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STATE CORPORATE TAX SHELTERS AND THE NEED FOR "COMBINED REPORTING"

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Executive Summary

A growing number of states are adopting or considering a key corporate tax reform known as "combined reporting." Most large corporations consist of a parent corporation and its subsidiaries; combined reporting effectively treats the parent and most or all of its subsidiaries as a single corporation for state income tax purposes.

Almost half the states with corporate income taxes have adopted combined reporting. Five states have enacted the reform in the last three years, and several others have seriously considered doing so. A major reason for states' growing interest is their recognition of how badly corporate tax shelters that exploit the lack of combined reporting are eroding state corporate tax payments. Corporations have devised a wide variety of strategies to artificially shift profits to out-of-state subsidiaries. Combined reporting largely negates these strategies by enabling the state to tax a fair share of the profit shifted into a related, out-of-state corporation.

This report discusses some of the corporate tax-avoidance strategies to which non–combined reporting states are most vulnerable and explains how combined reporting can help a state preserve a strong and fair corporate income tax.

KEY FINDINGS

- To shore up their eroding corporate income taxes, an increasing number of states are adopting a policy known as "combined reporting." Combined reporting treats a business composed of a parent corporation and one or more subsidiaries as a single corporation for tax purposes.
- States without combined reporting are vulnerable to a wide variety of corporate tax shelters and tax-avoidance strategies that are based on artificially shifting profits to subsidiaries located in "tax-haven" states.
- Combined reporting nullifies most of these shelters in one fell swoop. Attacking them one by one, as some states are doing, is inefficient and costly. Moreover, some of the strategies simply cannot be shut down effectively by any policy other than combined reporting.

Reform Nullifies Three Common Tax Shelters

Three of the most common state corporate tax shelters rely on the creation of subsidiaries that are expressly or effectively exempt from corporate income taxes in the states in which they are formed. The types of subsidiaries are:

- **Passive investment companies (PICs).** PICs are set up to manage — and collect income from — intangible assets such as corporate trademarks, patents, stocks, and bonds. PICs are most often formed in Nevada and Delaware. Nevada has no state corporate income tax, and Delaware exempts from its state corporate income tax a corporation with income arising only from the ownership of intangible assets.

- **Real Estate Investment Trusts (REITs).** REITs are set up to manage — and collect income from — real estate and related financial instruments (such as mortgage loans). Under federal and state tax law, a REIT can deduct from its taxable income the dividends it pays to shareholders — which means it is effectively tax-exempt. Most REITs are owned by thousands of shareholders and serve their intended goal of being the real-estate equivalent of a stock or bond mutual fund. However, they can also be used as a state tax shelter when they take the form of "captive REITs" effectively owned by a single corporation.

- **Captive Insurance Companies ("captives").** A captive insurance company is a subsidiary set up by a corporation to insure the corporation against risks such as the loss of a product liability lawsuit. In most states, captives — like regular insurance companies — are exempt from state corporate income tax, which means their investment income is not taxed at all. In contrast to PICs and captive REITs, which clearly are established primarily as tax shelters, captives are often set up for legitimate self-insurance purposes, with the potential for tax sheltering a secondary benefit.

There are two basic ways in which corporations use these three kinds of subsidiaries to shelter corporate profits from state income taxation in states that do not have combined reporting:

- **Shifting taxable profits into a tax-haven subsidiary.** This happens when the operational part of the corporate group pays the subsidiary for the right to use assets such as real estate or a trademark. This payment is tax deductible, so it reduces the taxable profit of the operational part of the corporate group. In addition, the resulting profit for the subsidiary is not taxed by the state in which the subsidiary is located, either because that state has no corporate income tax or because the state exempts that particular form of subsidiary from the tax.

  For example, as recently described in the *Wall Street Journal*, Wal-Mart has transferred the ownership of its stores to a subsidiary that qualifies as a REIT. The parent corporation pays rent to the REIT for the right to use the stores, which reduces the taxable profit of stores located in non–combined reporting states. Wal-Mart saved *$350 million* in state corporate income taxes over the four-year period from 1998 to 2001 on $7.3 billion in rent paid by Wal-Mart and Sam's Club stores to the company's REIT, according to accountants consulted by the *Journal*.

- **"Stashing" corporate assets that earn income from outside the corporation.** In addition to using PICs, REITs, and captive insurance companies to artificially shift income *within* the corporate group, corporations also use these entities as a place to stash a variety of assets that earn income from *outside* the corporate group.

  For example, banks widely use PICs to keep income-earning assets away from taxation by non–combined reporting states. One such state, Wisconsin, has engaged in a four-year effort to force its in-state banks to pay taxes on assets they have "parked" in Nevada subsidiaries. The Wisconsin Department of Revenue believes that at least 250 of the state's 320 banks have Nevada PICs; thus far, it has reached settlements with 180 of them, collecting approximately $42 million in back-tax payments.

  Similarly, a recent *Business Week* article highlighted Apple Computer's creation of a Nevada subsidiary to manage its $8.7 billion portfolio of cash and other "liquid" assets. Also, Microsoft's recent annual report to the Securities and Exchange Commission names 11 separate subsidiaries in Nevada, with names like "Microsoft Treasury, Inc." and "Microsoft Investments, Inc." — strongly suggesting that at least some of them are PICs.

A properly conceived and drafted combined reporting law would nullify such uses of these subsidiaries to avoid state income taxes. Combined reporting eliminates the tax benefit of artificially shifting income into one of these entities because it counts the subsidiary's income in the calculation of the corporation's total income, of which the state can then tax its appropriate share.

Reform Also Effective Against Other Tax-Avoidance Strategies

One of the most basic strategies corporations use to minimize their income tax liability is to "wall off" as much of the corporation's profit as possible in a subsidiary that is not taxable in the state(s) where the subsidiary's customers are located. This is known as "nexus isolation." ("Nexus" is a legal term that means "engaging in sufficient activities in a state to become subject to a tax in that state.")

Manufacturers are particularly well positioned to engage in nexus isolation. They can take advantage of a little-known federal law that sets a nexus threshold for state corporate income taxes. The law bars states from taxing the income of out-of-state corporations if the firms limit their activities within the state to "solicitation of orders."

Ordinarily, if a manufacturer repairs its products at the customers' locations, supervises installation of the products, or trains its customers' employees in how to use them, these activities would "create nexus" for the manufacturer in its customers' states and subject a share of its profits to taxation in each one. Because of the federal law, however, the manufacturer has another option. It can create a subsidiary to conduct such activities in its customers' states, while limiting the activities of the parent corporation in these states to soliciting orders. The customers' states will now be able to tax the (likely nominal) profits of the subsidiary, but the vast bulk of the corporation's profits — those derived from the *sale* of the products — will have been walled off in the parent corporation, which the customers' states cannot tax.

A widely used handbook on multistate corporate income tax laws recommends this nexus isolation strategy:

> When nexus is created by sales representatives performing repair and maintenance services in the state, one strategy would be to separately incorporate the sales division that operates in the state. This would prevent a nonunitary state [i.e., one without combined reporting] from taxing the profits attributable to the parent corporation's out-of-state assets and activities. . . .

Combined-reporting states are much less vulnerable than other states to this form of corporate tax avoidance. Once a combined-reporting state has nexus over one subsidiary in a corporate group, the subsidiary must calculate its tax on the basis of the corporate group's *combined* profit. This eliminates much of the tax savings from isolating profits in out-of-state subsidiaries, since those profits are added back into the taxable base of the in-state entity — of which the state then taxes its fair share.

Combined reporting also counters a related tax-avoidance strategy called "transfer pricing," in which a parent corporation sells its products to an out-of-state subsidiary, which in turn sells them to the final customers. If the parent does no more than solicit orders from its own subsidiary, it is not taxable in the state in which the subsidiary is located. Moreover, the parent has substantial leeway to manipulate the prices (called "transfer prices") at which it sells its products to the subsidiary in order to minimize its nationwide state corporate tax liability.

For example, if corporate taxes are higher in the state where the manufacturing plant is located than in most states where customers are located, the corporation can set the transfer price at an artificially low level. This will reduce the corporation's overall state income tax bill by shifting part of the corporation's profits from a higher-tax state (where the manufacturing plant is located) to lower-tax states (where the subsidiaries are located).

In combined-reporting states, however, corporate manipulation of transfer prices does not affect state corporate tax revenues. Since the profits of a corporation's components are added together to determine the corporation's taxable base, the allocation of those profits within the corporation is irrelevant.

Combined Reporting More Effective Than Attacking Tax Shelters Individually

Some non–combined reporting states have tried to challenge the tax-avoidance strategies discussed above with *ad hoc* litigation based on general anti-tax-avoidance language in their statutes. Other states have enacted targeted legislation to close these shelters individually. Such approaches can be useful stop-gaps, but they are inferior to combined reporting for a number of reasons:

- Case-by-case litigation and settlement negotiation is both labor intensive and time consuming.
- Some of the targeted anti–tax shelter legislation as drafted contains loopholes or may be vulnerable to legal challenges.
- Corporations can hire the best legal and accounting talent in the country and are likely to

remain one step ahead of state tax administrators in formulating tax-avoidance techniques.

- Most importantly, some tax-avoidance strategies can only be addressed effectively by combined reporting. For example, there is no practical alternative to combined reporting to address nexus isolation and transfer pricing; non–combined reporting states are effectively defenseless against them.

Combined reporting is not a panacea for the erosion of the state corporate income tax. Some combined-reporting laws themselves contain loopholes, and most combined-reporting states are vulnerable to tax shelters formed outside the United States. Nonetheless, many large and small states alike have used combined reporting successfully for decades, and the U.S. Supreme Court has twice upheld its legality. Thus, while taxing the profits of sophisticated multistate corporations will always be challenging, combined reporting is a critical element in maintaining a fair and effective state corporate income tax.

Introduction

In 2007, West Virginia, New York, and Michigan became the nineteenth, twentieth, and twenty-first states to enact an important state corporate income tax reform known as "combined reporting." Combined reporting (CR) addresses the fact that most large corporations are actually multi-corporate groups composed of a parent corporation and one or more subsidiary corporations owned by the parent. Combined reporting effectively treats such a multi-corporate group as a single corporation for state income tax purposes, requiring that the profits of the parent and most or all of the subsidiaries be added together in the calculation of the corporation's profit. The state then taxes a share of the combined profit using an apportionment formula that compares the corporation's activities in the state to its activities in other states. (The measures of activity typically are the corporation's property value, payroll, and sales.)

Sixteen states have mandated combined reporting for at least two decades. Vermont enacted the policy in 2004, and it went into effect there in 2006. New York enacted a CR law in April 2007, retroactive to the beginning of the year. Texas and West Virginia will implement combined reporting in 2008 and 2009, respectively. Combined reporting is also included in a newly-enacted "Michigan Business Tax" that will go into effect in 2008 as well. This leaves 24 states and the District of Columbia with corporate income taxes that do not require combined reporting; they often are referred to as "separate entity" states.[1]

There are several reasons why an increasing number of states are giving serious consideration to this important policy option. Probably the most significant of these is a growing recognition that states that do *not* mandate combined reporting are vulnerable to a variety of corporate tax-avoidance strategies. Most of these strategies involve subdividing the corporation into multiple entities, locating one or more of these affiliated corporations in states that are beyond the tax reach of the non-CR state, and then having the corporation that *is* taxable in the non-CR state engage in artificial transactions with its non-taxable, out-of-state affiliates. These transactions shift taxable profits out of the non-CR state and into states in which they will be taxed at a lower rate — or, often, not at all.

Several states without combined reporting have recently enacted laws aimed at nullifying particular tax shelters. Others have taken advantage of general statutory authority they have to address abusive tax shelters by initiating enforcement actions against specific corporations. (Often these actions are followed up by a broad offer to negotiate settlements with all companies that may have used a specific shelter.) These approaches can be useful stop-gaps to arrest a hemorrhaging of state corporate income tax receipts. They are becoming increasingly untenable, however, as well-trained and highly compensated corporate tax attorneys and accountants continue to devise new — and increasingly aggressive — strategies to reduce state corporate tax payments. Resource-constrained state revenue departments are likely to remain at least one step behind sophisticated multistate corporations in recognizing and responding to new tax shelters.

This report describes some of the major tax shelters and "tax planning" strategies (an often preferred euphemism) that private-sector tax experts have devised to reduce corporate tax payments to non–combined reporting states. Some of these techniques are transparent and widely known; others have become public only as states have used various *ad hoc* approaches to try to invalidate them. A few tax shelters have come to light in marketing materials prepared by accounting firms to interest potential clients in them. What all of the following tax-avoidance strategies have in common is that they could be largely or completely nullified by combined reporting.

Tax-Avoidance Strategy #I: Passive Investment Companies (PICs)

Probably the best known and most widely used state corporate tax shelter is the so-called "Delaware Holding Company" or "passive investment company" (PIC).[2] In this strategy, a corporation transfers ownership of its trademarks and patents to a subsidiary located in a state that does not tax royalties, interest, or similar types of "intangible income." The subsidiary charges 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, so it reduces the corporation's profits in the states in which it is taxable. Moreover, the PIC often loans its "profits" back to the rest of the corporation, which can then reduce its taxable profits further by taking a tax deduction for the interest it pays on the loan.

PIC subsidiaries are most often established in Delaware and Nevada, the former because it has a special income tax exemption for corporations whose activities are limited to owning and collecting income from intangible assets and the latter because it has no corporate income tax at all.[3]

How Prevalent Are PICs?

It is not possible to obtain a comprehensive picture of how much otherwise taxable profit is being shifted into tax-haven states through the use of PICs, because the information is confidential. Corporations do not have to identify particular subsidiaries as PICs or publicly disclose payments of royalties and interest to affiliated corporations. However, data gleaned from court cases in which PIC arrangements have been challenged by states suggest that the sums involved may be substantial:

- The Delaware PIC of Toys "R" Us received $55 million in royalty and other passive income in 1990 by charging the company's stores for the use of the Toys "R" Us name, trademarks, and "merchandising skills."[4]

- The Delaware PICs of the Limited / Victoria's Secret / Lane Bryant / Express retail conglomerate earned $949 million in royalty income between 1992 and 1994 by licensing the companies' trademarks back to the stores.[5]

- Kmart's Michigan PIC earned $1.25 billion in royalty income between 1991 and 1995 in the same way.[6] (Michigan's recently-repealed Single Business Tax, its alternative to a corporate income tax, exempted intangible income.)

In other words, just three corporate groups — out of thousands doing business in the United States — have been shifting roughly $750 million annually into their trademark subsidiaries located in tax-haven states. States typically tax corporate profits at a top rate of around 6-8 percent, so every $100 million in profits shifted to tax-haven states represents $6-8 million in lost tax revenue.

The above cases cover tax years from more than a decade ago; the revenue losses are undoubtedly much larger today. An even more aggressive use of a PIC, with an even larger adverse impact on state revenues, was revealed in a 2004 court case involving the now defunct telecommunications / Internet company MCI-Worldcom.[7] (See the text box on the next page.)

A wide variety of financial, law, accounting, and consulting firms have made a major business of helping out-of-state corporations set up and operate PICs in Delaware and Nevada. Striking evidence of how little economic substance many Delaware PICs appear to have is the fact that more than 700 corporate "headquarters," including the PICs of British Airways, Colgate-Palmolive, General Electric, Ikea, Nabisco, Pepsico, and Shell, were located on five floors of a single Wilmington office building when a reporter investigated back in 1996.[8]

Thanks to the ready availability of "brass nameplate" headquarters like these, PICs can provide enormous state corporate income tax savings at a very small cost.[9] As of the end of 1998, approximately 6,000 PICs had been incorporated in Delaware alone, with new ones being created at a rate of 600-800 per year.[10] Several years ago it was revealed that approximately 132,000 businesses incorporated in Nevada have *no employees whatsoever;* many of these could be PICs.[11] A 2002 front-page *Wall Street Journal* article on PICs named almost 50 corporations that had been involved in litigation with states regarding their use of PICs. (See the text box at right.) A more recent listing by tax officials in Maryland identified an additional six companies with PICs.[12] New examples regularly trickle out of state court proceedings.

Which Corporations Are Known To Have PIC Subsidiaries?

A 2002 *Wall Street Journal* article identified almost 50 corporations that have been involved in litigation with states regarding their use of PICs. The article observes that "in every case, the companies contend they haven't violated state tax laws or regulations." The companies are:

Aaron Rents
ADP, Inc.
American Greetings Corp.
Beatrice
Budget Rent-a-Car Corp.
Burger King
CompUSA
ConAgra Foods, Inc.
Crown Cork & Seal
Dover Elevator
Dress Barn
Eaton Admin Corp.
Gap, Inc.
Gore Industries
Hologic, Inc.
Home Depot USA
Honeywell International, Inc.
J.P. Stevens and Co.
Kimberly Clark Corp.
Kmart Corp.
Kohl's
Lamb Weston, Inc.
Long John Silver's
McCormick & Co.
Mallinckrodt Medical
Marsh Supermarkets, Inc.
Marsh Village Pantries, Inc.
May Dept. Stores
Novacare
Payless Shoesource, Inc.
PF Brands, Inc.
Premark FEG Corporation
R. Scientific Products
Radio Shack Corp.
Sherwin Williams
Snap on Tool
Sonoco Products Co.
Stanley Works
Staples
Sunglass Hut International, Inc.
Syms
The Limited Brands
TJX Cos.
Toys "R" Us
Tyson Foods, Inc.
United Refrigeration of Del.
Urban Outfitters
Yellow Freight System
York International

Source: Glenn R. Simpson, "A Tax Maneuver in Delaware Puts Squeeze on Other States," *Wall Street Journal*, August 9, 2002, page A-1.

Worldcom: Setting a New Standard in the Aggressive Use of PICs

On the heels of a $9 billion accounting fraud that came to light in 2001, the telecommunications/Internet company Worldcom filed for bankruptcy in 2002. Bankruptcy court filings revealed that the company had set a new standard in the aggressive use of a PIC to avoid state corporate income taxes. At the suggestion of the accounting firm KPMG, Worldcom implemented a corporate restructuring in which its subsidiaries paid $19.4 *billion* in tax-deductible royalties to a new Delaware PIC in the three-year period from 1999 through 2001. The "asset" that the subsidiaries obtained the right to use in exchange for their royalty payments was the "management foresight" of the corporation's top executives.

That Worldcom subsidiaries would pay sums of that magnitude for the "foresight" of a senior management team that led the company into what was — and even after Enron, remains — the largest corporate bankruptcy in U.S. history is only one element of the corporation's egregious tax-avoidance behavior. A report issued by former Pennsylvania governor Dick Thornburgh at the request of the bankruptcy court also found that:

- In seeking key private legal rulings from the Mississippi and District of Columbia tax agencies, Worldcom misled these agencies, as well as its own in-house intellectual property attorneys, into thinking that the royalty payments were for the use of the company's trademarks.
- The subsidiaries took deductions for the royalty payments even though no payments were actually made.
- The royalties far exceeded the total profits of the overall Worldcom corporate group.

Thornburgh concluded that the tax-avoidance scheme was legally flawed at its core because there was no "persuasive legal authority that 'management foresight' is an intangible asset for which royalties may be charged."

Thornburgh estimated that on a national basis, the company would have saved $100-350 million in state corporate income taxes from the strategy had it not come to light. Instead, 15 states and the District of Columbia jointly sued the company and, in a settlement prior to trial, recovered $315 million in taxes, penalties, and interest. In a separate settlement with Mississippi, where Worldcom was headquartered, the company forfeited an additional $118 million. *None of the states in the settlement had implemented combined reporting.* The combined-reporting states quickly concluded that they had lost no corporate income tax revenue as the result of what Worldcom had done.

Worldcom appears to be the only publicly revealed case in which corporations paid royalties to a PIC for the use of "management foresight." However, given that the company was sold on the plan by an accounting firm that has also settled with the IRS on charges that it aggressively marketed illegal *federal* income tax shelters to corporations and individuals, it seems quite possible that other corporations implemented the same strategy. The public is unlikely ever to learn this, however. Given the enormous settlement that Worldcom was forced to enter into, other companies are likely to capitulate to state demands for additional payments before the cases get into court — assuming the states uncover the schemes before statutes of limitations run out.

Although the states pursued a highly effective coordinated strategy that ultimately stripped Worldcom of most or all of its fraudulent gains, it is not reassuring that Worldcom's scheme was uncovered by the bondholders of one of its subsidiaries and not state tax auditors. Had Worldcom not gone into bankruptcy, its PIC might never have come to light. The states that recovered their tax revenues by suing Worldcom would have been far better protected had they implemented combined reporting.

A 2007 court case in New York, for example, revealed that the Talbot's clothing store chain also has a PIC.[13]

Targeted Attacks on PICs vs. Combined Reporting

A number of states have sought to nullify PIC-based tax avoidance with strategies other than combined reporting. For example, about a dozen states have enacted legislation that disallows deductions for royalty and interest payments to related corporations — including PICs. However, many of those bills were so watered down in the legislative process by business objections that their effectiveness is in question; the answer will not be known for several years, until state corporate tax audits covering the years after the laws went into effect reveal whether corporations have stopped deducting their royalty payments to their PICs as the laws require.[14] Moreover, some of this targeted anti-PIC legislation may be subject to legal challenge; a test case in Alabama already went against that state. Several articles have been written by corporate tax attorneys advising their clients on how to attack these laws on the grounds that they discriminate against interstate commerce.[15]

Other states have sought to nullify PICs by asserting that the PIC itself is taxable in any state in which a trademark it owns is used. While the states have had a fairly good track record in sustaining this assertion in their own courts, multistate corporations continue to argue that these cases were wrongly-decided. The U.S. Supreme Court has never accepted one of these state court decisions for review. In the absence of a Supreme Court decision, it is possible that many corporations (other than the ones that lost the cases) would not comply with the state court rulings. Moreover, federal legislation has been introduced to reverse these state court decisions.[16]

In contrast, the U.S. Supreme Court has twice upheld the fundamental fairness and constitutionality of combined reporting.[17] Given that the principal alternative strategies for addressing the PIC problem are still subject to legal challenge, state reliance on them in lieu of combined reporting seems questionable.

Another Use for PICs: Isolating Assets That Earn Outside Income

Corporations use PICs in a second way to reduce state taxes. If a corporation has intangible assets that are earning income from *outside* the corporation, it can transfer those assets to a PIC to shield the income from taxation by non–combined reporting states.

Financial institutions are particularly likely to use PICs in this manner. Banks make direct loans to households and corporations and invest in interest-earning financial instruments like mortgage-backed securities and federal treasury bills. These intangible assets can be transferred to a PIC in Delaware or Nevada, which will not tax the interest income. If the rest of the corporate group needs that interest income, the PIC can loan it to its parent or sister corporations, which enables the parent to shift additional profits to the PIC in the form of tax-deductible interest paid on the loan. Alternatively, the parent can have the PIC pay it a dividend; generally the dividend will qualify for a substantial tax deduction, so most or all of the dividend income to the parent will not be taxed.

This "asset isolation" strategy deprives non–combined reporting states of their legitimate right to tax the income arising from the PIC's intangible property. In the case of a bank, for example, the state allowed the bank to deduct its employees' wages, the depreciation on its buildings, and the

“Apple Takes Its Bankroll to Reno”

Evidence suggests that banks and other financial institutions are the primary types of corporations that use Nevada and Delaware PICs to minimize their income tax payments in non–combined reporting states through asset isolation. Nonetheless, any corporation with substantial financial or other “intangible” assets (such as trademarks and patents) can benefit from this strategy. *Business Week* has reported that Apple Computer set up a Nevada subsidiary to manage the investment of the company’s cash and other “liquid” assets — estimated at the time at $8.7 billion. The article noted that “Nevada has no corporate income tax, no capital-gains tax, and the state doesn’t share information with the U.S. Internal Revenue Service” and asks, “Where better to manage at least part of [Apple’s] cash, than in Nevada?” (Arik Hesseldahl, “Apple Takes Its Bankroll to Reno,” *Business Week*, April 5, 2006.)

Apple’s fiercest competitor, Microsoft, may be engaged in the same tax-avoidance strategy. Its 2006 annual report to the Securities and Exchange Commission lists 11 separate subsidiaries incorporated in Nevada. Many of their names are suggestive of passive investments, such as Microsoft Treasury, Inc., Microsoft T-Holdings, Inc., Microsoft Investments, Inc., and Microsoft Capital Group, L.P.. (Perhaps motivated by a desire to make state tax-avoidance goals less transparent, Microsoft’s *2007* SEC report changes the location of incorporation for these subsidiaries from “Nevada” to just “United States.”)

Apple’s and Microsoft’s investment pools are likely much larger than what they need for “working capital,” and therefore earnings on a large share of the assets may not be taxable even by combined reporting states; the Supreme Court has held that the asset must be used in the general operations of the business in order to be included in the “apportionable income” of the corporate group. Nonetheless, non-combined reporting states are unable to tax *any* of the earnings from financial assets stashed in tax havens — an unnecessary and avoidable loss of revenue.

interest it paid to its depositors from the bank’s income in calculating its corporate income tax liability. Yet the PIC scheme prevents the state from taxing some of the corporate profits that those expenses help generate. The intangible assets isolated in the PIC are part and parcel of the bank’s overall operation, and any state in which the bank is located should be able to tax a fair share of its total income — including the income of the PICs.[18]

Unlike the trademark PICs discussed in the previous section, there has not been a great deal of litigation by non–combined reporting states against corporations employing PICs for asset-isolation purposes. Accordingly, it is difficult to discern just how widespread this strategy is.

However, evidence from Wisconsin suggests that financial institutions broadly employ this tax-reduction strategy. After the Wisconsin legislature rejected Governor Tommy Thompson’s 1999 recommendation that the state mandate combined reporting, the Wisconsin Department of Revenue initiated a systematic, multi-year effort to investigate and nullify the use of PICs by the state’s banks. That effort is still going on. Already, the state has entered into settlements with 180 banks and collected approximately $42 million in back-tax payments. The state estimates that up to 80 percent of the 320 banks doing in business in the state may have Nevada or Delaware PICs.[19]

Prior to the state crackdown, the use of PICs had had a significant adverse impact on Wisconsin corporate income tax collections. According to the *Capital Times*, the tax liability of Wisconsin banks fell by 44 percent between 1996 and 2000.[20] Wisconsin is the only state in which it is possible to find out exactly how much income tax a particular corporation paid to the state in a particular year, and the *Capital Times* reported in 2003 that:

> As a result [of the use of Nevada-based PICs], many of the largest banks in Wisconsin no longer pay taxes at all. . . . Records show 11 of the state's 15 largest banks — including M&I Marshall & Ilsley Bank of Milwaukee, Associated Bank of Green Bay and First Federal Savings Bank of La Crosse-Madison — paid no Wisconsin corporate income tax in 2000.[21]

There is little evidence that non–combined reporting states other than Wisconsin have ever taken concerted action to nullify asset isolation.[22] While trademark PICs often are clearly created solely for tax-avoidance purposes, the intangible assets isolated in the PIC generate income from "arm's-length" transactions at market rates with independent third parties. As a result, most non–combined reporting states have little discretionary legal authority with which to address this tax-avoidance scheme. Moreover, the royalty and interest deduction disallowance laws that states like Maryland and Massachusetts have enacted do not nullify PICs used for asset isolation, because the tax shelter does not involve income-shifting within the corporate group. In short, until they require combined reporting, most states will likely remain almost completely defenseless against the use of PICs for asset isolation.[23]

Even if other non–combined reporting states consider following Wisconsin's lead, the challenges are daunting. Case-by-case negotiation or adjudication of such disputes is labor-intensive and costly. It has taken Wisconsin almost four years to reach settlements with slightly more than half the banks doing business in the state. Moreover, some banks are still challenging the state's legal authority to tax the income of their Nevada PICs; a state defeat in a single court case could undo all those settlements, at least with respect to future tax years.[24] Again, the adoption of combined reporting would appear to be the more cost-effective and legally-sustainable approach to nullifying asset-isolation PICs.

Tax-Avoidance Strategy #II: Captive Real Estate Investment Trusts (REITs)

A new corporate tax shelter analogous to PICs has come to light only in the past few years. Known as the captive Real Estate Investment Trust or captive REIT (pronounced "reet"), it received widespread public attention when its use by Wal-Mart was described in a front-page *Wall Street Journal* article in February 2007.[25]

REITs are a special type of business authorized under federal law. Their original purpose was to enable individuals to invest in a broad, professionally selected and managed portfolio of real estate projects, just as mutual funds facilitate investment in a broad portfolio of stocks. REITs can only invest in real estate and related assets (such as mortgage loan pools), they must have at least 100 investors, and they must annually pay out at least 90 percent of their earnings to their investors. If a business qualifies as a REIT, it may deduct from its taxable income the dividends it pays to its investors each year; if it pays out all of its income, it has no corporate income tax liability. (Instead, the dividends represent taxable income to the REIT's investors.) States generally afford the same tax treatment to REITs that the federal government does.

How Captive REITs Shelter Corporate Profits

REITs can be an effective state corporate income tax shelter. A corporation can create a subsidiary that qualifies as a REIT, transfer ownership of real-estate assets to the REIT, then lease

Captive REITS Are Also Used for Asset Isolation

Like PICs, captive REITs can be used both to shift income from the operational part of a corporation into a subsidiary in a tax-haven state like Delaware or Nevada, and to isolate in such a subsidiary assets that earn income from transactions with outside businesses.

As was the case with PICs, banks appear to be the type of corporation most likely to use captive REITs for asset isolation. There are numerous reasons why. For example, many states tax the interest an out-of-state bank receives from a mortgage loan made in the state, since in-state property serves as security for the loan. But if the bank transfers this mortgage to a captive REIT, the earnings on the loan will not be subject to tax by the state (assuming the state conforms to the federal tax treatment of REITs). The REIT's dividend payments back to its parent bank may not be subject to tax either, if, for example, the state in which the bank is located has failed to close the dividends-received loophole described in the body of this report.

Massachusetts has devoted substantial resources to nullifying the use of REITs by banks, settling cases with more than 50 of them and litigating two major cases with BankBoston and Fleet Funding. Even though the state settled for only 50 percent of the taxes in dispute, the settlements reaped $110 million. An additional $46 million is at stake in the Fleet Funding case, which the state won in August 2007 but which may be appealed.

The litigation revealed that the captive REIT was marketed to Massachusetts banks by the accounting firm KPMG. Accordingly, it seems likely that other states continue to suffer revenue losses from banks' use of this same tax-avoidance vehicle. A 2004 article in an Annapolis, Maryland newspaper, for example, discussed an application to state banking regulators by a major Maryland bank, Provident, to set up a Delaware REIT subsidiary.

Charles Stein, "The Selling of a State Tax Loophole," *Boston Globe*, April 17, 2003; Scott Bernard Nelson, "Mass. Banks Pay $110m to Settle Dispute with State over Back Taxes," *Boston Globe*, June 25, 2003; Kathleen Johnston Jarboe, "Delaware Tax Break Appeals to Provident," *Daily Record*, January 6, 2004.

the use of this real estate back from the REIT in exchange for the payment of tax-deductible rent.[26] This enables the corporation to siphon profits out of its operational arm and into the REIT, which is effectively tax-exempt. (To satisfy the requirement that a REIT have at least 100 investors, the corporation can provide at least 99 managers of the corporation with at least one share of non-voting stock.)

Such a shelter is called a "captive" REIT because the REIT is effectively owned and controlled by a single corporation, not individual investors. It is also called a "rental REIT" because the payment of rent is the basic mechanism of tax-avoidance.

As noted above, a REIT must pay out at least 90 percent of its earnings as dividends to its owners. For federal tax purposes, those dividends are fully taxable to the recipient, because Congress has made dividend payments from REITs to other corporations *ineligible* for the "dividends-received deduction," which effectively exempts most dividends paid from one corporation to another from the federal corporate income tax. However, a significant number of states have failed to follow Congress in enacting that exception to the dividends-received deduction. This loophole means that the income earned by the REIT goes completely untaxed in many states.

In states that *have* closed this loophole, corporations can still salvage some tax savings by adding another layer of avoidance: combining a REIT with a Delaware or Nevada PIC. Rather than own the REIT directly, the corporation sets up a subsidiary in Delaware or Nevada that in turn owns the REIT. The REIT's dividends to the subsidiary are untaxed because of Delaware's special PIC exemption or Nevada's lack of a corporate income tax. When the subsidiary in turn pays out those dividends to the corporation, they are *no longer taxable dividends from a REIT;* instead they are now dividends from an ordinary corporation, generally eligible for a 100-percent dividends-received deduction. There is no evidence that any states that lost revenue through this strategy have made any attempt to characterize these dividends as effectively (if not technically) REIT dividends and thus subject to tax.

Combined Reporting Is the Best Response to Captive REITS

To date, state court cases have identified only two corporations using captive *rental* REITs to avoid state taxes. The first case was brought by Louisiana several years ago against the Autozone auto-parts store chain. The more recent case involved Wal-Mart.[27] As recently described in the *Wall Street Journal*, Wal-Mart has transferred the ownership of its stores to a subsidiary that qualifies as a REIT. The parent corporation pays rent to the REIT for the right to use the stores, which reduces the taxable profit of stores located in non–combined reporting states. Wal-Mart saved an estimated $350 million in state corporate income taxes over the four-year period from 1998 to 2001 on $7.3 billion in rent paid by Wal-Mart and Sam's Club stores to the company's REIT, according to accountants consulted by the *Journal*.[28]

As with all state corporate tax shelters, the prevalence of captive REITs is unknown. New examples are likely to come to light because of the awareness among state tax officials and auditors generated by the *Wall Street Journal* article and an educational effort initiated by the Multistate Tax Commission, an organization of state revenue departments. A few non–combined reporting states, including Maryland and Kentucky, have already enacted targeted legislation aimed at nullifying corporate tax savings from captive REITs.

The Wal-Mart case suggests, however, that states would be well-advised to address corporate tax shelters through the comprehensive approach of combined reporting rather than a case-by-case approach. Wal-Mart set up its rental REIT just as it was unwinding its conventional trademark PIC, likely because the latter had become a red flag for state auditors. This suggests that private-sector accountants and attorneys are likely to remain one step ahead of non–combined reporting states in devising effective state tax-avoidance mechanisms. A properly structured combined-reporting law will nullify captive REITs and many other tax-avoidance strategies that rely on shifting profits within a multi-corporate group by ensuring that such shifts have no effect on the group's total tax liability.

Tax-Avoidance Strategy #III: Captive Insurance Companies

An increasing number of large corporations are establishing subsidiaries to accumulate assets needed to insure themselves against a variety of risks, such as major property damage or losses in product liability lawsuits. Such "captive insurance companies" are an alternative or supplement to buying insurance from independent insurance firms.

Most states exempt all insurance companies, including captives, from their corporate income taxes, instead imposing a low-rate tax on their gross income from insurance premiums. Therefore, an insurance company's income from its investments generally is not taxed. This is an important advantage: investment earnings typically comprise a large share of insurers' profits, since these companies must accumulate significant reserves with which to pay claims. (Banks, in contrast, have very similar types of investment earnings as insurers but *are* subject to corporate income taxes on them.) In short, the state tax treatment of insurance companies is quite favorable in comparison to that of regular corporations.

Moreover, a few states have sought to make themselves attractive locations in which to form captive insurance companies by taxing the premiums they receive at a much lower rate than premiums for regular insurance companies. For example, while most state premiums taxes range between 2 and 3 percent, the maximum premiums tax on captives in Vermont is below 0.5 percent, and a captive's total annual tax liability is capped at $200,000. Just as Delaware decided to turn itself into a tax haven for PICs by exempting income from intangible assets from its corporate income tax, Vermont turned itself into a tax haven for captive insurance companies by taxing them at an extremely low rate.[29]

From auditing corporations that have insurance subsidiaries, a number of states have concluded that some captives are being used as state corporate tax shelters. Corporations are employing the same income-shifting and asset-isolation strategies discussed above in connection with both PICs and REITs. Parent corporations are transferring to their captives more financial assets than are needed to pay expected claims — a practice sometimes referred to as "insurance stuffing." Because such asset transfers are considered capitalization or investment, not premium payments, they are not subject to even the low-rate premiums taxes imposed on such companies by states like Vermont. The earnings on such assets are not taxed either, as noted above. Moreover, a parent corporation can obtain the assets isolated in the captive when needed by having the captive pay a (generally tax-deductible) dividend back to the parent.

Interestingly, most of the litigation to date aimed at nullifying this tax shelter appears to have been initiated by combined-reporting states. Domestically, the captive insurance industry has sprung up only in the last 15 years, and states have been slow to recognize that automatically extending to captives the tax-exempt treatment they give regular insurance companies could significantly erode their corporate income tax receipts. Some states have now recognized the seriousness of this loophole and are taking legal or legislative action to close it. In the combined-reporting states, the state almost always bases its litigation on its authority to require the captive's profits to be added to the parent's profits in the calculation of the corporation's tax liability, notwithstanding the fact that the captive itself is not subject to the corporate income tax.

State Efforts to Stop the Use of Captives as a Tax Shelter

Kansas is a combined-reporting state with current litigation aimed at stopping the use of captives to avoid state taxes. The case involves Wendy's International, the fast-food restaurant operator and franchisor. Wendy's has transferred its trademarks to its Vermont captive insurance company and charges both the stores it owns and the stores owned by its independent franchisees a royalty equal to 4 percent of sales to use the trademarks. As of 2003, Wendy's was sheltering nearly $218 million annually in royalty income in its Vermont captive.[30] The royalty payments, which are tax-deductible expenses for the restaurants Wendy's owns, siphon some of Wendy's profits into the captive subsidiary. Wendy's also isolates in the captive insurer the royalty income that the company (legitimately) charges its franchisees.

Wendy's argues that because its insurance subsidiary is exempt from Kansas' corporate income tax, the captive should not be included in a combined report with the part of the corporate group that operates or franchises the restaurants. It seems likely that Wendy's also did not include its insurance subsidiary in the combined group in many other combined-reporting states.

Clearly, should Wendy's experience a major economic loss, the trademarks would not really be available to compensate for it. Selling them would effectively end the company's existence, precisely the outcome that insurance is intended to prevent. In short, the evidence strongly suggests that the goal of transferring the trademarks was avoiding state corporate income taxes, not self-insurance.

As with captive REITs, there has not been a great deal of state tax litigation involving captive insurance companies. In addition to the Kansas case, a longstanding case with Exxon is pending in Illinois. Illinois also won a case against Armstrong World Industries (maker of Armstrong flooring) in 2001 and settled a case in 2007 with Waste Management (a nationwide solid and hazardous waste disposal company). New Mexico had three cases against captive insurance companies as of 2004, one of which is still pending. Oregon successfully litigated a case in 1999.

Substantial potential exists for widespread use of captives to avoid state taxes. At least *560 major corporations* have captives in Vermont, including Wal-Mart, Starbucks, McGraw-Hill, Alcoa, Exxon, Microsoft, and Walt Disney. Hawaii had 154 captives as of mid-2005, South Carolina had 122, and Arizona and the District of Columbia each had more than 50.[31]

Some combined-reporting states, most notably California, have chosen to target abusive income-shifting directly, such as by restricting the amount of dividends that can be transferred tax-free from a captive back to its parent.[32] In California's case, this approach was largely dictated by a provision of the state's constitution that has been interpreted to bar the inclusion of a captive in its parent's combined group.

Other combined reporting states, however, have made clear that they wish to address the problem in the normal way, by combining the captive insurance subsidiary with its parent and sister corporations for tax purposes. The litigation in such states suggests a need to clarify state law to ensure that this can be done even if the captive itself is not subject to the state corporate income tax. Regardless of the solution chosen by combined-reporting states, it is clear that *non*–combined reporting states remain largely defenseless against the artificial shifting of profits by corporations into their captive insurance subsidiaries.

Tax-Avoidance Strategy #IV: Nexus Isolation

One of the most basic strategies corporations use to minimize their income tax liability in non–combined reporting states might be termed "nexus isolation."[33] "Nexus" is a legal term that means "engaging in sufficient activities in a state to become subject to a tax in that state." Nexus isolation happens when a corporation maximizes the amount of its activities that take place in a subsidiary that is not taxable (i.e., does not have nexus) in one or more states. The goal of nexus isolation is to "wall off" as much of the corporation's profit in a no-nexus, out-of-state subsidiary as possible; it does not necessarily entail any artificial shifting of income to the subsidiary (as is done with the trademark PICs and captive rental REITs discussed above).

Nexus isolation often relies on a federal law that is little known to the general public, and probably most state policymakers. Public Law 86-272, enacted in 1959, allows a corporation selling physical goods in a state to do so without creating corporate income tax nexus if its activities in the state are limited to "solicitation of orders." P.L. 86-272 can immunize a corporation from income taxation in a state in which it makes sales — even if those sales are substantial, even if the corporation has salespeople permanently in the state, and even if it delivers the orders with its own vehicles — as long as the corporation meets three requirements:[34]

- The in-state salespeople must limit their activities to "solicitation of orders" and very closely related pre-sale activities, such as demonstrating to the buying agent how a product works.
- The salespeople must work out of their homes or visit from out of state; there can be no company office for the sales force in the state.
- The corporation must ship goods to the customer from outside the state; it cannot have a warehouse or otherwise store the inventory it is selling in the state.

How Nexus Isolation Works

Some wholesale distributors, and many manufacturers, are able to take advantage of P.L. 86-272 to protect themselves from corporate income taxation in numerous states. Many such businesses can easily serve regional or even nationwide markets from a handful of warehouses and manufacturing plants by soliciting purchases from retailers, which in turn resell the goods to final customers.[35]

If a wholesaler or manufacturer can limit its activities in a particular state to soliciting orders for goods, and can fulfill those orders from an out-of-state warehouse or plant, it makes no difference whether that state requires combined reporting. The corporation is simply not taxable in the state due to P.L. 86-272.

However, many sellers cannot limit their activities in their customers' states to "solicitation of orders." For example:

- A small business or school system purchasing computers from a manufacturer may expect the company to link those computers in a local area network and provide on-site warranty repairs if necessary.
- A seller of a complex product, such as a medical imaging system or a new type of machine tool, may be expected to supervise installation of the product at its customer's facility and to train its customer's employees in how to use the product.

- A manufacturer might decide that it needs an in-state office for its sales force to work out of and an in-state warehouse from which inventory can quickly be delivered to customers.

In all of these examples, the activities of the corporation and its employees in the state go beyond "solicitation," so an apportioned share of the corporation's profit would be taxable in every state in which the corporation has customers. However, these corporations can avoid such taxation by forming a subsidiary to employ the people who do the work that must occur within the state(s) where the customers are located. For example, a manufacturer that felt the need to have an in-state sales office could form a wholesaling subsidiary to operate the office. The manufacturer would sell its output to the subsidiary, which would be the nominal reseller of the goods to the final customer.

To be sure, the states in which these activities occur could tax the profits of the in-state subsidiary. However, the profits associated with the sale of the manufactured goods themselves would be taxable only in the states where the manufacturing occurred due to careful conformity of the manufacturing arm with the requirements of P.L. 86-272. Even if the transactions between the in-state subsidiary and the out-of-state manufacturing plant occur at regular market (i.e., "arm's-length") prices, the vast majority of the profit likely would be retained by the manufacturing arm of the corporation, because manufacturing is likely to be much more complex and involve more proprietary, technical know-how than marketing-related functions.

The combination of P.L. 86-272 and corporations' almost unlimited discretion to divide themselves into parent and subsidiary entities places the corporate tax receipts of non–combined reporting states at substantial risk. Such arrangements often prevent states from taxing a fair share of the income of out-of-state manufacturers and wholesale distributors that are making profitable sales to customers within their borders. The above-described scenarios are common and perfectly legal, and there is little if anything non–combined reporting states can do to counteract them.[36] As a widely used handbook on multistate corporate income tax laws explains:

- "When nexus is created by sales representatives performing repair and maintenance services in the state [that is, activities not protected by P.L. 86-272], one strategy would be to separately incorporate the sales division that operates in the state. This would prevent a nonunitary state [i.e., one without combined reporting] from taxing the profits attributable to the parent corporation's out-of-state assets and activities."

- "[I]f a multistate corporation's only activity in a high-tax state is sales and distribution, which are often relatively low-margin activities, and if the high-tax state allows separate company returns [that is, it does not require combined reporting], the corporation may be able to insulate its out-of-state assets and activities from taxation in the high-tax state by forming a sales subsidiary that is responsible for marketing its products in the state."[37]

Corporations' Incentives for Nexus Isolation

While the preceding discussion demonstrates the broad *opportunity* corporations have to engage in nexus isolation in non–combined reporting states, the last quotation hints at the *motivation* corporations may have. There are at least three reasons why corporations may want to wall off a large share of their profits in a subsidiary that is taxable in only one or a few states, rather than in all of the states in which the corporation has customers.[38]

- **Tax-rate differentials.** As implied in the previous quotation, the corporate income tax rate in the state where the manufacturing occurs may be lower on average than the tax rates that apply in the states where the manufacturer's customers are located. Indeed, the tax rate in the manufacturing state may be zero. A manufacturer in Nevada (which has no corporate income tax) and substantial sales in New Mexico (which has a 7.6 percent top corporate income tax rate) has an obvious incentive to minimize the amount of its profit that it must report to the latter state.

- **Favorable apportionment formulas.** Even if the tax *rate* in the state where the manufacturing occurs is not advantageous, the state's apportionment formula may be such that the corporation can avoid income taxation of much — sometimes all — of its profit on sales made to out-of-state customers. (As noted in the Introduction, the apportionment formula determines how much of a multistate corporation's profit will be assigned to a particular state for corporate income taxation.)

  More than a dozen states have enacted "single sales factor" apportionment formulas, which only tax manufacturers in proportion to sales delivered to customers within their borders. Connecticut is one example. Thus, if all of a Connecticut manufacturer's customers are in New York and Massachusetts, the manufacturer will owe no corporate income tax whatsoever to Connecticut. If this manufacturer establishes nexus in New York and Massachusetts, 100 percent of its profit will be split for tax purposes between those two states, because both of them use the single sales factor formula as well. However, if the corporation can avoid establishing nexus in New York and Massachusetts, none of its profit will be subject to tax in *any* of the three states.

  If such a manufacturer must, because of the nature of its business, engage in some limited activity in its customers' states beyond "solicitation," it obviously has an enormous incentive to incorporate a subsidiary to conduct that activity. That will isolate virtually all of its profit in a manufacturing entity that will not be taxed by any of the three states in which it is doing business.[39]

- **Favorable tax incentives.** States often provide generous tax incentives for manufacturers. If, for example, a manufacturer has received a large investment tax credit, it may want to maximize the amount of profit it reports to the state in which the manufacturing occurs in order to be able to use the full value of the credit.

Combined Reporting as a (Partial) Solution to Nexus Isolation

Combined-reporting states are not as vulnerable to nexus isolation as other states are, and they can structure their corporate tax laws so that their revenues are not affected by nexus isolation at all. Once a combined-reporting state has nexus over one subsidiary in a corporate group, the state requires that subsidiary to calculate its tax by apportioning the combined profit of the corporate group of which it is a part.[40] That reduces the tax savings attributable to isolating profits in out-of-state subsidiaries without nexus, since those profits are added back into the taxable base of the in-state entity.

It should be noted, however, that the way a state's combined-reporting law is drafted will affect the degree of protection the state receives from nexus isolation. Three combined-reporting states — Arizona, Kansas, and Utah — take the sales of subsidiaries that do *not* have nexus within their borders into account in calculating the tax liability of subsidiaries that *do* have nexus.[41] Under such an approach (which California formerly used and was recently upheld in a court case in New York), nexus isolation has little if any impact on the corporation's tax liability in the state. In effect, the corporation's tax liability to the combined-reporting state is substantially the same as it would be if the corporation had organized itself as a single legal entity rather than as a parent with subsidiaries. All combined-reporting states have the option of adopting such a policy.[42]

Tax-Avoidance Strategy #V: Transfer Pricing

In the previous section on "nexus isolation," the discussion of transactions between a manufacturer and its out-of-state subsidiary assumed that those transactions were conducted at the price that would prevail in the marketplace between unrelated parties doing business at "arm's length." The point of the discussion was that corporations could substantially reduce their corporate income tax payments in non–combined reporting states by forming a separate subsidiary to "house" any activities that physically had to take place in such states, even if arm's-length pricing occurred.

One of the most serious flaws of corporate income taxes in non–combined reporting states, however, is that tax revenues can be severely eroded by transactions between related in-state and out-of-state entities that are *not* conducted using arm's-length prices.

How Tax-Motivated Transfer Pricing Works

Consider again the example of the manufacturer that needs to have a sales office and a warehouse in its customers' states but also wants to isolate as much of its profit as possible in the state where its plant is located. It forms a distribution subsidiary to employ the sales force and operate the warehouse. The plant sells its product to the subsidiary, which in turn resells it to the corporation's ultimate customers. The price at which the plant sells the product to the subsidiary is called the "transfer price," because it is a transaction between two parts of what effectively is one company.

The corporation has substantial discretion to set its transfer prices in a way that minimizes its total tax liability, as long as both the plant and its out-of-state customers are located in non–combined reporting states. For example, if the corporate income tax rate where the plant is located is higher than the average rate where customers are located, the corporation can have the plant charge the distribution subsidiary an artificially low price for the product. That will reduce the amount of taxable profit reported by the corporation that owns the manufacturing plant. It will also increase the amount of profit reported by the distribution subsidiary, since the latter's profit is measured as the difference between the (artificially low) cost of the goods and the sales price. Overall, the corporation will pay less state income tax because some of the profit will have been shifted from a high-tax-rate state (where the plant is located) to lower-tax-rate states (where the subsidiary is located).

Conversely, if tax rates are higher where the customers are located than where the plant is located, the plant can charge an artificially high transfer price, thereby reducing the subsidiary's profits and increasing the plant's.

This strategy is available to any corporation that is divided into different entities that engage in transactions with each other and in which those entities have nexus in some but not all states. For example, a "vertically integrated" oil company that owns oil fields, refineries, pipelines, a wholesale distributor, and gas stations has numerous business reasons — not just tax reasons — to incorporate the various components separately. Nonetheless, by manipulating the prices at which the crude oil is sold to the refinery and the refined gasoline is sold to the retail gas stations, the oil company can minimize its nationwide state corporate income tax liability.

Tax-motivated transfer pricing is a fundamental corporate tax-avoidance strategy. A recent newsletter for clients of the BDO Seidman accounting firm discussed a (rare) New York state court victory against a Delaware trademark PIC. The article reassures 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 . . . Effective Use of Transfer Pricing.[43]

Non–Combined Reporting States Largely Unable to Stop Transfer Pricing

Given their vulnerability to manipulation of transfer prices, virtually every non–combined reporting state allows its tax department to adjust transfer prices on a case-by-case basis to fairly reflect the income actually earned in the state. Combined reporting states generally grant this authority as well. (See the text box on the next page.)

Nonetheless, in practical terms, discretionary authority for states to adjust transfer prices is almost completely useless. State revenue departments simply do not have the audit resources to monitor the millions of transactions that may occur within a large multi-corporate group each year — let alone the legal and economic staffs needed to prove to a court what the true, arm's-length price should have been.

The federal corporate income tax is just as vulnerable to *international* transfer pricing as state corporate income taxes in non–combined reporting states are to *interstate* transfer pricing. Nonetheless, the IRS generally litigates only very high-stakes transfer-pricing disputes, such as the royalty charged on the key ingredient of a blockbuster prescription drug. Even with a large legal staff and a budget to hire expert economists as witnesses, the IRS has a poor track record in winning such cases because there often are no truly comparable arm's-length prices to serve as benchmarks.

As long as a corporation is not so aggressive as to set its transfer prices in a way that leads its subsidiaries to report literally zero profits year after year, it is extremely unlikely that any non–combined reporting state will challenge its transfer prices. In fact, there are only a handful of reported cases in which a state has brought such a challenge — let alone won.[44] In short, as with many of the other tax-avoidance strategies discussed in this report, non–combined reporting states

Combined-Reporting States Remain Vulnerable to *International* Income-Shifting

At one time, most states that mandated combined reporting applied it on a worldwide basis, requiring corporations to add together the profits not only of their subsidiaries formed in the United States, but also of their subsidiaries formed abroad. They then taxed an apportioned share of the corporation's worldwide combined income. This practice applied to corporate groups with U.S. and foreign parents alike, and it was upheld with regard to each in 1983 and 1994 U.S. Supreme Court cases, respectively.

Multinational corporations — foreign-headquartered ones especially — strenuously objected to worldwide combined reporting (WWCR), and for nearly two decades they sought federal legislation banning it. In the early 1980s, the Reagan Administration made clear that it would push such legislation through Congress if WWCR states did not allow all multinationals the option of limiting the combined group to domestically-formed corporations. All of the WWCR states capitulated to this demand within a few years.

As a result of withdrawing to "water's-edge combined reporting," combined-reporting states became vulnerable to some of the same kinds of tax-avoidance strategies as non–combined reporting states, if a corporation conducts them across the U.S. border. For example, tax-motivated international transfer pricing has been recognized as a serious problem for decades. Awareness is also growing that many major multinationals are forming PIC-like entities abroad; a 2005 *Wall Street Journal* article, for example, discussed Microsoft's formation of an Irish subsidiary to house some of its software licenses.

In these kinds of international tax-avoidance schemes, states have the federal government as an ally. Abusive international transfer pricing, for example, adversely affects federal as well as state corporate income tax receipts, and the IRS devotes significant resources to trying to stop it. As noted in the body of the report, however, the IRS has had only limited success in this effort. Accordingly, a number of international tax experts have long advocated that the federal government adopt WWCR as its method of taxing multinational corporations.

If that were to happen, the states could revert to WWCR by piggybacking on federal practice. Although European governments have in the past reacted strongly and negatively to the slightest indication that federal policymakers were considering this option, the European Union itself may be moving toward combined reporting for taxation of corporate operations within EU boundaries. After a few years of experience with such a system, EU members might well accept WWCR as the international norm for taxation of multinational corporations.

In the meantime, combined-reporting states must largely resign themselves to the fact that they remain vulnerable to cross-border tax sheltering and keep pressure on the IRS to devote as much effort and resources as possible to stopping it. Montana, however, has taken a small step back toward WWCR by requiring corporations to include subsidiaries formed in well-known foreign tax havens in their combined group. West Virginia adopted the same provision in its recently enacted combined reporting law, which will be implemented in 2009. As evidence continues to mount that the IRS is being outgunned in its efforts to halt international profit-shifting, many other states may give serious consideration to the new practice pioneered by Montana.

are almost completely defenseless against manipulation of transfer prices to minimize overall corporate tax payments.

In contrast, combined reporting states are unaffected by the prices set on interstate transactions between related corporations. Because the profits of all entities in a corporate group are added together to determine the taxable base, the allocation of total profit among those entities is irrelevant. Under combined reporting, taxable corporate profit is, in effect, the difference between sales to *independent* parties and purchases from *independent* parties

Conclusion

The corporate income taxes of non–combined reporting states are fatally flawed. Such states are vulnerable to a wide variety of tax-avoidance strategies, from the creation of a trademark passive investment company as a tax shelter to the manipulation of transfer prices within a corporate group.

Combined reporting is not a panacea. Some combined-reporting laws themselves contain significant loopholes. More importantly, the fact that almost no combined-reporting states include foreign subsidiaries in the combined group leaves them vulnerable on an international basis to some of the same strategies corporations use with non–combined reporting states to artificially shift profits on an interstate basis. Nonetheless, a well conceived and well drafted combined-reporting law — such as the model statute recently developed by the Multistate Tax Commission — will nullify most of the aggressive corporate-tax avoidance techniques developed by lawyers and accountants advising major multistate corporations.[45]

Combined reporting has stood the test of time, having been used for at least two decades by 16 states and having twice been upheld by the U.S. Supreme Court as a fair and legal method of taxing multistate and multinational corporations. States that wish to have viable corporate income taxes that are not vulnerable to the tax-avoidance strategies described in this report will give serious consideration to this critical corporate tax reform.

Notes

[1] The remained "separate entity" or non-combined reporting states are: Alabama, Arkansas, Connecticut, Delaware, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, Missouri, New Jersey, New Mexico, North Carolina, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Virginia, and Wisconsin. The District of Columbia also is a separate-entity jurisdiction.

Nevada, South Dakota, Washington, and Wyoming do not have corporate income taxes or other general business taxes for which combined reporting is relevant, and Ohio is phasing out its corporate income tax.

[2] These entities are also sometimes referred to as "intangibles holding companies" or "trademark holding companies."

[3] Evidence is emerging that corporations are also beginning to lodge ownership of their trademarks and patents in subsidiaries located in combined-reporting states. This has few or no tax consequences in such states because they will tax a share of the intangible income regardless of where the asset generating the income is located. However, such a location may conceal the nature of the transaction from auditors in non–combined reporting states, for whom subsidiaries incorporated in Nevada and Delaware are now "red flags."

[4] See: *Geoffrey, Inc.* v. *South Carolina Tax Commission*, State of South Carolina Supreme Court, Opinion No. 23886, July 6, 1993. (Geoffrey, of course, is the name of the Toys "R" Us giraffe trademark.)

[5] See: *In the Matter of Secretary of Revenue* v. *A&F Trademark, Inc.* et al., North Carolina Tax Review Board, May 7, 2002. The board's opinion in this case also indicates that the PICs loaned their royalty income back to the subsidiaries owning the stores, shifting an additional $237 million in profit into tax-free Delaware through the payment of tax-deductible interest to the PICs. This case and similar cases brought against the companies by Maryland, New Jersey, and New York have identified 11 different corporations in the corporate group as using PICs: The Limited, Inc.; Abercrombie & Fitch, Inc.; Bath & Body Works, Inc.; Cacique, Inc.; Express, Inc.; Lane Bryant, Inc.; Lerner New York, Inc.; Limited London, Paris, New York, Inc.; Limited Too, Inc.; Structure, Inc.; and Victoria's Secret Stores. Several of these businesses were spun off from The Limited group subsequent to the tax years at issue in these cases.

[6] *In the Matter of Kmart Properties, Inc.*, decision of New Mexico Taxation and Revenue Department hearing officer No. 00-04, January 31, 2000. The case further revealed that Kmart's PIC earned an additional $78 million in interest over the same five-year period by lending its royalty receipts back to Kmart — usually two to three days after they were received.

[7] For details about the Worldcom case, see: Carrick Mollenkamp and Glenn R. Simpson, "Worldcom Tax Strategy May Have Saved Millions," *Wall Street Journal*, August 14, 2003; Dana Cimilluca, "MCI to Pay $118.2 Million to Mississippi Over Tax Dispute," Bloomberg News, May 9, 2005; Barney Tumey *et al.*, "States Will Receive $315 Million from MCI in Tax Settlement," *BNA Daily Tax Report*, October 5, 2005; United States Bankruptcy Court, Southern District of New York, In re: Worldcom, Inc., *et al.*, Debtors, *Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner*, January 26, 2004, available at http://www.som.yale.edu/faculty/Sunder/FinancialFraud/WorldCom3rd%20Report.pdf..

[8] Joseph N. DiStefano, "In the War Between the States, Delaware is Stealing the Spoils," Gannett News Service, January 25, 1996. More recently, this same reporter documented Enron Corporation's use of PICs managed by Entity Services Group, one of the many companies that specialize in setting up Delaware PICs for out-of-state corporations. See: Joseph N. DiStefano, "Delaware a Tax Shelter for Enron," Knight Ridder Newspapers, February 4, 2002.

[9] A number of states have sought to challenge PIC arrangements through audits and litigation, and private tax practitioners increasingly urge corporations to ensure that their PICs have some economic substance. (See, for example, Peter L. Faber, "Planning for the Use of Intangibles Holding Companies," *State Tax Notes*, June 15, 1998.) Even if a corporation decides to protect its PIC by having an employee or two on the PIC's payroll and paying a consultant to certify that the PIC's royalty rate is what would be charged to an independent licensee of the trademark, the tax savings remain large in relation to the costs incurred.

[10] Statement of William Remington, director of the Delaware Division of Revenue, at the "Delaware: The First Choice for Financial and Tax Planning Conference," December 15, 1998, Wilmington, Delaware. Delaware requires corporations claiming tax-free PIC status to file a form annually with the state, but the form does not require disclosure of dollar amounts of passive assets held or intangible income received. The forms are not available to the public.

[11] "Corporate Fee Bills Aim to Raise $65 Million," *Las Vegas Review-Journal*, May 16, 2001.

[12] The Maryland Comptroller publicly identified six companies as having PICs that were not listed in the *Wall Street Journal* article: A.O. Smith Corp.; Colombo, Inc.; D.R. Horton, Inc.; MCI Telecommunication Corp., Inc; Pep Boys; and

SSI Medical Services, Inc. The listing was an attachment to William Donald Schaefer *et al.*, *Presentation to the Commission on Maryland's Fiscal Structure*, October 10, 2002. Many more companies doing business in Maryland have PICs, as can be seen by the fact that the comptroller entered into negotiated settlements with 443 PICs, compelling them to pay $200 million in additional taxes, penalties, and interest to the state. See: "Comptroller Schaefer Says Holding Company Settlement Program Reaps $198.7 Million," press release from the office of Maryland Comptroller William Donald Schaefer, December 8, 2004.

[13] *In the Matter of the Petition of The Talbots, Inc.*, State of New York Division of Tax Appeals, March 22, 2007.

[14] Some 100 corporations were still deducting royalty payments to PICs more than two years after a Maryland law clamped down on the deductions. See: Kathleen Johnston Jarboe, "Loophole Still Used Even After Closure," *Daily Record*, May 6, 2006.

[15] See, for example: Thomas H. Steele and Pilar M. Sansone, "Surveying Constitutional Theories for Challenges to Add Back Statutes," website of the Morrison and Foerster law firm, February 23, 2005. The Alabama case, which was not decided on constitutional grounds, is discussed in Matthew S. Houser, Christopher R. Grissom, and Bruce P. Ely, "Alabama Judge Rules for Jeans Manufacturer in Addback Case," *State Tax Notes*, January 29, 2007.

[16] See, for example, the "Business Activity Tax Simplification Act of 2007," S. 1726.

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

[18] This same logic underlies the only state litigation against asset isolation of which the author is aware that did *not* involve a financial institution. In the 1994 case of *Merck & Co., Inc.* v. *Georgia State Revenue Commissioner*, the state challenged the drug company's attempt to isolate in a PIC royalty earnings from the licensing of drug-ingredient patents to independent third parties. In a letter denying the company's protest of its additional tax liability, the revenue department wrote:

> As you noted in your letter of protest, the taxpayer, Merck & Company, Inc., has for a number of years been shifting the rights to certain intellectual property, which has been researched and developed by the taxpayer, to Merck and Company, Incorporated, a Delaware Holding Company. To the best of my knowledge, Georgia has endured and borne the cost of developing the patents, trademarks, and know-how reflected in these intellectual properties by allowing the taxpayer a deduction for its research and development expenses. The 1987 Merck & Co., Inc. return reflects a deduction of $161,499,160.00 for "Research Expenses." To then move the income earning assets which were created by this research and development activity to a separately incorporated entity that does not report to Georgia clearly constitutes an action which distorts the true net income of this taxpayer, and thereby, the net income properly attributable to this state.

The case was settled before the court reached a decision.

[19] Paul Gores, "Not All Banks Settle in Tax Fight; Institutions May Sue over Issue of Subsidiaries in No-Tax States," *Milwaukee Journal Sentinel*, April 16, 2007; Mike Ivey, "State Banks Can Keep Subsidiaries," [Madison] *Capital Times*, September 17, 2004.

[20] Mike Ivey, "Even Small Banks Follow the Leaders; They Set Up Shell Subsidiaries in No-tax States," *The Capital Times*, May 14, 2003.

[21] Mike Ivey, "Big Firms Avoid State Tax; Banks Especially Aggressive in Using Loopholes," *The Capital Times*, May 14, 2003. 2000 was a year of strong national economic growth, the year the U.S. economy peaked before slipping into the 2001 recession.

[22] New York initiated one court case against a financial institution as far back as 1991, but the institution soon failed and there is no evidence that other financial institutions were ever investigated for PIC-based asset isolation. See: Selwyn Raab, "New York's Largest Saving Bank Faces Tax Fraud Inquiry," *New York Times*, January 20, 1991.

[23] As long ago as 1992, the Iowa Department of Revenue conceded that Nevada asset management subsidiaries of Iowa banks were not taxable in the state. *Firstar Corp.*, Iowa Department of Revenue and Finance, Declaratory Ruling 92-30-6-0376, October 21, 1992.

[24] See the first article cited in Note 19.

[25] Jesse Drucker, "Friendly Landlord: Wal-Mart Cuts Taxes by Paying Rent to Itself," *Wall Street Journal*, February 1, 2007, page A-1.

[26] The reason why the real estate needs to be owned by a REIT rather than, for example, a normal Nevada PIC subsidiary, is that the subsidiary that owned the real estate would *itself* be subject to a corporate income tax in any state in which the real estate is located, if not for the effectively tax-exempt status of a REIT. That would nullify the tax savings from shifting the income to the out-of-state company. In the case of trademark PICs, in contrast, there is still a legal question in most non–combined reporting states as to whether the PIC becomes taxable in the states where its trademark is used; given that ambiguity, most corporations will not concede that the PIC is in fact taxable in such states. As discussed above, some states have successfully asserted taxing jurisdiction over Delaware trademark holding companies, nullifying their tax advantages in that way.

[27] Wal-Mart's REIT came to light when North Carolina audited the company, sought to nullify the tax shelter by using its discretionary authority to require combined reporting, and was sued by the company to obtain a tax refund on the grounds that the combined reporting was unwarranted. As is often the case, the lawsuit opened up Wal-Mart's tax-avoidance actions to public scrutiny See: David Ranii, "Wal-Mart Contests State's Tax Bill," Raleigh *News and Observer*, July 7, 2006.

[28] Not only do the parent corporation's rental payments to the REIT reduce the taxable profit of stores located in non–combined reporting states, but these states cannot tax the income of the REIT when it is paid out in the form of dividends to the parent because the dividends are first paid to a *second* Wal-Mart subsidiary, a Delaware PIC. When that subsidiary pays out its REIT dividend income in the form of dividends to the parent, the otherwise taxable REIT dividends are converted into general corporate dividends, which are tax exempt in almost all states. (See the discussion the previous section.)

[29] See: John D. McKinnon, "Vermont 'Captives' Dog Dean Campaign; Some States Say Insurance Tax Shelter Pushed by Former Governor Is Often Abused," *Wall Street Journal*, January 12, 2004.

[30] *In the Matter of the Appeal of Wendy's International, Inc and Subsidiaries from the Issuance of Corporate Tax Assessments*, Board of Tax Appeals of the State of Kansas, Kansas Department of Revenue's Response to Taxpayer's Motion for Summary Judgment and Cross Motion for Summary Judgment, November 2006.

[31] Dean Foust, "A Tax Paradise Right Here at Home," *Business Week*, September 13, 2004; Shefali Anand, "States Compete to Reel in 'Captive' Insurers," *Wall Street Journal*, August 9, 2005; Ross Sneyd, "Multi-million-dollar Captive Industry Celebrates 25th Birthday," *Boston Globe*, August 9, 2006; Lynnley Browning, "Vermont Becomes 'Offshore' Insurance Haven," *New York Times*, April 4, 2007.

[32] See Assembly Bill 263, 2004. Similar legislation was recently considered in Montana, Senate Bill 138, 2007.

[33] The strategy is often also referred to as "entity isolation."

[34] There is an additional requirement, but it is a little more than a formality: the salesperson cannot "accept" the order, but must rather forward it to an out-of-state office where it is "accepted."

[35] There is also a common scenario of nexus isolation in the retailing industry. A number of so-called "bricks and clicks" retailers have separately incorporated their Internet operations and their retail store chains. The companies claim that the profits of the Internet subsidiary cannot be taxed in the state where the stores are located because P.L. 86-272-protected solicitation is the only activity the subsidiary engages in outside of where it is headquartered and warehouses its inventory.

[36] See, for example, Virginia Tax Commissioner Ruling 07-24, March 27, 2007. (Out-of-state Internet retailer held not to have corporate income tax nexus in Virginia despite the in-state presence of a warehouse subsidiary that stores and ships goods on behalf of its out-of-state parent to Virginia customers of the parent.) See also the case discussed in Note 44 below.

[37] John C. Healy and Michael S. Schadewald, *2007 Multistate Corporate Tax Guide on CD-ROM*, section titled "Basic Multistate Tax Planning Strategies."

[38] The bulleted examples are framed in terms of manufacturers, but a firm in any industry may have similar incentives to engage in nexus isolation.

[39] For an expanded discussion of this issue, see: Michael Mazerov, "The 'Single Sales Factor' Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?" Center on Budget and Policy Priorities, September 2005, Chapter III.

[40] More precisely, the subsidiary must calculate its tax by apportioning the combined profit of the "unitary business" of which it is a part, which may not encompass all of the other subsidiaries in the corporate group. A "unitary business" is the group of subsidiaries or divisions of a corporation that constitute an integrated economic enterprise in which the activities of one subsidiary/division create synergy with the activities of other subsidiaries/divisions. A vertically integrated oil company that has separate subsidiaries exploring for oil, extracting it, refining it, transporting it, and selling it to retailers, but that is not engaged in any other business, would likely constitute a unitary business; the parent and all of its subsidiaries would be included in a single combined report. In contrast, a corporation composed of a parent and one subsidiary that manufactured machinery and two other subsidiaries that operated cattle ranches might contain two "unitary businesses" that would file two combined reports. For a slightly more in-depth discussion of this issue, see Appendix B of Michael Mazerov, "State Corporate Tax Disclosure: The Next Step in Corporate Tax Reform," February 2007. Available at www.cbpp.org/2-13-07sfp.pdf.

[41] This is the so-called "Finnigan" approach to addressing the issue of how in-state sales are to be treated for apportionment purposes when one or more members of a unitary combined group have nexus in a state and others do not. The name comes from two California court cases in which the approach to addressing this issue currently taken by Arizona, Kansas, and Utah was raised. See: John C. Healy and Michael S. Schadewald, *2007 Multistate Corporate Tax Guide on CD-ROM*, section titled "Sales Factor: Throwback Rules."

[42] The main reason more combined reporting states have not adopted the Finnigan approach to apportionment is that it is an open question whether such a policy is constitutional and/or violates P.L. 86-272. A fierce debate continues to range within the legal profession on the matter, with eminent experts on both sides of the debate. State courts that have considered the question have generally concluded that taking into account the sales of non-nexus subsidiaries in calculating the tax liability of subsidiaries that do have nexus in a state is not a violation of P.L. 86-272 or the Constitution. A recent article reaches the same conclusion, while arguing that states nonetheless should not do so because the majority of combined reporting states do not. See: Jennifer Carr and Cara Griffith, "*Matter of Disney* — A New Player in the *Joyce/Finnigan* Debate," *State Tax Notes*, January 30, 2006. *Matter of Disney* is the recent New York court case that upheld the legality of the minority, Finnigan practice.

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

[44] Most of these cases have been brought by New York, which has lost most of them. For a description of New York's loss in a recent transfer-pricing case to which it devoted substantial resources, see: Paul H. Frankel, Irwin M. Slomka, and Amy F. Nogid, "New York State Tribunal Affirms Section 482 Reasonableness Standards for Combination in Hallmark Marketing," *State Tax Notes*, July 30, 2007. The facts in the case were almost identical to the scenario set forth several times in this report: an out-of-state manufacturer (the well-known greeting-card producer Hallmark) with a wholesaling subsidiary doing business in New York. In this case, the company had actually commissioned a study aimed at establishing the arm's-length transfer prices for its products. The state sought, unsuccessfully, to challenge the prices set by the study.

[45] 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/AllocaitonandApportionmentReg.pdf. (The latter URL is correct at this writing despite the apparent misspelling.)