Testimony to the Connecticut General Assembly Joint Committee on Finance, Revenue and Bonding

In Opposition to House Bill 6628
Mandatory Unitary Combined Reporting

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Co-Chairs Daily and Widlitz and Members of the Committee, thank you for the opportunity to provide testimony today on behalf of the Council On State Taxation (COST) in opposition to House Bill 6628, which would impose mandatory unitary combined reporting (MUCR). MUCR arbitrarily assigns income to a State, negatively impacts the real economy, has an unpredictable effect on State revenue and imposes significant administrative burden on both the taxpayer and the State.

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 nearly 600 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.

COST's Position Mandatory Unitary Combined Reporting

The COST Board of Directors has adopted a formal policy statement on MUCR. 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.*

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Problems with Mandatory Unitary Combined Reporting

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and business taxpayers is how a state should determine the corporate income tax base. The first approach, "separate entity reporting," treats each corporation as a separate taxpayer. This is the method Connecticut currently uses. The second approach, MUCR, treats affiliated corporations (parents and subsidiaries) engaged in a "unitary business" as a single group for tax purposes of determining taxable income.[1] MUCR has several serious flaws.

- **Reduces Jobs –** Proponents of MUCR have focused on the benefits in terms of reducing tax planning opportunities, but they fail to acknowledge the evidence that adopting MUCR hinders investment and job creation. Even if MUCR results in only 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.

  States that use separate entity reporting have experienced higher job growth than have states with MUCR. From 1982-2006, job growth was 6% higher in states without MUCR than in states with it (after adjusting for population changes).[2] Furthermore, MUCR has been found to reduce economic growth, especially at higher tax rates.[3] Finally, during the current recession, states with MUCR experienced economic declines 16% greater than states without MUCR.[4]

- **Uncertain Revenue –** Implementing MUCR would have an unpredictable and uncertain effect on the Connecticut's revenue. The corporate income tax is the most volatile tax in every state in which it is levied, regardless of whether MUCR is employed. The University of Tennessee found no evidence that states with MUCR collect more revenue in one study, and then later found that MUCR may or may not increase revenue.[5] Importantly, state budget

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[1] The concept of a "unitary business" is a constitutional requirement that limits the states' authority to determine the income of a multistate enterprise taxable in a state. Due to varying state definitions and case law decisions, the entities included in a unitary group are likely to vary significantly from state to state.
[2] Robert Cline, "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," Ernst & Young, May 30, 2008, p. 16.
[3] William F. Fox, LeAnn Luna, Rebekah McCarty, Ann Boyd Davis and Zhou Yang, "An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes," University of Tennessee, Center for Business and Economic Research, October 30, 2009, p. 39. A more recent study by the two lead authors commissioned by the National Conference of State Legislatures reached similar conclusions.
[4] Robert Cline, "Comparison of State Economic and Fiscal Performance During the Recession," Ernst & Young, January 12, 2010, p. 2.
[5] Ibid. 3, p. 34.

deficits during the current fiscal recession were 41% larger in states with MUCR than in states without it.[6]

- **Administrative Complexity –** MUCR is by definition complex, requiring extensive fact-finding to determine the composition of the "unitary group" and to calculate combined income. This complexity results in unnecessary and significant compliance costs for both taxpayers and the State.

  - *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 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.

- **Arbitrary –** 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.

[6] Ibid. 4, p. 2.

Conclusion

Connecticut, like nearly every state, is grappling with severe fiscal problems. Those problems result from the significant downturn in the real economy that began in 2008. Most economic indicators suggest that the economy is beginning to improve; the General Assembly must ensure that any tax policies it adopts to address the State's short-term fiscal problems do not hinder the economic recovery. Studies show that MUCR is the most costly way for the State to raise revenue because of its negative impact on job creation. MUCR will not help Connecticut attract jobs or investment and should not be adopted.