual state-specific tax return information with data from other sources that may have limited applicability to the state considering combined reporting or may provide only partial state-specific information that is difficult to extrapolate to the population of state taxpayers. The alternative sources of information that have been used in different states include:

- Federal tax return information for consolidated federal returns that include state taxpayers in the consolidated group.
- Tax return information from unitary states that may partially match actual taxpayers filing separately in the state preparing the combined reporting revenue estimate.
- The experience of a state's auditors in challenging transactions or structures under the state's current separate income tax filing system.
- Revenue estimates prepared by other states that are applied to the estimating state using ratios of tax return information combined with comparisons of state economic variables.

The following discussion highlights the difficulties in producing reliable estimates under the various approaches. The discussion of the key issues challenging all revenue estimators is followed by a summary of specific state estimates of the expected impact of adopting combined reporting. The evaluation is not a critique of revenue estimators, but rather a reflection of the lack of information for reliably estimating the revenue impacts of adopting a different corporate income tax system.

A. Factors affecting revenue impacts

This section identifies several of the most important data limitations that increase uncertainty in the revenue estimates of the impact of combined reporting.

Identifying members of a unitary group

Mandatory combined reporting requires affiliated companies in a unitary group to file a combined return. Unfortunately, combined reporting laws do not provide specific details on what constitutes a unitary relationship among related companies. Consequently, it is left to revenue agency regulations and court decisions, only available after the adoption of combined reporting, to offer guidance on how to define a unitary business. Revenue estimates of the switch to combined reporting have to be made without this guidance. This is an important source of the uncertainty in the revenue estimating process.

Under the combined reporting concept, there are two independent tests that must be met before an entity can be included in a combined report. First, only firms that meet minimum ownership requirement thresholds are to be included in the group filing a combined return. Typically, the group includes firms with at least fifty percent common ownership. However, there is little, if any, information on state separate tax returns or attached state-required versions of federal corporate tax returns to identify firms that may be included in a unitary group if they meet the ownership test. Because federal consolidated returns use an 80 percent ownership test, members of the federal consolidated group do not, in many cases, match the potential members of a state combined group.

The second test for being included on a combined report is that the included firms must have a unitary relationship, which is a constitutional requirement. In other words, definite economic and managerial interactions must provide a link between the members of the group. States are constitutionally limited to including only the companies that have a unitary business connection among the firms in the state combined group. Even if members of the federal combined group are identical to a state's common ownership group, some members of the federal group may not meet the state's unitary requirement. As discussed in the section on compliance costs, there is significant uncertainty over the factors that determine a unitary relationship among members of a group meeting the ownership requirements. Determining the unitary group of taxpayers is a difficult first step in the estimation process.

Net operating losses

A key factor in determining the change in revenue from adopting combined reporting is the treatment of net operating losses (NOLs). Consistent with the underlying theory that is used to justify the combination of a unitary group's income, combined reporting should also allow any NOLs earned by separate members to be aggregated and used to offset the group's combined income going forward. However, this consistent treatment of NOLs can result in a significant reduction in the unitary group's taxable income in the transition from separate to combined reporting. This occurs because combination can convert unused NOLs (for separate filers) into current "used" deductions against the combined net income of the unitary group. In other words, a greater amount of NOLs can be used earlier to offset current positive taxable income. While this is a transition issue for carryovers from the separate filing system, it can have a significant impact on the estimated revenue impacts of adopting combined reporting.

For example, under separate filing each affiliated company is restricted to deducting only carryforward NOLs or current-

... combined reporting should also allow any NOLs earned by separate members to be aggregated and used to offset the group's combined income going forward.

year losses that they generate. In other words, the NOLs from a subsidiary cannot be used to offset the taxable income of the parent company under separate filing. Under combined reporting, the NOLs and current losses may be used to offset the combined income of the affiliated group. In effect, combined reporting is likely to increase the amount of NOLs that effectively offset net income and reduce corporate income tax collections. As discussed in the state case studies in the Appendix, one of the most significant challenges in estimating the net revenue impact of combined reporting is determining the negative impact of future and previously accumulated NOLs on the combined unitary income base. The revenue impacts of adopting combined reporting are heavily influenced by the treatment of NOLs under combined reporting. This is particularly important when the economy is experiencing a sharp economic slowdown or a recession.

State corporate income taxpayers have accumulated large net operating losses over the last decade. For example, as reported in annual reports of the California Franchise Tax Board, annual losses reported on state corporate returns grew significantly faster than reported profits from 1997 to 2001; as a result, the ratio of losses to profits increased from 35 to 81 percent over the four-year period. Since the end of the recession in 2001, losses have continued to average over 50 percent of profits. To the extent that corporations taxable in states currently considering adopting combined reporting have experienced a similar surge in annual losses, the cumulative stock of NOLs may substantially reduce expected revenue or even result in an initial revenue loss from adopting combined reporting.

Assuming that taxpayers in a separate filing state are allowed to carry forward unused NOLs to future years, switching to combined reporting should provide the same carryforward treatment. However, because combined reporting treats the affiliated companies as a single corporation, any carryforward NOLs from separate returns should be allowed to offset the income of the combined group, not just the income of the entity generating the NOLs under separate filing. Any limit on the use of the carryforwards would be inconsistent with the rationale for requiring combined reporting.

The following example illustrates the possible negative impact of NOLs on state corporate income tax collections. Two subsidiaries and a parent company operate as part of a verti-

cally integrated company. State A that is adopting combined reporting has a 100% sales factor apportionment formula. It is also assumed that the manufacturing and sales distribution companies have nexus in State A; the parent's headquarter company does not.

- The manufacturing subsidiary has net income of \$50 and sells 50% of its output to a sales distribution subsidiary located in State A.
- The sales distribution subsidiary has net income of \$50 and sells 50% of the company's final product in State A and 50% to final customers in other states.
- The parent company has operating losses of \$60 based on economic activity unrelated to the subsidiaries and sales to final customers outside of State A.

Under separate filing, the two subsidiaries are taxpayers in State A. With 50 percent of their sales in the state, they both have 50 percent apportionment percentages in State A, and the sum of their taxable incomes attributable to State A is \$50.

Any limit on the use of the carryforwards would be inconsistent with the rationale for requiring combined reporting.

If State A adopts combined reporting, the sales factor for the combined group excludes intercompany sales and is equal to sales to unrelated parties for the three companies (\$700 in State A and \$1,500 in the U.S.) by the sales and distribution subsidiary in State A.¹⁴ However, the income of all three companies is combined for a total of \$40 of income. The income loss of the parent company, which does not have nexus in State A, is included in the combined group U.S. income amount, resulting in \$60 less of U.S. net income subject to apportionment to State A.¹⁵ Despite the fact that the apportionment factor remains the same under separate and combined reporting, the inclusion of losses held in the parent company reduces income taxable in State A by 60%.¹⁶

Tax revenue estimators have limited information on the carryover stock of NOLs for existing taxpayers. Even if reported on tax returns, this information may not be captured when returns are processed. More importantly, the unitary group will normally include corporations that are not current taxpayers, since it includes non-nexus companies. Revenue estimators will have no information on the carryovers for these firms.

Table 5
How Net Operating Losses May Reduce Taxable Income Under Combined Reporting

Filing system	Sales factor		Apport. factor	Taxable income	
	US	State A		US	State A
<i>Separate filing</i>					
Manufacturing subsidiary	\$1,000	\$500	50%	\$50	\$25
Sales/distribution subsidiary	1,400	700	50	50	25
Headquarters	100	-	-	-60	-
Separate filing income					\$50
<i>Combined filing</i>					
Manufacturing subsidiary	\$1,000	\$500		\$50	
Sales/distribution subsidiary	1,400	700		50	
Headquarters	100	-		-60	
Eliminate intercomp. sales	-1,100	-500			
Total for combined group				\$40	\$20
Change in taxable income					-\$30

Apportionment factors

Even if the net income of a unitary group is measured accurately, it is difficult for estimators to measure the apportionment factors of members of the unitary group that are not currently state taxpayers. Mandatory combined reporting requires that the group's net income be apportioned to the combined filing state based on the state's share of the group's factors that include a weighted average of the state's share of payroll, property and sales or a single sales factor. Separate filing states are generally limited to knowing only the in-state share of factors for each separate filer without having information on intercompany sales between members of the combined group. In addition, if a unitary group includes companies that are not current state taxpayers, revenue estimators may have no information about the factors of the non-nexus members of the combined group. As shown in the examples included in this study, small errors in the estimates of the apportionment factor can have large impacts on revenue estimates.

Addback statutes

As illustrated in several of the case studies, there can be substantial differences in the expected additional revenues from combined reporting depending upon whether or not a separate-filing state has already adopted expense addback provisions for royalties and expenses related to payments to affiliates for the use of intangible property and, in some states, for interest payments to affiliates as well. States with addback provisions already collect a portion of the revenue normally

States with addback provisions already collect a portion of the revenue normally expected from adopting combined reporting.

expected from adopting combined reporting. The revenue estimates should not double count this revenue. There are now 22 states with various forms of addback statutes.

B. Case studies of combined reporting revenue impacts

This section summarizes the revenue estimating experience of states that either have adopted combined reporting or have recently considered the adoption. The Appendix provides more detailed information about the revenue estimates and lessons learned from the estimating process.

Table 6 presents the results of this state-by-state review. The table identifies both the estimated annual revenue impacts and the percentage change in corporate income taxes from adopting combined reporting. Where available, the estimates represent the first full-year impacts of the change in tax collections in switching from separate filing to combined reporting. The comments in the last column of the table identify issues that are specific to a state and that may, therefore, limit the application of the results to other states.

**Table 6
State Revenue Estimates of the Impact of Combined Reporting**

State revenue estimates	Annual impact (millions)*	Percent of corporate income taxes	Year estimate was prepared	Comments
Iowa	\$75	16.7%	2007	Permits consolidated filing
Maryland	25	3.0	2007	Addback of expenses
Massachusetts	188	8.9	2007	Addback of expenses; methodology not described
Minnesota – initial est.	23	5.5	1981	Low end of estimated range
Minnesota – revised est.	–	–	1984	Short-run, post-implementation
New York	315	6.0	2007	Addback of expenses
New Mexico	90	20.0	2008	Permits comb./ consol. election; methodology not described
Pennsylvania	150	7.9	2004	With uncapped NOLs
West Virginia	24	10.0	2007	Methodology not described
Wisconsin	30	3.5	2007	Est. for non-bank taxpayers

*For the first full-year of tax impacts, where available.

The individual state studies provide important insights and lessons related to estimating the revenue impacts of adopting combined reporting. The following highlights summarize the detailed, state-by-state descriptions of revenue impact analyses presented in the Appendix.

High Degree of Uncertainty of Revenue Impacts

There is a very large range of estimates of the revenue impacts across the states as shown in the table. For analyses prepared at the time of the adoption of combined reporting, the percentage increases range from 3 percent of corporate tax revenue in Maryland to 20% percent in New Mexico. While states do differ in the structure of their corporate income taxes and the composition of their economies, this unusually wide range illustrates the inherent uncertainty in estimating these impacts.

It should be noted that bill analyses for three of the high-end estimates of the percentage increase in corporate taxes from adopting combined reporting (Massachusetts, New Mexico and West Virginia) do not provide a description of the methodology used to estimate the impacts. The estimates based on detailed analyses of corporate tax return data or information from state tax auditors (New York, Pennsylvania and Wisconsin, for example) report significantly lower impact estimates. Several of the bill analyses (Maryland and Minnesota) actually note that the impacts cannot be reliably estimated.

In addition, this wide range in the net impacts masks substantially larger potential errors in the tax increase and tax decrease components of the estimated net change. Small errors in estimating both increases and decreases can have large impacts on the net change revenue estimates. As explained in the discussion of Pennsylvania’s estimates in the Appendix, if tax increases were overestimated by 10 percent and decreases underestimated by 10 percent, the Pennsylvania estimate of the combined reporting impact would drop by 60 percent. In this case, the additional revenue from combined reporting would drop from 7.9 percent as reported in Table 6 to a little over 3 percent.

... this wide range in the net impacts masks substantially larger potential errors ...

The important point is that the size of the potential errors should be made clearer in the estimation process, especially if legislators are relying on the adoption of combined reporting to close state tax revenue gaps due to the current economic slowdown. As an example, the Minnesota bill analysis pointed out to lawmakers that the estimated switch to combined

reporting was expected to raise between \$23 and \$103 million, an unusually large range for a bill analysis. As explained below, the actual results in Minnesota were closer to a zero increase.

Shorter-run revenue increases could be very small

Only one state, Minnesota, conducted an analysis of the revenue impacts of adopting combined reporting after implementation of the law change. Using actual tax return data, Minnesota researchers compared initial taxes paid under combined reporting with estimates of the sum of taxes that would have been paid by members of the combined group if separate filing had continued. The comparison found that, for the first tax year under combined reporting, tax collections actually decreased. Instead of collecting 15% more in taxes as predicted in the bill analysis, state taxes fell 9% with the adoption of combined reporting.

After analyzing additional tax return data, the researchers concluded that the short-to-intermediate impact was no change in corporate tax revenue. A major reason for this unexpected result was the fact that combined reporting “unlocked” net operating losses (NOLs) that previously could not be claimed on separate returns. In the transition, the NOLs actually reduced the income tax base.

Instead of collecting 15% more in taxes as predicted in the bill analysis, state taxes fell 9% with the adoption of combined reporting.

As illustrated by Pennsylvania’s experience, the revenue estimates are very sensitive to the treatment of NOLs under combined reporting. In the Pennsylvania estimates, full allowance of NOLs (both carried in from the separate filing system and earned under the combined reporting system) reduced the expected additional revenue from combined reporting by 64 percent; for manufacturing, the reduction was 80 percent. In addition, revenue estimators often are asked to estimate the impact of combined reporting proposals that do not clearly specify the NOL treatment. Combined with the lack of information about the accumulated stock of NOLs, this creates significant uncertainty in the estimation process.

As the U.S. economy continues to slow in early 2008, corporate profits are declining and net losses in selected industries may increase significantly. As a result, NOLs will become increasingly more important in determining the shorter-run revenue impacts of switching to combined reporting. This will add further to forecasting risk.

Even if the longer-run estimates of revenue impacts from adopting combined reporting are reliable, states lack sufficient information to determine the time profile of the revenue response as taxpayers adjust to combined reporting. As shown in the Minnesota case, little additional revenue may be collected in the short-run, an adjustment period that may cover several years. This creates an additional fiscal risk for legislators who view combined reporting as a short-run, budget-balancing component.

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Addback provisions substantially reduce revenue impacts

Approximately 20 states have adopted various add-back provisions that deny income tax deductions for selected expenses paid to affiliates for the use of intangible assets. Of this group, 16 are separate filing states. The addbacks have the effect of increasing the taxable income of separate filers in the state by the amount of the disallowed deductions without requiring combined reporting. These provisions, therefore, reduce the additional revenues expected from adopting combined reporting.

For separate filing states with add-back provisions, the percentage increase in corporate taxes shown in Table 6 averages 5.9 percent; for New York and Maryland, the average is 4.5 percent. The revenue impact estimates in Maryland, for example, suggest that the adoption of expense add-back provisions reduced the additional revenue from combined reporting by approximately by roughly 55 percent.

Based on this experience, it is reasonable to conclude that the large number of separate filing states with add-back provisions can expect additional intermediate- or long-run corporate income tax collection increases of no more than 5 percent in shifting from separate to combined filing.

Each state’s experience is unique

In considering the use of revenue impact ratio estimates for combined reporting from other states, tax researchers must carefully consider the unique tax system features and tax compliance issues in each of the other states. For example, Wisconsin estimated that combined reporting would increase corporate tax collections by 10.5 percent. However, an estimated 75 percent of the total was from banks. Because many states tax banks under separate tax systems from gen-

eral corporate taxpayers, the Wisconsin ratio is not applicable in these other states. Adjusted to remove banks, the Wisconsin ratio was 3.5 percent, the figure shown in Table 6.

A related point is that the members of a combined unitary group may vary across states and will differ from the corporations included on federal consolidated returns. States may use different ownership tests for affiliation, as well as different concepts for determining a unitary relationship among affiliated corporations. These differences greatly limit the applicability of federal or other state tax return information in the estimation process.

Revenue estimates do not consider negative impacts on the economy

All of the revenue estimates reviewed in this study are static revenue estimates. In other words, the estimates assume that there will be no change in the level of economic activity or corporate tax bases in response to the adoption of combined reporting. However, as discussed further in the next section, combined reporting will increase the taxes paid for many corporations operating in a state. In response to higher taxes, these corporations can be expected to reduce their level of investment in the state. This results in a negative feedback effect in the form of reduced state and local taxes from all sources, not just corporate income taxes. If this dynamic tax effect is included in the revenue estimates, the net impact of combined reporting on state tax collections may be substantially reduced from the static revenue impacts reported in Table 6.

In response to higher taxes, these corporations can be expected to reduce their level of investment in the state.

III. IMPACTS OF COMBINED REPORTING ON A STATE'S ECONOMIC COMPETITIVENESS

Some proponents of combined reporting suggest that the shift from separate to combined reporting would not have any negative impact on a state's economy. For example, after citing manufacturing job growth performance in selected combined states and anecdotes about corporation investment decisions, one proponent suggests "that the burden of proof ought to lie with combined reporting opponents to demonstrate that the policy has a negative impact on state economic growth."¹⁷ In legislative testimony focusing on combined reporting in 2005, the Secretary of the Pennsylvania Department of Revenue stated: "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."¹⁸

Measuring the impact of a single tax policy change, such as adopting combined reporting, on a state's economy is, in fact, difficult to do. The basic problem lies in the inability to account for "all other factors" that are changing simultaneously and affect a state's economy. These factors include changes in the U.S. economy, changes in the composition of economic activity within a state, and changes in tax policies in other states. This is why simple comparisons of groups of states on a single economic measure, such as manufacturing job growth, cannot "prove" that the policy change has had either a positive or a negative impact on an economy.

This section discusses several different approaches to identifying the economic impacts of combined reporting. These different approaches suggest that combined reporting may have a negative impact on a state's economy. The approaches include predictions derived from economic theory, the simulation of corporate tax changes using state economic models (which attempt to hold other factors constant), empirical studies of the response of economic activity to changes in business tax rates, and an expanded comparison of state job growth rates.

... simple comparisons of groups of states on a single economic measure, such as manufacturing job growth, cannot "prove" that the policy change has had either a positive or a negative impact on an economy.

A. How does combined reporting affect a state's competitiveness?

Proponents of combined reporting focus on the increase in the corporate income tax base that they anticipate from eliminating income-shifting opportunities under separate filing tax systems. The expectation is that combining income of affiliated corporations will negate any tax-related shifts in income among states due to transactions or restructuring that are unrelated to the on-going business operations in a state. However, this perspective assumes that combined reporting can achieve revenue-raising objectives without having a significant negative impact on the level of payroll, property and sales in a state. In other words, this perception assumes that any income-shifting activity has no real economic substance

and negating these shifts will have no impact on a state's real economy. This is not correct. In fact, a shift to combined reporting can have substantial negative impacts on the real economy.

... a shift to combined reporting can have substantial negative impacts on the real economy.

As shown in the taxpayer example in Table 3, adopting combined reporting may actually increase effective corporate income tax rates even in cases where there is no tax planning that distorts income. This occurs when the income per dollar of factors used in the apportionment formula is higher for the additional firms added to the combined group compared to the ratio for the original separate filing company. In this case, combination increases income to be apportioned by a greater percentage than the decrease in the apportionment factor and state tax payments increase. Compared to the income earned by the separate filing company, this increases the effective tax rate on additional investment in the state adopting combined reporting. It is also possible that the move to combined reporting could decrease effective tax rates, but if state revenue estimators score the legislation as a tax increase, then effective tax rates on average must also be assumed to increase.

Enactment of combined reporting will increase effective tax rates on some new investment and may trigger redistributions of investments and jobs among states, independent of any reduction in tax planning opportunities. As pointed out in the discussion of the revenue estimates, even if combined reporting results in a relatively small increase in net corporate taxes, there will be significant firm-level increases and decreases in tax liabilities. Depending upon the industry distribution of winners and losers and the overall size of the net tax increase, adopting combined reporting may have a negative impact on a state's overall economy.¹⁹

If the increased tax liabilities are imposed on multistate firms sensitive to interstate effective tax rate differences, combined reporting may result in a reduction in the level of investment and jobs in a state. The companies most affected would be those that sell products or services in national or international markets and use significant amounts of mobile capital. These are firms that will have a limited ability to pass higher taxes on to customers in higher prices but do have the option of shifting capital and jobs to locations with lower state tax rates.

To the extent that combined reporting increases a state's taxes (relative to other states) and reduces the after-tax rate of return on mobile investments, it can negatively impact a state's real economy. The higher corporate taxes directly lower the after-tax rate of return on the firm's operations in the state. In response, the firm is likely to shift payroll, property, and even sales to other states to reduce the percentage of total combined income subject to the higher tax rate. This shift will continue until output prices increase or the number of workers or the amounts paid to workers and capital in the state fall enough to increase the firm's before-tax net income from operations in the tax-increase state.

The shifting process ends when the after-tax rate of return is restored to a competitive level. Note that the adjustment process results in reduced employment, investment, and overall economic activity in the state. These are changes in real economic activities, not just changes in a state's share of a fixed level of the taxpayer's U.S.-wide corporate income. Economic theory suggests that the combination of relatively fixed in-state labor and increasingly mobile capital (including intangibles, machinery and equipment, and structures) across state and national borders will result in corporate tax increases being borne by labor in the state through fewer jobs (or lower wages over time) or by in-state consumers through higher prices for goods and services.²⁰ In other words, the burden of the higher corporate taxes will fall primarily on the residents of a state, not on capital investors.

... the burden of the higher corporate taxes will fall primarily on the residents of a state, not on capital investors.

B. Tax simulations of impacts of corporate income tax changes

State tax policy simulation model analysis also suggests that a shift from separate to combined reporting for corporate income taxes can reduce the level of jobs and investment in a state. In a recent study, E&Y estimated the potential economic and fiscal impacts of adopting combined reporting in Maryland.²¹ Policy options that E&Y was asked to analyze included a corporate income tax increase and a shift to combined reporting.

The first step in modeling the expected economic impacts is to estimate the increase in tax liabilities from combined reporting (the "static" revenue impact). E&Y used the \$25 million impact estimate reported in the fiscal note prepared by the

... a shift from separate to combined reporting for corporate income taxes can reduce the level of jobs and investment in a state.

Maryland Department of Legislative Services described earlier. Starting with the \$25 million net change, E&Y distributed the change by industry. The estimated revenue impact for each industry was then used as inputs into an economic model of Maryland's economy.²² The model incorporates empirical estimates from the economic literature on the response of investment and employment to changes in the cost of investing (cost of capital) in the state. The economic model was used to translate the change in each industry's cost of capital (equal to the change in tax liabilities) into changes in economic output, income, and jobs recognizing the complex interactions of all the sectors in Maryland's economy.

The results of the simulation show that the negative impact of adopting combined reporting on the Maryland economy, in terms of lost jobs per dollar of increased tax revenue, is actually slightly larger than the negative job impact from increasing the corporate income tax rate. This difference is primarily due to differences in the distribution of net tax changes by industry between rate changes and adopting combined reporting.

These results are consistent with recent empirical studies of the impact of business tax changes on state economies. As summarized by a nationally-recognized public finance economist, "... the majority view among economists is that the long-run effect of a 10 percent cut in state and local business taxes, holding other effects on business location constant, is to raise business activity in a state by about 2 percent."²³ Conversely, if combined reporting raises net business taxes by 10 percent, economic activity would fall by 2 percent, based on this "elasticity" of response. The negative impact on jobs will vary with the composition of a state's economy and the size and industry distribution of winners and losers.²⁴

C. Expanded interstate growth comparisons

As already noted, some proponents of combined reporting have suggested that adopting combined reporting may not have a negative impact on a state's economy. This conclusion is sometimes based on simple comparisons of economic growth between states with unitary combined reporting and separate filing. Such comparisons are an oversimplification that does not hold constant key economic and demographic

factors that determine differences in state growth rates. For example, prior trends, tax policy, or demographic factors could not have predicted the growth of Silicon Valley in California in the 1990s.

Job growth comparisons

Table 7 illustrates the limitations of this simple comparison approach in trying to identify the impact of combined reporting on a state's economy. The table provides a high-level comparison of private-sector job growth rates for separate filing and combined filing tax states. Unlike the comparisons of changes in manufacturing jobs only that have been used to evaluate the economic performance of combined and separate filing states, the employment data in the table cover all private-sector employees including the fast-growing financial and service sectors of the economy. The 24-year period covers the years between the adoption of combined reporting in Minnesota and Illinois and the first effective year of Vermont's adoption of combined reporting.

The first column in Table 7 shows the private-sector employment growth rate between 1982 and 2006. The second column shows population growth over the same period. The third column shows the difference between the employment and population growth rates. For example, in California, the employment growth rate (67 percent) exceeded the population growth rate (47 percent) by 20 percentage points. The weighted average growth rate differences are reported at the top of the combined reporting and separate filing state groups.

Even a cursory state-by-state comparison of the job and population growth rates indicates that the difference in the job growth rates between combined reporting and separate filing states is due primarily to the region in which a state is located, not its corporate income tax structure. The second column in Table illustrates this point. The combined states have aggregate population growth ratios that are almost 63 percent higher than the rate for separate filing states.

The subtraction of population growth in the third column is a simple way to "control" for other state-specific growth factors that are not directly related to corporate taxation. A comparison of the aggregate growth rate differences suggests that job growth (relative to population growth rates) has been about 6 percent higher in the separate filing states. The use of population growth as a single measure of all the complex factors explaining changes in a state's private-sector employment is a vast oversimplification. However, it does show that adjusting job growth measures for population changes provides additional insight into the source of differences in interstate job growth.

Table 7
Job Growth by State, Combined and Separate Filing States (1982-2006)

State	Employment growth	Population growth	Employment/population growth
Combined Total:	72%	39%	33%
Alaska	76	49	27
Arizona	174	113	61
California	67	47	20
Colorado	90	55	35
Hawaii	69	43	26
Idaho	129	51	79
Illinois	42	12	30
Kansas	50	15	35
Maine	63	16	46
Minnesota	73	25	48
Montana	79	17	61
Nebraska	60	12	49
New Hampshire	79	39	40
North Dakota	50	-5	55
Oregon	93	39	54
Utah	146	64	82
Separate Filing Total:	59%	24%	35%
Alabama	68	17	50
Arkansas	71	23	48
Connecticut	29	12	18
District of Columbia	39	-8	48
Delaware	82	42	40
Florida	124	73	51
Georgia	108	66	43
Indiana	56	15	41
Iowa	50	3	47
Kentucky	62	14	48
Louisiana	26	-1	27
Maryland	79	31	48
Massachusetts	37	12	26
Michigan	52	11	41
Mississippi	54	14	40
Missouri	52	19	33
New Jersey	44	17	27
New Mexico	91	53	38
New York	29	10	19
North Carolina	86	47	39
Ohio	43	7	36
Oklahoma	31	29	1
Pennsylvania	37	5	32
Rhode Island	35	12	23
South Carolina	76	35	41
South Dakota	88	13	74
Tennessee	81	30	51
Texas	71	12	60
Virginia	91	39	52
Vermont	68	20	48
West Virginia	28	-7	34
Wisconsin	61	18	44

Note: Controlling for population growth, job growth is nearly the same from 1982 to 2006 for combined reporting and separate filing states.

... job growth ... has been about 6 percent higher in the separate filing states.

Regression analysis

The job and population growth information from Table 7 was further analyzed using linear regression analysis. The regression analysis related the state-by-state job growth numbers to differences in population growth rates, average levels of private-sector wages and a variable that identifies combined reporting states.²⁵ After accounting for the other factors, the coefficient on the combined reporting variable is not significantly different from zero. In other words, this equation using highly-aggregated data does not find an independent impact of combined reporting on state job growth for all states combined.²⁶

D. Recent state-by-state data on investment trends

A final source of information for comparing the economic performance of states with combined and separate reporting is E&Y's annual 50-state study of new capital investment and new and retained jobs for major business investment projects.²⁷ The information on project investments was compiled by E&Y from both public and private data sources and information from state economic development agencies. The E&Y study provides a snapshot of where recent major investments are being made in the U.S. by both domestic and foreign companies.

Table 8 provides the state-by-state information on new and retained jobs that are associated with the announced investments included in each of the past three years of projects (2004 through 2006). To scale for differences in the size of state economies, the three-year sum of project jobs is divided by the 2006 measure of private-sector gross state product (GSP), the most comprehensive measure of the level of annual economic activity in a state.

The figures in the Jobs column in Table 8 present the ratios of new and retained jobs per \$1 billion of GSP. For example, over the three-year period, announced projects in California accounted for 22.4 jobs per \$1 billion of 2006 GSP, a relatively small number compared to most other states. The states are divided into combined and separate filing states; the combined states include those that had combined reporting in effect prior to the 2006 implementation of combined reporting in Vermont.

The average figures (sum of jobs divided by the sum of GSP in each group) for the two groups of states are presented in the last rows of Table 8. There is a significant difference in

the number of new or retained project jobs relative to \$1 billion of GSP: the ratio is 134 for separate filing states and 50 for combined reporting states. A number of separate filing states in the Southeast and the Midwest show the highest job gain relative to GSP from major investments over the last three years.

Table 8
New and Retained Jobs from Mobile Investments,
per \$1 billion of Gross State Product (2004-2006)

Combined filing		Separate filing	
State	Jobs*	State	Jobs*
Alaska	n.a.	Alabama	334.6
Arizona	17.2	Arkansas	47.3
California	22.4	Connecticut	61.3
Colorado	14.8	Delaware	56.7
Hawaii	n.a.	District of Columbia	11.4
Idaho	72.6	Florida	109.3
Illinois	93.9	Georgia	218.1
Kansas	193.0	Idaho	72.6
Maine	53.5	Indiana	258.2
Minnesota	103.3	Iowa	230.2
Montana	24.8	Kentucky	321.3
Nebraska	122.9	Louisiana	129.2
New Hampshire	15.0	Maryland	106.7
North Dakota	74.4	Massachusetts	11.1
Oregon	17.2	Michigan	199.7
Utah	145.3	Mississippi	171.8
Average	50.0	Missouri	126.7
		New Jersey	28.6
		New Mexico	112.8
		New York	65.0
		North Carolina	208.2
		Ohio	145.5
		Oklahoma	241.5
		Pennsylvania	86.2
		Rhode Island	92.7
		South Carolina	200.9
		South Dakota	34.6
		Tennessee	183.0
		Texas	136.0
		Vermont	6.0
		Virginia	270.3
		West Virginia	133.3
		Wisconsin	80.5
		Average	134.2

*Figures are 3-year sums of new jobs per \$1 billion of gross state product.

While this comparison also does not control for other factors that explain the differences in the ratios, it does show that separate filing states have recently been more successful in attracting new investments that add or retain jobs. This new investment is the source of future growth in state investment, employment, productivity and real household income.

... separate filing states in the Southeast and the Midwest show the highest job gain relative to GSP from major investments over the last three years.

E. Summary of economic impacts

This study does not provide a comprehensive analysis of all the factors that explain differences in the growth of jobs across the states. It does look at additional sources of information that can be used to begin addressing the question of what the economic impact will be if a state adopts combined reporting given the mix of combined and separate filing states. Given the fact that combined reporting will result in increases in corporate income taxes on a significant number of multistate companies, even if the net change in tax revenue is small, economic theory predicts that combined reporting will have a negative impact on the state's economic growth if it also raises tax revenue. Economic modeling of the impacts using a comprehensive model of Maryland's economy supports this conclusion.

In addition, there is recent evidence that separate filing states are attracting substantially more new investment and employment than are combined reporting states, although this difference cannot be directly attributable to variation in the structure of state corporate income taxes. Finally, after controlling for population growth, a variable that is not "explained" by differences in corporate income tax systems, comparisons of job growth rates find that separate filing states have slightly higher job growth rates. While this additional analysis does not "prove" that a shift to combined reporting by a single state will harm the state's economy, it does suggest that legislators should be more concerned about the possible negative effects on investment and jobs when debating the merits of adopting combined reporting.

... legislators should be more concerned about the possible negative effects on investment and jobs when debating the merits of adopting combined reporting.

IV. COMPLIANCE AND ADMINISTRATIVE IMPACTS

Combined reporting creates complexities in corporate income tax systems that can add to taxpayer compliance costs and state administrative costs. The following sections outline the complex steps that are involved in implementing combined reporting for state corporate income taxes. The steps include determining 1) the affiliated companies to include in a unitary group, 2) the taxable income of the unitary group, and 3) a state's share of the taxable income.

Determining the unitary group

In determining if affiliated corporations are engaged in a unitary business, taxpayers and tax administrators must first address the challenging question of how to define the trade or business that is unitary. This involves examining the economic relationships between divisions within a single company or interactions and interdependencies among affiliated corporations linked by common ownership. Members of a unitary group must be linked by more than a passive investment relationship; there must be an exchange or flow of economic value among affiliates that exceeds the flows between independent, unrelated business entities. Therefore, a finding of a unitary relationship must be based on a determination of the economic relationship among commonly owned corporations.

Taxpayers are often left to determine which corporations to include in the unitary group without detailed guidance from state statutes or, in many cases, without detailed regulations. The economic relationships must be traced by identifying the activities undertaken by each division or subsidiary and the resulting flows of goods and services, often by product or service line, between related corporations. In the case of corporations with a number of business activities that are not in the same line of business or are not related processes in one line of business, the unitary determinations involve not only quantitative measures, but also qualitative dimensions. These qualitative dimensions introduce both controversy and uncertainty into the corporate tax system. As a result, taxpayers and tax administrators often disagree on the affiliated corporations that meet the unitary test. More complex audits and appeals and increased litigation can be expected as a result of the unitary determination in states adopting combined reporting.

The complexity in determining the affiliated corporations to be included in a unitary group can be seen in a recent New York State Department of Taxation and Finance explanation of the rules for complying with the 2007 expanded requirements for mandatory filing of a combined report.²⁸ Under

the new law, combined reporting is required when there are "substantial intercompany transfers" among related corporations. The rules list ten specific steps (several of which involve repeated rounds of calculations) to follow in determining if a combined return is required and, if so, which firms to include. The initial step requires each taxpayer to determine all related corporations that meet specific ownership requirements. In following steps, taxpayers continually expand the number of corporations to be included in the unitary return by identifying every corporation with substantial intercompany transfers with any other corporation included in a prior step. In determining whether substantial intercompany transactions exist, taxpayers must examine the "facts and circumstances" for all activities and transactions between all related companies and the taxpayer in each step.²⁹

More complex audits and appeals and increased litigation can be expected as a result of the unitary determination in states adopting combined reporting.

Combined reporting also involves substantial administrative costs. To evaluate the taxpayer's determination of a unitary relationship, state auditors must look beyond accounting and tax return information. They must rely on publicly available information or ask taxpayers for detailed information on ownership shares, organizational charts, directories of officers and directors for each affiliate, inter-corporate reporting requirements and communications, annual changes in corporate structure and operations each year and descriptions of inter-corporate transactions, including financial flows related to loans and the production and use of intangible property, in evaluating ownership and economic factors that determine a unitary relationship. Service flows include research, insurance, training, purchasing, advertising accounting, human relations, administration and computing.

In effect, auditors must determine how a taxpayer and its affiliates operate at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation's operational and tax staffs to gather this operational information. Determining the scope of the unitary group is a complicated, subjective, and costly process that is not required in separate filing states.³⁰

Combined reporting also involves substantial administrative costs.

The determination of the unitary relationship must be done annually in light of on-going changes in business operations and structure such as mergers, acquisitions and divestitures. In other words, the unitary concept is a dynamic one that must be continually evaluated. In addition, it involves examining the economic relationships between all affiliated companies, not just those that have nexus in the taxing state.

Calculating combined income

Once the unitary group is defined, the net income to be included on a combined report must be determined. This step is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most combined reporting states, the group of corporations included in a federal consolidated return differs from the members of a combined group. This occurs because most states use a different ownership test for inclusion, and more importantly, state combined groups may include only firms that are unitary in operation, a concept that has no federal counterpart. Included groups and their taxable income may also differ across states because of different state-specific requirements for determining which corporations are unitary.

This step also involves identifying the split between apportionable business income and allocable non-business income. This is a determination that, in theory, requires examining the relationship between income sources and the business operations of each corporation included in a unitary business. Again, the determination applies to all firms in the unitary group, not just those corporations with nexus in the taxing state that were already separate filers in a state before the adoption of combined reporting. It also involves accurately attributing related expenses to both business and non-business income.

It should also be noted that transfer pricing issues still arise under combined reporting. Only the inter-corporate transactions among the companies included in the unitary group are eliminated in determining combined income. Transfer pricing issues will still remain for any transactions between the unitary group and affiliated companies not included in the unitary group.

Apportioning income

The final determination is calculating the apportionment percentage to be applied to the combined income of the unitary group in determining the state's share of the income. The factors included in the apportionment formula should be related geographically to the production of the unitary group's income. Factors that are related to non-business income and non-unitary businesses should not be included in the apportionment formula. These factors have to be determined separately for each corporation in the combined group and for each combined reporting state.

An additional complication under combined reporting is the need to eliminate sales among members of the combined group to avoid including the sales multiple times in the apportionment formula. In making these adjustments taxpayers have to eliminate sales among the unitary members but not sales between affiliated corporations that are not in the unitary group. This increases the number of additional calculations in determining apportioned net income in combined reporting states. In addition, factors normally have to be calculated (and inter-corporate sales eliminated) for all members of the unitary group, not just members with nexus.

In addition to variations in apportionment formulas among the states that apply to all corporate taxpayers, further compliance costs related to combined reporting result from variations across states in the methods used to calculate the apportionment factors. For example, the numerators of apportionment factors may include or exclude the dollar amounts of factors for members of the unitary group that do not have nexus in a state. As another example, states vary in the treatment of factors from foreign subsidiaries that are associated with foreign income, such as dividends from foreign subsidiaries, included in the combined income of a unitary group. All of these variations add to compliance and administrative costs.

V. CONCLUSIONS

This study has provided a detailed analysis of the mechanics of combined reporting. It shows that switching from separate filing to combined reporting can decrease, increase or leave state tax collections unchanged depending upon the complex economic relationships among corporations included in a combined group. Because of this complexity, the overall revenue impact of adopting combined reporting is very difficult to predict reliably. As a result, significant uncertainty is associated with bill analyses prepared by state revenue estimators. A comparison of these estimates suggests that the additional revenues generated by combined reporting may be fairly modest, particularly in separate-filing states that have already adopted expense disallowances for affiliated corporations.

While the proponents of combined reporting have focused on the benefits in terms of reducing tax planning opportunities, the paper points out additional costs related to combined reporting that state legislators need to consider. These include the potential negative economic impacts of increasing effective corporate tax rates on corporations operating in a state. The higher effective tax rates are expected to reduce investment and jobs in a state. This negative impact on a state's business tax competitiveness affects all taxpayers facing higher effective rates, not just those using tax planning techniques. The additional compliance, administrative and

litigation costs associated with combined reporting should also be included in a balanced evaluation of combined reporting.

The analysis in this paper suggests that combined reporting is not a panacea for addressing the problem of how to determine accurately multistate business income that is attributable to economic activity in a state. While proponents argue that it helps to overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under combined reporting create new distortions in assigning income to different states. The combined reporting assumption that all corporations in an affiliated unitary group have the same profitability per dollar of factors (payroll, property and/or sales) is not consistent with either economic theory or business experience. Consequently, combined reporting may reduce the link between income tax liabilities and where income is actually earned even in the absence of distorted transfer prices or income shifting strategies. In this situation, many corporate taxpayers may conclude that there is a significant risk that combined reporting will arbitrarily attribute more income to a state than is justified by the level of a corporation's real economic activity in the state.

... combined reporting is not a panacea for addressing the problem of how to determine accurately multistate business income that is attributable to economic activity in a state.

State legislators should carefully evaluate the revenue, economic development, and tax administration and compliance impacts before adopting combined reporting. The impacts are complex and, in some cases, uncertain. Given this uncertainty, legislators should consider all the options available for achieving their tax policy and/or revenue objectives at a lower cost in terms of the unintended consequences associated with combined reporting.

State legislators should carefully evaluate the revenue, economic development, and tax administration and compliance impacts before adopting combined reporting.

APPENDIX: STATE ESTIMATES OF COMBINED REPORTING REVENUE IMPACTS

This Appendix provides a more detailed discussion of state-by-state estimates of the static revenue impacts of proposals to adopt combined reporting. It includes a detailed discussion of the methodology and data used to prepare the estimates. The sources of the information include bill analyses prepared during legislative sessions, tax agency studies, state tax studies and testimony before tax committees and tax commissions.

Minnesota

The Minnesota legislature adopted mandatory combined reporting in 1982.³¹ Combined reporting was adopted with limited debate about the tax policy issues related to the bill, but considerable discussion over the revenue estimates. Because Minnesota corporate taxpayers filed tax returns on a separate entity basis prior to the law change, there was no state tax return data that could be used directly to determine combined filing groups and their tax liabilities under combined reporting. Based on a survey of other states with combined reporting, Minnesota assumed a 15 percent increase in tax collections from adopting combined reporting. At the time, a 15 percent increase in corporate income taxes generated \$63 million (over 18 months). Recognizing the high degree of uncertainty in estimating the revenue impacts of the law change, lawmakers were warned that the impact could range from \$23 and \$103 million, an unusually wide range for a bill analysis. In almost all tax bill analyses in Minnesota, a single number (point estimate) is provided for revenue impacts.

Because the law adopting combined reporting also required a report to the legislature on some elements of the revenue impacts of the law change, Minnesota provides a unique, post-law-change evaluation of the impact of combined reporting. Comparing actual liabilities for firms filing combined returns in 1982-83 with recomputed liabilities as if they had filed separate returns, the Department of Revenue found that combined reporting actually reduced tax liabilities by roughly nine percent on initial combined returns. The decline was partially due to the conversion of unused separate entity losses into current loss offsets for 100 percent Minnesota unitary groups and bank holding companies filing combined reports.³²

Based on the calculations from actual combined reports, the estimates of the additional revenue raised from combined reporting were lowered to zero for each fiscal year through 1985, four years after mandatory combined reporting went

... the Department of Revenue found that combined reporting actually reduced tax liabilities by roughly nine percent on initial combined returns.

into effect. Even if the adoption of combined reporting leads to higher corporate income tax collections over the longer run, the Minnesota ex-post evaluation does suggest that the initial impact of adopting combined unitary reporting may be a smaller revenue increase than forecasted or actually a decrease in revenues. An actual short-run reduction in revenue may occur if the stock of NOLs carried into the new system is significant. The Minnesota experience clearly illustrates the difficulty in reliably forecasting corporate income tax changes when a state moves from separate returns to combined reporting.

Wisconsin

The Wisconsin Department of Revenue prepared revenue estimates of a proposal to adopt mandatory combined reporting in 2003.³³ Similar to the Minnesota experience, Wisconsin was also constrained by the lack of data on corporate tax returns filed on a separate entity basis. The method chosen to estimate the revenue impact of combined reporting was to integrate 1994-1995 Wisconsin tax return information with Minnesota Department of Revenue data for taxpayers filing combined reports in Minnesota, a mandatory combined reporting state.

Wisconsin research staff identified large state corporate income taxpayers and asked Minnesota to match each Wisconsin taxpayer to a Minnesota group based on federal taxpayer identification numbers. Minnesota identified the combined groups and Minnesota nexus taxpayers that were linked to the identified Wisconsin separate filers. This taxpayer list was then used by Wisconsin to pull separate filing information for the taxpayers provided by Minnesota. The Wisconsin staff then merged the Minnesota and Wisconsin taxpayer information. This database was used to estimate the impact of combined reporting.

A noteworthy limitation on the Minnesota taxpayer data was the fact that it did not include information on banks. The Wisconsin researchers developed independent estimates for the banks. While the estimates discussed during the presentation were only preliminary, combined reporting was expected to generate \$75 million based on tax year 1996 collections. However, only \$25 million was estimated to come from non-bank taxpayers. The \$75 million figure was 11.7 percent of the corresponding total Wisconsin corporate income tax col-

lections. For non-bank taxpayers, the \$25 million tax increase was 4.2 percent of non-bank corporate tax collections, a figure that is more applicable in states that tax banks and other financial institutions under separate tax systems.

In July 2007, the Wisconsin Legislative Fiscal Bureau estimated the full-year impact of adopting mandatory combined reporting at \$90 million for FY 2009. This estimate is 10.5 percent of the projected total corporate income tax collections under current law. No separate estimate was available for the non-bank impact from combined reporting in the July 2007 estimates. However, a better gauge of the revenue impact of combined reporting may be estimated by the non-bank impact. Because Wisconsin has more recently aggressively challenged the use of Nevada-based, intangible asset holding companies owned by banks, the state may already have collected a substantial portion of the estimated \$90 million through targeted compliance activities under their separate filing system. If the \$90 million estimate is adjusted to remove the same portion of the total attributed to banks in the 2003 estimates, the additional revenue from combined reporting would drop to \$30 million or 3.5 percent of projected revenues. This is the percentage shown in the summary table.

Pennsylvania

Pennsylvania's experience in estimating the corporate tax impacts of adopting combined reporting provides a clear example of how NOL provisions may significantly affect the estimates. In 2004, the Pennsylvania Department of Revenue (DOR) presented their preliminary estimates of the revenue impact of adopting combined reporting at a meeting of the Pennsylvania Business Tax Reform Commission.³⁴ Similar to the methodology used by Wisconsin, the DOR also relied on Minnesota corporate income tax data (for tax year 2000), using combined income and apportionment data for Minnesota filers with Pennsylvania and IRS corporate tax data, to derive Pennsylvania-specific estimates. In addition to identifying the affiliates that may be required to file as a unitary group, Pennsylvania also used the combined dataset to estimate the impact of carryforward NOLs.

According to the treatment of NOLs, the estimated increases in corporate taxes expected from combined reporting ranged from \$150 million to \$411 million.³⁵ The larger tax increase assumed that the separate company NOLs carried into the new system were capped at \$2 million per year per entity (with a 20-year carryover) and that no cap was imposed on NOLs earned by the group. The much lower tax increase estimate assumed that NOLs (carried in from separate filing) were uncapped for an individual company and could be used by all members of a unitary group without any annual cap. In other words, full utilization of NOLs reduced the pro-

jected net gain in corporate tax revenue by 64 percent; for manufacturing the reduction in additional taxes was nearly 80 percent.

Another way to understand this difference in impact estimates is to note that the relatively large estimate of net revenue from combined reporting in Pennsylvania results from the state's unique cap on NOLs and denying the full use of precombination NOLs. For this reason, the higher Pennsylvania revenue estimates cannot be used as a basis for estimating the revenue impacts of adopting combined reporting in other states that allow full NOL offsets.

The Pennsylvania debate over combined reporting provides a clear example of the importance of NOLs in determining the short- to intermediate-run revenue impacts of adopting combined reporting. It also illustrates the difficulties involved in determining how to integrate precombination losses into a new combined reporting system. The Pennsylvania Tax Commission report's discussion of combined reporting considered a number of options, ranging from disallowing any carryovers to allowing full, uncapped carryovers that can be used by the full unitary group.³⁶ The recommendation to continue the cap on NOLs generated prior to combined reporting was designed to maximize the revenue impact of adopting combined reporting.

To summarize the revenue impacts, the \$411 million estimate for increased corporate income tax revenue from combined reporting represented 21.7 percent of estimated Pennsylvania tax collections in 2000. However, allowing full use of NOLs would have generated \$150 million, a much smaller 7.9 percent increase.

The Pennsylvania estimates also show that a shift to combined reporting creates significant winners and losers. The \$150 million estimate results from the offsetting of large tax increases and decreases. For the combined groups that were identified from the Minnesota data (excluding regional firms), the losers paid \$187 million more in taxes and the winners paid \$133 million less, for a net change of only \$54 million.³⁷ There were an estimated 2,546 groups with tax increases and 2,097 groups with tax decreases. Small errors in estimating both increases and decreases from the Minnesota sample can have large impacts on the net change estimated. For example, if tax increases are overestimated by 10 percent and decreases are underestimated by 10 percent, the estimat-

The Pennsylvania estimates also show that a shift to combined reporting creates significant winners and losers.

ed net change from combined reporting would drop by 60 percent to only \$22 million.

There are additional issues with the estimating methodology that suggest that even the smaller estimate still overstates the probable impact of adopting combined reporting in Pennsylvania. These include:

- The relatively small number of Minnesota taxpayer groups actually used in the estimating process (152 out of over 4,600 groups supplied by Minnesota) presents a challenge in extrapolating the Minnesota data to all Pennsylvania taxpayers.
- There were a number of large regional firms that have nexus in Pennsylvania but were not included in a Minnesota combined group. The impact on these firms had to be estimated with less detailed information on combined group entities and apportionment factors.
- The apportionment factors and NOL information for the Minnesota sample firms was determined by Minnesota, not Pennsylvania, tax provisions.
- The estimates do not allow for the carry-in NOLs to be used by the entire unitary group, a treatment inconsistent with the theory of combining the income (and losses) of a unitary group.
- There was a lack of detailed information on the cumulative unitary group NOLs or unused credits that could potentially be used to offset tax increases from combined reporting.

Maryland

In 2004, the Maryland Department of Legislative Services estimated the fiscal impact of a bill requiring water's edge mandatory combined reporting (SB 727). The bill included corporations located in "tax havens" in the unitary group. The fiscal note estimated that combined reporting would raise \$55 million each year through FY 2009.³⁸ However, the estimate was not based on any Maryland-specific tax return information. The estimate was, in fact, prepared by the Multistate Tax Commission in a 2004 study.

The Department of Legislative Services reestimated the revenue impact of combined reporting in the 2007 fiscal note for SB393. In this analysis, the estimated, on-going impact of combined reporting was reduced by 55 percent to \$25 million annually.³⁹ The primary reason for the 55 percent reduction in the estimate of the revenue impact appears to be the fact that a large portion of the revenue expected earlier from combined reporting was picked up by expense addback legislation adopted by the legislature in 2004.⁴⁰ The \$25 million increase is 3.0 percent of corporate income tax collections in fiscal year 2006.

The fiscal note points out that the impact “cannot be reliably estimated.” Again, the estimate was based on national data and, in addition, estimates prepared by other states.⁴¹ The Department also acknowledged that they did not have Maryland taxpayer information to use in the estimating process, primarily because the Department did not have access to confidential taxpayer information.

The 2007 Maryland budget bill did not impose mandatory combined reporting. However, it did require for all tax years beginning after 31 December 2007, that corporate taxpayers report information to the Comptroller for each entity in an affiliated group, including firms that are not currently Maryland taxpayers. Taxpayers must calculate and report the tax liability of a water’s edge unitary group as if Maryland had already adopted combined reporting. This information will be used by the Comptroller’s Office to estimate the impact of adopting combined reporting in Maryland.

Iowa

Iowa currently offers taxpayers the choice between filing separate or consolidated returns with affiliated companies doing business in Iowa. The governor’s budget recommendations for fiscal year 2009 included a proposal for mandatory combined reporting estimated to raise \$75 million in 2009. This would be an increase of 16.7 percent in forecasted 2008 corporate income tax revenues. The proposal appears to require mandatory filing of a combined return following federal consolidated return provisions for determining an affiliated group.

A 2007 Department of Revenue study estimating the revenue impact of requiring combined reporting for all corporate taxpayers provides some background information on the estimating methodology.⁴² The study used federal consolidated corporate income tax data for federal filers that matched Iowa taxpayer identification numbers (including both separate and consolidated state filers). Federal and Iowa tax data were combined to estimate the revenue changes for mandatory combined filing. The Iowa results show the challenges of trying to use federal consolidated return information to estimate state combined filing proposals:

- Only 51 percent of Iowa separate filers (not matched to federal separate filers) could be linked to a federal consolidated return.
- For those Iowa taxpayers linked to a federal consolidated return, the Department had to calculate the major Iowa line-item subtractions and additions that convert federal income into the state income concept.

- For Iowa taxpayers filing separate returns, the study estimated that the increase due to combined filing (based on 2001 data) was \$31 million. The increase for Iowa taxpayers currently electing to file state consolidated returns would increase by a similar \$30 million in 2003. Apparently, a move to mandatory combined reporting is expected to substantially increase the income apportioned to Iowa for consolidated nexus groups because of the addition of factors and income for non-nexus affiliated companies.
- As the study pointed out, the estimates do not include any allowance for the unlocking of state NOL carryovers on combined returns. In addition, only NOLs reported on Iowa returns were used in the calculations; no information was available for firms in the federal consolidated group that were not Iowa taxpayers. As noted earlier, the estimated net impacts of adopting combined reporting are sensitive to the size of NOLs and the provisions affecting the use of NOLs by members of the combined group.
- Another important limitation of the study was the assumption that the members of the state combined group would mirror the firms reported on federal consolidated returns. In other words, it is assumed that all members of the federal consolidated group are unitary in operation, despite the fact that there is no unitary requirement (or concept) for federal consolidation. State revenue estimates that are based on combined income including non-unitary members of the federal consolidated group will overstate the revenue from combined reporting. In addition, companies taxed under alternative state tax systems, such as insurance companies and banks, were not eliminated from the state calculations.

In conclusion, if the \$75 million net revenue estimate included in the governor’s 2009 budget recommendations is based on the study’s methodology, the estimate may be significantly overstated.

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Massachusetts

In 2007, the governor recommended mandatory combined reporting. The estimated revenue increase for fiscal year 2009 was \$188 million, 8.9 percent of projected corporate income tax collections.

Massachusetts adopted addback provisions in 2003. Addback is required for otherwise deductible royalty expenses and related interest expenses paid to related entities with exemptions. Compared to the estimates produced by several other states with addback statutes, Massachusetts appears to have estimated a significantly higher percentage increase in corporate taxes from combined reporting.

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New York

For tax years beginning 1 January 2007, New York requires mandatory combined reporting for related corporations with substantial inter-corporate transactions. Prior to the change, taxpayers could file separate returns in the presence of substantial intercompany transactions if they could demonstrate that these transactions were conducted at arm's-length prices. While New York asserts that they are not a combined reporting state, the new filing requirements are much closer in effect to combined reporting.

The estimated impact of the law change was an increase of \$315 million, 6.0 percent of corporation franchise (income) taxes.⁴³ New York estimators derived the revenue estimate from auditor-feedback and New York corporate taxpayer information. It is not clear whether the estimate reflects New York's requirement for corporate taxpayers to add back selected royalty expenses, including interest payments related to intangible assets, paid to related companies in determining taxable income. The addback provision should reduce the additional revenue expected from expanding the mandatory combined filing requirements in New York.

West Virginia

West Virginia adopted mandatory combined reporting for the corporate net income tax in 2007 for tax years beginning in 2009. The full-year revenue impact, as reported in the Fiscal Note Summary for SB 749, was estimated at \$24.3 million or an increase of 10 percent of estimated fiscal year 2009 corporate income taxes; the increase is 6.5 percent for combined corporate income and business franchise tax collections. The fiscal note states that the estimate was "based on the experience of other states that have adopted combined reporting." As noted in the discussion of the estimating experience in other states, differences in taxpayer characteristics and state corporate tax features make it difficult to extrapolate revenue impacts from estimates made in different states.

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New Mexico

HB 51 introduced in the 2008 legislative session makes combined reporting mandatory beginning for tax year 2008. New Mexico currently permits taxpayers to elect to file a consolidated or a combined return. The fiscal impact report for the bill estimates that the change will generate \$90 million in additional revenue, an increase of 20 percent in corporate tax collections when fully phased in by fiscal year 2009. The fiscal report does not describe the methodology used to estimate the revenue impact.

The fiscal impact report does note that in fiscal year 2005 taxpayers electing to file combined returns accounted for 14 percent of all tax payments and taxpayers electing to file a consolidated return accounted for 32 percent of all payments. As discussed in the Pennsylvania example, any revenue increase from shifting to a combined reporting system is the net effect of large increases and losses for different taxpayers. The New Mexico fiscal note implies that the election of either combined or consolidated filing has already partially reduced corporate income tax collections compared to a separately filing system. Therefore, the impact of adopting mandatory combined filing will primarily be to increase taxes for the companies that elected to file separately under current law.

Given the fact that New Mexico currently allows taxpayers with an election to file combined or consolidated returns (including domestic corporations that meet federal rules for common ownership), the relative size of the New Mexico revenue impact estimate of adopting mandatory combined reporting is not applicable to other states that are considering moving from separate to mandatory combined filing systems.

ENDNOTES

1. The concept of a “unitary business” is a constitutional requirement that limits the states’ authority to determine the income of a multistate enterprise taxable in a state. The criteria used to determine whether a group of business entities or divisions are unitary are derived from state statutes and regulations and state and federal case law. These criteria are often based on a “flow of value” among the entities and divisions and include the following: unity of ownership, unity of operation and unity of use. Due to varying state definitions and case law decisions, the entities included in a unitary group are likely to vary significantly from state to state.
2. There are 20 corporate income tax states that can be described as combined reporting states, including New York and Michigan. In addition, Texas is using the combined reporting approach to determine the tax base under their modified gross receipts taxes that replaced corporate income taxes.
3. A group of related corporations may consist of multiple unitary groups. Although ownership is one test to determine whether separate legal entities are engaged in a unitary business, it is not the sole test. The number of unitary groups, and the composition of those unitary groups, will vary significantly for each corporate group and each state.
4. For a detailed discussion of the proponents view see Michael J. McIntyre, Paull Mines and Richard D. Pomp, “*Designing a Combined Reporting Regime for a State Corporate Income Tax*,” Louisiana Law Review, pp. 699-761 (Summer 2001). A more recent summary is provided in Michael Mazarov, “State Corporate Tax Shelters and the Need for Combined Reporting,” *State Tax Notes* (November 26, 2007).
5. It is also assumed that the income being combined for the two companies is U.S.-wide income, not world-wide income. This is consistent with the companies making a water’s-edge election for state corporate income tax purposes.
6. The calculations in the examples are consistent with the approach to combined reporting that respects the separate entities of the taxpayer members of a combined group. In this approach each corporation reports the unitary group’s combined income on its own tax return and uses its own in-state factors (divided by the group’s U.S.-wide factors) to apportion the combined income to a state. (This is often described as the *Joyce* approach to apportioning combined income based on a California corporate tax court case.) This approach is also consistent with Multistate Tax Commission Model Statute for Combined Reporting, as described in “Report of the Hearing Officer Regarding the Proposed Model Statute for Combined Reporting,” Multistate Tax Commission (April 25, 2005).
7. Under combined reporting the in-state numerators of the two companies do not change. However, the sum of each factor for the two firms becomes the new denominator in the calculation of the overall apportionment ratio. The new apportionment ratios under combined reporting equal 3.6% for Company A and 13.9% for Company B.
8. While payroll and property are the sources of value added, state apportionment formulas also include destination sales in the formula to reflect a market state’s interest in a portion of the income. The inclusion of sales in the apportionment formula weakens the link between income and the location of payroll and property, the factors that create value added. For states using sales only apportionment formulas, there is no direct link between the location of payroll and property that creates income and the apportionment formula that assigns the income to a state. Adding combined reporting to single sales factor apportionment compounds the disconnect between where income is produced and where income is apportioned. The exclusion of intangible capital, a growing source of income, from the property factor further adds to this disconnect. These features add to the perception among many business taxpayers that the current corporate income tax system is overstating the taxable income generated by economic activity in many states.
9. For simplicity, this calculation ignores the elimination of sales between the two companies. It also assumes that sales of Company 1 are not included in the numerators of the combined apportionment factors. (This is often described as the *Joyce* approach to apportioning combined income based on a California corporate tax court case.)
10. H.B. 768 was passed by the House Education Appropriations Committee on April 16, 2008.
11. Proponents of combined reporting would argue that state taxable income may not be reported correctly, due to improper transfer pricing and/or shifting of assets or liabilities between affiliated companies. Distinguishing improper actions from business-driven actions is difficult.
12. Pennsylvania’s percentage is from tax year 2002 returns that were heavily influenced by the sharp reduction in corporate profits and the increase in actual losses due to the 2001 recession. Minnesota’s percentage may also have been affected by the recession to a lesser extent.
13. This result is not unique to state income tax systems. At the federal level, approximately one-half of Subchapter C corporations have no taxable income in a given year, and approximately two-thirds of C corporations have no tax liability in a given year after subtracting special deductions, net operating loss carryforwards and tax credits. The percentage of C corporation returns without taxable income ranged from 45-52% between 1999 and 2005. The percentage of returns without tax liability ranged from 61-69% during the same period. (Source: IRS Statistics of Income data from the *Complete Corporate Report*, years 1999-2005.)
14. The example assumes that the sales into State A for the headquarters company are not included in the numerator (State A sales) of the apportionment formula under combined reporting.
15. In theory, the elimination of intercompany transactions would also result in a redistribution in the profits attributable to the manufacturing and distribution subsidiaries with no change in total combined profits. This redistribution is not shown in the table.
16. This same “unlocking” effect may occur with unused credits if a state allows credits to be used by any member of a combined group. Unlike NOLs that most states allow to be carried over to future years with some limits, tax credits may be lost if not used in the year in which they are earned by the taxpayer. Tax credits that went unused under separate filing because of insufficient taxable income and tax liabilities may be converted to used credits if the income of the unitary group increases under combined reporting.
17. Michael Mazarov, “Growing Number of States Considering a Key Corporate Tax Reform,” Center on Budget and Policy Priorities,” 12 September 2007, p. 9.
18. Gregory C. Fajt, Secretary, Pennsylvania Department of Revenue, Testimony before the House Finance Committee, 14 April 2005, p. 4. Secretary Fajt described the assertion that combined reporting will be bad for the state’s economy as a “myth.”
19. Several theoretical studies of the impact of combined reporting and apportionment on the allocation of economic activity among the states suggest that combined reporting, compared to separate filing, may increase the responsiveness of economic activity to state corporate income tax changes. After analyzing different simulations of the impact of tax rate changes for hypothetical groups of combined and separate filing states, a study concluded that shifts in sales, payroll and property factors are “far more sensitive” to changes in state corporate income tax rates under combined filing vs. separate filing tax systems. (Michael G. Williams, Charles W. Swenson, and Terry L. Lease, “Effects of Unitary vs. Nonunitary State Income Taxes on Interstate Resource Allocation: Some Analytical and Simulation Results,” *The Journal of the American Taxation Association*, Spring 2001, p. 54). Also see Roger Gordon and John D. Wilson, “An Examination of Multijurisdictional Corporate Income Taxation Under Formula Apportionment,” *Econometrica*, November 1986.
20. See Minnesota Department of Revenue, *2007 Minnesota Tax Incidence Study* (March 2007) for a discussion of how state and local business tax burdens are distributed among workers, investors, and households.

21. See Ernst & Young LLP, *Economic and Fiscal Impact Analysis of Maryland Tax Policy Options* (September 2007). The study was prepared for the Maryland Chamber of Commerce and associated local chambers and other organizations.
22. The dynamic impact simulations were done using a Regional Economic Models, Inc. (REMI) model of the Maryland economy. This model is used widely by state agencies as well as private-sector analysts.
23. Timothy J. Bartik, et al., *Michigan's Economic Competitiveness and Public Policy*, the W.E. Upjohn Institute for Employment Research (August 2006).
24. There is some evidence that investment decisions of multinational corporations are even more sensitive to state tax changes. In a study of foreign direct investment in individual states, the author found that a roughly 10 percent increase in state corporate tax rates would result in a 6 percent reduction in investment in the state. (See James R. Hines, Jr., "Altered States: Taxes and Location of Foreign Direct Investment in America," *The American Economic Review* (December 1996).
25. Regression equation: $\text{Job Growth} = 0.62 + 0.036 \text{ CRdummy} + 1.15 \text{ Population Growth} - 0.01 \text{ Average Salary}$
 T Statistic: (3.89)(0.81) (12.60) (-3.30)
 R-squared = 0.81
- Job Growth is the 1982-2006 growth in private-sector employment, CRdummy is a dummy variable with a value of 1.0 for combined reporting states, Population Growth is the 1982-2006 growth in population, and average salary is an average of the beginning and ending level of private-sector salaries.
26. The average salary measure serves as one measure of private-sector costs in a state. As expected, job growth is lower in states with higher wages.
27. See Ernst & Young LLP, *The 2007 U.S. Investment Monitor* (2007) for further details on the data and methodology. The projects included in the studies are announced projects with a minimum of \$20 million in capital investment and 20 new or retained jobs.
28. New York State Department of Taxation and Finance, Combined Reporting for General Business Corporations, TSB-M-07(6)C, 25 June 2007. For a more comprehensive discussion of the complexities involved in complying with the expanded New York State combined reporting requirements, see Kenneth T. Zemsky, "Understanding the New Developments Regarding Combined Filing in New York," *Journal of Multistate Taxation* (March/April 2008).
29. The rules list six specific types of transactions that have to be examined including intercorporate receipts, expenses and asset transfers.
30. On the other hand, separate filing states involve tax compliance and administrative costs related to the determination and auditing of transfer prices applied to transactions between affiliated companies.
31. The precursor to the combined reporting bill was a bill passed by the legislature in special session that required world-wide combined reporting for major oil companies. The bill was supported by a state organization affiliated with the national Citizens/Labor Energy Coalition. The bill was vetoed by the governor. (See Arthur C. Roemer, "Minnesota Taxation of Unitary Corporations," *Minnesota Tax Journal*, December 1982.) This article discusses the initial revenue estimates for the combined reporting bill adopted in 1982.
32. A draft report, "Unitary Primer," prepared by the Department of Revenue in January 1984 explained that these losses were not taken into account in preparing the initial revenue estimates. It is also possible that the weakness in the U.S. economy in the early 1980s produced a larger stock of unused NOLs than anticipated in the revenue estimates.
33. As reported by Eng Braun, Wisconsin Division of Research and Policy, Wisconsin Department of Revenue, *Corporate Tax Modeling for Combined Reporting*, presentation to the Federation of Tax Administrators Conference on Revenue Estimating and Tax Research, September 2003.
34. "Fiscal Impact of Combined Reporting on the Pennsylvania Corporate Net Income Tax" (27 May 2004) and "Revenue Estimate Update" (20 October 2004), presentations to the Pennsylvania Business Tax Reform Commission by Brenda S. Warburton, Research Director, Pennsylvania Department of Revenue.
35. The \$150 million figure is estimated based on information in the 27 May 2004 Department of Revenue presentation on the ratio of additional revenue under the capped and uncapped (by individual firm) NOL options. The \$150 million does not, however, allow for the carry-in NOLs to be used by the entire unitary group.
36. Pennsylvania Business Tax Reform Commission Report, November 2004 (Chapter 14, "Modifications of Existing Pennsylvania Net Operating Losses")
37. The distributions of winners and losers are from the estimates presented by the Department of Taxation on 27 May 2004. The ratio of winners to losers from these earlier estimates was applied to the October revised estimates to derive the tax change amounts for winners and losers reported here. These figures do not include the large regional groups estimated separately.
38. The estimate reported in the Maryland fiscal note did not include any separate estimate of possibly higher revenue from the tax haven component of the bill.
39. This was the low-end of an estimated range of \$25 to \$50 million. As pointed out in the fiscal note, the \$25 million figure is more likely in the "near term."
40. The addback provisions increase state corporate income taxes by disallowing deductions for certain expenses paid to out-of-state affiliates. Combined reporting would also increase taxes in this situation in the absence of addback provisions. In effect, Maryland already added this revenue during the prior year by adopting addbacks, reducing the expected additional revenue from combined reporting. According to a recent *Estimated Maryland Revenues Report* from the Maryland Board of Revenue Estimates (13 December 2006), the new addback provisions resulted in at least \$44.1 million in additional tax revenue in 2004.
41. It is interesting to note that the Maryland 2007 analysis refers to the Pennsylvania Department of Revenue estimates of combined reporting discussed above. As noted earlier, the Pennsylvania estimates relied heavily on Minnesota corporate tax return information. It is not clear how the Pennsylvania results were actually used in the Maryland estimating process.
42. "Combined Reporting: An Option for Apportioning Iowa Corporate Income Tax," Tax Research and Program Analysis Section, Iowa Department of Revenue (March 2007).
43. The percentage increase was based on the increase divided by the actual fiscal year 2007 corporate franchise tax, corporation and utility tax, and the income component of insurance taxes.

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