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WRITTEN TESTIMONY SUBMITTED TO THE RHODE ISLAND HOUSE FINANCE COMMITTEE REGARDING HOUSE BILL 5738 MAY 19, 2011

Chairman Melo and Members of the Committee, thank you for the opportunity to testify on House Bill 5738. I am Carl Davis, Senior Analyst with the Institute on Taxation and Economic Policy (ITEP), a nonprofit research group based in Washington, DC. ITEP's research focuses on federal and state tax policy issues, with an emphasis on tax fairness and adequacy.

My testimony today examines the erosion of Rhode Island's corporate income tax, and the multi-state tax avoidance schemes that have contributed to this erosion. In addition, it discusses the single best strategy available to lawmakers seeking to respond to the problem of corporate tax avoidance—mandatory combined reporting. Requiring combined reporting of the income of multi-state corporations would help ensure the long-term viability of the Rhode Island corporate income tax. It would also make the corporate tax more equitable—both among businesses and between businesses and individual taxpayers—by eliminating the incentive for multi-state corporations to avoid state income taxes by artificially shifting income from one taxing jurisdiction to another.

A majority of states with corporate income taxes or similar taxes currently require combined reporting—including Massachusetts, New York, and Vermont, each of which were part of a larger wave of states that recently implemented this reform. Two other nearby states—Maine and New Hampshire—have required combined reporting for over two decades.

THE DECLINE OF RHODE ISLAND'S CORPORATE INCOME TAX

Simply put, the corporate income tax is in decline. At both the federal and state levels, governments now collect far less in corporate income taxes, as a share of the economy or as a share of total revenues, than they did just a quarter century ago. Rhode Island's corporate tax collections have mirrored this nationwide decline.

The decline of the corporate tax is troublesome for two reasons.

First, it appears to be at least partially the result of tax avoidance strategies by corporations, rather than the conscious design of federal and state policymakers. At the federal level, the growing prevalence of corporate tax loopholes has resulted in a number of large corporations paying nothing at all to the federal government, despite being hugely profitable. Many of these same loopholes are automatically passed-through to Rhode Island's tax code, where their noxious effects are further amplified. Moreover, given the plethora of multi-state tax avoidance schemes currently available to many multi-state companies, avoiding corporate taxes at the state level is often even easier than at the federal level

Second, the decline of the corporate taxes paid by the biggest, most profitable companies inevitably means that taxes paid by smaller businesses and taxes paid directly by individuals must make up a bigger share of the tax pie. Over the last three decades, Rhode Island corporate taxes as a share of total state tax revenue has shrunk from a respectable 10%, down to just over 5% today.

TAX AVOIDANCE STRATEGIES

How are large companies avoiding so much of the corporate income tax in Rhode Island? One widely recognized avenue for state tax avoidance is that some states permit companies to determine their in-state taxable income using "separate accounting" for each of their related subsidiaries. Separate accounting is a bookkeeping procedure that determines each company's taxable income by having companies keep separate accounts for their in-state and out-of-state business segments. Every transaction between the legally distinct subsidiaries of a company is supposed to have a transfer price (that is, the "sales price" at which these companies are essentially selling products to themselves) attached to it, which is supposed to be carefully scrutinized by auditors.

Not surprisingly, separate accounting is subject to abuse by large, multistate companies. In fact, it's an open highway for corporate tax avoidance. A large multistate company can use separate accounting to shift their taxable profits to low-tax jurisdictions. Here's how it works:

Consider a multistate company that has two subsidiaries, one in State A that permits separate accounting and one in State B, which has no corporate income tax. To reduce its taxable profits, the subsidiary in State A might say that it "pays" high transfer prices for the items it "buys" from the State B subsidiary. This shifts income out of State A (where it would be taxed) and into State B (where it's not).

For example, a furniture company might machine the metal parts for its furniture in State B, but assemble the furniture in State A. The company will, on paper, charge very high prices to its State A subsidiary for the metal parts. This makes the State B subsidiary look like it has very high profits (which are not taxed) and the State A subsidiary look like it has very low (taxable) profits.

Of course, except for tax considerations it doesn't matter to the parent company if its State B subsidiary has 80 percent of the total profits and its State A subsidiary has only 20 percent. Either way, the parent company gets 100 percent of the profits.

Trying to prevent companies from using income-shifting techniques like transfer pricing under separate accounting creates huge enforcement problems. It is a time-consuming, complicated and often impossible job for state auditors to determine whether separate accounting methods accurately reflect a company's net business income in the state. The federal government, which tries to apply the same approach to multinational corporations, has had the same kinds of difficulties.

COMBINED REPORTING: A SIMPLE APPROACH TO PREVENTING TAX AVOIDANCE

States seeking to prevent artificial income-shifting have two options. They can close down some of these loopholes one at a time—as Rhode Island and a few other states have done with anti-Delaware Holding Company legislation—or they can adopt a comprehensive solution known as combined reporting.

Combined reporting requires a multi-state corporation to determine its apportionable income by adding together the profits of all its subsidiaries—without regard to their location—into one total. Since the income of subsidiaries in the various states is added together in one sum, there is no tax advantage to income shifting between these subsidiaries under a combined reporting regime.

Combined reporting is intuitively more fair than separate accounting because it ensures that a company's tax liability should not change just because its organizational structure changes. It also creates a level playing field between smaller and larger companies. Small companies doing business only in Rhode Island are at a competitive disadvantage because they can't use separate accounting to reduce their tax. This is because they have no business units in other states to which to shift their income. Large, multi-state corporations will find it easier to avoid tax using separate accounting because they do have business units in multiple states.

While "Delaware Trademark Holding Company" and "captive REIT" reforms of the type Rhode Island enacted in 2007 can close down specific paths to tax avoidance, combined reporting is a better, more comprehensive approach to loophole-closing because it simply removes the incentive to shift income from higher-tax to lower-tax jurisdictions. Absent combined reporting, multi-state corporations will continue to seek out new, previously unknown income-shifting avenues. The only limitation facing these companies is the imagination of their accountants.

If Rhode Island were to enact combined reporting legislation, it would join twenty three other states that already require related companies to file a combined report.

COMBINED REPORTING AND ECONOMIC PERFORMANCE

Virtually every state legislature that has entertained options for closing corporate tax loopholes has heard apocalyptic predictions of the dire economic consequences that would result from these changes. In Rhode Island, many of the parties making these predictions have relied on a recent study by the National Conference of State Legislatures that claimed to demonstrate a linkage between combined reporting and slightly reduced economic growth.[1] The findings of this study should be viewed with considerable skepticism.

For starters, the findings of this new study directly contradict a similar study from just four years ago, which happens to have been co-authored by the principal author of the NCSL study in question. That study found that "there is no evidence that [combined reporting] requirements diminish economic activity in states."[2] The authors of the NCSL study made no attempt to reconcile these contradictory findings.

Additionally, while combined reporting is currently used in twenty three states, the findings of the NCSL study are driven by just two states, over a period of just a few years. The authors state very candidly that "we are primarily measuring the effects arising from the recent adoption of combined reporting in Vermont and New York. …Other adopters [of combined reporting] have implemented the policy too recently for the effects to be measured in the data. This suggests that additional study is warranted."[3] Simply put, it is unwise to rely on a study with such a narrow focus in formulating policy decisions.

At the end of the day, corporate income taxes are a small part of the total taxes that most businesses pay. And state and local taxes overall represent a very small part of the cost of doing business for Rhode Island firms. Other costs of doing business are far more important in determining a state's business climate. As New York City Mayor and long-time business leader Michael Bloomberg once put it, "Any company that makes a decision as to where they are going to be based on the tax rate is a company that won't be around very long. If you're down to that incremental margin you don't have a business."

CONCLUSION

There is no legitimate rationale for preserving tax loopholes that encourage companies to devote their resources to accounting shenanigans but add no economic value to a company or to a state's economy. Combined reporting—the single best reform available for closing such loopholes—would ensure the long-term viability of the Rhode Island corporate income tax and would have a salutory effect on tax fairness and adequacy in the state.

The adoption of combined reporting is a vitally important step towards making the Rhode Island tax system more reflective of the modern economy.

Thank you for the opportunity to testify.

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[1] William F. Fox, and LeAnn Luna, "Combined Reporting with the Corporate Income Tax," Report Commissioned by the NCSL Task Force on State & Local Taxation of Communications and Interstate Commerce, 2010.

[2] Donald Bruce, John Deskins, and William F. Fox, "On the Extent, Growth, and Efficiency Consequences of State Business Tax Planning," in Alan J. Auerbach, James R. Hines, Jr., and Joel Slemrod, Editors, *Taxing Corporate Income in the 21st Century*, Cambridge University Press, 2007.

[3] Ibid. 3, p. 36.

BACKGROUND ON ITEP

The Institute on Taxation and Economic Policy (ITEP) has engaged in research on tax issues since 1980. Since 1996 ITEP has used a *microsimulation tax model* to conduct research on federal, state, and local tax systems. A microsimulation model uses a large sample of tax returns and other data to estimate the impact of tax systems and tax proposals on actual taxpayers at different income levels. This is the same type of tax model used on the federal level by the U.S. Treasury Department, the Congressional Joint Committee on Taxation, and the Congressional Budget Office, as well as by many state revenue departments. A properly constructed microsimulation model can provide accurate estimates of revenue yield and tax incidence by income group.

ITEP's microsimulation model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to 750,000 records. This database is based on federal tax returns, with statistically valid samples from every state and the District of Columbia. The database is augmented with a sampling of records from the U.S. Decennial Census "five percent sample" (which contains a random sample of five percent of all census forms received by the Census Bureau); the Census data are statistically matched with the tax return records. The data on these records is then extrapolated to subsequent years using federal tax micro and tabular data, Census Bureau Current Population Survey micro and tabular data, and other widely respected data sources.

These, and other, data are used by the ITEP model's four modules: Personal Income Tax, Property Tax, Consumption Tax and Business Tax. These modules calculate tax liability on a record-by-record basis and sum the results to provide revenue and tax incidence estimates. (A complete description and methodology for the ITEP model is available on request.)

The ITEP model has the unique capability of analyzing all major taxes for every state and the District of Columbia. In 2009, the ITEP model was used to produce the study *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. This study shows the distributional impact, by income level, of all major state and local taxes for each of the 50 states. It has been used by many state revenue departments and legislative fiscal offices since its publication.

The ITEP Model is also unique in its ability to forecast the effect of both federal and state tax changes on taxpayers in a given state. This capability is especially important in analyzing the impact of proposed tax changes that affect people on multiple levels. For example, proposals for federal tax reform often impact state tax collections. Similarly, proposals to change state tax structures, such as the bills under discussion today, can affect the federal taxes paid by a state's residents in ways that can drastically affect the overall incidence of these proposals.

In addition to its fifty-state analyses, ITEP often conducts research in individual states. This work has been primarily funded by private foundations. ITEP's full body of research is available at www.itepnet.org.