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CONNECTICUT
STATE COUNCIL

SERVICE EMPLOYEES
INTERNATIONAL UNION
CTW, CLC

Statement by Paul Filson, Director of Service Employees International Union (SEIU) Connecticut State Council on S.B. No. 946 AN ACT CONCERNING REVENUE ITEMS TO IMPLEMENT THE GOVERNOR'S BUDGET.– **Before the Finance, Revenue and Bonding Committee**

Good afternoon, Co-Chairs, Senator Fonfara, Representative Berger and distinguished members of the Finance, Revenue and Bonding Committee - I appreciate the opportunity to be here before you today. My name is Paul Filson and I am Director of SEIU's Connecticut State Council. The State Council represents over 65,000 active members in Connecticut. SEIU is Connecticut's largest union. SEIU advocates for a responsible, fair, reliable, transparent and accountable taxation system for Connecticut.

A key component to designing and implementing, a sensible and reliable revenue raising tax code, for Connecticut is understanding who pays taxes and how much they pay. A balanced tax system will result in a steady stream of revenue more able to withstand the ups and downs of our economy. In the past, corporate business income taxes accounted for up to 14% of all taxes collected. Today, that figure is less than 5%. Income taxes are too flat across most income levels, in Connecticut, hurting working and middle class tax-payers more than wealthy ones, and represent nearly one third of our revenues. Wealthy Connecticut residents pay a much lower percent of their income in taxes than do low and moderate income people. Our personal income taxes should be made more progressive and the highest income earners should have higher marginal rates. Sales and sin taxes, which are much more burdensome and have a greater impact on poor and moderate-income people, account for over 20%. This means individuals, and the taxes they pay, account for quite a bit more than 50% of Connecticut's tax stream while corporate income taxes account for only 5% or less.

It is no mean feat to design a system of corporate taxes that balances the need to raise revenues and the need to promote job growth. Taxes are used to pay for the entire infrastructure that is needed to attract corporations and businesses to Connecticut. In any list of reasons why companies' decide to locate in a particular region of the country, infrastructure related items such as, an educated and trained pool of workers, good transportation, and quality of life rank higher than taxes and other business cost items. This does not minimize the impact overly high taxes and the cost of doing business might play in making a decision, but Connecticut clearly has moved too far in the direction of placing tax burdens on individuals.

There are dozens and dozens of tax incentives or tax expenditures for corporations written into Connecticut's tax code. These account for nearly $1 billion in taxes that are not collected from corporations. Rather than praise or condemn them, I recommend the

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committee examine and evaluate each of them for current validity and utility. These corporate tax loopholes must be examined on a regular basis.

Some of these Incentives were designed to attract or retain jobs in Connecticut. Many incentives were passed during a time of higher corporate tax burdens and a growing economy. Some tax incentives were passed to compete with other states in our region. One such incentive passed in 1998 allows financial services corporations and passive investment companies like Webster Bank to reduce their Connecticut tax liability to nothing. Webster Bank has earned profits in excess of $1 billion since 2000. Perhaps, in 1998, such a tax reduction made sense, but today, while programs for children and health services are being cut and our cities and towns struggle to keep property taxes down, it makes less sense.

The public has a right to know if Connecticut businesses are paying their fair share. Furthermore, it is becoming clear that certain businesses achieve breaks while others do not. Are tax breaks distributed based on their political connections or is there equity and purpose in the way tax breaks are designed? Without a regular systematic study the General Assembly and the public will never know.

In addition to countless tax breaks, wealthy Connecticut corporations use a variety of accounting schemes to avoid paying taxes. While these schemes may be legal, their effect has been to lower the net amount of taxes collected from corporations. When filing tax returns, corporations that operate across state lines apportion their income among the states where they do business. 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. Half the states use combined reporting including: Texas, Massachusetts, New York Arizona, Wisconsin and California. Companies known to evade state taxes through these accounting schemes include: The Gap, Home Depot, Ikea, Kmart, Kohl's, Limited Brands(which owns Bath & Body Works, Victoria's Secret, The Limited, and other chains), Payless Shoes, Staples, Toys "R" Us, and Wal-Mart. Instituting combined reporting will add much needed revenue on an annual basis.

SEIU and its members support creating the fairest, most transparent and accountable system possible. Sales taxes disproportionately hurt lower income people. Removing most exemptions and lowering the overall rate should be the goal. As our economy becomes more reliant on services it makes sense to tax some of those services. Broadening the sales tax would allow a general lowering of the sales tax by 1% or more and would on balance be fair and provide for a reliable stream of revenue for the state.

Connecticut's tax system is antiquated and unfair. Our system is ill equipped to account for the changes a global and computer economy have created. The revenues and jobs gained by requiring all to pay their fair share, and to account for the incentives they receive, will make Connecticut a better place to live and do business.

ITEP
INSTITUTE ON TAXATION AND ECONOMIC POLICY

Policy Brief

Informing the debate over tax policy nationwide

August 2011

Combined Reporting of State Corporate Income Taxes: A Primer

Over the past several decades, state corporate income taxes have declined markedly. One of the factors contributing to this decline has been aggressive tax avoidance on the part of large, multi-state corporations costing states billions of dollars. The most effective approach to combating corporate tax avoidance is the use of combined reporting, a method of taxation currently employed in more than half of the states with a corporate income tax. Eight states have enacted legislation to institute combined reporting within the past five years. Commissions and lawmakers in several other states, such as North Carolina, Maryland, Rhode Island and Kentucky, have recently recommended its adoption. This policy brief explains how combined reporting works.

How Combined Reporting Works

For corporations that only do business in one state, paying corporate income taxes can be pretty simple – all of their profits are taxable in the state in which they are located. For corporations with subsidiaries in multiple states, the task of determining the amount of profits subject to taxation is more complicated. There are broadly two ways of doing this: **combined reporting**, which requires a multi-state corporation to add together the profits of all of its subsidiaries, regardless of their location, into one report, and **separate accounting**, which allows companies to report the profit of each of its subsidiaries independently.

For example, if the Acme Corporation has three subsidiaries in three different states, a combined reporting state would require Acme to report the profits of the four parts of the corporation as one total, on the grounds that each of the parts of the corporation contribute to its profitability. In contrast, a separate accounting state would require only those parts of the Acme Corporation that have "nexus" in that state – that is, enough in-state economic activity to be subject to the state's corporate income tax – to report their profits, even if the out-of-state parts of the corporation are responsible for the bulk of Acme's overall profits.

States with Combined Reporting, 2011

Alaska, Arizona, California, Colorado, District of Columbia, Hawaii, Idaho, Illinois, Kansas, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, Texas, Utah, Vermont, West Virginia, Wisconsin

As of 2011, twenty four states have adopted combined reporting. The District of Columbia, Massachusetts, Michigan, Texas, New York, Vermont, West Virginia, and Wisconsin all enacted legislation to institute combined reporting within the past five years.

How Businesses Abuse Separate Accounting

In addition to allowing companies to structure their operations so that some subsidiaries avoid taxation, separate accounting enables corporations to use certain gimmicks to shift their profits from high-tax states to low-tax states. The most infamous example of this is the passive investment company (PIC) loophole.

Here's how the PIC loophole works: suppose the Acme Corporation is based in State A, which uses separate accounting. If Acme has sales of $100 million and expenses of $70 million, its taxable profits ought to be $30 million. If Acme sets up a subsidiary – commonly referred to as a passive investment company (PIC) – in a state, like Delaware, that does not tax intangible property such as trademarks and patents and makes that subsidiary the owner of Acme's intangible property, then the

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subsidiary can charge Acme for the use of these trademarks. Although Acme's payment to the PIC is basically a transfer of funds within the company, under separate accounting, this expense counts as a cost of doing business—and can therefore be subtracted from Acme's income in determining its taxable profits in State A. Since the subsidiary can charge Acme whatever it wants for the use of the trademarks, Acme may actually be able to zero out its taxable profit through this sham "expense."

In the example below, Acme's subsidiary (i.e. its PIC) charges it $30 million for the use of the trademarks, which reduces Acme's taxable profit in State A to zero. Because the subsidiary exists only to lease trademarks to Acme, none of the subsidiary's sham "income" is taxable in Delaware. Furthermore, because the PIC does not have nexus in State A, Acme pays no tax to State A on the profits generated by the PIC. A wide variety of major corporations currently use the PIC loophole in separate accounting states, including K Mart, Home Depot and Toys R Us.

How the PIC Loophole Creates a "Zero Tax" Corporation

Revenue and Expenses	Combined Reporting	Separate Accounting	
		Acme	Subsidiary
Revenues	$100	$100	
Normal Expenses	($70)	($70)	
Sham Revenues			$30 (not taxed)
Sham Expenses		($30)	
Taxable Profits	$30	$0	$0

Unfortunately, the PIC loophole is one of just many tax avoidance techniques available to corporations operating in separate accounting states. For example, a February 2007 *Wall Street Journal* article notes that Wal-Mart may have been able to avoid as much as $350 million in state corporate income taxes between 1998 and 2001 due to another, similar loophole know as "captive real estate investment trusts (REITs)".

Combined Reporting: A Simple Approach to Preventing Tax Avoidance

In a combined reporting system, all of the income and expenses of Acme and its subsidiaries would be added together, so that PICs and other loopholes would have no impact at all on the company's taxable profits. For example, if Acme tried to use the PIC loophole, the subsidiary's $30 million of income from the sham transaction would be canceled out by Acme's $30 million of expenses, with a net impact of zero on Acme's taxable profits.

Of course, combined reporting is not the only option available to states seeking to prevent the use of accounting gimmicks such as the PIC loophole. States can also close these loopholes one at a time. For example, several states have enacted legislation that specifically prohibits shifting income to tax haven states through the use of passive investment corporations. The main shortcoming of this approach is that in the absence of combined reporting, multi-state corporations will always be able to develop new methods of transferring profits from high-tax to low-tax states. The only limit to the emergence of new approaches to transferring income to tax haven states is the creativity of corporate accountants. Combined reporting is a single, comprehensive solution that eliminates all potential tax advantages that can be derived from moving corporate income between states.

Combined Reporting Levels the Playing Field

Combined reporting is fairer than separate accounting because it ensures that a company's tax should not change because its organizational structure changes. It creates a level playing field between smaller and larger companies: small companies doing business in only one state can't use separate accounting to reduce their tax because they have no business units in other states to shift their income to. Large, multi-state corporations will find it easier to avoid paying taxes using separate accounting because they have business units in multiple states.

Conclusion

Strategies that broaden the corporate income tax base by eliminating loopholes can ensure that profitable corporations pay their fair share for the public services they use every day, can level the playing field between multistate corporations and locally-based companies that can not avail themselves of tax avoidance schemes, and can help balance state budgets without requiring unpopular increases in tax rates. Requiring combined reporting is the single best strategy available to lawmakers seeking to stamp out accounting shenanigans by large and profitable corporations.

For more information on Combined Reporting, see the Center on Budget and Policy Priorities' report, **A Majority of States Have Now Adopted a Key Corporate Tax Reform- "Combined Reporting".**