April 16, 2007

The Case for Combined Reporting:
Changing Missouri's Tax Policy Makes Good Business Sense

By Tom Kruckemeyer, Chief Economist,
Amy Blouin, Executive Director and
Signe Peterson, Policy Fellow

Background

Several states have moved recently to address corporate income tax avoidance by instituting new state Combined Reporting measures. Combined reporting treats the parent corporation and each of its subsidiaries as one corporation for the purposes of calculating state income taxes. Twenty of the 46 states that collect corporate income taxes require combined reporting and States operating under combined reporting statute are doing well economically.

Missouri's corporate tax policy places the state in an adverse position. Today, corporate tax collections in Missouri are at a 20-year low as a percent of the economy. In 2005, Missouri's corporate income tax ranked 46th in the nation (four states do not levy a corporate income tax). Current tax law in Missouri allows for several practices that other states have discontinued; these tax avoidance practices have resulted in significant losses to state revenue.

Benefits of Combined Reporting

Missouri legislators have introduced Combined Reporting bills in the state legislature for the past four years. If Missouri were to adopt combined reporting measures, among the benefits the sate would realize are:

- Creation of taxpayer equity among all corporations doing business in the state;
- A gain of approximately $40 to $70 million in tax revenue annually; and
- Increased economic development through more investment in infrastructure including education and transportation.

Following is an examination of Missouri's corporate tax policy, its impact on the states fiscal situation and how the adoption of combined reporting would be advantageous for the state.

Understanding Corporate Taxes in Missouri

The state of Missouri levies two major types of taxes on corporations: A Corporate Income Tax and a Corporate Franchise Tax. The **corporate income tax** is a tax on a corporation's net income

or profits. Missouri law allows corporations to take deductions and provides tax credits to reduce the taxable net income.[1] The **corporate franchise tax** is a tax on a corporation's assets. The amount that is taxed equals either the total assets of a corporation or the value of its paid-up capital stock, whichever is greater. As with the corporate income tax, the tax base may be eligible for deductions through tax credits.

During the 1990s, Missouri made significant changes to its corporate tax structure. First, in 1993, the allowable deduction for corporate federal income taxes was reduced from 100% to 50% of the total amount of federal income taxes paid. Additionally, the corporate income tax rate was increased from 5.0% to 6.25%.[2] These measures increased the tax base and tax rate for corporations.

In 1999, however, Missouri reduced its corporate franchise tax. Missouri raised the minimum asset requirement from $200,000 to $1,000,000. Effectively, corporations with assets totaling less than $1,000,000 are exempt from the corporate franchise tax. Additionally, the corporate franchise tax rate was reduced from 0.05% to 0.0333%.[3]

Collection Trends from Corporate Taxes in Missouri

Missouri is a relatively low tax state compared to other states around the country. This is in part due to low corporate taxes. In 2005, Missouri's corporate income tax ranked 46th in the nation (four states do not levy a corporate income tax).[4] Missouri's corporate income tax collections of $38 per capita were the lowest in the nation of states utilizing this tax.[5]

While current collections per capita are low in Missouri, collections from Missouri corporate taxes have fluctuated over the past two decades. Table 1, below, displays the net corporate income and net corporate franchise tax receipts in Missouri since fiscal year 1985.

[1] For more information on Missouri corporate income tax deductions and credits, see the *Tax Expenditure Report* (January 2007). Conducted by the State & Regional Fiscal Studies Unit at the University of Missouri-Columbia under contract to the Missouri Office of Administration.
[2] Ibid.
[3] Ibid.
[4] Morgan Quitno, *"2007 State Rankings Book", page 325*
[5] IBID

Table 1

Fiscal Year	Net Corporate Income and Franchise Tax ** Amounts in Millions*
1985	$190.6
1986	$201.4
1987	$228.4
1988	$246.3
1989	$259.5
1990	$248.5
1991	$258.5
1992	$259.4
1993	$223.8
1994	$281.6
1995	$412.3
1996	$477.3
1997	$473.8
1998	$420.3
1999	$351.0
2000	$327.3
2001	$289.4
2002	$295.9
2003	$228.1
2004	$304.0
2005	$328.1
2006	$404.7
2007Estimate	$430.6

Source: Missouri Office of Administration Corporate Tax Receipts Records. Note: In 2002, Missouri began allowing corporations to report both their income and franchise tax on the same form. The state can no longer precisely differentiate between income and franchise tax receipts. In order to present a consistent timeline, the two taxes are combined above.

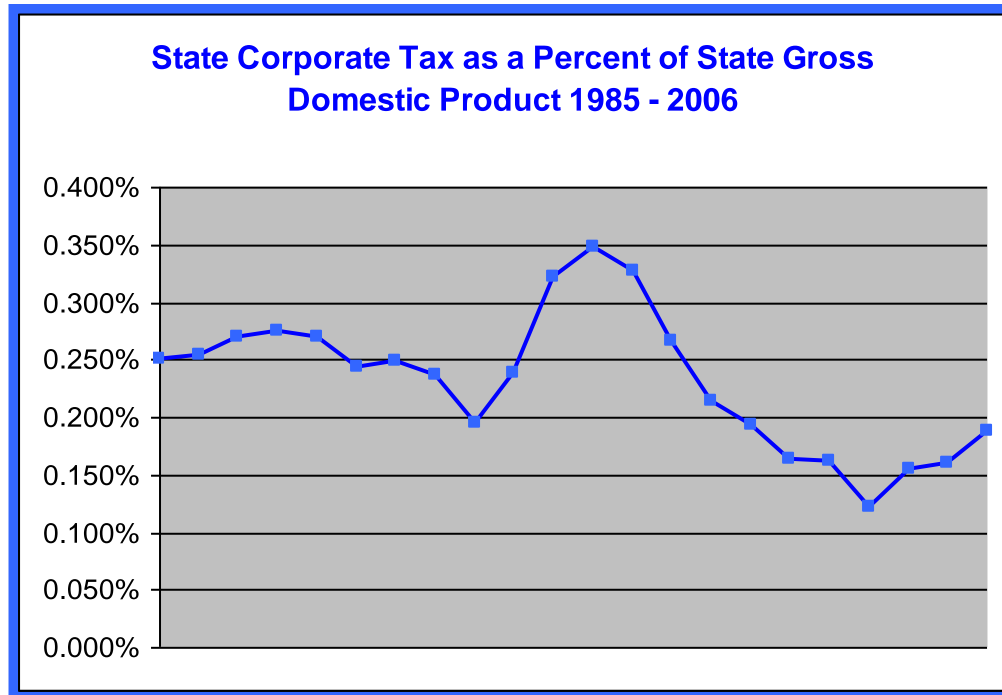
As shown above, net corporate tax collections in Missouri peaked in fiscal year 1996 at $477.3 million, in part due to the changes to the corporate income tax implemented three years prior. Net collections declined slightly in fiscal year 1997 and continued to decrease over five of the next six years. In 2003, net corporate tax collections reached their lowest level since 1987 at $228.1 million.

While total collections have fluctuated, **examining corporate tax collections as a percentage of state general revenue collections shows a downward trend.** In fiscal year 1996, net corporate tax collections accounted for approximately 9.0% of total state general revenue collections. By fiscal year 2006, net corporate tax collections represented only 5.5% of total state general revenue collections.

Corporate Taxes Relative to the State Economy and Corporate Profits

Another way to assess the changes in corporate tax collections over time is to consider Missouri's net corporate tax collections as a percentage of the Gross State Product (GSP). Table 2 below displays Missouri corporate taxes (after refunds) as a percentage of GSP between FY 1985 and 2006.

Table 2



As indicated, corporate tax collections in Missouri as a percent of the economy are at a 20 year low. This percentage increased in the mid-1990s as a result of a strong economy and the corporate income tax rate increase. However, between fiscal years 1996 and 2003, corporate taxes as a percent of the economy declined sharply from 0.347% to 0.121%. This was due in part to the reduction in the corporation franchise tax. As of fiscal year 2006, corporate taxes as a percent of the state's economy are 0.187%, well below their peak in fiscal year 1996 (0.347%) and below fiscal year 1985 (0.251%).

In addition, corporate profits at the national level have grown much faster than corporate tax collections in Missouri. In calendar year 2001, U.S. corporate profits stood at $719.2 billion. By 2006, U.S. Corporate Profits more than doubled and reached $1,776.6 billion, an increase of 147%. Over a roughly comparable period (state FY 2001 through state FY 2006) Missouri corporate tax collections grew from $289.4 million to $404.7 million, an increase of only 40%.[6] While one would not expect a near perfect correlation, this growth discrepancy suggests that non-economic factors are acting to suppress corporate tax collections in Missouri.

[6]Corporate Profits data is from the Bureau of Economic Analysis Website, Corporate Tax Collections data from the Missouri Office of Administration.

Why Corporate Tax Revenues Have Declined in Missouri: Tax Preferences

There is no simple explanation for the apparent disconnect between reported corporate profits nationally, Missouri economic growth and the decline in Missouri corporate tax collections. However, there are several provisions in the Missouri tax code that limit corporate tax collection in Missouri. The following tax preferences certainly have played a role:

The Federal Income Tax Deduction: Missouri law allows corporations to deduct 50% of the taxes paid on their federal corporate income tax return. Missouri is one of only five states that allow for any federal income tax deduction.[7]

Tax Credit Programs: Missouri tax credit programs reduce corporate income tax collections and are designed to stimulate investment and benefit a wide array of economic interests. Missouri law allows for 50 tax credit programs.[8] The revenue loss associated with these programs is substantial. According to data obtained from the Missouri Office of Administration, the corporate income tax collections were reduced by $76.6 million in fiscal year 2005 and by an additional $84.1 million in fiscal year 2006. While these tax credits may have fostered economic activity and tax revenue that would not otherwise have occurred, there can be no doubt that their cost to the state has been and will continue to be a substantial sum.

Single Sales Factor vs. Three Factor Formula: Most corporations earn their income by conducting business in several states. Missouri is ***the only state*** that allows multi-state corporations to choose the formula by which they allocate taxable income to Missouri. A corporation may choose either the "single sales factor" or the "three factor formula". Single sales factor apportionment benefits corporations who make most of their sales to out-of-state customers but rely heavily on Missouri infrastructure because they have facilities and employees here. This tax preference benefits approximately four percent of corporations that file income taxes in Missouri. The fiscal year 2005 Missouri Executive Budget estimated that disallowing single sales factor apportionment would result in a $57 million revenue gain to the state.[9]

Why Corporate Taxes Have Declined in Missouri: Tax Avoidance Practices

In addition to the tax preferences above, Missouri tax law currently allows multi-state corporations to avoid paying state income taxes. Most large multi-state corporations are composed of a parent corporation and one or more subsidiary corporations, all owned by the same company. Many multi-state corporations use the relationship between the parent corporation and subsidiaries to avoid tax liability by artificially shifting profits from states with higher corporate taxes to states with lower corporate taxes or even no corporate taxes at all. The following examples are the most common corporate tax avoidance practices.

Passive Investment Companies: The "Geoffrey" Loophole

Passive Investment Companies (PICs) are essentially shell corporations established in states with no corporate income tax.[10] The parent company will create a PIC and transfers its patents, trademarks, and other intangible assets over to the PIC. The PIC then gives the parent

---

[7] Data from *The Federation of Tax Administrators* Website

[8] See the *Tax Expenditure Report* (January 2007), Conducted by the State & Regional Fiscal Studies Unit at the University of Missouri-Columbia under contract to the Missouri Office of Administration.

[9] Missouri Executive Budget Fiscal Year 2005

[10] Common states for establishing passive investment companies include Delaware, Nevada, and Michigan.

corporation a license for the right to access the intangible assets. The parent corporation that is earning taxable profits in a state with a corporate income tax, will pay tax deductible royalties to the PIC in the state that has no corporate tax. In many cases, this strategy reduces or completely eliminates corporate tax liability. The PIC practice is commonly referred to as the *Geoffrey Loophole* after the Toys R Us mascot. Toys R Us, however, is only one of nearly 50 documented PIC companies. Others include Kmart, the Gap, and even Burger King.[11]

Real Estate Investment Trusts: The Wal-Mart Loophole

Recently public attention is focusing on a relatively new corporate tax avoidance practice, referred to as "REITS". Real Estate Investment Trusts (or REITs) are created when a parent corporation establishes a subsidiary to own its real estate (e.g. retail stores). The parent corporation transfers its retail stores to the REIT. The REIT will then lease the stores to the parent corporation in exchange for rent payments. The rent payments reduce or eliminate the taxable profit of the parent corporation, and the REIT is not subject to tax on its profit, thus eliminating state corporate income tax for the corporation entirely.

This tax avoidance practice was recently highlighted in a *Wall Street Journal* article that estimated that Wal-Mart avoided paying as much as $350 million in state income taxes over a four year period.[12] Interestingly, Wal-Mart established its REIT after it eliminated its PIC in 2006. Wal-Mart is drawing a good deal of attention recently due to the recent *Wall Street Journal* article, but it is not alone in utilizing the REIT practice. AutoZone is another documented case of REIT state corporate income tax avoidance.

Transfer Pricing

Transfer pricing uses artificially high or low charges among affiliated corporations to shift income between states. For example, say State A has a low corporate income tax and State B has a high corporate income tax. A manufacturing subsidiary in State A charges a wholesaling subsidiary in State B an artificially high price for widgets. This reduces the taxable income in State B and shifts it into State A. This allows the corporation to reduce its corporate tax liabilities.

The Impact on Missouri

There is no easy way to estimate the amount of tax revenue that is lost in Missouri from the discussed corporate tax loopholes, or how much of Missouri's corporate tax decline results from the use of corporate tax avoidance practices. However, according to national experts, the following accounts of tax avoidance have been documented, and indicate how large the impact could be:

- Kmart sheltered $1 billion in profits over a 3 year period in the 1990s through its Michigan PIC; and

---

[11] See: Glenn Simpson, *"A Tax Maneuver in Delaware Puts Squeeze on Other States"*, Wall Street Journal, August 9, 2002, page 1.

[12] See: Jesse Drucker *"Friendly Landlord: Wal-Mart Cuts Taxes by Paying Rent to Itself",* Wall Street Journal, February 1, 2007, page 1

- The Limited Corporation sheltered $1.2 billion in profits over a three year period in the 1990s through its Delaware PIC.[13]

With nearly 50 multi-state corporations being documented to utilize the PIC and most recently REIT practices, the impact of tax avoidance on Missouri's revenue could be significant.

What about the "Little Guy"

It's also important to note that in Missouri solely state-based corporations are not able to take advantage of these accounting practices to avoid state income tax. A Missouri corporation or small business that operates exclusively in-state is most likely paying its full share of state income tax. Most in-state corporations in fact are good corporate citizens and understand that paying their state income tax is not only the cost of doing business, but contributes to the State's expenses associated with supporting economic development and business infrastructure needs. Allowing the corporate tax loopholes to continue in a State allows the "Big Guys" to avoid paying their fair share at the expense of the "little guy".

The Case for Combined Reporting

Several states have moved recently to combat corporate income tax avoidance by instituting new state Combined Reporting measures. Combined reporting simply treats the parent corporation and each of its subsidiaries as one corporation for the purposes of calculating state income taxes. The nationwide profits are added together and then each state taxes a share of this net income or profit. The share of profit allocated to each state is based on the corporation's level of activity in the specific state as compared to its activity in other states. Implementing combined reporting would reduce the ability of corporations to shift profits between states to avoid corporate taxes.

Already, 20 of the 46 states that collect corporate income taxes now require combined reporting, including: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Michigan, Mississippi, Montana, Nebraska, New York, North Dakota, Oregon, Texas, Utah, Vermont, and West Virginia. Additionally, 5 State Governors have proposed legislation this year to implement combined reporting in their states.[14]

The states that have operated under combined reporting statute are doing well economically. For example, since 1990 only ten states with corporate income tax have had net gains in manufacturing employment. Of those states, 9 of the 10 were combined reporting states.[15]

---

[13] Mazerov, Michael *"Growing Number of States Considering a Key Corporate Tax Reform"*, Center on Budget & Policy Priorities, April 5 2007: http://www.cbpp.org/4-5-07sfp.htm and Mazerov, Michael *"Combined Reporting: The key to a Robust and Fair State Corporate Income Tax in New York"*, Center on Budget & Policy Priorities, March 16 2007, PowerPoint

[14] See Mazerov, Michael *"Growing Number of States Considering a Key Corporate Tax Reform"*, Center on Budget & Policy Priorities, April 5 2007: http://www.cbpp.org/4-5-07sfp.htm
And " Corporate Shell Games – How Wal-Mart and Others Shield Their Profits from New Mexico Taxes", April 11, 2007, New Mexico Fiscal Policy Project, http://www.nmvoices.org/fiscalpolicyproject.htm

[15] Mazerov, Michael *"Growing Number of States Considering a Key Corporate Tax Reform"*, Center on Budget & Policy Priorities, April 5 2007: http://www.cbpp.org/4-5-07sfp.htm and Mazerov, Michael *"Combined Reporting: The key to a Robust and Fair State Corporate Income Tax in New York"*, Center on Budget & Policy Priorities, March 16 2007, PowerPoint

California has applied combined reporting successfully for 60 years, and 15 other states have used it for decades.

Missouri legislators have introduced Combined Reporting bills in the state legislature for the past four years. If Missouri were to adopt combined reporting measures, there would be many benefits to the state.

Tax Fairness – Leveling the Playing Field

Corporations that operate entirely in Missouri are not able to shift profits to subsidiaries in other states. Rather, they must pay taxes on all of the profits they earn in Missouri. Implementing combined reporting in Missouri would create taxpayer equity among all corporations doing business here. Large multi-state corporations should not be able to pay a lower income tax rate than Missouri based corporations.

Enhanced Revenues

Estimates vary on the amount of revenue that could be gained in Missouri by implementing combined reporting. However, Michael Mazerov, tax expert at the *Center on Budget and Policy Priorities,* estimates that the corporate tax revenue in states with combined reporting increases anywhere from 13 to 24%. Based on this range, Missouri could gain approximately $40 to $70 million in state tax revenue; revenue that is currently hidden via corporate tax loopholes.

Economic Development

Corporate tax revenue contributes to economic development in the state. An additional $40 to $70 million in enhanced revenues would help Missouri pay for much needed improvements such as infrastructure, education and transportation funding. These factors are both critical to attracting and retaining corporations. While some corporations would face increased taxes in Missouri as a result of combined reporting, state and local taxes comprise a very small fraction of business costs.