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Comments on Your Government

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An Analysis of Combined Reporting

This RIPEC Comments examines combined reporting, including an overview and analysis of the Governor's proposal to implement combined reporting, along with a number of other changes to the state's corporate tax system. The Comments are intended to provide a background for policymakers as they evaluate the merits of making changes to the state's corporate tax system.

Introduction

As Rhode Island's economy slowly recovers from the current recession, the state must turn its attention to developing strategies that will make the state more competitive with regard to attracting and retaining business investment. The modern economy is based on mobile capital and labor. States and countries must work to find a competitive edge with regard to business growth and economic development. There are a number of issues outside of business taxes that factor into business location or relocation decisions, such as the quality of a state's workforce, energy costs, climate, access to capital, and overall quality of life. However, a state's tax climate does matter to businesses: tax policy is one of the few factors affecting business location decisions that are within a state's ability to control.

In general, Rhode Island is not perceived as a good place to start or grow a business in national reviews. The most recent analyses from three organizations – The Tax Foundation, Forbes, and the Small Business and Entrepreneurship (SBE) Council – rank Rhode Island among the bottom ten states for doing business. While taxes are not the only measure in two of the studies (Forbes and SBE), they factor heavily into the rankings in each of the three and, in all three cases, Rhode Island's tax policy was a significant factor in the state's low ranking.

Table 1
National Rankings - Business Climate

	The Tax Foundation	Forbes	SBE Council
Connecticut	47	36	40
Maine	31	50	46
Massachusetts	32	16	44
New Hampshire	7	19	33
Rhode Island	42	49	45
Vermont	38	46	47

SOURCE: Tax Foundation, Forbes, SBE Council

At the same time, due to recent changes to the state's tax system, Rhode Island's ranking has improved over the years. Adoption of S 3050, the property tax cap legislation, and revisions to the state's personal income tax have been viewed favorably by The Tax Foundation. The Governor's FY 2012 budget makes further changes to the state's tax structure by revising the state sales tax and making changes to the

Table 2
FY 2012 Business Tax Competitiveness Proposal ($ millions)

	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Rate Reduction Phase-In	$ (8.5)	$ (20.0)	$ (34.0)	$ (35.3)	$ (36.5)
Job Dev Act Phase Out	4.8	9.3	15.4	16.0	16.5
Combined Reporting	8.9	10.0	11.0	11.4	11.8
Minimum Tax Restructure	(6.1)	(6.2)	(6.2)	(6.3)	(6.4)
Total	**$ (0.9)**	**$ (6.8)**	**$ (13.9)**	**$ (14.2)**	**$ (14.6)**

SOURCE: RI Budget Office

current corporate tax system. The corporate tax changes include: phasing-in a reduction of the corporate tax rate from 9.0 percent to 7.5 percent; eliminating the Jobs Development Act over a three-year period; implementing combined reporting; and restructuring the corporate minimum tax by broadening the entities subject to the tax and by implementing a tiered tax structure based on gross receipts. Based on estimates by the administration, these changes would result in a net decrease in business tax revenue of $0.9 million in FY 2012, and a net decrease in business tax revenue of $14.6 million by FY 2016.

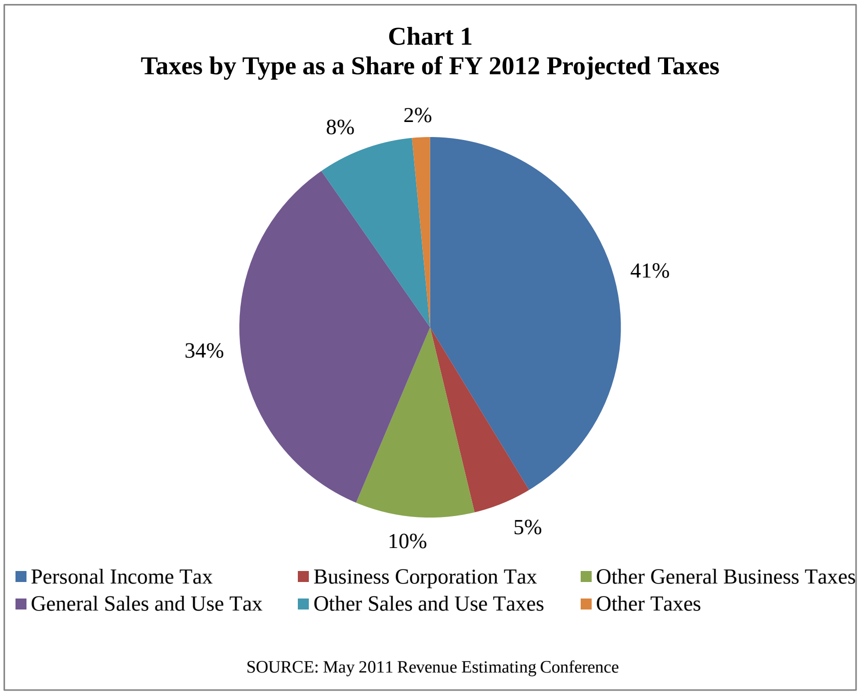
Combined Reporting Overview

Along with the other changes the Governor has proposed, Article 25 of the budget includes a provision to implement combined reporting in Rhode Island. Under combined reporting, a group of related companies that have a “flow of value” between them must combine their income for tax purposes. Not all members of a group of related companies need have a physical presence in the state to be subject to taxation in the state. The combined net income of the group of related companies is then apportioned to the state based on the combined apportionment factors of the group. Currently, 23 of the 46 states that tax some form of corporate income (including Maine, Massachusetts, New Hampshire and Vermont), along with the federal government, require combined reporting.

Overview of Corporate Taxation

Across the United States, 43 states levy a tax on corporate income, four levy a tax exclusively on corporate gross receipts, and three have both a corporate income tax and a gross receipts tax. There is significant variation in rates among the states with a corporate income tax, and whether a state has a flat tax or a progressive tax structure. Top marginal rates (or the flat rate) range from a low of 4.3 percent in Colorado to a high of 12.0 percent in Iowa.

In Rhode Island, corporations and businesses, wherever incorporated, deriving any income from sources within Rhode Island or engaging in any activities or transactions within the State for purposes of profit or gain must file taxes. The state has a 9.0 percent flat corporate income tax rate that is levied on all C-corporations. For businesses filing corporate income tax returns, the franchise tax rate is $500 per million of authorized capital stock or $500, whichever is greater. The amount of the franchise tax liability counts against the amount of corporate income tax paid. Entities incorporated as S-corporations pay at least the minimum franchise tax, while LLCs are required to pay the corporate minimum tax.



Nationally, state corporate income taxes have accounted for 5.6 percent of total state tax collections and have been declining as a share of state tax revenues over the past two decades[1]. This decline has been attributed to: the increasing popularity of other forms of business incorporation, changes to the federal tax base, state tax policy actions, and tax planning strategies. In Rhode Island, business corporation taxes are projected to account for 4.6 percent of all FY 2012 tax revenues. Between TY 2007 and TY 2009, the most recent year for which complete information is available, the total number of taxpayers has remained relatively steady; however, corporate income taxpayers have declined slightly, from 3,476 in TY 2007 to 3,357 in TY 2009.

How Combined Reporting Works

The intent of combined reporting is to address aggressive tax-planning strategies used by multi-state corporations. That is, combined reporting attempts to prevent multi-state corporations from shifting profits out of state, for example, through the use of a passive investment company (PIC) or real estate investment trust (REIT) for tax purposes. Because combined reporting requires corporations to add together the profit of related businesses before the combined profit is subjected to formula apportionment, the corporation gains little or no advantage by shifting the profit between the various corporations in the corporate group — through PICs or any other mechanism.

Under combined reporting, companies are required to report all income made by all subsidiaries, regardless of the state in which it was earned, and then remit state corporate income taxes on the basis of the entity's economic activity in the state as determined by an apportionment formula. For example, if a parent corporation owns a widget plant in Minnesota, a mail-order subsidiary in Iowa that sells the widgets, and a subsidiary that operates retail widget stores throughout the United States, the profits of all three related corporations would be added together and apportioned to Minnesota using its normal apportionment formula if Minnesota required combined reporting.

Not all combined reporting statutes, however, are the same. Key factors which affect combined reporting are:

- The extent of that definition for tax purposes: states may elect a "water's edge" approach whereby the combined report is limited to operations within the

[1] Fox WF, Luna L. "Combined Reporting with the Corporate Income Tax", November 2010.

United States or to include foreign operations or entities.

- Apportionment: the basis upon which business or operating income is allocated to a state for purposes of taxation, which could be a combination of three factors: payroll, sales and property, or a variation thereof, such as single sales or double-weighted sales.
- The approach to the apportionment calculation: two methods can be employed – "Joyce" and "Finnegan". Under Joyce, the numerator of each factor includes only amounts attributable to the state by members of the related group of companies that have physical nexus in the state. Under Finnegan, the numerator of each factor includes the amounts attributable to the state generated by all members of the combined group without regard as to whether the member of the group has physical nexus in the state.

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There are multiple reasons a state may elect to adopt combined reporting. A state may implement the policy because it may generate additional revenue without raising nominal rates or imposing an additional tax. Other states may adopt combined reporting in order to "level the playing field" between in-state and multi-state corporations. Lastly, states may use the additional potential revenue generated by combined reporting as a means to lower their overall corporate tax rate in order to become more competitive.

Combined reporting represents a significant change in the structure of the state's corporate tax that heretofore has been based on the concept that every individual corporation in a multi-corporate group is taxed as a "separate entity." Accordingly, policymakers ought to study the proposed change to combined reporting in more depth than they would with regard to less sweeping changes in corporate tax law. As such, RIPEC would recommend that the state delay consideration of the proposed changes until there is more information on the impact of the changes. One course of action the state may want to consider is requiring a study period similar to the one required by Maryland. Entities were required to file two sets of returns, their regular corporate income tax return and a hypothetical return for entities that are part of a unitary group. The state was then able to determine the impact of combined reporting, which entities were the most likely to be affected, and expected revenues.

In addition to providing for an information-gathering period, the state should also evaluate the relative merits of different forms of implementation. Specifically, the state must examine whether continued reliance on a three-factor apportionment system[2] would unduly burden entities with significant amounts of payroll or property in the state, or would present a disincentive for businesses already in the state to grow their Rhode Island workforce or increase their capital investment in the state. Currently, all of the four states in New England that have combined reporting use a single or double-weighted sales apportionment factor. Additionally, just under half of the states that have combined reporting use a single sales factor. Rhode Island does not have adequate data at this time to determine the effect different apportionment factors would have on revenues. Additionally, there is little information on which businesses would be most affected, and how they would be affected, by adopting a different apportionment methodology.

[2] NOTE: Rhode Island has a double-weighted sales apportionment factor for manufacturing.

As RIPEC has noted, there is a clear need to continue to work on reforming the state's tax system in order to attract and retain business, as well as provide a stable revenue stream that allows the state to provide for the basic needs of its citizens. However, these changes must be part of a systemic and thoughtful process that is forward-looking rather than based in the need to generate revenue or balance budgets. The implications of tax changes must be known and made clear to policymakers and taxpayers alike. The state may also want to consider whether the absence of combined reporting would put the state at a competitive advantage.