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BTC Brief

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SHUTTING DOWN CORPORATE TAX SHELTERS:

North Carolina Should Follow the Lead of Other States by Adopting Key Corporate Tax Reform

Timely, accessible, and credible analysis of state and local budget and tax issues

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KEY FINDINGS:

- **Large, multi-state corporations are able to take advantage of tax shelters because most are structured as parent corporations that each own many separate subsidiary corporations in states across the country.**
- **Adopting a key corporate tax reform known as combined reporting would require parent corporations and their subsidiaries to "combine" for state tax purposes to file a joint tax return. The profits of the combined corporation would then be apportioned by formula to each state in which the corporation does business according the share of total business activity located in each state.**
- **Combined reporting would level the playing field between locally-owned businesses and multi-state corporations at a time when small and mid-sized businesses are struggling to compete with big corporations. That is because multi-state corporations can take advantage of the multiple jurisdictions within which they do business and through tax planning set up abusive corporate tax shelters.**
- **North Carolina's share of state tax revenue from the corporate income tax declined by more than all but four states from the late 1980s to the early 2000s. Adopting combined reporting would help to slow this steady erosion of revenue from the state's corporate income tax.**
- **In 2008, 88 percent of all corporate income tax revenue came from corporations with at least some out-of-state profits. If multi-state corporations in the state were able to shelter an additional quarter of their in-state profits to no-tax states due to the rising difficulty of restricting tax shelter abuse, it would cost the state more than $200 million in revenue each year.**

"Combined Reporting:" A Comprehensive Solution to Abusive Corporate Tax Shelters

Few would argue that locally-owned businesses in North Carolina should be taxed at higher rates than local branches of their national competitors. Yet over the past two decades, a dramatic increase in the abuse of corporate tax shelters by multi-state corporations has allowed many big corporations to escape paying their fair share in state taxes.

In response to the rise of abusive corporate tax shelters, a majority of states with a corporate income tax have adopted a key reform known as mandatory "combined reporting."[1] Instead of pursuing costly

attempts to put an end to corporate tax shelters one-by-one, mandatory combined reporting nullifies most inter-state corporate tax shelters by requiring corporate subsidiaries engaged in the same business to file a joint tax return.[2]

The North Carolina Department of Revenue currently has the authority to require multi-state corporations it suspects are engaging in illegal methods of evading corporate income taxes to file a combined return. In the 2009-10 fiscal year alone, the Department brought in $424 million in revenue to the state from settlements with corporations it demonstrated had engaged in abusing corporate tax shelters.[3]

The growing sophistication of state corporate tax shelters combined with the elimination of the threat of penalties for corporations engaging in corporate tax avoidance will make similar one-by-one successes harder to realize in future years.[4]

Adopting mandatory combined reporting for multi-state corporations is particularly vital at this time for three key reasons:

- Combined reporting would *level the playing field between locally owned businesses and multi-state corporations* at a time when small and mid-sized businesses are struggling to compete with big corporations.
- Combined reporting would *raise much-needed revenue to support key investments* in public education and health by putting an end to many abusive corporate tax shelters and ensuring that multi-state corporations pay their fair share in taxes.
- Enacting combined reporting would be an *important first step in modernizing North Carolina's out-dated tax system*, which no longer meets the needs of the state's 21st-century economy.

"Combined Reporting" Promotes Tax Fairness and Levels the Playing Field

The ability of multi-state corporations to hire expensive tax lawyers to set up abusive corporate tax shelters gives them a clear tax advantage over their locally-owned competitors here in North Carolina.

For example, few North Carolina businesses could have afforded the $2 million price tag charged by accounting firm Coopers & Lybrand to Food Lion's corporate parent for a corporate restructuring plan promising to cut the grocery chain's North Carolina corporate income tax liability by up to $75 million over five years.[5]

Large corporations are able to take advantage of tax shelters because most are structured as parent corporations that each own many separate subsidiary corporations in states across the country. Without combined reporting, multi-state corporations are able to shift income earned in one state to related corporate subsidiary in a state without a corporate income tax or with special corporate tax exemptions.

What combined reporting does is require parent corporations and their subsidiaries to "combine" for state tax purposes to file a joint tax return. The profits of the combined corporation are then apportioned by formula to each state in which the corporation does business according the share of total business activity located in each state.

As economist Charles McClure, senior fellow at the conservative Hoover Institution and former Deputy Assistant Secretary of the Treasury under President Reagan puts it, "failure to require unitary combination [i.e. combined reporting] is an open invitation to tax avoidance."[6] And when multi-state corporations are able to avoid paying taxes, locally-owned businesses and residents must make up the difference to pay for the public investments that benefit all businesses and residents in North Carolina.

"Combined Reporting" Would Raise Much-Needed Revenue to Support Public Investments

The budgets put forth by the Governor and by the General Assembly include substantial cuts to public investments that both acknowledge provide real benefits for the people of North Carolina.

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EXAMPLES OF COMMON CORPORATE TAX SHELTERS

Passive Investment Companies (aka the "Toys R Us Loophole"): Under this strategy, corporations set up so-called passive investment companies (PICs) to manage trademarks and other intangible assets in a state such as Delaware or Nevada that does not levy a corporate income tax on such income. These PICs then charge royalty fees that are deducted as expenses by subsidiaries operating in other states. One of the first corporations to use this strategy was Toys R Us, which set up a PIC called Geoffrey Inc. in Delaware to which the company's paid $55 million in royalty payments in 1990.

Real Estate Investment Trusts (aka the "Wal-Mart Loophole"): Under this strategy, corporations establish so-called real estate investment trusts (REITs) to manage real estate and related financial transactions. These REITs then charge rent to stores in other states, which in turn it can then refund to shareholders as tax-deductible dividends. Wal-Mart used this strategy against North Carolina and other states to shelter $7.3 billion in profits from state corporate income taxes from 1998 to 2001.

Captive Insurance Companies (aka the "Wendy's Loophole"): Captive insurance companies ("captives") can be used by corporations to accumulate assets to self-insure against potential risks. However, captives have also been used by corporations as a tax shelter due to preferential tax treatment of insurance companies' investments and premiums in some states. Wendy's International used this strategy to shelter more than $200 million per year from state corporate income taxes through a captive insurance subsidiary in Vermont.

Revenue Secretary Hoyle has suggested in public statements that adopting mandatory combined reporting would increase corporate income tax revenues by $80-$100 million per year.[7] This additional revenue could reverse some of the most damaging cuts included in state budget proposals such as those to public schools, proven early childhood programs, critical Medicaid health services.

Improving revenues from the corporate income tax is not just a short-term problem caused by the Great Recession. North Carolina's share of state tax revenue from the corporate income tax declined by more than all but four states from the late 1980s to the early 2000s.[8] Adopting combined reporting would help to slow this steady erosion of revenue from the state's corporate income tax, which is major contributor to the long-term gap between what is needed to sustain current levels of public investments and the future revenues available to support those investments.

"Combined Reporting" Would Be an Important First Step in Modernizing North Carolina's Tax System

There is widespread and bipartisan recognition that North Carolina's tax system, last reformed on a major scale during the Great Depression, no longer meets the needs of the people and businesses of the state. As one of the three pillars of North Carolina's tax system, the corporate income tax is no exception.

North Carolina's corporate income tax suffers from a multitude of exemptions and loopholes that reduce revenues and make the tax system less fair. By allowing multi-state corporations to shelter profits earned in North Carolina from the state corporate income tax, the failure to enact combined reporting is arguably the biggest single loophole in North Carolina's corporate income tax.

According to data published by the Department of Revenue for 2008, 88 percent of all corporate income tax revenue came from corporations with at least some out-of-state profits, and nearly 60 percent of all corporate income tax revenue came from corporations with at least three-quarters of their profits claimed in other states.

If multi-state corporations in the state are able to shelter an additional quarter of their in-state profits to no-tax states due to the rising difficulty of restricting tax shelter abuse, it would cost the state more than $200 million in revenue each year. The recent Food Lion/Delhaize case showed that North Carolina could have lost $60-$75 million in corporate tax revenue over five years ($12-$15 million per year) from tax shelter abuse from a single corporation if the Department of Revenue had not been successful in its efforts to close down this particular shelter.

North Carolina's corporate income tax was not designed for an economy where such a large percentage of corporate business in the state is undertaken by national and multi-national corporations conducting most of their business in other states. And there are major negative consequences likely if policymakers fail to modernize the state's corporate income tax to account for this significant change in the state's economy.

The Time Is Now: North Carolina Should Adopt Combined Reporting

No fewer than three commissions on modernizing state finances have recommended that North Carolina adopt combined reporting: the 2002 Governor's Commission to Modernize State Finances,[9] the 2007 Income Tax Subcommittee of the State and Local Fiscal Modernization Commission,[10] and the 2007 legislative Revenue Laws Study Committee.[11]

In the intervening time, seven more states have enacted combined reporting,[12] and others are considering adopting the reform this year.[13] The time is now for state policymakers to follow the lead of other states and the advice of state and national tax policy experts.

Shutting down corporate tax shelters by enacting combined reporting will result in tax system that is both fairer and better able to adequately fund the public investments and services the businesses and people of North Carolina rely on.

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4 Mejia, "Fair Tax Penalties."

5 Delhaize America, Inc. v Lay, NC Business Court. January 2011. Available at http://www.ncbusinesscourt.net/2011_NCBC_2.pdf

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7 Secretary David Hoyle. Remarks before the NC House Finance Committee. February 2011.

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11 Revenue Laws Study Committee, Report to the 2007 General Assembly of North Carolina, January 2007, Available at http://www.ncleg.net/DocumentSites/....General%20Assembly%20(2007%20Session).pdf

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