Combined Reporting:
A Key Element in West Virginia Tax Modernization

Since Governor Manchin launched his Tax Modernization Project, many observers of state tax policy have cited the need to reduce the corporate net income tax, phase out the business franchise tax, and remain revenue neutral. If lawmakers want to cut taxes, then they will be required to offset this lost revenue either by shifting the tax burden somewhere else or by cutting government services. One easy way to replace some of this lost revenue without raising tax rates would be to enact combined reporting, which would require multi-state corporations (chains) to be subject to the same corporate income tax as small businesses in West Virginia

An increasing number of states are looking to combined reporting to help balance their budgets and shore up their corporate tax base. Most recently, in June of 2004, Republican Governor Jim Douglas of Vermont signed into law a bill requiring combined reporting, and a dozen other states have considered this change in the last year. So far 18 states have combined reporting, including Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Nebraska, New Hampshire, North Dakota, Oregon, Texas (effective 2007), Utah, and Vermont.

According to Michael Mazerov, a Senior Fellow at the Center for Budget and Policy Priorities, if combined reporting was enacted in West Virginia the annual revenue gain would be between $60 and $111 million based on similar state estimates and West Virginia's 2005 CIT collections.

What is Combined Reporting?

When filing tax returns, corporations that operate across state lines apportion their income among the states where they do business. In doing so, corporations use many strategies to artificially shift the reporting of their income to low-tax or no-tax states. Combined reporting is the broadest and fairest reform to stop the most common tax avoidance strategies. Because combined reporting requires corporations to add together the profits of related businesses before the combined profit is subject to apportionment, the company gains little or no advantage by shifting profit among its subsidiaries in different states. Combined reporting ensures that a corporation's state income tax liability remains the same regardless of the corporation's legal structure.

Simply put, the adoption of combined reporting in West Virginia would make it more difficult for corporations to shift profits out of West Virginia and reduce their tax liability inappropriately. Combined reporting elevates substance over form - meaning that tax liabilities are determined by the substance of business activities in the state, not by the business's organizational structure. Charles McLure, a Senior Fellow at the Hoover Institution and a leading Treasury Department official in the Reagan Administration, has called the failure to use combined reporting "an open invitation to tax avoidance."

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Why does West Virginia need Combined Reporting?

√ Because tax cuts do not pay for themselves and West Virginia needs a balanced budget.

√ Corporate income tax revenues are already declining. From 1989 to 2003, West Virginia has seen its corporate income tax revenue fall by 47 percent as a share of the state economy. On the national level, corporate taxes are at their lowest levels since the 1930s.

√ The practice has given major retail chains in West Virginia an advantage over locally-owned businesses that pay state income tax on all of their earnings.

√ According to a 2003 Multistate Tax Commission, West Virginia has the highest percentage of corporate net income tax losses to out-of-state tax shelters of any state in the nation. In 2001, West Virginia lost 57.8 percent of its possible corporate tax revenues. This accounted for $65 million in lost revenue.

√ It doesn't hurt the business climate. In the words of Michael McIntyre, a professor of law at Wayne State University, combined reporting "has been a success in every state that has adopted it." Recent evidence certainly bears out McIntyre's conclusion, as states that mandate combined reporting are "disproportionately among the most economically successful" in recent years. Of the states with combined reporting, four were among the top five states in terms of manufacturing job growth over the 1995-2000 period; eight placed in the top ten in terms of manufacturing job growth.

√ By enacting combined reporting our tax system will fairer, less subject to manipulation, and better for all West Virginians.

Conclusion

Tax reform strategies that broaden the tax base by eliminating unfair and expensive loopholes can help offset any lost revenue due to tax cuts and help West Virginia balance its budget without requiring unpopular increases in tax rates — and requiring combined reporting is the single best option available to lawmakers seeking to stamp out accounting shenanigans by multi-state corporations.

For more information about combined reporting please contact Ted Boettner at ted@mserf.org or 304.346.8928.

The MSERF mission is to use research and analysis to advance policies and practices that benefit all West Virginians