Combined Reporting

The Effect on the District's Tax Revenue

FAHAD FAHIMULLAH
YI GENG
URANBILEG ENKHTUVSHIN

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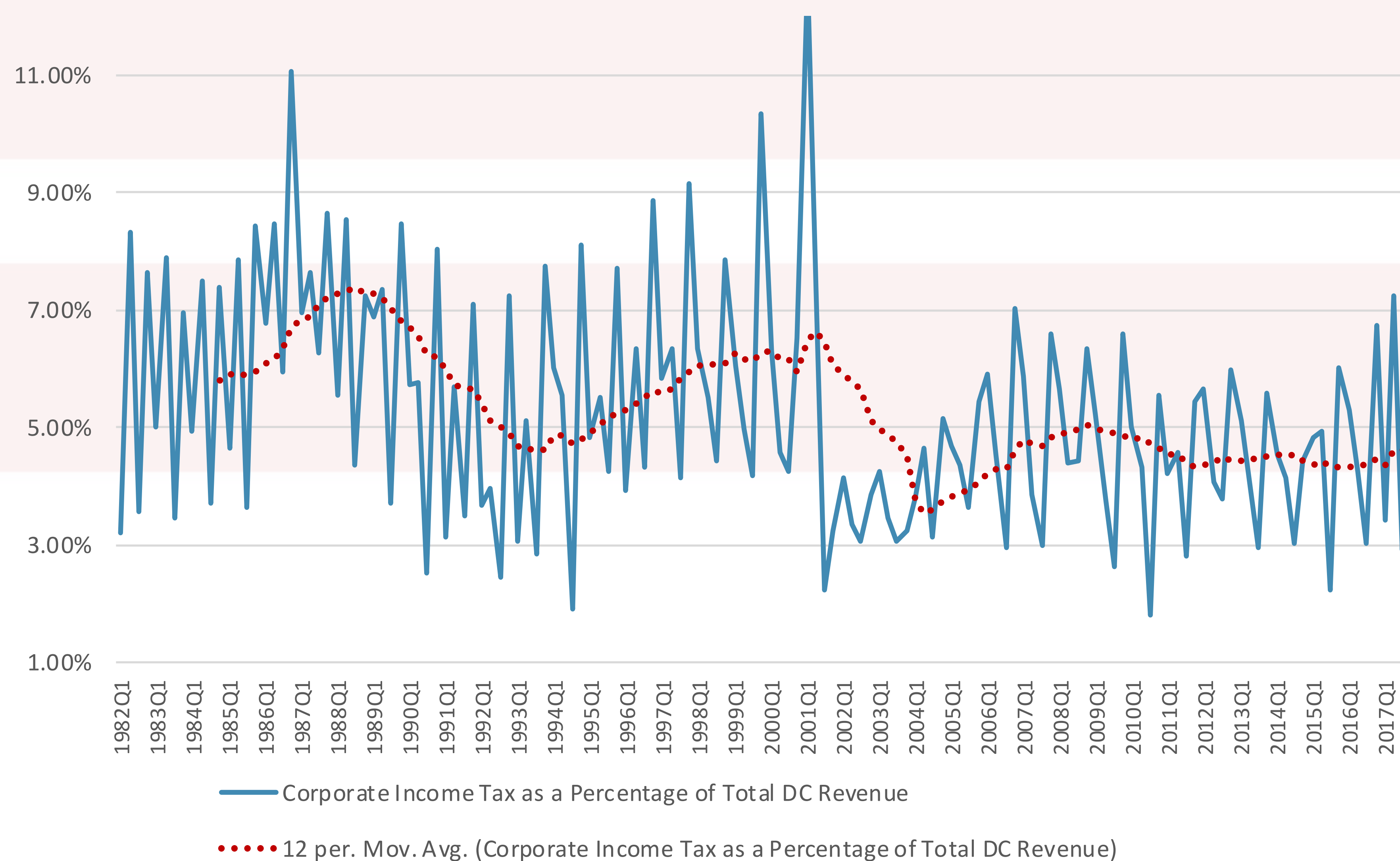
Corporate Tax Planning Issues

- Before 2011, Washington DC had required corporations to file separate-reporting returns with an option to file on a consolidated basis.
- However, multistate businesses have been able to minimize their legal tax liability via tax planning strategies.
- How? By shifting the corporation's profits to certain subsidiaries located in low tax or no tax states, (mostly Nevada or Delaware), using techniques such as
  - Transfer pricing
  - Passive investment companies (PICs)
  - Real estate investment trusts (REITs), or
  - Inter–company loans
- Evidence of Tax Planning
  - Toys "R" Us shifted $55 million to Delaware subsidiary, Geoffrey Inc. (a trademark holding co), in 1990 alone
  - Evidence submitted in a case in North Carolina revealed that, in one four-year period, from 1998 to 2001, Walmart and Sam's Club stores across the country paid captive REITs a total of $7.27 billion in "rent"

DC Implemented Combined Reporting to Minimize Tax Planning Problems

- As a result, the city's corporate franchise tax as a percentage of total DC revenue has declined markedly during the past several decades
- To minimize tax planning, the District of Columbia in 2011 tax year implemented combined reporting requirement for all unitary businesses

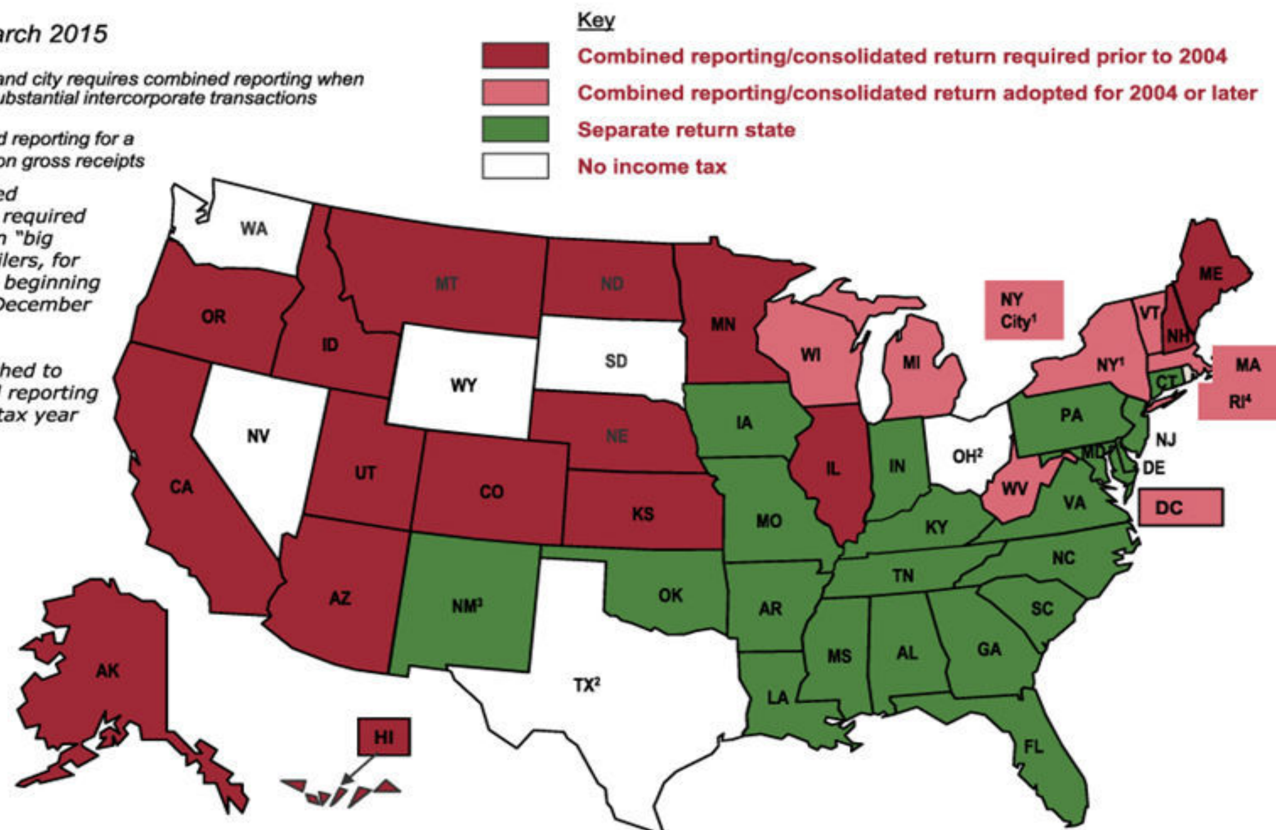


Combined Reporting – Definition and History

- Definition
  - Combined reporting is a regime adopted in the tax or revenue legislation of a number of states which treats a group of wholly owned or majority owned companies and other entities (such as trusts and partnerships) as a single entity for tax purposes
- Brief History*
  - Intercontinental railroads and new manufacturing machines allowed multi-state businesses to mass-produce goods for customers in other states
  - In the 1930s, California faced an income allocation problem with respect to income earned by its movie industry
  - Later in the 1950s and 1960s other states started to consider, by 1980s several states had adopted combined reporting

*Office of Fiscal and Management Analysis, page 10

Combined Reporting States



*This graphic shows which states have combined reporting as of March 2015. By Business Council of Alabama

- As of January 1, 2016, 25 states and DC require combined reporting while several others have proposed it.
- One of the primary goals of combined reporting is to level the playing field by mitigating the tax planning by multistate large businesses.

Types of Combined Reporting

- *Joyce vs Finnigan*
  - *The Joyce Rule* is a principle established in *Appeal of Joyce, Inc*. (Cal. SBOE 1966)
    - DC follows *the Joyce rule*
    - Apportionment factor *numerators* includes the property, payroll, and sales of subsidiaries with nexus to DC. In *Joyce* states, sales by a unitary group member lacking nexus in the state are excluded from the combined report numerator.
    - The *denominator* contains the property, payroll, and sales of the entire combined group regardless of nexus.
    - DC has a throwback rule for outbounding sales to Federal gov't or not taxed by any other states
  - *Finnigan* apportionment numerators includes both nexus and non-nexus subsidiaries. Finnigan aligns closer to the unitary business principle than Joyce
  - 15 states and DC follows Joyce and 9 states follows Finnigan.
- Water's edge vs worldwide reporting
  - DC Combined reporting is on a water's edge basis (the default)
  - Combined group may elect to report on a worldwide basis, and the worldwide reporting election is in effect for 10 years

Combined Reporting: an Illustration

Taxpayer Attributes	Parent	Subsidiary A	Subsidiary B	Consolidated** (Parent + Sub. A)	Combined Reporting Joyce (DC Law)	Combined Reporting Finnigan
DC Nexus	Yes	Yes	No			
Total US Net Income	$10,000	$300	$5,000	$10,300	$15,300	$15,300
DC Gross Sales	$5,000	$500	$1,500	$5,500	$5,500	$7,000
US Gross Sales	$50,000	$10,000	$10,000	$60,000	$70,000	$70,000
Single Sales Apportionment Factor*	10%	5%	15%	9%	8%	10%
DC Taxable Income	$1,000	$15	$0	$944	$1,202	$1,530

*For simplicity purposes, we use a single sales apportionment factor. Apportionment Factor=DC Gross Sales/US Gross Sales

** DC consolidated filing option excludes members without DC nexus

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DC Gross Sales	$5,000	$500	$1,500	$5,500	$5,500	$7,000
US Gross Sales	$50,000	$10,000	$30,000	$60,000	**$90,000**	**$90,000**
Single Sales Apportionment Factor	10%	5%	**5%**	9%	**6%**	**8%**
DC Taxable Income	$1,000	$15	$0	$944	**$935**	**$1,190**

*For simplicity purposes, we use a single sales apportionment factor. Apportionment Factor=DC Gross Sales/US Gross Sales

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Combined Reporting: A Smaller Share of a Bigger Pie

- Combined reporting (under *Joyce*) essentially allows states to grab a **smaller share** (apportionment ratio) of a **bigger pie** (company's U.S. Income before apportionment).

- Consolidated DC Taxable Income:

$$= \underbrace{(Nexus_US_Income)}_{\text{Pie}} * \underbrace{\frac{\text{Nexus DC sales}}{\text{Nexus US Sales}}}_{\text{share}}$$

- Combined DC Taxable Income:

$$= \underbrace{(Nexus_US_Income + NonNexus_Income)}_{\text{Bigger Pie}} * \underbrace{\frac{Nexus\ DC\ sales}{\text{Nexus US Sales + NonNexus US Sales}}}_{\text{Smaller share}}$$

- The "bigger pie" effect would dominate if the newly captured non-nexus businesses have higher profit margins.
- DC's throwback rule increases "Nexus DC sales" and the apportionment factor

Literature Review

- Gupta, et al, (2009) *Empirical Evidence on the Revenue Effects of State Corporate Income Tax Policies,* NTJ
  - Found that combined reporting surprisingly is not significantly associated with higher state corporate income tax revenues.
  - Use of a throwback rule are associated with higher state corporate tax revenues.

- Rhode Island (2014) *Tax Administrator's Study Of Combined Reporting*
  - Found that only 29% of those C-Corps would pay higher taxes under Combined Reporting in 2011 and 2012.
  - However, the small number of corps were responsible for $22-$23 m of tax avoidance.

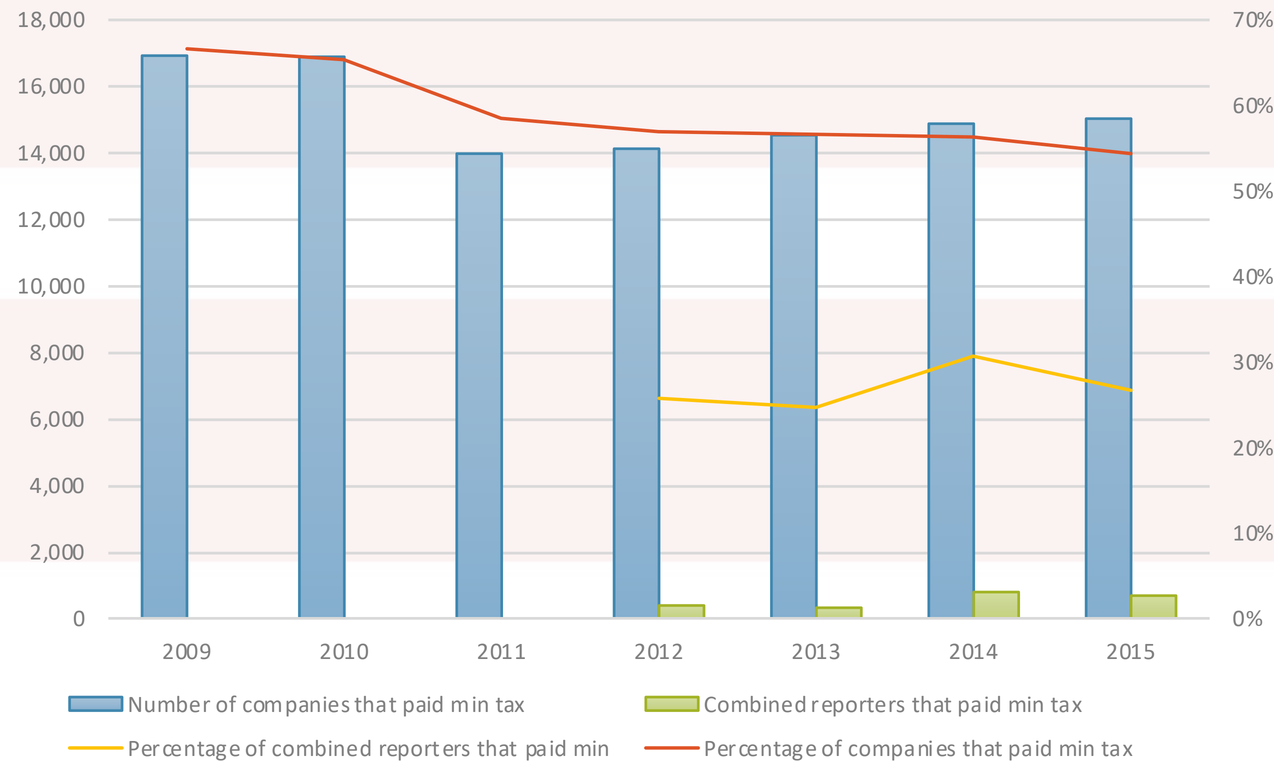
- Indiana Legislative Services Agency (2016) *Study of Practices Relating to and the Potential Impact of Combined Reporting*
  - The study was conducted on 44 states and 18 years of panel data
  - Combined reporting may have an initial positive impact on corporate income tax revenue but that this impact is not lasting

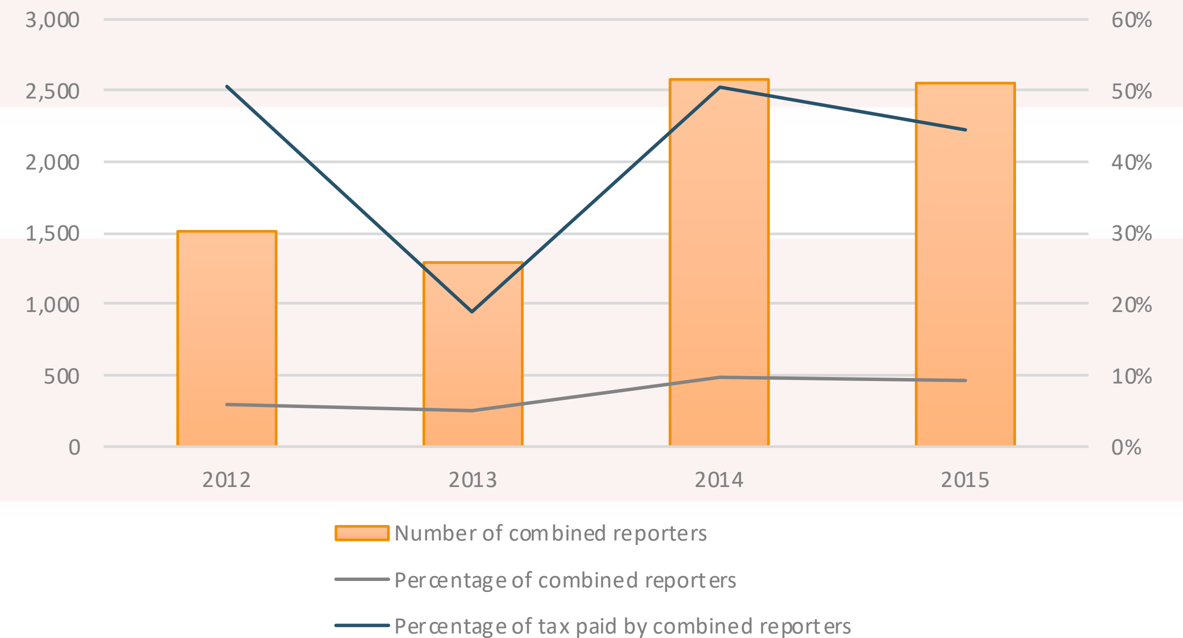
- Robert Cline, Ernst&Young (2008) *Understanding the Revenue and Competitive Effects of Combined Reporting*
  - Study based on simulations and previous literatures on combined reporting by state tax legislators
  - Found uncertain effects on tax revenue
  - Companies' behavior will shift in response to the adoption of combined reporting by reducing the level of investment and jobs

Motivation and objective of the research

- There are several researches and literatures on the topic of combined reporting, but none has been found to be conducted on state level real tax data
- This research is to answer the question of whether the combined reporting has indeed increased the District's tax revenue and what other effects it has on the apportionment factor

Descriptive Statistics

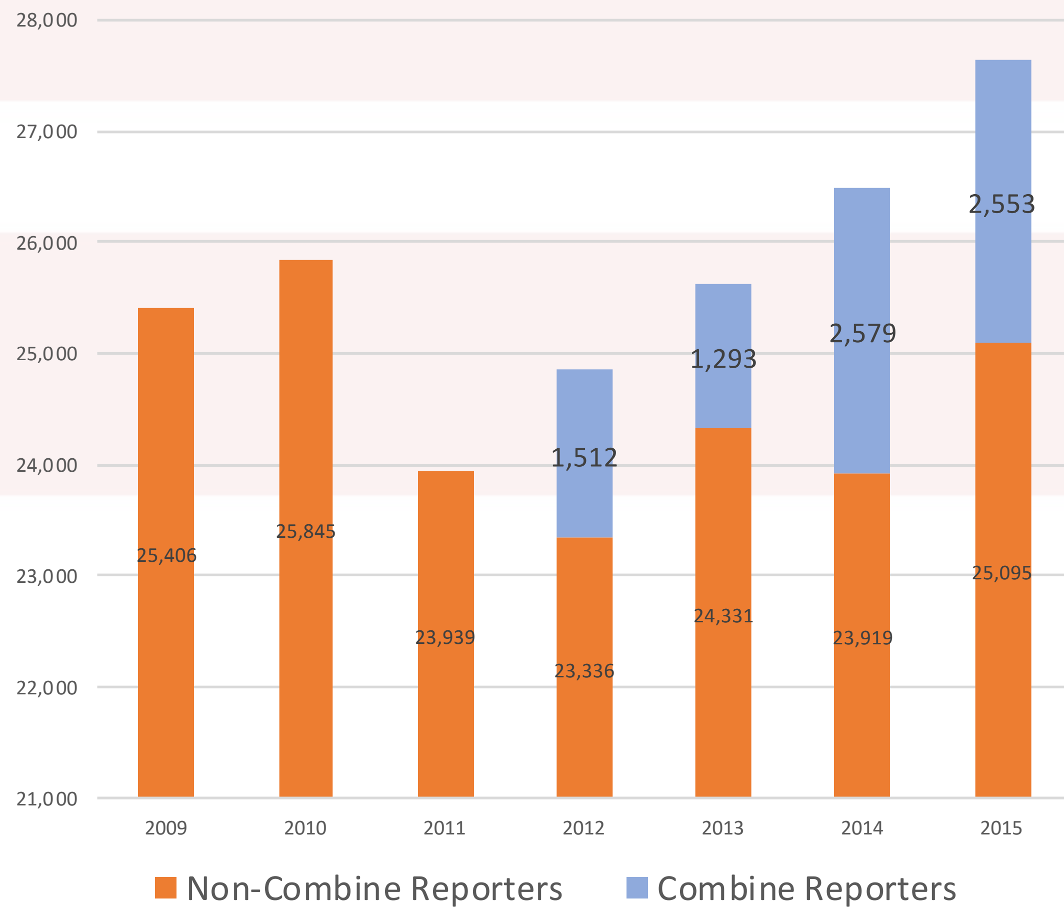


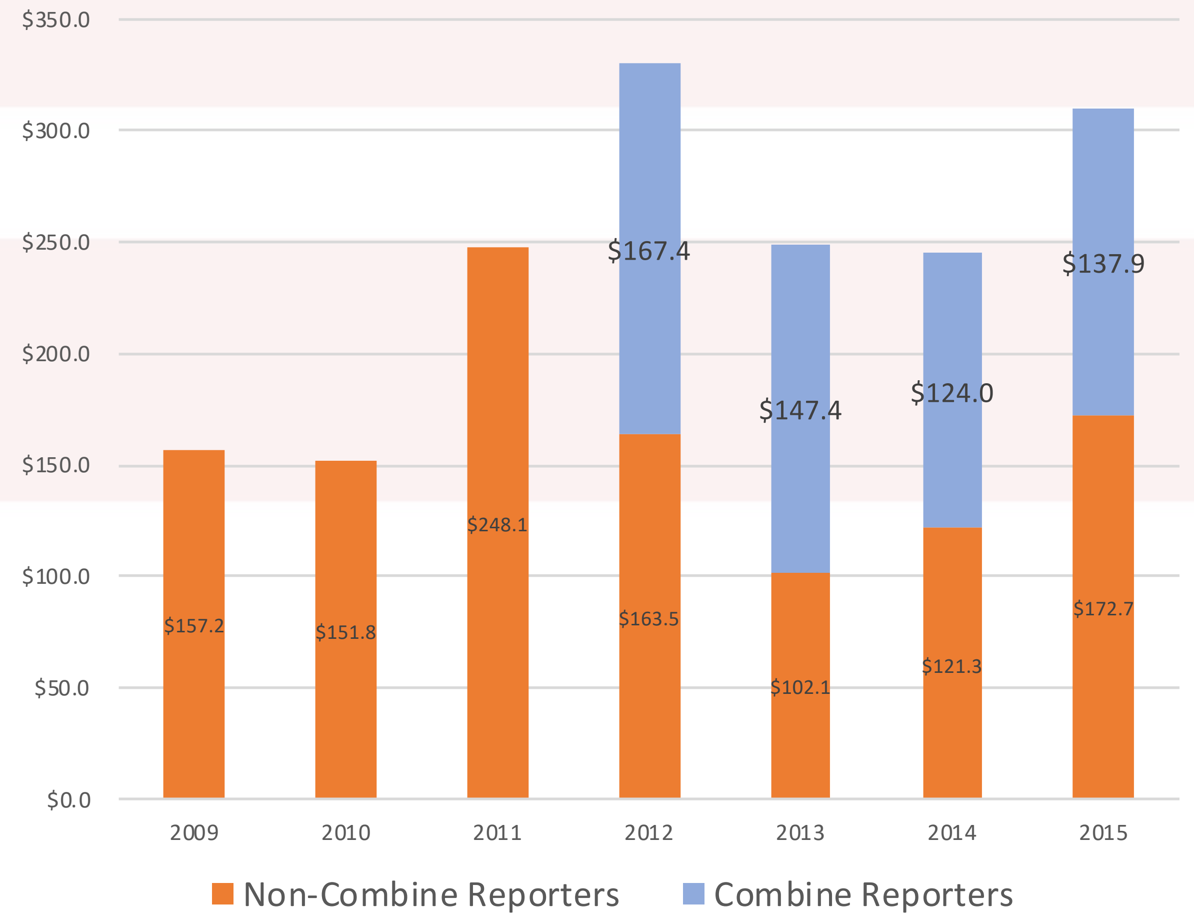


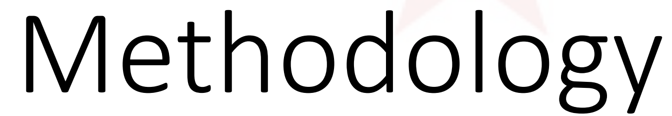
- Less number of combined reporters pay minimum tax compared to the rest

- Combined reporters are made up of only about 10 percent, but they pay about 40-50 percent of the total tax revenue

Descriptive Statistics







Methodology

- Fixed effect regression with six year of panel data
  - To control for other factors that affect the individual companies

$$\boldsymbol{Y_{it} = \beta_1 X_{it} + \alpha_i + u_{it}}$$

Where

- α_i (*i*=1…3817) is the unobserved individual effects (fixed characteristics) for entity *i.*
- Y_{it} is the dependent variable where *i*=1…3817 entity and *t* = 1…6
- X_{it} represents independent variables (time dummy, treatment dummy, GDP, business gross receipts, etc)
- β is the coefficient
- u_{it} is the error term

- Companies that filed tax for six consecutive years from 2009 to 2014
- Companies that have apportionment factor of 0.3 or less
    - To match the control group as close to the treatment group as possible
- Excluded companies that paid minimum tax all six years
- <u>Treatment group</u>
    - 230 companies
    - The “if combined report” oval is filled in, in the tax data, it is identified as “Y”
- <u>Control group</u>
    - 3587 companies
    - Rest of the companies that filed tax for six consecutive years

Effect on the Tax Revenue

lntax	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
Time	.1174833	.026369	4.46	0.000	.0657974	.1691692
Interaction	.5608512	.0776415	7.22	0.000	.4086662	.7130362
lnreceipt	.5573311	.017389	32.05	0.000	.523247	.5914151
lnsnp	.8431582	.0564634	14.93	0.000	.7324844	.9538321
_cons	-8.257894	.4656849	-17.73	0.000	-9.170682	-7.345105

$$ln(Net_Tax_{it}) = \beta_0 + \beta_1 Time + \beta_2 Interaction + \beta_3 ln(Gross_Receipt_{it}) + \beta_4 ln(S\&P500_t) + u_{it}$$

- Interaction = Time*Treatment
- Controlling for intra-company size fluctuation and economic growth
- Combined reporting has statistically significant positive effect on tax revenue
- Combined reporting companies pays 44.4% more from 3-year pre-combined-reporting periods to the 3-year post-combined-reporting, compared to the control group.
- Control group companies grows at 11.7%, while combined reporting companies grow at 56.1%, from pre to post combined reporting period, after controlling for company sizes and economic growth (the combined reporting effect is about 16% extra tax revenue growth).

Effect on D.C. Apportionment

Dc_Apporti~r	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
Time	.0504789	.00217	23.26	0.000	.0462254	.0547323
Interaction	-.0538673	.0101637	-5.30	0.000	-.073789	-.0339457
_cons	.1324424	.0014991	88.35	0.000	.1295041	.1353807

$$Dc_Apportion_Factor_{it} = \beta_0 + \beta_1 Time + \beta_2 Interaction + u_{it}$$

- Interaction = Time*Treatment
- Statistically significant negative impact on D.C. apportionment factor
- Compared to the control group, combined reporters' apportionment factors decline by 5.4% from pre to post combined reporting period.

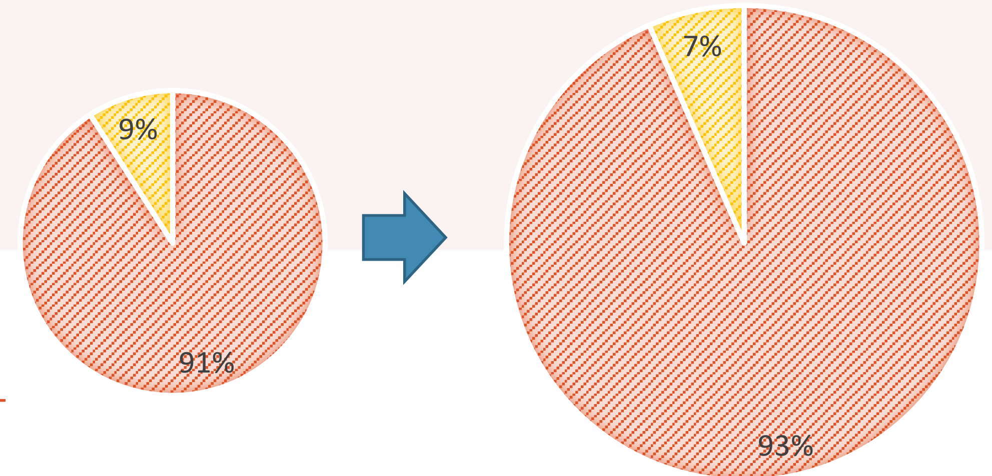
D.C. Apportionment

- Several factors could cause the apportionment factor to drop
- $\boldsymbol{Dependent\ Variable_{it} = \beta_0 + \beta_1 Time + \beta_2 Interaction + u_{it}}$
  - Individual payroll, property and sales factors

Dependent Variable*	$\boldsymbol{\beta_2}$ **Coefficient**	**T-test**
Payroll factor	-0.3094678	-5.10
Property factor	-0.5817965	-9.30
Sales factor	-0.0624633	**-1.05**

    - Sales factor does not decline as much as others
  - Net Income before apportionment

Dependent Variable	$\boldsymbol{\beta_2}$ **Coefficient**	**T-test**
Net Income before apportionment	0.271228	3.23



  - Bigger Pie, Smaller Share, and Higher DC Income before Apportionment

* Each of the dependent variables were run separately

Conclusions

- Combined Reporters: 56% more taxes from pre to post combined reporting period, compared with 11.7% for non-combined-reporters over the same periods. The difference (44.4%) can be attributed to "Combined-reporting"
- This 44.4% translates into $44.9 million annual fiscal impact (compared to 22.6 million estimated fiscal impact for tax year 2012).
- Slightly decline in apportionment factors for combined reporters relative to their control group counterparts over the same pre and post periods.
- A bigger pie and a smaller share indeed, and the bigger-pie effect dominates in DC (possibly due to more high-margin non-nexus businesses being captured), resulting in more corporate tax revenues.
- *Throwback rule* helps.