REVISED AGENDA
Senate Committee on Revenue and Taxation
House Committee on Revenue and Taxation
Meeting Jointly

November 17, 2011
10:00 AM
Room B, MAC
Little Rock, Arkansas

Sen. Larry Teague, Chair
Sen. Michael Lamoureux, Vice Chair
Sen. Jerry Taylor
Sen. Paul Bookout
Sen. Linda Chesterfield
Sen. Jake Files
Sen. Bill Sample
Sen. Eddie Joe Williams

Rep. Davy Carter, Chair
Rep. Larry Cowling, Vice Chair
Rep. Robert S. Moore, Jr.
Rep. Ed Garner
Rep. Mike Patterson
Rep. Uvalde Lindsey
Rep. Keith M. Ingram
Rep. Allen Kerr
Rep. John Burris
Rep. Stephen Meeks
Rep. Lane Jean
Rep. Fredrick J. Love
Rep. Mark Biviano
Rep. Charlie Collins
Rep. Homer Lenderman

Rep. Kelley Linck
Rep. Bruce Westerman
Rep. Justin T. Harris
Rep. Linda Collins-Smith
Rep. Nate Bell
Rep. Duncan Baird, Non-Voting
Rep. Stephanie Malone, Non-Voting
Rep. Walls McCrary, Non-Voting
Rep. Ann V. Clemmer, Non-Voting
Rep. Jim Nickels, Non-Voting
Rep. Matthew Shepherd, Non-Voting
Rep. Jon S. Eubanks, Non-Voting
Rep. Andy Mayberry, Non-Voting
Rep. Mary P. "Prissy" Hickerson, Non-Voting
Rep. David J. Sanders, Non-Voting

A. Call to Order

B. Opening Comments by Chairs: **Representative Davy Carter**
Senator Larry Teague

C. Adoption of Minutes from the September 15, 2011 Meeting **[EXHIBIT C]**

D. Report by the Arkansas State Chamber of Commerce
Randy Zook, Executive Director

E. Consideration to Adopt Interim Study Proposal 2011-183 by Senator Hendren **[EXHIBIT E]**
A STUDY CONCERNING THE FEASIBILITY OF EXCLUDING FROM THE SALES PRICE ON THE PURCHASE OF A MOTOR VEHICLE THE AMOUNT OF ANY REBATE FROM THE MANUFACTURER OR DEALER

   a. Sponsor Presentation
   b. Committee Discussion
   c. Public Comments

Notice: Silence your cell phones. Keep your personal conversations to a minimum. Observe restrictions designating areas as "*Members and Staff Only*"

F. Study of Interim Study Proposal 2011-090 by Representative Nickels **[EXHIBIT F, F-1, F-2, F-3]**
TO CREATE THE ARKANSAS SMALL BUSINESS TAX FAIRNESS ACT; TO REQUIRE COMBINED REPORTING FOR INCOME TAX PURPOSES; AND FOR OTHER PURPOSES

   a. Sponsor Presentation

   b. Committee Discussion

   c. Public Comments

G. Other Business

H. Adjournment

EXHIBIT C

DRAFT

SENATE AND HOUSE COMMITTEES ON REVENUE AND TAXATION
Interim Session, September 15, 2011, 10:00 a.m.
Room B, MAC, Little Rock, Arkansas
Meeting Minutes

The Senate and House Interim Committees on Revenue and Taxation met at 10:00 a.m. on Thursday, September 15, 2011 in Committee Room B, MAC, Little Rock, Arkansas.

Committee members in attendance were Senators Larry Teague, *Senate Chair*, Bill Sample, Eddie Joe Williams, Representatives Davy Carter, *House Chair,* Nate Bell, John Burris, Linda Collins-Smith, Ed Garner, Justin Harris, Lane Jean, Homer Lenderman, Kelly Linck, Stephen Meeks, and Mike Patterson.

Non-Voting members in attendance were Representatives Duncan Baird, Jon Eubanks, Prissy Hickerson, and Jim Nickels.

Other invited guests were Representatives Billy Gaskill, Gary Deffenbaugh, Eddie Cheatham, David Meeks, James McLean, Jody Dickinson, Tommy Wren, James Ratliff, Betty Overbey, Leslee Post, and Senators Steve Harrelson and Jonathan Dismang.

Representative Carter opened the meeting.

Adoption of Minutes
The minutes from the August 18, 2011 Senate and House Interim Committees on Revenue and Taxation were approved by acclamation.

Consideration to Adopt Interim Study Proposal
ISP 2011-177 BY REPRESENTATIVE D. MEEKS A STUDY CONCERNING THE POTENTIAL FISCAL IMPACT AND LOSS OF JOBS TO THE STATE OF ARKANSAS AS THE RESULT OF TRANSFERRING THE RESPONSIBILITY FOR THE COLLECTION OF SALES AND USE TAXES TO OUT-OF-STATE SELLERS THAT USE AN AFFILIATED PERSON OR THAT USE AN ARKANSAS RESIDENT TO REFER POTENTIAL PURCHASERS TO THE OUT-OF-STATE SELLERS

Senator Teague made a motion to adopt ISP 2011-177. Representative Carter second motion. Motion carried.

Meeting adjourned.

November 17, 2011

Arkansas Business Tax Competitiveness

EXECUTIVE SUMMARY

Overview

This analysis, prepared by Ernst & Young LLP for the Arkansas State Chamber of Commerce, compares the state and local tax burdens on selected new business investments in Arkansas and seven competitive states. The tax burden estimates presented in this study can be used to evaluate how competitive Arkansas's state and local business tax system is for new investment and job creation in the state for seven selected industries. The estimates measure the additional state and local taxes that a new or expanding business would pay on the capital investment, and economic activity added to the Arkansas economy. This comparative information is important in understanding the competitiveness of Arkansas's current tax system and in evaluating proposed tax changes to improve the state's competitiveness.

The eight states included in this analysis are: Arkansas, Kansas, Louisiana, Mississippi, Missouri Oklahoma, Tennessee, and Texas. The representative investments or types of economic activities include: a headquarters facility, a research and development facility, a business support services firm and investments for durable goods, food product, renewable energy equipment and motor vehicle parts manufacturing investments.

Estimates of state and local business tax burdens by industry are derived from EY's business tax competitiveness model (BTCM). The BTCM calculates current state and local business tax burdens imposed on new in-state capital investments, and projects these burdens by year over a 30-year life span. The methodology used in this analysis follows that used in EY's recent 50-state business tax competitiveness study.[1] The BTCM uses income statement and balance sheet financial information to estimate the major state and local tax bases for each investment and calculates tax liabilities on the new investments based on current-law state and local tax system parameters. The state and local taxes included in the study are: corporate income taxes, franchise taxes, sales and use taxes on business purchases, and local property taxes.

The state and local tax burdens are summarized as effective tax rates (ETRs). The ETR on a new investments measures the percentage reduction in the before-tax rate of return due to the state and local taxes imposed on the investment. For example, if the before-tax rate of return on an

[1] See Ernst & Young LLP, *Competitiveness of State and Local Business Taxes on New Investment: Ranking States by Tax Burden on New Investment* (April 2011). This study was done in conjunction with the Council on State Taxation (COST).

investment is 10% and the after-tax rate of return is 9%, the ETR is 10%. The study presents two sets of ETRs: 1) ETRs before the consideration of tax credits, and 2) ETRs including statutory tax credits that are generally available to corporate taxpayers. The comparison of before- and after-credit ETRs illustrates how statutory tax credits affect a state's business tax competitiveness.

Study Results

Table 1 provides an overview of the preliminary BTCM results. It presents the average ETRs by state for the manufacturing and services investments included in the study. The states are ranked in Table 1 in terms of their ETRs with 1 representing the highest ETR. Table 1 shows that Arkansas's general business tax system, before credits, imposes above average taxes on the investments included in the study. The table shows that:

- Compared to the average in the seven other states, Arkansas's ETR for the services investments is 7.4 percent higher; Arkansas ranks 4th highest for the services investments.
- Arkansas ranks 3rd highest for the manufacturing investments, 6.5 percent higher than the other-states average.
- For all industries combined, Arkansas is 6.5 percent above the average for the other seven states, ranking 2nd highest in the overall effective tax rate.
- The ETRs on the manufacturing and service investment groups are very similar. However, the ETRs for the separate investment examples do show significant variation within both manufacturing and services. (See Table 2.)

Figures 1 to 3 show how Arkansas compares to the seven other states in terms of average ETRs for manufacturing (Figure 1), services (Figure 2), and all industries included in the study (Figure 3). The horizontal dotted lines in each figure show the average seven-state ETRS for each category of investment. The bars also show the level and composition of the state and local tax ETRs for property, sales, and corporate income and franchise taxes. A comparison of the ETRs by tax type (illustrated by the components of each bar) shows each tax type's contribution to the overall ETR.

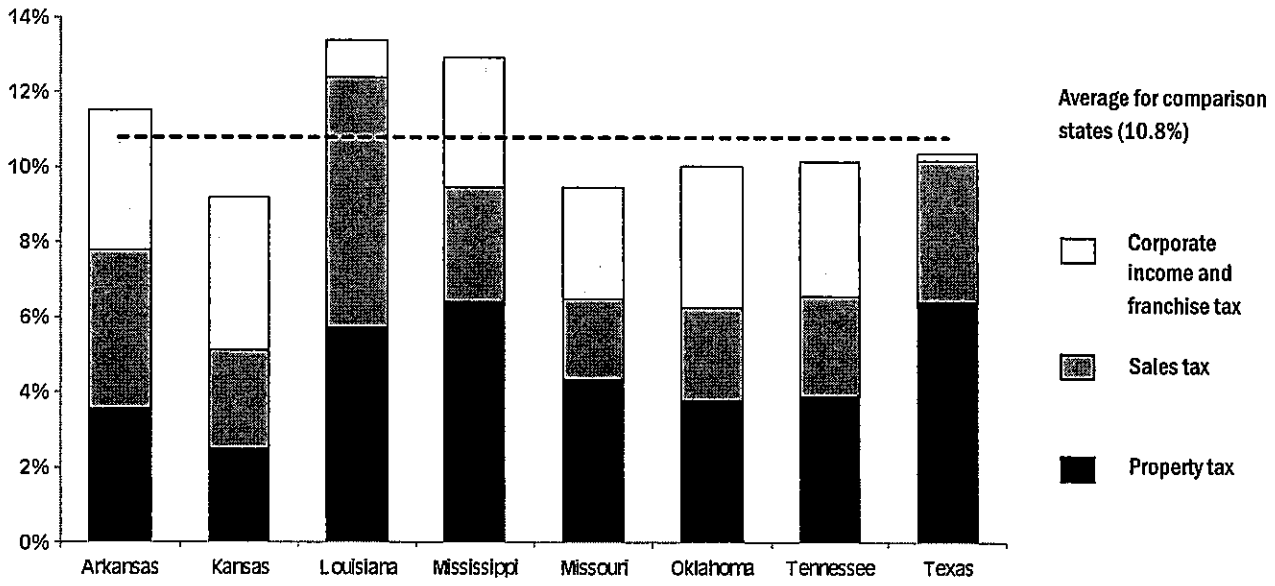
As shown in Figure 1, Arkansas imposes relatively high sales and corporate income tax burdens on the manufacturing investments that are only partly offset by below-average property taxes. The study results further show that:

- The sales tax ETR on manufacturing investments in Arkansas is almost 24% higher than the seven-state average.
- The sales tax in Arkansas accounts for 37% of the total state and local ETR on the four manufacturing investments, 20% higher than the sales tax share in other states.

Table-1
Average Effective State and Local Business Tax Rates by Investment Type

State	Services		Manufacturing		All Industries	
	ETR	Rank	ETR	Rank	ETR	Rank
Arkansas	11.5%	4	11.5%	3	11.5%	2
Kansas	12.6%	1	9.2%	8	10.7%	5
Louisiana	11.8%	3	13.4%	1	12.7%	1
Mississippi	8.8%	7	12.9%	2	11.2%	3
Missouri	11.0%	6	9.5%	7	10.1%	7
Oklahoma	11.2%	5	10.0%	6	10.5%	6
Tennessee	12.0%	2	10.2%	5	10.9%	4
Texas	7.5%	8	10.4%	4	9.1%	8
Other States' Average ETR	*10.7%*		*10.8%*		*10.8%*	

Figure 1
Average Effective Tax Rates for Manufacturing Industries



Source: E&Y Business Tax Competitiveness Model

Arkansas's sales tax share is second only to the unusually high sales tax share in Louisiana (50%).

- The effective corporate income tax rate on manufacturing investments is 37% higher than the other states' average.
- The relatively high ETRs from sales taxes and corporate income taxes is only partly offset by a property tax ETR for manufacturers that is 23% below the average for the other states.

Figure 2 shows that the sales tax is the largest contributor to the overall ETRs. In fact, the sales tax share of total business taxes for the services investments averages 57% for all the included states. Arkansas's share is only slightly lower. Figure 3 combines the services and manufacturing investments.

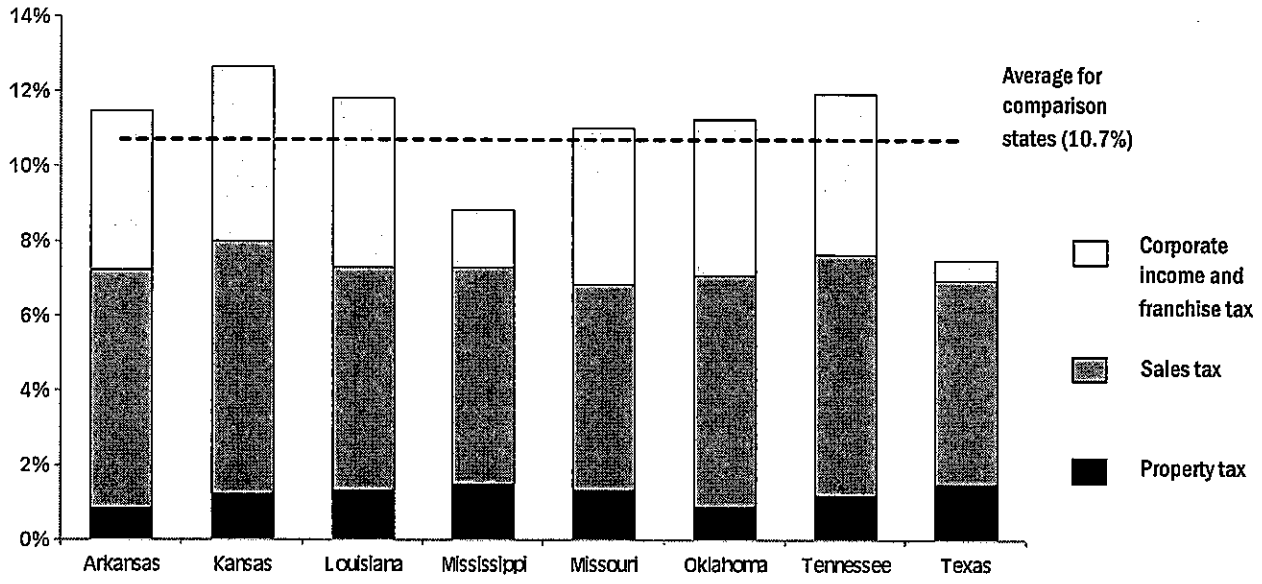
The relatively high sales tax ETRs in Arkansas are not the result of high statutory tax rates. The combined state and average local sales tax rate in Arkansas (7.8%) is only slightly higher than the average for the other states (7.7%). Arkansas's relatively high sales tax burden comes from the tax being imposed on a broader base of business purchases of goods and services. These include purchases of machinery and equipment by manufacturers and purchases of other tangible products and services by all businesses.

The Arkansas statutory corporate income tax rate (6.5%) is equal to the average rate for the other states (excluding the Texas margin tax). The relatively high Arkansas ETRs for manufacturers is partly due to the use of an apportionment formula with a 50% weight on the in-state sales factor to determine Arkansas's share of U.S. income. Three other states (Louisiana, Mississippi and Texas) use an apportionment formula for manufacturers with a 100% weight on the sales factor that reduces ETRs for the types of investments included in the study.

Figure 3 shows that the combined ETR in Arkansas (11.5%) ranks 2nd highest in the comparison states.

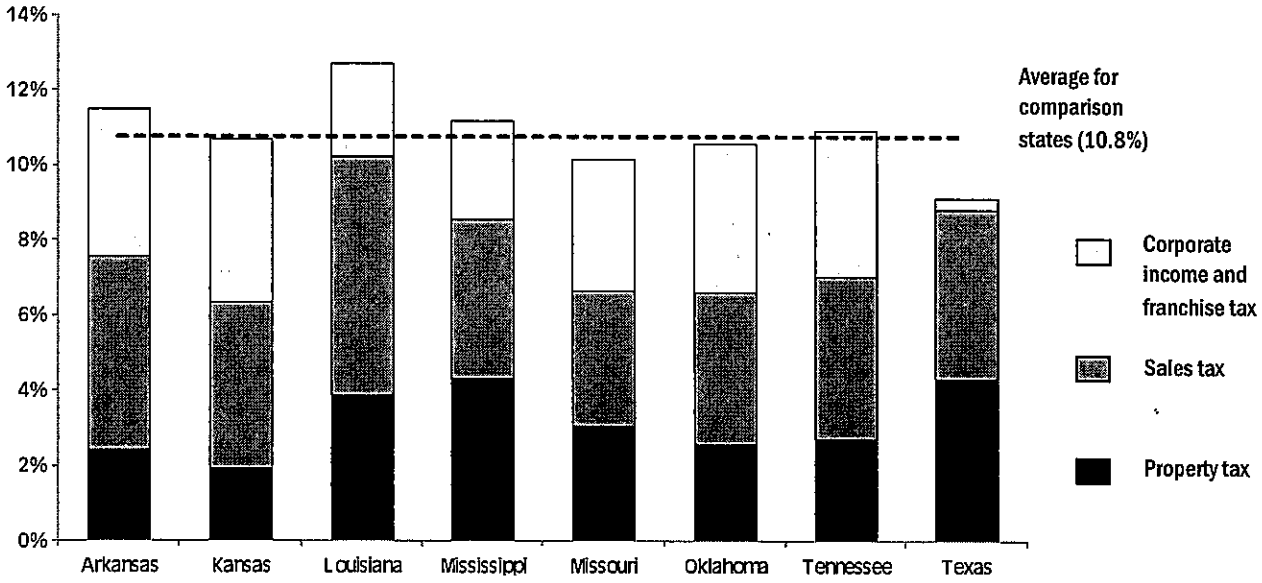
Table 2 shows the separate ETRs by state for each of the seven industries. While the average Arkansas manufacturing and service industry ETRs are equal, the ETRs in Arkansas differ across industries from a high of 16.2% for business support services to a low of 4.7% for corporate headquarters. Relative to other states, Arkansas's industry-specific ETRs vary from less than 1% above the other states' average for research and development to 27% above average for the headquarters investment.

Figure 2
Average Effective Tax Rates for Service Firms



Source: E&Y Business Tax Competitiveness Model

Figure 3
Overall Average Effective Tax Rates for All Included Industries



Source: E&Y Business Tax Competitiveness Model

Table 2
State and Local Effective Business Tax Rates and Rankings among Comparison States, by Industry and State

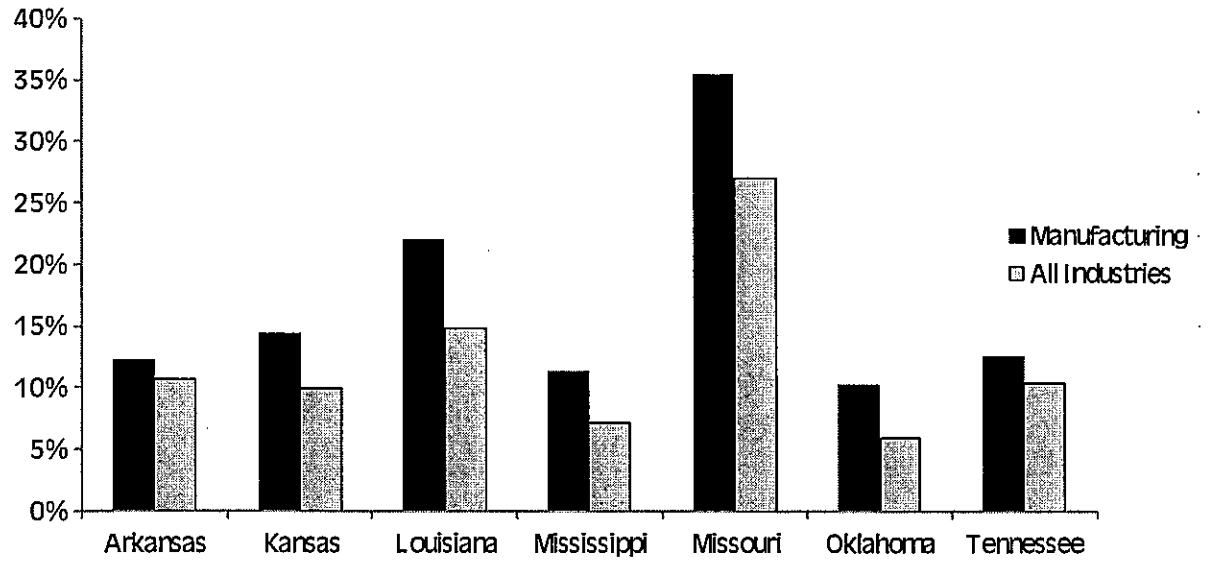
State	Headquarters		Research & Development		Durable Goods Manufacturing		Business Support Services		Food Product Manufacturing		Renewable Energy Equipment Manufacturing		Motor Vehicles and Parts Manufacturing	
	ETR	Rank	ETR	Rank	ETR	ETR	ETR	Rank	ETR	Rank	ETR	Rank	ETR	Rank
Arkansas	4.7%	2	11.6%	4	10.5%	2	18.0%	3	9.6%	3	13.8%	3	12.1%	4
Kansas	4.6%	3	13.1%	2	9.6%	5	20.2%	1	8.1%	5	10.2%	8	8.9%	8
Louisiana	6.2%	1	13.9%	1	9.1%	7	15.3%	6	10.7%	1	17.6%	1	16.2%	1
Mississippi	1.5%	7	10.1%	7	11.7%	1	15.0%	7	10.6%	2	15.8%	2	13.5%	3
Missouri	4.2%	6	11.6%	5	9.2%	6	17.3%	5	8.0%	7	10.4%	7	10.2%	6
Oklahoma	4.4%	5	11.4%	6	10.2%	4	18.0%	4	8.1%	6	11.8%	5	10.1%	7
Tennessee	4.6%	4	12.5%	3	10.5%	3	18.8%	2	8.5%	4	11.1%	6	10.7%	5
Texas	0.4%	8	8.4%	8	8.7%	8	13.7%	8	6.5%	8	12.6%	4	13.6%	2
Other States' Avg.	*3.7%*		*11.6%*		*9.9%*		*16.9%*		*8.6%*		*12.8%*		*11.9%*	

Impacts of Credits

The EY competitiveness study also includes estimates of the major statutory tax credits that are available to general taxpayers. Examples of credits included in the analysis are investment tax credits that reduce the net cost of in-state capital investment, tax incentives to hire new employees and research and development spending credits.

As shown in Figure 4 all of the comparison states (with the exception of Texas) provide substantial credits to partially offset before-credit taxes. For the seven industries, Arkansas's tax credits offset an average of 11% of the before-credit tax liability, equal to the average reduction for the competitive states, excluding Texas. The largest credit offsets are in Louisiana (15%) and Missouri (27%).

Figure 4
Potential Reduction in Total State and Local Effective Tax Rate from Statutory Credits, (Percentage Reduction in Pre-Credit Overall Effective Tax Rate)



REVISED 10-12-2011 15:20;

INTERIM STUDY PROPOSAL 2011-183

REQUESTING THAT THE ARKANSAS LEGISLATIVE COUNCIL OF THE EIGHTY-EIGHTH GENERAL ASSEMBLY REFER TO THE APPROPRIATE INTERIM COMMITTEE A STUDY CONCERNING THE FEASIBILITY OF EXCLUDING FROM THE SALES PRICE ON THE PURCHASE OF A MOTOR VEHICLE THE AMOUNT OF ANY REBATE FROM THE MANUFACTURER OR DEALER.

BE IT RESOLVED BY THE ARKANSAS LEGISLATIVE COUNCIL OF THE EIGHTY-EIGHTH GENERAL ASSEMBLY OF THE STATE OF ARKANSAS:

WHEREAS, purchasers of new motor vehicles registered in Arkansas are required to pay sales and use tax on the sales price of the motor vehicle;

WHEREAS, manufacturers and dealers are offering rebates as incentives to encourage people to buy new motor vehicles;

WHEREAS, the rebates are paid by the manufacturer or dealer and not by the purchaser; AND

WHEREAS, the amount of the manufacturer's or dealer's rebate is included in the sales price upon which the purchaser is required to pay sales and use tax.

NOW THEREFORE,
BE IT PROPOSED BY THE LEGISLATIVE COUNCIL OF THE EIGHTY-EIGHTH GENERAL ASSEMBLY:

THAT the appropriate Senate interim committee study the feasibility of excluding from the sales price on the purchase of a motor vehicle the manufacturer's and dealer's rebate.

Respectfully submitted,

Senator Kim Hendren
District 9

Respectfully submitted,

Representative Jon Woods
District 93

By: MMC/MMC

INTERIM STUDY PROPOSAL 2011-090

State of Arkansas
88th General Assembly
Regular Session, 2011

As Engrossed: H3/8/11 H3/9/11

A Bill

HOUSE BILL 1495

By: Representative Nickels

Filed with: Interim House Committee on Revenue and Taxation pursuant to A.C.A. §10-3-217.

For An Act To Be Entitled

AN ACT TO CREATE THE ARKANSAS SMALL BUSINESS TAX FAIRNESS ACT; TO REQUIRE COMBINED REPORTING FOR INCOME TAX PURPOSES; AND FOR OTHER PURPOSES.

Subtitle

TO CREATE THE ARKANSAS SMALL BUSINESS TAX FAIRNESS ACT AND TO REQUIRE COMBINED REPORTING FOR INCOME TAX PURPOSES.

BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF ARKANSAS:

SECTION 1. Arkansas Code Title 26, Chapter 51, is amended to add an additional subchapter to read as follows:

Subchapter 24 — Arkansas Small Business Tax Fairness Act

26-51-2401. Title.

This subchapter shall be known as the "Arkansas Small Business Tax Fairness Act".

26-51-2402. Definitions.

As used in this subchapter:

(1) "Combined group" means the group of persons whose income and apportionment factors are required to be taken into account under § 26-51-2403 in determining the taxpayer member's share of the net business income or loss to be apportioned to the state;

(2)(A) "Corporation" means an organization of any kind treated as a corporation for tax purposes under this chapter, wherever located, that if it were doing business in this state, would be a taxpayer.

(B) "Corporation" includes the business conducted by a partnership that is directly or indirectly held by a corporation to the extent of the corporation's distributive share of the partnership income, inclusive of guaranteed payments to the extent prescribed by law;

(3) "Doing business in a tax haven" means being engaged in activity sufficient for the tax haven jurisdiction to impose a tax under United States constitutional standards;

(4) "Partnership" means a general partnership, a limited partnership, or an organization of any kind that is treated as a partnership for tax purposes under this chapter;

(5) "Person" means:

(A) An individual;

(B) A firm;

(C) A partnership or a general partner of a partnership;

(D) A limited liability company;

(E) A registered limited liability partnership;

(F) A foreign limited liability partnership;

(G) An association;

(H) A corporation regardless of whether the corporation is or would be, if doing business in this state, subject to the Income Tax Act of 1929, § 26-51-101 et seq.;

(I) A company;

(J) A syndicate;

(K) An estate;

(L) A trust or trustee;

(M) A trustee in bankruptcy;

(N) A receiver;

(O) An executor or administrator; and

(P) An organization of any kind;

(6) "Tax haven" means a jurisdiction that, during the tax year, exhibits the following characteristics:

(A) Has no tax or a nominal effective tax on the relevant income;

(B) Has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;

(C)(i) Has a tax regime that lacks transparency.

(ii) A tax regime lacks transparency if:

(a) The details of legislative, legal, or administrative provisions are not open and apparent or are not consistently applied among similarly situated taxpayers; or

(b) The information needed by tax authorities to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation, is not adequately available;

(D) Facilitates the establishment of foreign-owned entities without the need for a local and substantive presence or prohibits foreign-owned entities from having a commercial impact on the local economy;

(E) Explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or

(F) Has a tax regime that is favorable for tax avoidance based upon an overall assessment of relevant factors, including without limitation whether the jurisdiction has a significant untaxed offshore financial sector or other services sector relative to its overall economy;

(7) "Unitary business" means a single economic enterprise that is made up of either separate parts of a single business entity or a commonly controlled group of business entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts; and

(8) "United States" means the fifty (50) states of the United States, the District of Columbia, and the territories and possessions of the United States.

26-51-2403. Combined reporting required – Discretion of director

(a)(1) A combined report shall be filed by one (1) of the following taxpayers engaged in a unitary business with one (1) or more other corporations:

(A) The federal consolidated parent corporation; or

(B) A subsidiary with a nexus to Arkansas, if the federal consolidated parent is not a member of the combined group.

(2) The combined report required under subdivision (a)(1) of this section shall include the following information for all corporations that are members of the unitary business:

(A) The income determined under § 26-51-2406;

(B) The apportionment factors determined under:

(i) The Uniform Division of Income for Tax Purposes Act, § 26-51-701 et seq.;

(ii) The apportionment and allocation requirements under §§ 26-51-1401–26-51-1405; and

(iii) The combined reporting requirements under § 26-51-2405; and

(3) Any other information required by the Director of the Department of Finance and Administration.

(b)(1) To reflect proper apportionment of income of entire unitary businesses, the combined report shall include the income and apportionment factors of any person not included under subsection (a) of this section who is a member of a unitary business.

(2) The director may require the filing of a combined report by persons that are not or would not be, if doing business in this state, subject to the Income Tax Act of 1929, § 26-51-101 et seq.

(3) If the director determines that the reported income or loss of a taxpayer engaged in a unitary business with any person not included under subsection (a) of this section represents an avoidance or evasion of tax by the taxpayer, all or part of the income and apportionment factors of the person shall be included in the taxpayer's combined report.

(4) With respect to inclusion of apportionment factors under this subsection (b), the director may require:

(A) The exclusion of any one (1) or more of the factors;

(B) The inclusion of one (1) or more additional factors that will fairly represent the taxpayer's business activity in the state; or

(C) The employment of any other method to properly reflect:

(i) The total amount of income subject to

apportionment; and

(ii) An equitable allocation and apportionment of the taxpayer's income.

26-51-2404. Determination of taxable income using combined report.

(a) The use of a combined report does not affect the separate identities of the taxpayer members of the combined group.

(b)(1) Each taxpayer member is responsible for tax based on the taxpayer member's taxable income or loss apportioned or allocated to Arkansas, including without limitation the taxpayer member's apportioned share of business income of the combined group.

(2) Business income of the combined group is calculated as a summation of the individual net business incomes of all members of the combined group.

(3) A member's net business income is determined by removing all but business income, expense, and loss from that member's total income under *this subchapter and multiplying the remainder by the combined apportionment factors of all members of the combined group.*

26-51-2405. Income subject to tax — Application of tax credits — Deductions after apportionment.

(a) Each taxpayer member is responsible for tax based on the taxpayer member's taxable income or loss apportioned or allocated to Arkansas, including without limitation the taxpayer member's:

(1) Share of business income that is apportioned to Arkansas of each of the combined groups of which it is a member, as determined under § 26-51-2406;

(2) Share of business income that is apportioned to Arkansas of a distinct business activity conducted within and without Arkansas wholly by the taxpayer member, as determined under the Uniform Division of Income for Tax Purposes Act, § 26-51-701 et seq., and the apportionment and allocation requirements under §§ 26-51-1401–26-51-1405;

(3) Income from a business conducted wholly by the taxpayer member entirely within Arkansas;

(4) Income sourced to Arkansas from the sale or exchange of capital or assets;

(5) Nonbusiness income or loss allocable to Arkansas, as determined under the Uniform Division of Income for Tax Purposes Act, § 26-51-701 et seq., and the apportionment and allocation requirements under §§ *26-51-1401–26-51-1405; and*

(6)(A) Net operating loss carryover.

(B)(i) If the taxable income computed under this subchapter results in a loss for a combined group, the combined group has an Arkansas net operating loss.

(ii) A net operating loss of the combined group is *applied as a deduction in a subsequent year only to the extent that the combined* group has Arkansas source positive net income.

(C)(i) Only a taxpayer member that joins a combined group and has a net operating loss from a tax year before the taxpayer member joined the combined group is subject to the carryover provisions of § 26-51-427, the net operating loss limitations, and the separate return limitation year restriction.

(ii) Separate return limitation year restrictions allow the net operating loss of a member that joins a combined return to offset the combined income of all corporations that were members of the same federal consolidated group when the net operating loss was created or that were members of the same Arkansas combined group when the net operating loss was created.

(b)(1) A tax credit earned by a member may be applied against the total tax liability of the combined group.

(2)(A) A charitable contribution made by a taxpayer member of the combined group is available as a deduction of the combined group subject to the limitations of 26 U.S.C. § 170, as it existed on January 1, 2011.

(B) A charitable contribution under subdivision (b)(2)(A) of this section is subtracted from the business income of the combined group before apportionment, and the remaining balance is treated as a nonbusiness expense allocable to the nonbusiness income of the combined group subject to the income limitations of 26 U.S.C. § 170, as it existed on January 1, 2011.

(C) A charitable contribution under subdivision (b)(2)(A) of this section that is disallowed under the income limitations of this subsection is allowed as a carryover deduction for up to five (5) years in accordance with 26 U.S.C. § 170, as it existed on January 1, 2011.

26-51-2406. Determination of share of business income of a combined group.

The taxpayer's share of the business income to be apportioned to Arkansas of each combined group of which it is a member is the product of:

(1) The business income of the combined group, as determined under § 26-51-2407; and

(2)(A) The taxpayer member's apportionment percentage, as determined under the Uniform Division of Income for Tax Purposes Act, § 26-51-701 et seq., and the apportionment and allocation requirements under §§ 26-51-1401–26-51-1405, including:

(i) In each numerator, the taxpayer's property, payroll, or sales factor associated with the combined group's unitary business in this state; and

(ii) In the denominator, the property, payroll, or sales factor of all members of the combined group, including the taxpayer, that are associated with the combined group's unitary business wherever located.

(B) The property, payroll, and sales factors of a partnership are included in the determination of the partner's apportionment percentage in proportion to a ratio the numerator of which is the amount of the partner's distributive share of partnership's unitary income included in the income of the combined group under § 26-51-2407 and the denominator of which is the amount of the partnership's total unitary income.

26-51-2407. Determination of business income of the combined group.

(a) The business income of a combined group is determined under this section.

(b) To determine the business income of the combined group, subtract any income and add any expense or loss other than the business income, expense, or loss of the combined group from the total income of the combined group, as determined under subsection (c) of this section.

(c)(1) Except as otherwise provided in this section, the total income of the combined group is the sum of the income of each member of the combined group, as determined under the Internal Revenue Code of 1986, 26 U.S.C. § 1 et seq., as it existed on January 1, 2011, as if the member were not

consolidated for federal purposes.

(2) The income of each member of the combined group is determined as follows:

(A) For a member incorporated in the United States or included in a consolidated federal corporate income tax return, the income to be included in the total income of the combined group is the taxable income for the corporation after making appropriate adjustments under the Income Tax Act of 1929, § 26-51-101 et seq.; and

(B)(i) For a member not included in subdivision (c)(2)(A) of this section, the income to be included in the total income of the combined group is determined as follows:

(a) A profit and loss statement shall be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained;

(b) Adjustments shall be made to the profit and loss statement to conform it to the accounting principles generally accepted in the United States for the preparation of profit and loss statements except as modified by this subchapter;

(c) Except as otherwise provided in this subchapter, the profit and loss statement of each member of the combined group and the related apportionment factors shall be expressed in United States dollars.

(d) Income apportioned to Arkansas shall be expressed in United States dollars.

(ii)(a) In lieu of the procedures in subdivision (c)(2)(B)(i) of this section and subject to the determination of the Director of the Department of Finance and Administration that it reasonably approximates income as determined under the Income Tax Act of 1929, § 26-51-101 et seq., a member not included in subdivision (c)(2)(A) of this section may determine its income on the basis of the consolidated profit and loss statement that includes the member and that is prepared for filing with the United States Securities and Exchange Commission by related corporations.

(b) If the member is not required to file with the United States Securities and Exchange Commission, the director may allow the use of a consolidated profit and loss statement prepared for reporting to shareholders and subject to review by an independent auditor.

(c) If the profit and loss statements in this subdivision (c)(2)(B)(ii) of this section do not reasonably approximate income as determined under this chapter, the director may accept profit and loss statements with appropriate adjustments to approximate the income as determined under this chapter.

(d) If a unitary business includes income from a partnership, the income included in the total income of the combined group is the member of the combined group's direct and indirect distributive share of the partnership's unitary business income.

(e)(1) Dividends paid by a member of the combined group to another member of the combined group shall be eliminated from the income of the recipient to the extent the dividends are paid out of the earnings and profits of the unitary business included in the combined report, in the current or a prior year.

(2) Subdivision (e)(1) of this section does not apply to dividends received from members of the unitary business that are not a part of the combined group.

(f)(1) Except as otherwise provided in this subchapter, business income from an intercompany transaction between members of the same combined group is deferred in the same manner as in 26 CFR § 1.1502-13, as it existed on January 1, 2011.

(2) Deferred business income resulting from an intercompany transaction between members of a combined group is restored to the income of the seller and is apportioned as business income earned immediately before the event if any of the following events occur:

(A) The object of a deferred intercompany transaction is:

(i) Resold by the buyer to an entity that is not a member of the combined group;

(ii) Resold by the buyer to an entity that is a member of the combined group for use outside the unitary business in which the buyer and seller are engaged; or

(iii) Converted by the buyer to a use outside the unitary business in which the buyer and seller are engaged; or

(B) The buyer and seller are no longer members of the same combined group regardless of whether the members remain unitary.

(g) An expense of a member of the unitary group that is directly or

indirectly attributable to the nonbusiness or exempt income of another member of the unitary group is allocated to the other member as corresponding nonbusiness or exempt expense as appropriate.

26-51-2408. Designation of surety.

(a)(1)(A)(i) Members of a combined reporting group shall annually designate one (1) taxpayer member of the combined group to file a single return in the form and manner prescribed by the Director of the Department of Finance and Administration, in lieu of each member filing its own respective return.

(ii) The surety designated under this section shall be either:

(a) The federal consolidated parent corporation; or

(b) A subsidiary with a nexus to Arkansas, if the federal consolidated parent is not a member of the combined group.

(B) The taxpayer designated to file the single return under subdivision (a)(1)(A) of this section:

(i) Consents to act as surety with respect to the tax liability of all other taxpayers properly included in the combined report; and

(ii) Agrees to act as agent on behalf of those taxpayers for the year of the election for tax matters relating to the combined report for that year.

(2) The designation of a surety under subdivision (a)(1) of this section does not change the respective liability of the group members.

(b) If for any reason the taxpayer designated as a surety under subsection (a) of this section is unwilling or unable to perform the surety's responsibilities, tax liability shall be assessed against all of the taxpayer members.

26-51-2409. Water's-edge election.

(a) Taxpayer members of a unitary group that meet the requirements of § 26-51-2410 may elect to determine each member's apportioned share of the net business income or loss of the combined group under a water's-edge election.

(b) Under the water's-edge election, taxpayer members shall take into account the income and apportionment factors of only the following members of the combined group:

(1) The entire income and apportionment factors of any member incorporated in the United States or formed under the laws of the United States;

(2) The entire income and apportionment factors of any member, regardless of the place incorporated or formed, if the average of its property, payroll, and sales factors within the United States is twenty percent (20%) or more;

(3) The entire income and apportionment factors of any member that is a domestic international sales corporation as described in 26 U.S.C. §§ 991–994, as they existed on January 1, 2011;

(4) The portion of the income of a member not described in subdivisions (b)(1)–(3) of this section that is derived from or attributable to sources within the United States, as determined under the Internal Revenue Code of 1986, 26 U.S.C. § 1 et seq., as it existed on January 1, 2011, and the related apportionment factors;

(5)(A) The income of a member that is a controlled foreign corporation, as defined under 26 U.S.C. § 957, as it existed on January 1, 2011, to the extent the income is described under 26 U.S.C. § 952, as it existed on January 1, 2011, not excluding lower-tier subsidiaries' distributions of income that were previously taxed and the apportionment factors related to the income.

(B) An item of income received by a controlled foreign corporation is excluded if the income was subject to an effective rate of income tax imposed by a foreign country greater than ninety percent (90%) of the maximum rate of tax specified in 26 U.S.C. § 11, as it existed on January 1, 2011;

(6) The income and apportionment factors of a member that earns income, directly or indirectly, from intangible property or service-related activities that are deductible against the business income of other members of the combined group; and

(7)(A) The entire income and apportionment factors of any member that is doing business in a tax haven.

(B) If the member's business activity within a tax haven

is entirely outside the scope of the laws, provisions, and practices that cause the jurisdiction to be a tax haven under § 26-51-2402, the activity of the member shall be treated as not having been conducted in a tax haven.

26-51-2410. Initiation and withdrawal of water's-edge election.

(a)(1) A water's-edge election is effective only if made on a timely filed, original return for the tax year by each member of the unitary business subject to tax under the Income Tax Act of 1929, § 26-51-101 et seq.

(2) The Director of the Department of Finance and Administration shall develop rules governing the impact, if any, on the scope or application of a water's-edge election, including without limitation termination or deemed election resulting from a change in the composition of the unitary group, the combined group, the taxpayer members, and any other similar change.

(b) In the discretion of the director, a water's-edge election may be disregarded in whole or in part, and the income and apportionment factors of any member of the taxpayer's unitary group may be included in the combined report without regard to the provisions of this section if:

(1) A member of the unitary group fails to comply with this subchapter; or

(2) A person otherwise not included in the water's-edge combined group was designated with the substantial objective of avoiding state income tax.

(c)(1) A water's-edge election is binding for and applicable to the tax year in which it is made and all tax years thereafter for a period of ten (10) years.

(2)(A) A water's-edge election may be withdrawn or reinstituted after withdrawal before the expiration of the ten-year period only upon written request for reasonable cause based on extraordinary hardship due to unforeseen changes in state tax statutes, law, or policy, and only with the written permission of the director.

(B) If the director grants a withdrawal of election, the director shall impose reasonable conditions to prevent the evasion of tax or to clearly reflect income for the election period before or after the withdrawal.

(3)(A) Upon the expiration of the ten-year period, a taxpayer

may withdraw from the water's edge election.

(B) Withdrawal under this section shall be made in writing within one (1) year of the expiration of the election.

(C) Withdrawal under this section is binding for a period of ten (10) years subject to the conditions that applied to the original election under this section.

(D) If no withdrawal is properly made, the water's edge election shall be in place for an additional ten-year period subject to the conditions that applied to the original election under this section.

24-51-2411. Rules.

The Director of the Department of Finance and Administration shall promulgate rules to implement this subchapter.

SECTION 2. Arkansas Code § 26-51-419(b), concerning deductions for charitable contributions, is amended to read as follows:

(b) ~~The provisions of subsection~~ Subsection (a) of this section ~~shall apply~~ applies to a corporation that files an Arkansas ~~consolidated corporation~~ combined income tax return ~~pursuant to § 26-51-805, provided that each member of the affiliated group shall follow the provisions of § 26-51-805(f) and calculate its contribution limits separately~~ under the Arkansas Small Business Tax Fairness Act, § 26-51-2401 et seq., in accordance with § 26-51-2405.

SECTION 3. Arkansas Code § 26-51-804(a), concerning income tax returns for corporations, is amended to read as follows:

(a)(1) Every corporation subject to taxation under this act shall make a return stating specifically the items of its gross income and the deductions and credits allowed by this act.

(2) Corporations that are members of a unitary business under the Arkansas Small Business Tax Fairness Act, § 26-51-2401 et seq., shall *file a combined return.*

(3) Corporations that are not members of a unitary business under the Arkansas Small Business Tax Fairness Act, § 26-51-2401 et seq., shall file returns on either a consolidated basis or a separate entity basis.

SECTION 4. Arkansas Code § 26-51-805(a), concerning consolidated income tax returns for corporations, is amended to read as follows:

(a)(1)(A) All corporations ~~which~~ that are eligible members of an affiliated group, as ~~that term is~~ defined in 26 U.S.C. § 1504(a) and (b), as ~~of~~ it existed on January 1, 1989, ~~which affiliated group files a federal consolidated corporate income tax return pursuant to 26 U.S.C. §§ 1501-1505 as of January 1, 1989, may elect to~~ shall file a ~~consolidated~~ combined Arkansas corporate income tax return under the Arkansas Small Business Tax Fairness Act, § 26-51-2401 et seq., if the affiliated group files a federal consolidated corporate income tax return under 26 U.S.C. §§ 1501–1505, as they existed on January 1, 1989.

(B) Corporations that are not members of a unitary business under the Arkansas Small Business Tax Fairness Act, § 26-51-2401 et seq., shall file returns on either a consolidated basis or a separate entity basis.

(2) However, only corporations in the affiliated group that have gross income from sources within ~~the State of~~ Arkansas that is subject to taxation under ~~the provisions of~~ the ~~Arkansas~~ Income Tax Act of 1929, ~~as amended,~~ § 26-51-101 et seq., shall be eligible to file consolidated corporate income tax returns in Arkansas.

SECTION 5. EFFECTIVE DATE. This act is effective for tax years beginning on or after January 1, 2012.

/s/Nickels

Referred by the Arkansas House of Representatives
Prepared by: JLL/VJF

Combined Reporting

- Total Arkansas corporate income tax collections received for the last 5 fiscal years are: FY07 - $363 M; FY08 - $343 M; FY09 - $346 M; FY10 - $362 M; and FY11 - $351 M. Approximately $60 M per year in collections is received from corporations currently using combined reporting.

- If Arkansas required combined reporting for all multistate unitary businesses, the expected revenue increase would be approximately **$18.7 M*** per year. Uniform compliance would not be expected upon implementation so this amount may be less during the first few years until DFA has time to enforce compliance through audits.

- This estimate is based on a review of 35 multistate companies who reported 15.8% of the corporate income tax paid in2010 by companies filing an Arkansas consolidated return. The average increase in tax liability for these companies using combined reporting was 6.1%. This estimate is less than the $35 M to $70 M range suggested by Professor Pomp. His estimate was based on estimates from other states before implementation.

- 12 of these 35 companies would have paid more Arkansas income tax in 2010 using combined reporting and 23 would have paid less. Of the 12 companies that would have paid more tax, 2 would have seen an increased tax liability of less than 10%, 2 would have increased by 10% to 20%, 3 by 50% to 75%, 3 by 100% to 150%, 1 by 233% and 1 by 941%. Of the 23 companies that would have paid less tax, the reduction would have been less than 10% for 4 companies, 10% to 20% for 3 companies, 20% to 50% for 5 companies, 50% to 100% for 9 companies, and 169% and 261% for each of the other two companies, respectively.

- 23 states plus the District of Columbia currently require combined reporting. The states of Texas, New York, Wisconsin, West Virginia, Vermont, and Michigan have all adopted combined reporting since 2004. (See Figure 1 attached)

- If combined reporting was required, the corporate income tax rate could be reduced from a graduated rate schedule with a maximum rate of 6.5% to a flat rate of 6.1% for all taxpayers and remain revenue neutral. Additional collections from combined reporting would total approximately $18.7 M and additional collections from eliminating the graduated rate structure would total approximately $2.8 M. Revenue loss from decreasing the maximum rate from 6.5% to 6.1% would be approximately $21.5 M.

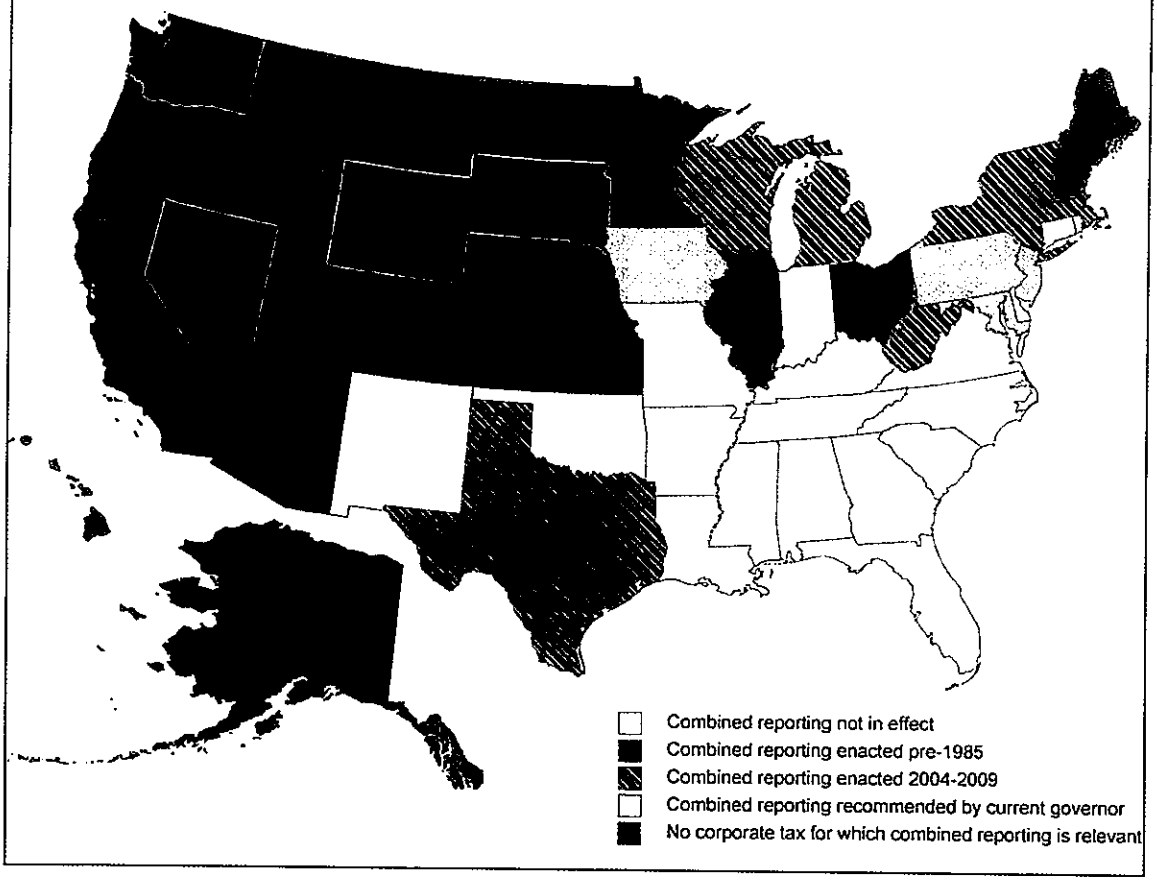
- Loss of the current graduated tax rate and adoption of a flat income tax rate for all income would increase the tax liability of each corporation by up to $1,060 yearly.

- The marginal corporate income tax rate is currently 6.38%.

*The level of taxpayer compliance and changes in economic conditions could affect the revenues derived from a combined reporting requirement.

FIGURE 1

Current Status of Combined Reporting



CORPORATION INCOME TAX RATES IN SURROUNDING STATES

We have been asked to provide the corporation income tax rates for the states surrounding Arkansas. They are as follows:

Missouri	6.25% on all income	
Tennessee	6.50% on all income	
Mississippi	3.00%	0 - $5,000
	4.00%	$5,000 - $10,000
	5.00%	$10,001 or more
Louisiana	4.00%	0 - $25,000
	5.00%	$25,001 - $50,000
	6.00%	$50,001 - $100,000
	7.00%	$100,001 - $200,000
	8.00%	$200,000 or more
Oklahoma	6% on all income	
Texas *	0.50%	Wholesale or Retail trade
	1.00%	All other businesses

*The Texas margin tax is not a traditional income tax. It replaces the franchise tax that treated different business types in differing manners resulting in many large corporations converting to partnerships or limited liability companies to take advantage of favorable treatment. The margin tax is uniform across all business types and requires taxpayers to pay tax on the greater of three separate calculations of gross margin:

1. total revenue minus cost of goods sold,
2. total revenue minus compensation
3. 70% of total revenue

Since most common income tax deductions are not allowed, the margin tax is a kind of hybrid of a gross receipts tax and an income tax. Taxpayers do have to file a single combined return for members of an affiliated group and therefore, Texas is considered a combined filing state. The tax rate is much less than those of states with a traditional income tax, but higher than Ohio and Washington which have gross receipts based business activity taxes.

Arkansas	1%	0 - $3,000
	2%	$3,001 - $6,000
	3%	$6,001 - $11,000
	5%	$11,001 - $25,000
	6%	$25,001 - $100,000
	6.5%	$ over $100,000

Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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A MAJORITY OF STATES HAVE NOW ADOPTED A KEY CORPORATE TAX REFORM — "COMBINED REPORTING"

by Michael Mazerov

A growing number of states are adopting a major reform in their corporate income taxes long advocated by state tax experts: "combined reporting." With the recent enactment of combined reporting legislation in Wisconsin, 23 of the 45 states with corporate income and similar business taxes have implemented this critical policy.

Most large multistate corporations are composed of a "parent" corporation and a number of "subsidiary" corporations owned by the parent. Combined reporting essentially treats the parent and most subsidiaries as one corporation for state income tax purposes. Their nationwide profits are combined — that is, added together — and the state then taxes a share of that combined income. The share is calculated by a formula that takes into account the corporate group's level of activity in the state as compared to its activity in other states.

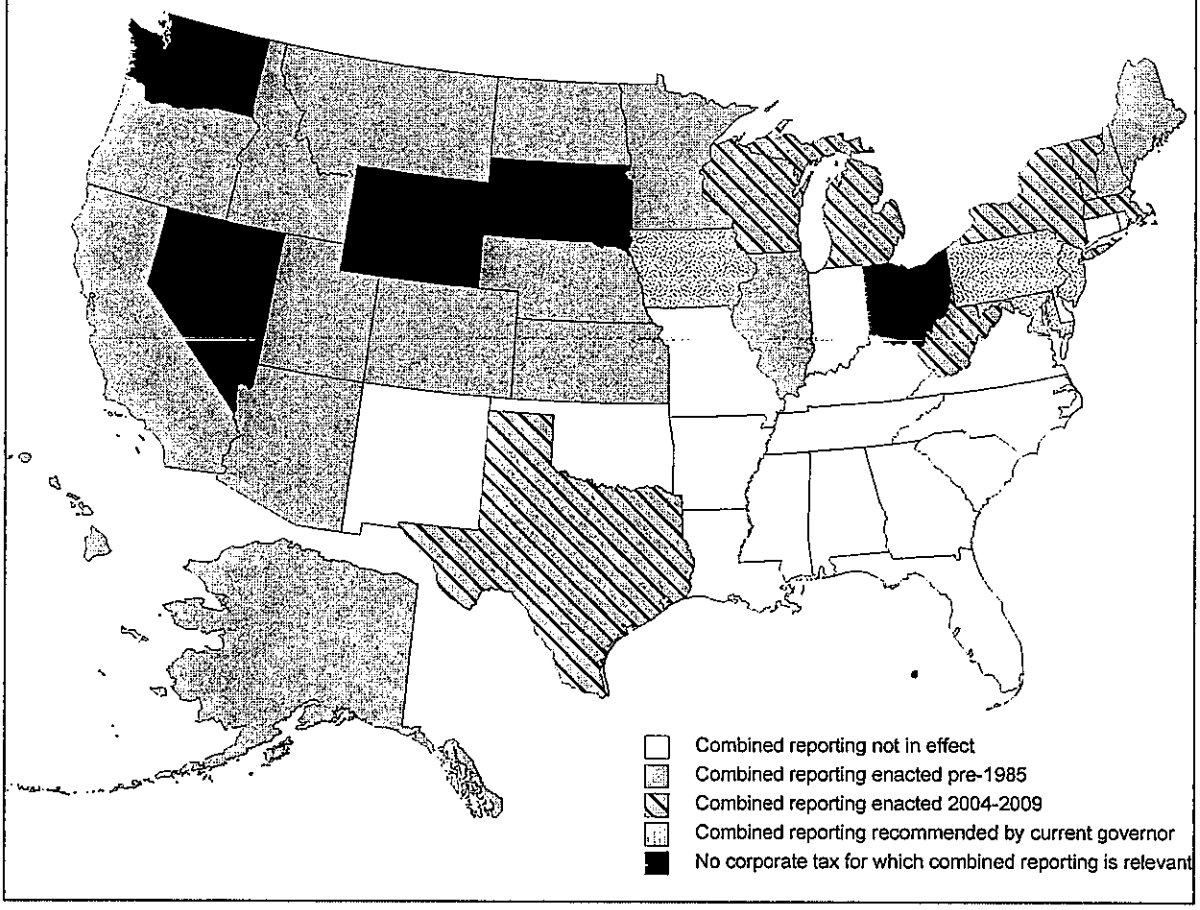
KEY FINDINGS

- A majority of states levying corporate income taxes have now adopted a key reform known as "combined reporting."
- Combined reporting nullifies a variety of abusive corporate income tax avoidance strategies. These include Wal-Mart's "captive REIT" tax shelter (featured in a front-page *Wall Street Journal* story in February 2007) and the "Delaware Trademark Holding Company" shelter adopted by Toys R Us and many other retailers
- Seven states – Massachusetts, Michigan, New York, Texas, Vermont, West Virginia, and Wisconsin – have adopted combined reporting since 2004, bringing to 23 the number of states implementing this policy.

By requiring corporate parents and subsidiaries to add their profits together, combined reporting states are able to nullify a variety of tax-avoidance strategies large multistate corporations have devised to artificially move profits out of the states in which they are earned and into states in which they will be taxed at lower rates — or not at all. These strategies cost the non-combined reporting states billions of dollars of lost corporate income tax revenue they need to finance essential public services, like education and health care. Households and small businesses, which do not have the opportunities or resources to engage in interstate income-shifting, end up paying higher taxes than necessary to make up for the taxes that large corporations are able to avoid.

FIGURE 1

Current Status of Combined Reporting



Growing Consideration of Combined Reporting

Sixteen states — slightly more than one third of the states with corporate income taxes — have mandated and successfully used combined reporting for decades. (See Figure 1.) Until recently, however, that group had not expanded at all — not even after the U.S. Supreme Court ruled in 1983 that combined reporting was a fair and constitutional method of taxing multinational (and, by extension, multistate) corporations.

That inertia is now being overcome. Seven states have enacted combined reporting legislation since 2004, and serious consideration of combined reporting is occurring in a number of other states:

- In 2004, Vermont became the first state in more than 20 years to adopt combined reporting, effective in 2006.

- In adopting a new general business tax in 2006 to substitute for its corporate income tax, Texas

also mandated combined reporting (effective 2008). Although the new tax differs in significant ways from a traditional income tax, the decision to require combined reporting was based on the same basic understanding that underlies the inclusion of combined reporting in state corporate income tax structures — that failure to do so would have given corporations free rein to artificially shift taxable income out of the state.

- In March 2007, West Virginia adopted combined reporting, effective with the 2009 tax year.

- As part of the state budget bill approved in April 2007, New York required combined reporting, retroactive to the beginning of 2007.

- In July 2007, Michigan Governor Jennifer Granholm signed into law a new "Michigan Business Tax" to replace the state's former "Single Business Tax." The new tax is a hybrid tax on corporate gross receipts and corporate profits and mandates the use of combined reporting.

- Massachusetts enacted combined reporting in May 2008 at the recommendation of Governor Deval Patrick, retroactive to the beginning of that year.

- Finally, Wisconsin Governor Jim Doyle signed Senate Bill 62 on February 19, 2009, implementing combined reporting retroactively on January 1, 2009.

There has also been serious discussion or consideration of combined reporting in a number of other states in recent years:

- Four current Governors — Jon Corzine of New Jersey, Chet Culver of Iowa, Martin O'Malley of Maryland, and Ed Rendell of Pennsylvania — have sponsored combined reporting legislation or expressed support for it.[1]

- The 2003 Blue Ribbon Tax Reform Commission in New Mexico recommended that the state adopt combined reporting.[2]

- In a November 2003 report, the Florida Senate Committee on Finance and Taxation wrote: "There are several changes in the Florida Income Tax Code that the legislature should consider to prevent further erosion from tax avoidance strategies by corporations that are taxable under current law: 1. Adopt combined reporting to nullify the use of passive investment companies and other corporate tax avoidance strategies. . . ."[3]

- In January 2007, the North Carolina Revenue Laws Committee formally recommended to the incoming legislature that the state adopt combined reporting legislation; the committee recently reaffirmed its support for combined reporting. [4]

- Combined reporting bills have been introduced in numerous states in 2008 and 2009, including Connecticut, Florida, Missouri, New Mexico, North Carolina, Pennsylvania, Rhode Island, and Tennessee.

State Corporate Tax Experts and Newspaper Editorial Boards Support Combined Reporting

In giving serious consideration to combined reporting, states are following advice long offered by state corporate tax policy experts. For example:

- Economist Charles McLure, Deputy Assistant Secretary of the Treasury Department in the Reagan Administration, has written: "Failure to require unitary combination is an open invitation to tax avoidance. (Or — to the extent transfer prices are misstated — is it tax evasion?) The advent of electronic commerce exacerbates the potential problems of economic interdependence and manipulation of transfer prices."[5]

- In a recent paper, George Washington University professors David Brunori and Joseph J. Cordes wrote: "Our research shows that requiring combined reporting would help the corporate income tax become a more significant source of revenue. . . The combined reporting requirement would severely limit the ability of corporations to use tax planning techniques such as creating nowhere income and establishing passive investment companies to avoid state corporate tax liability. . . ."[6]

- In an article in the prestigious *National Tax Journal*, Economists William F. Fox, Matthew N. Murray, and LeAnn Luna wrote: "[W]e argue for combined reporting in all states. This conclusion is based in part on economic considerations that are independent of any tax planning opportunities, such as the practical problems associated with measuring economies of scope across related firms. But combined reporting can also lessen tax planning distortions based only on corporate form that waste resources through avoidance and government oversight activities."[7]

Major newspapers have also editorialized in support of combined reporting. For example:

- The *Tampa Tribune* wrote: "Florida allows multistate businesses to shelter Florida income in other states. This makes the effective income-tax rate on small Florida businesses higher than the rate paid by corporations sheltering income elsewhere. A company can reduceits tax bill by paying rent to an out-of-state subsidiary. Or it might send profits, on paper, out of state to pay itself for its own patents and trademarks. Rep. Dan Geller, a Miami Beach Democrat, says closing the loophole with a technique called 'combined reporting' would raise $365 million a year. Many other states already use the approach, so technical and constitutional issues have been ironed out. . . [I]t is neither good politics nor smart economics to charge Florida businesses more [tax] than is charged the interstate rivals who already enjoy economies of scale."[8]

- According to the *Des Moines Register*: "The appropriate tax rate of business certainly is debatable, but everyone should agree those companies should pay the full taxes they owe, and multistate corporations shouldn't have a tax advantage over wholly local corporations. Last year [former Governor] Vilsack proposed combined reporting to lawmakers, but it didn't get anywhere. . . . That's unfortunate. . . . Ensuring taxes are collected by closing a loophole that's unfair to Iowa-based businesses should be a bipartisan no-brainer."[9]

Corporate Tax Shelters and the Need for Combined Reporting

Renewed discussion of combined reporting was sparked approximately a decade ago by a rash of court cases in which non-combined reporting states sought to nullify an abusive corporate tax shelter to which they are vulnerable. That tax shelter is frequently referred to as the "Delaware Trademark Holding Company" or "Passive Investment Company" (PIC). It is based on a corporation's transferring ownership of its trademarks and patents to a subsidiary corporation located in a state that does not tax royalties, interest, or similar types of "intangible income," such as Delaware and Nevada. Profits of the operational part of a business that otherwise would be taxable by the state(s) in which the company is located are siphoned out of such states by having the tax-haven subsidiary charge a royalty to the rest of the business for the use of the trademark or patent. The royalty is a deductible expense for the corporation paying it, and so reduces the amount of profit such a corporation has in the states in which it does business and is taxable. Moreover, the profits of the Passive Investment Company often are loaned back to the rest of the corporation, and a secondary siphoning of income occurs through the payment of deductible interest on the loan. Of course, the royalties and interest received by the PIC are not taxed; Delaware has a special income tax exemption for corporations whose activities are limited to owning and collecting income from intangible assets, and Nevada does not have a corporate income tax at all.

Combined reporting nullifies the PIC tax shelter because the profits of the subsidiary are added to the profits of the operational part(s) of the corporate group. The PIC remains in existence and the royalty payments continue to be made to the PIC, but the tax benefit of shifting profits to the PIC are eliminated by the combination.

Rather than adopt combined reporting, some states attempted to attack PICs in more limited ways. Some tried to impose their corporate income taxes on the out-of-state PICs directly, and others enacted laws disallowing the deduction of royalty and interest payments to the PICs. A widely-discussed front-page article in the *Wall Street Journal* in February 2007, however, underscored the need to take a comprehensive rather than piecemeal approach to the corporate tax avoidance strategies to which non-combined reporting states are vulnerable.[10]

The article discussed a tax shelter established by Wal-Mart that is analogous to the PIC but that would not be nullified by the targeted anti-PIC legislation that some states enacted. Indeed, the article revealed that Wal-Mart set up this shelter, known as a "captive Real Estate Investment Trust" (REIT), at approximately the same time it was liquidating its conventional PIC (perhaps because PICs had become a red flag for state auditors). Wal-Mart transferred ownership of all its stores to its REIT subsidiary, and the stores paid tax-deductible rent to the REIT for use of the buildings they occupied. As with royalty payments for the use of trademarks, the rent payments had the effect of reducing taxable profits of the stores and shifting the profits to the REIT. Virtually all states effectively treat the REIT as a tax-exempt entity — just as the federal government does. And the other Wal-Mart subsidiary that owned the REIT was only taxable in the state in which it was based, so the states where Wal-Mart's stores were located couldn't reach the REIT's profits when those were passed on in the form of dividends to the REIT's owner, either.

The Wal-Mart REIT example suggests that the comprehensive solution of combined reporting is a much better way for states to shore-up their corporate income taxes than narrower, case-by-case attacks on specific tax shelters, for at least four reasons:

- Highly-skilled and highly-compensated tax attorneys and accountants are likely to remain at least one step ahead of under-staffed state revenue departments in devising new mechanisms multistate corporations can use to minimize their state income taxes in non-combined reporting states. For example, a recent newsletter from the BDO Seidman accounting firm that discussed a (rare) New York State court victory against a PIC assured its clients that:

  "BDO Seidman can facilitate the replacement of your current Delaware Holding Company with state tax reducing strategies to fit naturally around your business operations. Examples of BDO Seidman's most popular state tax reducing strategies include:
  - 197 Strategy,
  - Embedded Royalty Company, and
  - Effective Use of Transfer Pricing."[11]

- It is labor-intensive, time-consuming, and costly for states to address these problems on a case-by-case basis. For example, after the Wisconsin legislature rejected the 1999 call by former Governor Tommy Thompson to mandate combined reporting, the state revenue department was compelled to engage in a four-year-long process of auditing and then negotiating individual agreements with 175 banks to stop tax avoidance based on the use of PICs located in Nevada.[12]

- Some of the laws aimed at nullifying specific tax shelters that non-combined reporting states are vulnerable to may be subject to legal challenge. Numerous articles have been written by corporate tax attorneys advising their clients how to attack these laws on the grounds that they discriminate against interstate commerce; a challenge to Alabama's law is currently on appeal to the U.S. Supreme Court.[13] In contrast, the legality of combined reporting has been upheld twice by the Court.[14]

- Perhaps most importantly, there are several tax-avoidance strategies that have been widely adopted by major multistate corporations that cannot be effectively countered through any policy other than combined reporting.[15]

The corporate income taxes of states that do not mandate combined reporting are fundamentally flawed because they permit intra-corporate transactions to affect how much income tax a corporation owes to a particular state. Attacking specific tax shelters that exploit this flaw is akin to treating the symptoms of a disease rather than the underlying defect that causes it.

Combined Reporting Is Primarily About Fairness, Not Revenue

The primary goal of combined reporting is to create a level playing field for all businesses. It seeks to ensure that large multistate corporations cannot end up paying income tax at a lower effective tax rate than small businesses by subdividing themselves into separate corporations and then manipulating transactions within the overall corporate group.

Because such manipulations appear to be widespread and because combined reporting nullifies their tax effects, most states that have studied the fiscal impact of combined reporting have concluded that its adoption would raise some additional revenue. In states that need new revenue sources, requiring combined reporting could certainly make a modest contribution toward that objective. Most states that have prepared estimates conclude that the adoption of combined reporting would increase corporate income tax receipts on the order of 10 to 25 percent.

If a state is considering combined reporting at a time when it does not need additional revenue, and if it wishes to maintain the current balance of taxes between businesses and households, it can use the revenue gained from combined reporting to make offsetting changes in other business tax provisions to ensure that the overall impact is revenue neutral. Even if other business tax changes are made to keep combined reporting revenue-neutral in the short run, its adoption will help to preserve the long-run revenue-generating capacity of the corporate income tax by nullifying a wide variety of corporate tax-avoidance techniques.

Combined Reporting and State Economic Development

As is often the case when changes in tax policy are proposed that would have the effect of increasing tax payments by some businesses, state consideration of combined reporting has elicited warnings from corporate interests that implementing the policy will harm the economic prospects of any state doing so.

In fact, combined reporting states are well-represented among the most economically-successful states in the country. Between 1990 and 2007 — a period roughly spanning the two business cycles preceding the current recession — only eight states that levy corporate income taxes managed to achieve net positive growth in manufacturing employment. Seven of those eight states — Arizona, Idaho, Kansas, Montana, Nebraska, North Dakota, and Utah — had combined reporting in effect throughout the period. The next two best-performing states, Oregon and Minnesota, each of which had roughly flat manufacturing employment during that period, were also combined-reporting states. All other states lost manufacturing jobs, and a majority of them did not require combined reporting.[16]

Three recent studies examined the location decisions of the largest manufacturing corporations in Iowa, North Carolina, and Wisconsin — each of which was considering the adoption of combined reporting when the studies were conducted.[17] All three studies found that the large majority of these companies maintained facilities in numerous combined reporting states and were therefore unquestionably subject to corporate income taxation in those states. If these businesses did not shun existing combined reporting states as locations for their facilities, there is no reason to think they would shun states implementing combined reporting in the future.

California is the state that has used combined reporting the longest and enforces it most aggressively, but this was not a barrier to the birth of Silicon Valley in the 1990s. The presence of combined reporting has not been a barrier to Intel Corporation's maintenance of its headquarters in California and its decision to place the bulk of its expensive chip fabrication plants in Oregon, Arizona, and Colorado — all combined reporting states. Such anecdotes and the data on manufacturing employment and facility location decisions cited above suggest that the burden of

proof ought to lie with combined reporting opponents to demonstrate that the policy has a negative impact on state economic growth.

Total state and local taxes paid by corporations represent approximately two and one-half percent of their expenses on average, and the state corporate income tax represents on average less than ten percent of that two and one-half percent.[18] A state's decision to adopt combined reporting increases that small corporate tax load only slightly. The potential influence on corporate location decisions of state corporate tax policies is simply overwhelmed in most cases by interstate differences in labor, energy, and transportation costs, which comprise a much greater share of corporate costs than state corporate income taxes do and often vary more among the states than effective rates of corporate taxation. It comes as no surprise, then, that a recent study by economists Robert Tannenwald and George Plesko, which measured interstate differences in overall state and local tax costs for corporations in a particularly rigorous way, found that there was not a statistically-significant (inverse) correlation between those costs and state success in attracting business investment.[19] In other words, higher state and local business taxes did not impede business investment.

Making the Transition to Combined Reporting

A state's adoption of combined reporting is a significant change in corporate tax policy, and therefore it necessitates some effort to educate state personnel and taxpayers alike in the ways in which it differs from the "separate entity" approach to corporate taxation that still prevails in slightly less than half the states.[20] Fortunately, assistance is available from the Multistate Tax Commission to states that wish to make the change to combined reporting. The MTC is an organization of state revenue departments whose members include most of the existing combined reporting states. In recent years, the MTC has promulgated a model statute for the implementation of combined reporting and a model regulation spelling out in considerable detail which corporate subsidiaries do and do not constitute parts of a "unitary business" that therefore must be included in a combined report.[21] The MTC also has a staff of corporate income tax auditors who audit large multistate corporations on behalf of numerous states simultaneously. They are quite familiar with auditing under combined reporting regimes. A state new to combined reporting could supplement its auditing efforts with MTC auditors as its audit staff familiarizes itself with the new approach. States do not need to be members of the MTC to participate in its Joint Audit Program.

Conclusion

That the number of combined reporting states has increased almost 50 percent in the last five years is compelling evidence that awareness of the need to reform state corporate tax structures is growing. As policymakers in non-combined reporting states ponder their states' ongoing vulnerability to a variety of aggressive corporate tax shelters — such as Wal-Mart's "captive REIT" — and objectively examine the decades-long experience of 16 states with this policy, the movement toward combined reporting seems likely to continue.

Notes

[1] On October 16, 2008, New Jersey Governor Corzine presented the "New Jersey Economic Assistance and Recovery Plan" to a joint session of the state legislature. Materials released at that time stated: "Governor Corzine is directing the Treasurer to immediately engage with major corporate business taxpayers to develop an appropriate strategy to move towards the so-called "single sales factor" method of tax liability computation and towards adoption of Unitary Combined Reporting." See: "Long Term Solutions," available at www.state.nj.us/governor/home/media_long.html.

As did his predecessor, Iowa Governor Chet Culver included recommendations for the adoption of combined reporting in both his FY08 and FY09 budgets. In the face of legislative resistance, however, he did not include the proposal in his FY10 budget package.

Maryland Governor Martin O'Malley proposed the enactment of combined reporting legislation as part of a budget-balancing plan submitted to the legislature during an October 2007 special session. The Maryland House of Delegates approved the proposal but the Senate did not concur. Instead, the legislature enacted legislation mandating that corporations prepare a "pro-forma" corporate tax return calculating their tax liability on the basis of combined reporting and establishing a Business Tax Reform Commission. That commission will get underway in 2009.

In February 2005, Pennsylvania Governor Ed Rendell proposed state adoption of combined reporting as part of his FY06 budget package. He has continued to press for the adoption of combined reporting since that time, although the legislature has not acted. In this year's budget address he stated: "I welcome any revenue enhancement proposals made by any member of the Legislature. Among some of the ideas that have been shared with me are, for example, amendments that close the enormous tax loopholes that exist for companies located outside the state who do business here. . . . These are good ideas and if the Legislature puts them or others on the table I will consider them." In a Februry 27, 2009 letter to the editor of the *Philadelphia Inquirer*, he wrote: "In my budget speech, I said I would be willing to consider other revenue enhancements, such as adopting combined reporting for businesses, if sent to me by legislative leaders."

[2] New Mexico Blue Ribbon Tax Reform Commission, table of recommendations, available at legis.state.nm.us/LCS/bluetaxdocs/BRTRCTableofRecommendations.pdf.

[3] Florida Senate Committee on Finance and Taxation, *Why Did Florida's Corporate Income Tax Revenue Fall While Corporate Profits Rose?* Available at www.flsenate.gov/data/Publications/2004/Senate/reports/interim_reports/pdf/2004-137ft.pdf.

[4] See: North Carolina Revenue Laws Study Committee, "Report to the 2009 General Assembly of North Carolina 2009 Session," pp. 49-50.

[5] Charles E. McLure, "The Nuttiness of State and Local Taxes and the Nuttiness of Responses Thereto," *State Tax Notes*, September 11, 2002, p. 851.

[6] David Brunori and Joseph J. Cordes, "The State Corporate Income Tax: Recent Trends for a Troubled Tax," unpublished paper submitted to the American Institute of Tax Policy, August 15, 2005.

[7] William F. Fox, Matthew N. Murray, and LeAnn Luna, "How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?" *National Tax Journal*, March 2005.

[8] "Tax Phobia in Tallahassee Protects Huge, Unfair Loopholes," *Tampa Tribune*, April 11, 2008.

[9] "First, Close Loopholes," *Des Moines Register*, February 20, 2004.

[10] Jesse Drucker, "Wal-mart Cuts Taxes by Paying Rent to Itself," *Wall Street Journal*, February 1, 2007.

[11] BDO Seidman, LLP, *State Tax Alert*, May 2005.

[12] Paul Gores, "Bankers Fear Doyle Cold Shoulder, Some Still Smarting Over Tax Shelter Issue," *Milwaukee Journal Sentinel*, November 15, 2006.

[13] See, for example: Thomas H. Steele and Pilar M. Sansone, "Surveying Constitutional Theories for Challenges to Add Back Statutes," web site of the Morrison and Foerster law firm, February 23, 2005. A friend-of-the-court brief filed by the Council on State Taxation (an organization representing large multistate corporations on state tax matters) arguing

that the Alabama statute disallowing deductions for royalties paid to PICs is unconstitutional is available at www.cost.org/WorkArea/DownloadAsset.aspx?id=72430.

[14] The cases were *Container Corporation of America* v. *California Franchise Tax Board* (1983) and *Barclays Bank* v. *California Franchise Tax Board* (1994).

[15] See: Michael Mazerov, "State Corporate Tax Shelters and the Need for 'Combined Reporting'," Center on Budget and Policy Priorities, October 2007, available at www.cbpp.org/10-26-07sfp.pdf.

[16] See: Michael Mazerov, "Most Large North Carolina Manufacturers Are Already Subject to 'Combined Reporting' in Other States," Center on Budget and Policy Priorities, January 2008, Table 1, p. 6. Available at www.cbpp.org/1-15-09sfp.pdf.

[17] See the study cited in Note 16. See also: Michael Mazerov, "Almost All Large Iowa Manufacturers Are Already Subject to 'Combined Reporting' in Other States; Fears of Job Flight from Reducing Corporate Tax Avoidance Are Unwarranted," Center on Budget and Policy Priorities, April 2008, available at www.cbpp.org/4-3-08sfp.pdf. See also: Jack Norman, "Combined Reporting: How Closing Corporate Loopholes Benefits Wisconsin," Institute for Wisconsin's Future, February 2009, available at www.wisconsinsfuture.org/publications/taxes/IWF_combined%20reporting_Feb09.pdf.

[18] See the source cited in Note 16, Endnote 9.

[19] George A. Plesko and Robert Tannenwald, *Measuring the Incentive Effects of State Tax Policies Toward Capital Investment,* Federal Reserve Bank of Boston Working Paper 01-4, December 3, 2001.

[20] The key differences between combined reporting and the "separate entity" approach to state corporate income taxation are discussed in Appendix B of Michael Mazerov, *State Corporate Tax Disclosure: The Next Step in Corporate Income Tax Reform*, February 2007. Available at www.cbpp.org/2-13-07sfp.pdf.

[21] The MTC's model combined reporting statute is available at www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf. The MTC's model definition of a "unitary business" for combined reporting purposes is available on pp. 5-14 of the following document www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocationandApportionmentReg.pdf.

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

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".

Competitiveness of state and local business taxes on new investment

Ranking states by tax burden on new investment

April 2011

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Executive summary

As states recover from the recent recession, legislators and policy-makers are focusing attention on state policies designed to retain and expand employment and attract new investment. State and local business tax policy is an important element of this policy discussion, and legislators want to know how a state's current business tax system compares to other states considered to be competitors for jobs and investment.

This study provides a state-by-state comparison of the tax liabilities that new investments in selected industries or types of economic activities would incur in each state, taking into consideration state and local statutory tax provisions and the financial and economic characteristics of the new investments. The analysis focuses on capital investments in industries that have location choices, such as factories or headquarters, rather than those that are tied to a specific geography, such as retailers or hotels. The estimated tax burdens on selected investments are combined to provide an overall measure of the business tax competitiveness of each state.

The results reflect the type of analysis that businesses use to evaluate decisions about where to locate new capital investments in plant and equipment. The business tax competitive indexes reported in this study isolate the impact of state and local business tax systems on new capital investment, the cornerstone of state economic development. Typically, companies select the location for new investments by examining a wide range of tax system features and non-tax cost factors, such as labor, utility, and transportation costs. While non-tax cost factors are usually more significant in determining the overall cost of operating a facility in each state, tax factors can be a determining factor between states with otherwise similar non-tax costs.

Site selection projects typically occur in two phases. The first phase involves a high-level examination of operating cost and tax factors for a number of states. By eliminating states with out-of-line tax and non-tax cost factors from further consideration, the investor narrows its investigation to a "short list" of states with favorable characteristics. Typically, the tax factors considered in determining the short list of states include readily-available tax features, such as statutory tax rates and income apportionment formulas. Most investors then conduct a more thorough analysis of the tax implications of investing in each of the states on its short list. The competitiveness index reported in this study provides a more accurate measure of the taxes imposed on new investments than a simple comparison of statutory effective tax rates.

State and local taxes imposed on business are extensive and complex. Certain tax system features were not included in the analysis and are discussed in the limitations section, including mandatory unitary combined reporting, tax credits, industry-specific taxes, and

Table E-1. Top-10 and Bottom-10 states ranked by Ernst & Young LLP/COST business tax competitiveness, 2009

States with the lowest ETR on new investment			States with the highest ETR on new investment		
State	Effective tax rate	Rank	State	Effective tax rate	Rank
Maine	3.0%	1	West Virginia	9.7%	42
Oregon	3.8%	2	Alabama	9.7%	43
Ohio	4.4%	3	Mississippi	10.2%	44
Wisconsin	4.5%	4	Tennessee	10.3%	45
Illinois	4.6%	5	Hawaii	10.8%	46
Virginia	5.4%	6	Louisiana	11.1%	47
New Hampshire	5.4%	7	Kansas	11.2%	48
Delaware	5.7%	8	Rhode Island	11.5%	49
Wyoming	5.8%	9	District of Columbia	16.6%	50
Minnesota	6.0%	10	New Mexico	16.6%	51

unemployment insurance taxes. The methodology used to estimate the Ernst & Young LLP/Council On State Taxation (COST) business tax competitiveness index reported in this study provides an objective, systematic approach to summarizing the tax impacts of the complex systems of state and local taxes on different types of new mobile capital investments in each state in terms of the effective tax rate on returns from the investments. The approach combines estimates of the actual tax amounts imposed on hypothetical new investments with information on the nation-wide composition of recent new capital investment to create a weighted average of business tax burdens on the types of investments that states are currently pursuing. These overall tax burdens are summarized in the Ernst & Young LLP/ COST business tax competitiveness index.

Table E-1 identifies the 10 states with the highest and lowest effective tax rates for the types of new capital investments being made in the U.S.

As explained in detail in this report, the business tax burdens include all major state and local taxes imposed on business activities associated with new capital investments including:

- Income and franchise taxes on profits (including gross receipts taxes)
- Real and personal property taxes
- Sales taxes on business input purchases

The types of mobile capital investments analyzed include:

- Headquarters facilities
- Research and development facilities
- Office and call center facilities
- Durable manufacturing facilities
- Non-durable manufacturing facilities

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The modeling of business tax burdens combines detailed information on tax provisions affecting the definition of tax bases, as well as statutory tax rates. The rankings show that differences in how states define tax bases are, for many states, more important in determining tax competitiveness than the statutory tax rates.

The results also clearly show that legislators need to examine the entire system of state and local business taxes, not just a single tax, in evaluating their state's tax competitiveness. In fact, the results suggest that legislators have not paid enough attention to the role of "sales" in understanding tax burdens imposed on business investments and on-going operations. This includes both (1) sales to businesses subject to sales taxes imposed on taxable products and (2) services purchased as business inputs, and the "sourcing" or geographic assignment of sales by business in determining instate corporate income and gross receipts tax bases. Because both sales taxes and entity-level business taxes are levied at high rates, variations in the definition of these tax bases have a significant impact on the competitiveness rankings presented in this study.

In addition to providing a snapshot at a point in time of the competitiveness of current state and local business tax systems, the competitiveness index provides an objective, systematic way for evaluating the positive or negative impacts of legislative tax changes on a state's competitiveness. These impacts will be visible in changes in the annual business tax competiveness index rankings over time.

Table 2. State and Local Business Tax Competitiveness Index:
Taxes on New Investment by Selected Industries

State	Weighted by Capital Investment ETR	Rank	Weighted by Jobs ETR	Rank
Maine	3.0%	1	4.3%	1
Oregon	3.8%	2	4.4%	2
Ohio	4.4%	3	5.6%	3
Wisconsin	4.5%	4	5.7%	4
Illinois	4.6%	5	6.0%	8
Virginia	5.4%	6	6.6%	10
New Hampshire	5.4%	7	5.9%	6
Delaware	5.7%	8	5.8%	5
Wyoming	5.8%	9	6.4%	9
Minnesota	6.0%	10	7.5%	13
Montana	6.1%	11	6.0%	7
Maryland	6.3%	12	8.7%	25
South Dakota	6.4%	13	7.1%	11
Iowa	6.4%	14	8.1%	18
Kentucky	6.5%	15	7.8%	15
Georgia	6.6%	16	7.9%	16
Utah	6.7%	17	8.0%	17
Colorado	6.8%	18	7.7%	14
Indiana	6.8%	19	8.3%	21
Texas	6.9%	20	8.2%	19
Pennsylvania	7.1%	21	8.3%	20
Missouri	7.1%	22	8.4%	24
New York	7.1%	23	8.9%	27
Michigan	7.2%	24	8.4%	22
Alaska	7.2%	25	7.2%	12
North Dakota	7.3%	26	8.4%	23
Florida	7.4%	27	8.7%	26
New Jersey	7.5%	28	9.2%	31
California	7.7%	29	10.0%	35
Idaho	7.7%	30	9.1%	30
Vermont	7.8%	31	9.0%	29
Massachusetts	8.2%	32	9.7%	34
Nevada	8.2%	33	8.9%	28
North Carolina	8.6%	34	10.2%	36
Oklahoma	8.8%	35	10.5%	38
Arkansas	8.9%	36	10.5%	39
South Carolina	8.9%	37	9.5%	33
Connecticut	8.9%	38	9.4%	32
Arizona	9.3%	39	11.0%	42
Washington	9.4%	40	12.4%	47
Nebraska	9.4%	41	10.2%	37
West Virginia	9.7%	42	10.9%	41
Alabama	9.7%	43	11.0%	44
Mississippi	10.2%	44	10.8%	40
Tennessee	10.3%	45	11.8%	45
Hawaii	10.8%	46	11.0%	43
Louisiana	11.1%	47	12.0%	46
Kansas	11.2%	48	12.5%	48
Rhode Island	11.5%	49	13.4%	49
District of Columbia	16.6%	50	16.7%	50
New Mexico	16.6%	51	17.9%	51
50-state mean	7.9%		9.1%	
50-state median	7.3%		8.7%	