COST
COUNCIL ON STATE TAXATION

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In Opposition to Mandatory Unitary Combined Reporting and In Opposition to Sales Taxation of Business Inputs

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Chairman Daily, Chairman Staples and Members of the Committee, thank you for the opportunity to provide testimony on behalf of the Council On State Taxation (COST) in opposition to mandatory unitary combined reporting (SB 807) and in opposition to new sales taxes on business inputs (HB 6349 and HB 6350).

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of over 620 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Mandatory Unitary Combined Reporting (SB 807)

The COST Board of Directors has adopted a formal policy statement on mandatory unitary combined reporting. COST's policy position is:

> *Mandatory unitary combined reporting ("MUCR") is not a panacea for the problem of how to accurately determine multistate business income attributable to economic activity in a State. For business taxpayers, there is a significant risk that MUCR will arbitrarily attribute more income to a State than is justified by the level of a corporation's real economic activity in the State. A switch to MUCR may have significant and unintended impacts on both taxpayers and States. Further, MUCR is an unpredictable and burdensome tax system. COST opposes MUCR.*

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and corporate taxpayers is how a State should determine the corporate income tax base for multistate corporations with multiple businesses and entities. One possible system—MUCR—arbitrarily assigns income to a State, negatively impacts the real economy, has an unpredictable affect on State revenue and imposes significant administrative burdens on both the taxpayer and State.[1]

- Arbitrarily Assigns Income – Although proponents of MUCR argue that it helps to overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under MUCR create new distortions in assigning income to different States. The MUCR assumption that all corporations in an affiliated unitary group have the same level of profitability is not consistent with either economic theory or business experience. Consequently, MUCR may reduce the link between income tax liabilities and where income is actually earned. Many corporate taxpayers may conclude that there is a significant risk that MUCR will arbitrarily attribute more income to a State than is justified by the level of a corporation's real economic activity in the State.

- Negatively Impacts the Real Economy – Proponents of MUCR have focused on the benefits in terms of reducing tax planning opportunities, but they fail to acknowledge that adopting MUCR may actually increase effective corporate income tax rates. Even if MUCR results in a relatively small increase in net corporate tax revenue, there will be significant increases and decreases in tax liabilities for specific businesses. Depending upon the industry distribution of winners and losers, adopting MUCR may have a negative impact on a state's overall economy. Moreover, economic theory suggests that any tax increase resulting from adopting MUCR will ultimately be borne by labor in the State through fewer jobs (or lower wages over time) or by in-state consumers through higher prices for goods and services.

- Unpredictable Affect on State Revenue – MUCR has uncertain effects on a state's revenues, making it very difficult to predict the revenue effect of adopting MUCR. Switching from separate filing to MUCR can decrease, increase or leave state tax collections unchanged depending upon the complex economic relationships among corporations included in a unitary group and the apportionment methodology selected by the state. Because of this complexity, the overall revenue impact of adopting MUCR cannot be predicted reliably.

- Significant Administrative Burden

    - *Determining the Unitary Group:* The concept of a "unitary business" is uniquely factual and universally poorly-defined. It is a constitutional (Due Process) concept that looks at the business as a whole rather than individual separate entities or

[1] A thorough discussion of the problems associated with MUCR can be found in the study prepared for COST by Ernst & Young LLP, *"Understanding the Revenue and Competitive Effects of Mandatory Unitary Combined Reporting"* (www.statetax.org).

separate geographic locations. In order to evaluate the taxpayer's determination of a unitary relationship, state auditors must look beyond accounting and tax return information. Auditors must annually determine how a taxpayer and its affiliates operate at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation's operational and tax staff to gather this operational information. In practice, however, auditors routinely refuse to make a determination regarding a unitary relationship on operational information and instead wait to determine unitary relationships until after they have performed tax computations. In other words, the tax result of the finding that a unitary relationship exists (or does not exist) often significantly influences, or in fact controls the auditor's finding. Determining the scope of the unitary group is a complicated, subjective, and costly process that is not required in separate filing states and often results in expensive, time-consuming litigation.

- *Calculating Combined Income* – Calculating combined income is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most MUCR states, the group of corporations included in a federal consolidated return differs from the members of the unitary group. In addition to variations in apportionment formulas among the States that apply to all corporate taxpayers, further compliance costs related to MUCR result from variations across States in the methods used to calculate the apportionment factors.

Sales Taxes on Business Inputs (HB 6349 and HB 6350)

The COST Board of Directors adopted a formal policy statement regarding sales taxes on business inputs. COST's policy position is:

> *Imposing sales taxes on business inputs violates several tax policy principles and causes significant economic distortions. Taxing business inputs raises production costs and places businesses within a State at a competitive disadvantage to businesses not burdened by such taxes. Taxes on business inputs, including taxes on services purchased by businesses, must be avoided.*

A sales tax on business inputs violates several tax policy principles—economic growth, equity, simplicity and efficiency—and causes a number of economic distortions. Notably, these distortions result from pyramiding, where a tax is imposed at multiple levels, such that the effective tax rate exceeds the retail sales tax rate. Companies are forced to either pass these increased costs on to consumers or reduce their economic activity in the State in order to remain competitive with other producers who do not bear the burden of such taxes. As a result of the choices businesses are forced to make, the economic burden of taxes on business inputs inevitably shifts to labor in the State (through lower wages and employment) or consumers (through higher prices).

All states that impose sales tax currently tax business inputs to some extent, but few states tax services principally purchased by businesses. Nationwide, taxation of business inputs already accounts for nearly 43% of all state and local sales tax revenues. In Connecticut, nearly 50% of current sales tax revenues come from taxes imposed on businesses inputs—items that the business purchases for its own use in the operation of the business.[2]

Proposals to eliminate existing sales tax exemptions for business inputs or to extend the sales tax to services purchased primarily by businesses further exacerbate the adverse economic distortions from the current taxation of business purchases. For example:

- Taxing business inputs encourages companies to self-provide business services to avoid the tax rather than purchasing them from more efficient providers and paying tax (vertical integration);
- Taxing business inputs places companies selling in international, national and regional markets at a competitive disadvantage to many of their competitors, leading to a reduction in investment and employment in the State;
- Taxing business inputs unfairly and inefficiently taxes some products and services more than others by imposing varying degrees of tax on inputs in addition to a general tax rate on final sales; and
- Taxing business inputs unfairly hides the true cost of government services by embedding a portion of the sales tax in the final price of goods and services.

Conclusion

Connecticut, like most states, faces considerable budget difficulties. Those difficulties are caused by a severe downturn in the real economy. Enacting legislation that discourages investment, such as mandatory unitary combined reporting and new sales taxes on business inputs, further punishes businesses that are already struggling. Connecticut policymakers should be focused first and foremost on making changes to the tax system that encourage investment and job creation. The legislation before you today is the opposite of what Connecticut needs, and COST urges you to reject it.

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[2] A thorough discussion of the problems associated with the taxation of business inputs, including services purchased by business, can be found in the study prepared for COST by Ernst & Young LLP, *"Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services"* (www.statetax.org).