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State Tax Reform: Proposals for Wisconsin

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STATE TAX REFORM: PROPOSALS FOR WISCONSIN

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I. INTRODUCTION[1]

Once upon a time, issues of state and local taxation played to a small audience. Federal tax matters held center stage; state issues were relegated to the wings. But in the last twenty years or so, state tax matters have emerged from their secondary status and have moved into the spotlight.

Two federal tax acts helped move state tax issues onto center stage. The first was the Economic Recovery Tax Act of 1981 ("ERTA"),[2] which gutted the federal corporate income tax by revamping the treatment of depreciation and by introducing safe-harbor leasing. Many of the largest corporations in the United States paid no federal corporate income tax for several years because of ERTA.

If ERTA's rules on depreciation and safe-harbor leasing had been incorporated into state tax laws, many states would have suffered significant losses of tax revenue without receiving commensurate benefits. Accordingly, many states refused to embrace fully the federal changes and "decoupled" from ERTA's rules on depreciation and safe-harbor leasing, similar to what some states have recently done with respect to the new federal bonus depreciation and estate tax changes.

ERTA had severe repercussions for state tax practitioners. By decreasing the impact of the federal income tax on many corporations, ERTA substantially increased the relative significance and prominence of state taxes,

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1. *See* Richard D. Pomp, *The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer, in* DAVID BRUNORI, THE FUTURE OF STATE TAXATION (1998).

2. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

especially in states that had decoupled. In many cases, a corporation's state income tax was greater than its federal tax—a situation that did not escape notice by CEOs, CFOs, or corporate tax managers. Corporations that had typically treated state issues as secondary to federal concerns started to shift their emphasis from compliance to planning.

The second of the two federal changes was the Tax Reform Act of 1986.[3] By lowering the federal marginal tax rates, the Act increased the after-tax cost of deductible state taxes. The Act generated additional pressure on lawyers and accountants to reduce state taxes through planning. This pressure was exacerbated by increases occurring in state taxes across the country.

The 1986 Act also eliminated many of the federal tax lawyer's bread and butter issues, altering the complexion of a federal tax practice. Since 1986, my impression is that the real job growth in the tax profession has taken place in two areas: international tax and state taxation—and much of that growth has taken place in the accounting firms and not in the law firms or corporations.

The larger corporations have always had first-rate persons in their state tax departments. But the recent emphasis on downsizing, restructuring, and outsourcing, coupled with a corporate mentality that often views the tax department as overhead and not as a profit center, has kept in-house departments small.

There are a small number of well known, highly competent law firms with active, full-time state tax practices. They are staffed with the luminaries in the field. These firms, however, are the exception. Many large, prominent firms with traditionally strong federal tax practices have been late in recognizing the potential of the state tax market. Such firms have displayed the common bias of federal tax lawyers who traditionally have looked down on their state counterparts as the Rodney Dangerfields of the profession. But times have changed, and these firms are now playing catch up; nonetheless, overall the amount of new hires by the law firms pales in comparison to the accounting firms.

The bigger accounting firms are no longer content to do compliance work and now have dynamic and growing state practices geared to planning and tax minimization strategies. Actively recruiting from law firms, industry, and government, and wooing recent graduates with attractive starting salaries (often commensurate with those of law firms), these accounting firms now claim some of the brightest minds in the business, people who combine technical virtuosity with a creativity and a boldness that were more commonly

3. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

associated in the past with the federal tax bar. With their extensive network of offices, their computer simulation models, their large staffs that can handle an array of state tax issues from challenges to property tax valuations to unemployment compensation ratings, and everything in between, and their increased willingness to become involved in dispute resolution issues, the accounting firms have changed the nature of a state tax practice and have emerged as major players.

Unlike most law firms, the bigger accounting firms typically have groups devoted to developing multistate tax minimization strategies, which go well beyond dealing with only issues of local law. The firms market these strategies to corporations, sometimes for a fee based on the tax savings. This type of marketing places a premium on pressing formal rules to their limits, aggressively exploiting weaknesses in state tax structures, shifting income and deductions among the states, identifying and capitalizing on gaps in the interfacing of state laws and their lack of harmonization, restructuring corporate entities, and using pass-through entities. The firms also bring to bear on state issues many of the techniques that have been developed in the international and federal context. The only cloud on the horizon is the new constraints imposed by Sarbanes-Oxley.

Having worked closely over the years with some of the tax maestros in the law firms, accounting firms, and corporations, I know the intellectual firepower that the private sector can bring to bear on the corporate income tax. The private sector is a repository of some of the finest talent in the tax profession, whose prowess and sophistication I greatly respect. Because of the weaknesses in many state tax structures, including Wisconsin's, taxpayers often can control their tax liabilities, putting a new spin on the concept of "voluntary compliance."

The corporate and sales taxes labor under enough weaknesses without being the target of this formidable firepower. These taxes are built on a rickety foundation, constructed during the first half of this century to deal with what, by today's standards, seems to be the rather mundane taxation of manufacturing and mercantile activities. Those were simpler times, when substantial sectors of the economy, such as transportation, communications, banking, insurance, and power generation were either subject to exhaustive regulation or subject to significant federal controls. Multinational corporations and conglomerates were yet to emerge, and few corporations had substantial amounts of foreign income. It was a world in which corporations did not electronically transfer funds around the globe and did not make much use of financial derivatives. Large mail-order houses had not yet proliferated, 800 telephone numbers were not widespread, UPS and Federal Express were in their infancy, and the Internet did not exist. Limited liability companies,

limited liability partnerships, and other pass-through entities were not commonly used.

For much of the early history of the states, their taxes were low enough (and state tax administrators passive enough) that litigation was infrequent. Low rates can bury many sins. Moreover, the corporate income tax dealt with changes in the economy primarily through the development of special apportionment formulas in response to the needs of particular industries.

Today's challenges to the Wisconsin tax structure from the expanding, aggressive, and sophisticated private sector pose a fundamentally different type of problem. The antiquated structure of the tax makes it difficult to repel attacks by tax lawyers and accountants who are using modern weapons.

The first line of defense is the Wisconsin tax department. Many in the tax department can go head-to-head with their counterparts in the private sector. The Wisconsin tax department, however, is understaffed, overworked, and plagued by turnover. The state's civil service salary structure cannot easily accommodate the marketable skills and higher opportunity costs of those in specialized areas like taxation. Like most state tax departments, Wisconsin often loses valuable personnel to the private sector. The surprising thing is how much the state manages to accomplish with so few resources.

The second line of defense is the Wisconsin Legislature. The legislature should be busy plugging holes in the tax base, discarding inefficient provisions, modernizing the tax, and providing tax administrators with the tools they need. The legislature, however, has fallen way short of this action. This Article suggests changes in the corporate income tax and the sales tax that the legislature should consider if it is going to regain control of its tax base from taxpayers. The Article concludes with some suggestions for dealing with the problems of tax-exempt property.[4]

II. THE CORPORATE INCOME TAX

The number one weakness with the Wisconsin corporate income tax is the lack of combined reporting. The *Milwaukee Journal Sentinel* has exposed one manifestation of this defect with its coverage of the use of Nevada subsidiaries by some of Wisconsin's largest banks. According to the paper, about 250 banks transferred certain of their assets to out-of-state subsidiaries. One common strategy was to transfer U.S. Treasury and municipal bonds to a Nevada subsidiary. The goal was to transfer the interest income generated by these securities, which is taxable under Wisconsin law, to Nevada, which does

4. This Article can only begin to scratch the surface of possible tax reform proposals. What is needed is an in-depth study. For one possible model of such a study, see Richard D. Pomp, *Reforming a State Corporate Income Tax*, 51 ALB. L. REV. 383, 383–91 (1987).

not have a corporate income tax.[5]

The *Journal Sentinel* also reported that as a share of total Wisconsin taxes, the corporate income tax fell from more than 11% in 1979 to less than 5% in 2001,[6] a sharp decline that other states have also experienced. The Multistate Tax Commission estimated that tax sheltering by all corporations, not just banks, cost Wisconsin $174 million in 2001.[7] The key to much of this sheltering is the lack of combined reporting.

Combined reporting is part of the larger issue of how a state should determine its share of the income earned by a multistate group of corporations. The U.S. Supreme Court has described this issue as bearing "some resemblance . . . to slicing a shadow."[8] As described below, the states have developed a variety of approaches for dealing with this issue. The primary method is known as formulary apportionment, which is used by Wisconsin and every state with a corporate income tax. Combined reporting is a logical extension of formulary apportionment.[9]

A. Separate Accounting[10]

Under the U.S. Constitution, Wisconsin may tax that portion of a corporation's income that has a sufficient connection or relationship (nexus) with the state. There are three approaches for determining the amount of a corporation's taxable income that can be taxed: separate accounting, formulary apportionment, and specific allocation.

Formulary apportionment and combined reporting are best understood as a response to the defects inherent in separate accounting. Separate accounting is based on the premise that it is both possible and practical to isolate the taxable income of portions of the business that a corporation carries on within a state.

5. Paul Gores, *State Seeks Taxes From Banks*, MILW. J. SENTINEL, Feb. 17, 2004, *at* http://www.jsonline.com/bym/news/feb04/208334.asp. As this Article was in galleys, the Department of Revenue announced that 26 banks have agreed to pay the state $23 million to settle back taxes and that another 195 have contacted the Department of Revenue to discuss possible settlement agreements. Mike Ivey, *State Banks Can Keep Subsidiaries*, CAP. TIMES, Sept. 16, 2004, *at* http://www.madison.com/archives/read.php?ref=tct:2004:09:16:386637:BUSINESS.

6. Avrum D. Lank & Steven Walters, *Tax on Profits Has No Teeth*, MILW. J. SENTINEL, Apr. 13, 2002, *at* http://www.jsonline.com/news/state/apr02/35111.asp.

7. Paul Gores, *Audits Check Banks' Use of Subsidiaries*, MILW. J. SENTINEL, Feb. 3, 2004, *at* http://www.jsonline.com/bym/news/feb04/204827.asp.

8. Container Corp. of Am. v. Franchise Tax Bd. of Cal., 463 U.S. 159, 192 (1983).

9. Michael J. McIntyre, Paul Mines, & Richard D. Pomp, *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*, 61 LA. L. REV. 699 (2001).

10. *See* RICHARD D. POMP & OLIVER OLDMAN, STATE AND LOCAL TAXATION 10-7–10-10 (4th ed. 2001).

To illustrate the workings of separate accounting, consider a corporation that manufactures a product in Wisconsin, warehouses it in Minnesota, and sells it through a sales division in Iowa to a customer in Illinois. In calculating its Wisconsin tax using separate accounting, the corporation would assume that its manufacturing activities in Wisconsin were conducted by an independent business entity that sells the manufactured good to a third party that will warehouse and sell it.

One approach to calculating the manufacturing entity's taxable income in Wisconsin is to determine the hypothetical price at which the assumed entity manufacturing the good would sell it to an assumed independent and unrelated third party. That hypothetical arm's length sales price would determine the assumed entity's sales proceeds, which in turn would determine the amount of its taxable income.

Both theoretical and practical problems limit the utility of separate accounting. Administratively, determining the arm's length transfer price is difficult, if not impossible, in many cases. One way to determine a hypothetical transfer price in the above example would be to examine the prices at which comparable manufacturers sell comparable goods to their independent distributors. But comparable manufacturers might not exist, or if they exist, they might not manufacture comparable products, or if they do, they might not sell them to independent distributors.

Even if comparable transactions exist, other hurdles remain. Comparable transactions provide only an estimate of the relevant transfer price. Such transactions may establish a range within which the appropriate transfer price might fall, but if this range is too wide, no useable information will be provided.

Establishing what might be hundreds or thousands of hypothetical transfer prices is another severe administrative problem. Separate accounting is an expensive system to operate for both the public and private sectors. A state tax department would not have the resources to police the large number of corporations engaged in cross-border transactions. Small and medium-sized businesses would not have the capacity to implement separate accounting and perhaps neither would large corporations.

Moreover, under separate accounting, a theoretical flaw arises whenever a corporation's overall profitability is attributable to activities that are interdependent, integrated, or synergistic. In such a case, involving what is known as a unitary business, each activity of the unitary business contributes to the business as a whole, and reasonable efforts at imputing a transfer price for a hypothetical transaction might fail to capture the inherent transfers of value. As a common example, consider the transfer of value that occurs when a vice president of manufacturing telephones a vice president of research and

design and resolves a problem in a way that will increase corporate profitability. Assume all of the manufacturing is done in Illinois and all of the research and design activities occur in Wisconsin. Separate accounting cannot impute a value to that telephone call in order to calculate Wisconsin's and Illinois' appropriate share of the corporation's tax base.

As a further illustration, consider a corporation that operates two stores. One store operates in Wisconsin and the other operates in Illinois. The corporation buys its inventory centrally on behalf of its two stores. On a separate accounting basis, the corporation reports a high profit to Illinois and breaks even in Wisconsin.

Suppose, however, that if the Wisconsin store closed, the profits of the Illinois store would decline. This result might occur if the inventory sold by the Wisconsin store allowed the corporation to obtain a volume discount on all of the inventory it purchased, including that sold by the Illinois store. In other words, even though the Wisconsin store appears, based on separate accounting, to break even, it actually contributes to the corporation's overall financial profitability. Separate accounting might lead to a misleading result under these circumstances. As the U.S. Supreme Court has recognized, separate accounting "often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise."[11]

B. Formulary Apportionment[12]

Because of the theoretical and administrative problems inherent in separate accounting, the states developed an alternative method—formulary apportionment—for dividing and sharing the tax base of a corporation. As the name suggests, a formula is used to apportion a corporation's taxable income to those states in which it has activities. More specifically, a formula is used to generate an apportionment percentage that is based on the relative amount of a taxpayer's in-state activities or "presence." The application of Wisconsin's formula is as follows:

11. *Container Corp.*, 463 U.S. at 164–65. Separate accounting can play a role in challenging the distortion that will arise from the misapplication of formulary apportionment.

12. *See* POMP & OLDMAN, *supra* note 10, at 10-10–10-28.

$TI_{WI} = TI_{WW} \times 1/4\ (2 \times Sales_{WI}/Sales_{WW} + Payroll_{WI}/Payroll_{WW} + Property_{WI}/Property_{WW})$

Where:

1. TI_{WI} is the amount of the corporation's worldwide taxable income, computed under Wisconsin law, which is apportioned to Wisconsin;
2. TI_{WW} is the amount of the corporation's worldwide taxable income apportionable under Wisconsin law;
3. $Sales_{WI}$ is the amount of the corporation's sales (or receipts) within Wisconsin;
4. $Sales_{WW}$ is the amount of the corporation's worldwide sales (or receipts);
5. $Payroll_{WI}$ is the amount of the corporation's payroll in Wisconsin;
6. $Payroll_{WW}$ is the amount of the corporation's worldwide payroll;
7. $Property_{WI}$ is the amount of the corporation's property located in Wisconsin;
8. $Property_{WW}$ is the amount of the corporation's worldwide property.

A corporation calculates its tax in Wisconsin by first calculating its apportionable worldwide taxable income under Wisconsin law. This amount represents a corporation's preapportionment tax base. The corporation then calculates its apportionment percentage, based on the above formula. Next, the corporation multiplies its worldwide apportionable taxable income by the apportionment percentage. The result is the amount of the taxable income of the corporation that is apportioned to Wisconsin.

Wisconsin has long employed a system of formulary apportionment for determining the Wisconsin taxable income of a corporation that is operating within and without Wisconsin through multiple divisions or branches. In adopting formulary apportionment, the Wisconsin Legislature has implicitly concluded that apportioning income by payroll, property, and receipts (sales) is superior, as a system of tax accounting, to a system based on the separate transactions of the taxpayer, as reflected on its books of account. Combined reporting is merely an application of that philosophy.

C. Combined Reporting

1. Combined Reporting Emphasizes Substance over Form

The case for combined reporting is a logical extension of the case for

apportioning by formula the business income of an individual corporation.[13] The central element of that case is that the substance of the business activities in the state should control, not the organizational structure of the business entity or entities conducting those activities. That is, whether a business enterprise chooses to have numerous divisions or whether it chooses to incorporate those divisions and operate them as subsidiaries should have as little impact as feasible on the amount of Wisconsin income tax paid by that enterprise.

Consider, for example, the earlier example of a single corporation that manufactures a product in Wisconsin, warehouses it in Minnesota, and sells it through a sales division in Iowa to a customer in Illinois. In calculating its Wisconsin tax, that corporation would calculate its apportionment percentage by taking into account all of its factors in Wisconsin, Minnesota, Iowa, and Illinois. That percentage would be used to apportion its unitary business income to Wisconsin.

Suppose, however, that the nonmanufacturing activities are incorporated in a new U.S. subsidiary. Assume the corporate structure now consists of a parent corporation, which manufactures in Wisconsin, and a subsidiary, which warehouses the inventory in Minnesota and sells the product in Illinois through a sales division based in Iowa. The parent sells the inventory to its subsidiary at a price set by the parent corporation—a price that might have been purposely set to reduce Wisconsin tax.

One way to deal with the above situation is to apportion the income of only the corporation that has a nexus itself with Wisconsin. That is, only the income and factors of the parent corporation would enter into the calculation of the Wisconsin income tax. States that calculate the taxable income and apportionment percentage of the parent and ignore the taxable income and factors of the subsidiary are known as separate entity states.

Separate entity states treat related corporations as if they were unrelated strangers. Because a stranger's income and factors would have no effect on another corporation's income and factors, the existence of the subsidiary has no bearing on calculating the parent's apportionable taxable income. Conversely, the income and factors of the parent would have no effect on calculating the subsidiary's apportionable taxable income. (The tax department would, however, have the right to challenge any of the transfer prices occurring between the parent and its affiliated entities.)

States that take the opposite approach, ignoring the formal corporate structure of a unitary business by treating unitary subsidiaries as if they were

13. *See* McIntyre, Mines, & Pomp, *supra* note 9, at 702–38.

divisions or branches of the parent, are known as combined reporting states. A combined report would treat the parent and the subsidiary as if they were divisions of the same unitary business. Intercorporate transactions between them would be eliminated, and the income reported on the books of the subsidiary would be added to the income reported on the books of the parent and modified pursuant to state law. Similarly, the apportionment percentage would be calculated by taking into account the factors of both the parent and subsidiary.

A combined report is an accounting document prepared on behalf of a group of corporations engaged in a unitary business. It contains a tabulation of the aggregate taxable income derived by the members of the group from that unitary business. The initial step in preparing a combined report is to determine the scope of the group's unitary business. In computing the aggregate taxable income of group members from that unitary business, transactions between members of the group generally are eliminated. The combined report also includes a tabulation of each group member's apportionment factors used in the apportionment formula. The corporations that are included in a combined report are sometimes referred to as a combined group or a unitary group.

A combined reporting state requires the unitary group to use the combined report to determine the amount of the group's taxable unitary income apportioned to the state. That amount equals the aggregate taxable income of the group, which should then be multiplied by each member's apportionment percentage. The apportionment percentage is determined by applying the apportionment formula to each corporation included in the group. If the apportionment percentage were, for example, 25%, then 25% of the aggregate taxable unitary income of the combined group would be taxable to that corporation. The tax is not imposed, however, on the unitary group itself. Rather, each member of the group having nexus with the state is made taxable on its assigned share of the unitary income apportioned to the state under the apportionment formula.[14]

2. Combined Reporting Is a Better Measurement of Wisconsin Income

The U.S. Supreme Court has acknowledged that combined reporting is both a better method for measuring the income of a unitary business and a safeguard against taxpayer manipulation:

> The problem with [formal geographical or transactional accounting,

14. Consequently, if a corporation is protected by P.L. 86-272, any income apportioned to it should not be taxable by the state. Not all states, however, follow this approach.

> including separate accounting] is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise. The unitary business/formula apportionment method is a very different approach to the problem of taxing businesses operating in more than one jurisdiction. It rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the unitary business of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that unitary business between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction.[15]

The premise of combined reporting is that the synergies, interdependencies, and sharing of knowledge, know-how, and experiences that are typical features of a unitary business often cannot be properly captured by separate entity accounting. By taking into account only the income and factors of the corporation having nexus with the taxing state, separate entity accounting often cannot provide an accurate measurement of the income of the unitary business that is properly attributable to that state. A combined reporting regime, in contrast, avoids this failing by automatically apportioning all of the unitary business income of a unitary group among the states where it is engaging in meaningful business activities.

To illustrate, consider a unitary oil enterprise that explores, refines, and markets oil products. The parent company is PCo. Its geologists assure PCo that an oil field that straddles States X and Y is rich in oil. The geologists estimate that if ten wells are drilled, one is likely to be a gusher and the other nine wells will be dry holes. PCo directs YCo to drill for oil on the Y side of the oil field. It directs XCo to drill on the X side. YCo drills five holes and finds no oil. XCo also drills five holes and discovers oil. The crude oil is transferred to RCo, another subsidiary of PCo, and RCo refines it into gasoline at a Texas refinery. CCo, another PCo subsidiary, sells the gasoline in California. The profits for the year from the combined activities of the related companies are $100. Under separate accounting, none of that income would be apportioned to State Y. Yet the Y activities were integral to finding oil in X and to the other operations of the unitary business.

15. Container Corp. of Am. v. Franchise Tax Bd. of Cal., 463 U.S. 159, 164–65 (1983) (citations omitted). These sentiments were repeated in part in Barclays Bank PLC v. Franchise Tax Bd. of Cal., 512 U.S. 298, 303–04 (1994).

The example above dealt with affiliated companies engaged in transactions between related entities for which the market provides at least some evidence of arm's length prices. In many cases of related-person transactions, however, market prices cannot be determined with reasonable accuracy. Market prices are particularly difficult to obtain for the value contributed through use of intangible property, such as a trademark, patent, trade secret, franchise, customer list, copyright, unique management system, and know-how.[16]

Combined reporting also helps create a level playing field for intrastate corporate groups, whether large or small and whether conducting an intrastate or an interstate business. A unitary group that is engaged in business only in Wisconsin is taxable on all of its income. The imposition of combined reporting would not change that result. A multistate corporate group, however, is currently able to reduce its Wisconsin apportionable income, and hence its Wisconsin income taxes, by isolating highly profitable parts of its unitary business in corporations that are not taxable in Wisconsin, or by moving assets into tax havens. Combined reporting would nullify those efforts.

3. Combined Reporting Protects Against Tax Avoidance

Tax planners have developed numerous techniques to exploit the weaknesses of a separate reporting system. One popular strategy for a corporate group is to isolate nexus-creating activities and property of its unitary business in one corporation. That corporation is taxable by the state on an apportioned share of its taxable income. Other members of that group, however, have no nexus-creating activities or property in the state and are thereby insulated from tax by that state on any part of their unitary income. As a result, the state gets to tax only that portion of the income of the unitary group that appears on the books of account of the corporation having nexus with the state, even though all of the members of the corporate group are engaged in the same unitary business.

Another technique used by multistate and multinational corporate groups to minimize state income taxes is to create an intragroup expense on the books of a corporation having nexus with the state that is payable to another member of the unitary group located outside the state, typically in a tax haven. Yet another technique is for the members of a unitary group to set the prices charged for the transfer or provision of goods and services to related persons in a way that allows them to shift income from high-tax states to low-tax states. Tax planners may use some or all of these techniques simultaneously.

16. *See* POMP & OLDMAN, *supra* note 10, at 10-8–10-10.

A separate reporting state is not defenseless against these tax-planning techniques. To combat them, however, its tax department must take aggressive action to detect their use and to find some way under the separate reporting rules to tax the deflected income. Sometimes the tax department will enjoy some measure of success. In many cases, however, the unitary group is successful in having its tax-planning techniques upheld.

The combined report directly blocks these techniques and other similar tax-minimization strategies. The isolation of nexus-creating activities in a single corporation is impossible because the state imposes its income tax and an apportioned share of the aggregate income of the members of the unitary group. Deflecting income by manipulating transfer prices or by setting up intercompany payables is unsuccessful because transactions between members of a unitary group are washed out in preparing the combined report.

The advantages of combined reporting in combating tax avoidance are nicely illustrated by examining the treatment of tax-haven holding companies under separate reporting and combined reporting. The use of a holding company is a common tax-minimization technique in Wisconsin and other separate reporting states. In the typical approach, the holding company is domiciled in a state that has no income tax or that has favorable rules on the taxation of passive income. One state with these favorable rules is Delaware. Under Delaware law, a corporation is not subject to Delaware tax if its activities in that state are limited to maintaining and managing intangible assets that generate income such as capital gains, dividends, interest, and royalties.

As an example of the potential advantages of using a holding company, assume that PCo is a corporation that is domiciled in Illinois and is engaged in business in Wisconsin. PCo establishes HCo, a holding company domiciled in Delaware. PCo transfers valuable trademarks and trade names that it is using in its business to HCo. HCo executes a license agreement allowing PCo to use the transferred property in exchange for a royalty equal to 5% of its sales receipts. PCo deducts the royalty payment to HCo in calculating its preapportionment income. The royalty income is not taxed by Delaware.

The licensing of a trademark is only one way of using a Delaware holding company to generate a deduction for the payer without any tax being paid by the payee. Another way involves loans made by the Delaware corporation to the related payer corporations. Assume, for example, that PCo in the example above needs additional capital for its business. HCo has accumulated a large cash pool from its royalty income. HCo lends PCo $500 at a market interest rate of 8%. The annual interest payment of $40 ($500 × .08) is deducted by PCo in computing its preapportionment income. The interest income of that same amount is not taxable to HCo because of the exemption provided by

Delaware.[17]

The *Milwaukee Journal Sentinel*'s exposé of a strategy used by the banks illustrates another way of exploiting the lack of combined reporting. By moving their U.S. bonds and debt to Nevada, the banks effectively sheltered their interest income from Wisconsin income taxation. Combined reporting would nullify that strategy because the interest income would be included in a bank's apportionable income.

A separate reporting state like Wisconsin can assert a variety of arguments to defeat the tax-avoidance schemes described above, but these arguments may or may not be successful. The advantage of combined reporting is that it makes these arguments unnecessary. The tax advantage of the holding company is nullified without the state having to prevail after long and costly ad hoc litigation. In a combined reporting state, the income of the holding company (often substantial) is added to the preapportionment tax base of the unitary group, and the factors of the holding company (often modest) would be taken into account in applying the apportionment formula.[18]

4. Combined Reporting is a Neutral Method of Accounting

A combined report is not biased against taxpayers and does not systematically lead to a higher tax than would separate entity reporting. Both a corporation's taxable income and its apportionment percentage will change when a combined report is filed. Whether these changes will lead to a higher or lower amount of tax cannot be predicted *a priori*. To take an extreme example, suppose a parent corporation with nexus in Wisconsin has a unitary subsidiary operating at a loss that is greater in amount than the profit of the parent. In this case, a combined report would reduce the parent's liability to zero.

Because combined reporting undercuts so many orthodox tax planning techniques, its adoption will almost certainly raise revenue. But the issue of what the state should do with this increased revenue is independent of whether combined reporting should be adopted. The state could, for example, give back whatever money is raised through reductions in the corporate tax rate. This issue is not one of increasing taxes but rather taxing fairer and more efficiently.

D. Identifying a Unitary Business

Combined reporting with formulary apportionment is applied to unitary

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17. *Id.* at 10-33–10-35.
18. *Id.*

businesses. The term "unitary business" is a flexible concept. The U.S. Supreme Court has acknowledged that "the unitary business concept is . . . not, so to speak, unitary: there are variations on the theme, and any number of them is logically consistent with the underlying principles motivating the approach."[19] Instead, it has identified some of the indicia of a unitary business, including the following:

1. Unity of use and management;[20]
2. A concrete relationship between the out-of-state and the in-state activities that is established by the existence of a unitary business;[21]
3. Functional integration, centralization of management, and economies of scale;[22]
4. Substantial mutual interdependence;[23] and
5. Some sharing or exchange of value not capable of precise identification or measurement beyond the mere flow of funds arising out of a passive investment or a distinct business operation.[24]

E. Opposition to Combined Reporting

If the case for combined reporting is so overwhelming, as the above discussion suggests, why have more states not embraced it? One possible answer is that it was not until the Court's 1983 decision in *Container* and its 1994 decision in *Barclays* that constitutional doubts about combined reporting were eliminated. Secondly, the boom years of the 1990s obscured the erosion of state corporate income taxes and the need for combined reporting.

But probably the major reason is business opposition. No one should expect that multinational and multistate firms would embrace a proposal that puts some teeth into the corporate income tax. Many of them will oppose it for the same reason a state should embrace it: because it is a fairer, better method of taxation that will convert the Wisconsin corporate income tax from a voluntary one into a real one. Right now, the legislature does not fully control the corporate income tax base: the largest corporations do. Why would these corporations want to give up that power?

Predicting the arguments made against combined reporting is easy. The

19. Container Corp. of Am. v. Franchise Tax Bd. of Cal., 463 U.S. 159, 167 (1983).
20. Butler Bros. v. McColgan, 315 U.S. 501, 508 (1942).
21. *Container Corp.*, 463 U.S. at 166.
22. Mobil Oil Corp. v. Comm'r, 445 U.S. 425, 438 (1980).
23. F.W. Woolworth Co. v. New Mexico, 458 U.S. 354, 371 (1982).
24. *Container Corp.*, 463 U.S. at 166.

debate is typically not over the merits of whether combined reporting is a better system or not. Instead, opponents typically argue that combined reporting will lose money in the short term because tax administrators will be unfamiliar with the method and taxpayers will game the system.

There are at least two possible answers. The first is to have a rule that if the Wisconsin taxpayer is included in a combined report in any other state, it will have to file a combined report in Wisconsin unless it can prove that separate entity accounting would produce a better result. The second is to use combined reporting as an alternative tax to the existing corporate income tax. In other words, taxpayers will pay the higher of the tax calculated under the current rules or under combined reporting. In this manner, Wisconsin cannot possibly lose money from adopting combined reporting.

Sometimes opponents of combined reporting cloak themselves with the banner of economic development. Adopting combined reporting will be bad for Wisconsin's "business climate," chase businesses out of the state, discourage new ones from coming to Wisconsin, and reduce jobs. It is a wonder they do not predict that combined reporting will turn Wisconsin into a preagrarian economy of pagan worship. At best, these charges are hyperbolic and unproven.[25] At worst, it suggests that the only corporate tax that is compatible with a good business climate is a tax that corporations are able to avoid. Unfortunately, as a political matter, business opposition cannot be ignored. Moreover, whether the issue is combined reporting, single factor apportionment, tax credits, or a panoply of other probusiness issues, the legislature is faced with similar arguments. Accordingly, discussed below is the issue of taxation and economic development, which drives much of the debate about state tax reform.

1. Taxes and Economic Development

For many years, the orthodox learning has been that state taxes had

25. In his Senate confirmation hearings, Treasury Secretary-designate Paul O'Neill stated: "As a businessman I never made an investment decision based on the tax code . . . . If you give money away I will take it, but good business people don't do things because of inducements." Joseph Kahn, *Treasury Choice Varies from Bush on Tax Outlook*, N.Y. TIMES, Jan. 18, 2001, at A-1, A-16. Roger Smith, former Chairman of General Motors, whose Saturn plant was sought after by nearly every governor, stressed that tax breaks cannot make a silk purse out of a sow's ear. DETROIT FREE PRESS, Mar. 18, 1985, at 1A. According to Smith, "we're going to be in business for the long term . . . you've got to look at more than just what the great big cookie is that's coming in on the plate." *Id.* Consistent with this philosophy, the first state General Motors eliminated as a site for the Saturn plant was Florida, a state that is perceived as having an extremely favorable tax climate (e.g., no personal income tax, no estate tax, a double-weighted receipts factor, and no worldwide combined reporting). For an overview of the business climate literature, see Peter D. Enrich, *Saving the States From Themselves: Commerce Clause Constraints on Tax Incentives for Business*, 110 HARV. L. REV. 378, 392–97 (1996).

insignificant impact on the location of economic activity (other than income from capital). In the last decade or so, there has been some attempt to challenge this wisdom. For example, some researchers have claimed that they have found correlations between certain tax factors and certain indicia of economic activity. A recent review of these studies by Professor Lynch, however, concluded that their results were often inconsistent and idiosyncratic and that the correlations do not appear large.

> [D]o tax cuts and incentives create jobs in a cost-effective manner? Conversely, do state and local public services undermine growth? A review of the available data strongly suggests that the answer to both of those questions is no. And while state and local tax cuts may in theory stimulate economic activity, in practice they are unlikely to do so. That means state and local governments may be wasting billions of dollars annually on tax cut policies that are failing, while underfunding programs that can promote long-term growth and job creation.[26]

Many reasons exist why legislators should be skeptical about arguments that changes in the tax system that are opposed by business will be bad for economic development.

First, innumerable factors are important to a business in its decision about where to locate. Depending on the type of business at issue, the locational decision can be influenced by plant or site availability,[27] access to financing, access to and cost of transportation,[28] quality[29] and cost of labor,[30] proximity

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26. Robert G. Lynch, *The Effects of State and Local Taxes and Public Services on Economic Development*, 32 ST. TAX NOTES 767, 767–68 (2004).

27. The red tape involved in site assembly may be a much greater investment barrier than the price of land. *See* R. VAUGHAN, STATE TAXATION AND ECONOMIC DEVELOPMENT 25 (1979).

28. Transportation costs affect both the revenue a firm receives from its sales and the prices it pays for its inputs. Availability of transportation linkages, such as the ease with which trucks can make deliveries and collections, or the proximity of a railroad spur, shipping pier, or major airport, can also be critical for some activities. Cities like New York, which have traditionally housed a large number of small firms whose products are fairly transportation-intensive, suffer from inadequate access to rail transportation and inconvenient access to truck routes. *See* VAUGHAN, *supra* note 27, at 24.

29. Because training labor is expensive, businesses are attracted to areas that have a ready supply of skilled labor. Labor that is priced low relative to its skill was a major factor in the development of manufacturing in the South. *See* VAUGHAN, *supra* note 27, at 24. Skilled labor also appears critical to attracting technology-oriented firms. *See* note 35, *infra*.

30. The cost of labor may be a major consideration in competitive labor-intensive industries, for example, apparel, leather, furniture, and consumer electronics. Another labor consideration is whether the workforce is likely to be unionized. *See* R. SCHMENNER, MAKING BUSINESS LOCATION DECISIONS 37 (1982). A company with seasonal needs for labor has to be located in an area with a

to markets,[31] cost of utilities,[32] proximity to supplies,[33] proximity to other company facilities,[34] the regulatory environment, the quality of a state's schools, colleges, and universities,[35] the cost of housing,[36] the level and

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large labor pool. *See* VAUGHAN, *supra* note 27, at 24.

31. A site near established markets may be essential for industries such as printing, plastics fabrication, paper conversion, and can manufacturing, which involve commodities that have a low value-to-weight ratio and thus have transportation costs that are a high percentage of the selling price of the goods. *See* SCHMENNER, *supra* note 30, at 37.

32. One of the factors cited by Bankers Trust for transferring part of its operations from New York to New Jersey was the lower cost of utilities, an important consideration presumably because of the large amount of electricity needed to run the company's computers. *See* N.Y. TIMES, Apr. 29, 1983, at B3. Energy costs are commonly mentioned as one of the reasons why the banking and insurance industries are relocating part of their operations outside of New York City. *See* N.Y. TIMES, Mar. 2, 1982, at D23; N.Y. TIMES, Dec. 23, 1981, at D14. State and local taxes, of course, contribute to the cost of energy. The price and availability of office space is another factor contributing to the movement of firms from New York City to less dense regions, both within and without the state.

33. For example, paper mills typically locate near a supply of trees and water; fruit and vegetable processors are usually located near farms; and petrochemical complexes must be close to pipelines. *See* SCHMENNER, *supra* note 30, at 37.

34. Some manufacturing plants operate as satellites to a base or main plant and cannot be located too far from the main plant without stretching the lines of support too taut. SCHMENNER, *supra* note 30, at 37. Savin Corporation decided to build a plant in Union, New York because four of its feeder plants were already in the area. According to the corporation's senior vice president, "the choice wasn't made because of tax considerations." WALL ST. J., July 1, 1980. Nonetheless, the State's Commerce Commissioner chose to describe Savin's decision as "a splendid example" of the drawing power of tax incentives. *Id.* As the Savin example suggests, state officials responsible for economic development have an institutional interest in exaggerating the impact of tax incentives. When Church and Dwight built a new plant in Ohio, one economic development official claimed: "The tax incentive was the keystone of the deal." WALL ST. J., June 30, 1978, at 1. The corporate comptroller, however, stated that: "The tax abatement was a nice kicker at the end, but we chose Ohio mainly because of its strategic location for distribution and market growth." *Id.*

35. High-tech companies, which have been wooed by many states, are especially sensitive to the existence of prominent universities having graduate-level technical programs that produce a pool of potential employees. A well-known but dated example involves Microelectronics and Computer Technology Co., a joint venture of 12 major companies, including Control Data, Digital Equipment, Honeywell, RCA, and Sperry, which was courted by 57 cities. According to the president of Microelectronics, in selecting Austin, Texas for its site the corporation emphasized "the output of technical people in the area," particularly electrical engineers and computer scientists with advanced degrees—and "not who's holding a gold watch to get you to come." WALL ST. J., May 12, 1983. The existence of high quality graduate programs no doubt explains the presence of high-tech firms along Route 128 in Massachusetts and in the Silicon Valley in California.

Sweeping changes in educational policies were pursued throughout the South in order to attract industries dependent on the educational depth of the work force. Many of these changes were financed by increased taxes. N.Y. TIMES, Mar. 20, 1982, at A26. The Alabama Governor's Task Force on Economic Recovery expressed a similar concern: "Alabama's traditional combination of low taxes and minimum services no longer constitutes a sound basis for progress . . . . Today the premium is on the elements which support technology—the educational system, engineering resources, communications research." N.Y. TIMES, June 14, 1983, at A19.

36. Before the dot.com bubble burst, the high cost of housing in the Silicon Valley was making

quality of public services,[37] and the range of other amenities that enter into the general quality of life offered.[38]

Second, taxes are one of the many costs of doing business and the magnitude of these other costs may easily swamp the amount of state taxes involved. For example, an analysis by New York of those corporations which apportioned their income for purposes of the state franchise tax—a group that paid approximately 70% of the corporate tax revenues—indicated that their labor costs in New York were 53 times as large as their state corporate tax payments. A 2% wage differential was equivalent in its effect on profits to a 106% corporate tax differential. For a labor-intensive corporation, a few pennies difference in the hourly wages paid to employees might reduce its costs by more than any conceivable tax savings that would result from locating in one state rather than another.[39]

Third, state and local tax payments are deductible for purposes of the federal corporate income tax. The effect of this deduction, the so-called federal offset, is to reduce both the absolute burden of state and local taxes and differences in burdens among the states. For example, consider a corporation subject to a 35% federal corporate marginal tax rate. Assume that this corporation is deciding whether to move from State A to State B. Taxes would be $200 in State A but would be only $100 in State B—a $100 difference. After taking into account the federal offset, however, the out-of-pocket cost of state taxes is $130 in State A and $65 in State B. The net difference in taxes between A and B is reduced to $65 ($130-$65), from $100

it increasingly difficult for companies to attract employees and caused some corporations to move to lower-cost areas. WALL ST. J., May 11, 1983, at 37. The cost of housing played a role in the selection of Austin, Texas by Microelectronics and Computer Technology Company, *supra* note 35. "The biggest economic factor was the cost of private housing. Taxes didn't play a significant role in our decision . . . . The governor of Texas put together a statewide task force of bankers, industrialists, educators and political figures . . . and they did some clever things to reduce the hassles of relocating—such as getting bank commitments for mortgage money below FHA rates, and starting a job placement center for spouses." USA TODAY, Aug. 24, 1983, at A8.

37. Improvements in the level and quality of public services, such as a state's infrastructure, will benefit many firms, both large and small. By comparison, tax incentives tend to accrue to a small percentage of large firms.

38. According to one of the leading researchers on locational decision-making, corporations visit a potential site in order to gather information about the community—its attractiveness as a place to live and raise a family, its housing, schools, medical facilities, cultural and recreational activities, and its civic pride. SCHMENNER, *supra* note 30, at 20.

39. Many studies have concluded that regional differences in labor costs, construction costs, and energy costs are generally too large to be offset by differences in tax levels. For one of the pioneering studies, see GARY L. CORNIA, WILLIAM A. TESTA & FREDERICK D. STOCKER, STATE-LOCAL FISCAL INCENTIVES AND ECONOMIC DEVELOPMENT (Acad. for Contemporary Problems, Urban and Regional Dev. Series No. 4, 1978).

($200-$100).[40]

In 2000, state and local taxes paid by businesses reduced their total receipts by 1.1% and amounted to only 1.2% of their costs of doing business. That burden was further reduced by the federal deductibility of state and local taxes. After federal deductibility, all state and local taxes paid by businesses reduced their revenues by 0.7% and accounted for only 0.8% of their costs. Moreover, each dollar of taxes collected from business lowers profits by less than $1 because firms, to some unknowable extent, can shift their taxes to customers, employees, suppliers, or shareholders.[41]

Fourth, differences in state and local taxes may reflect differences in the level and quality of state and local public goods and services, which also affect business locational decisions. Low taxes are not necessarily attractive to businesses if they mean that the firm will have to supply, at its own expense, what is supplied through the public sector in other states or other jurisdictions. Furthermore, if low taxes mean inferior schools, a state may lack the educated and literate labor force that is essential to certain types of businesses.[42] Of course, not all public goods and services are equally important to businesses.

Fifth, to the extent that tax rate differentials are capitalized, their impact will be reduced. For example, low property taxes in one jurisdiction might mean that land sells there for a higher price than what it would sell for in another jurisdiction having higher property taxes. In other words, land located in a high-property-tax jurisdiction may sell for less than an equivalent parcel of land in a low-tax jurisdiction, assuming that differences in taxation are not reflected in differences in public services, which might also be capitalized.[43]

Sixth, most relocating companies plan to stay at their new site years longer than any group of elected officials is likely to be in office. Consequently, current tax levels, special concessions, or special features of the tax law may not be a reliable basis upon which to make a multimillion dollar investment. What one group of legislators might grant today by way of concession another might eliminate tomorrow, especially if financial conditions change significantly. Fiscal stability and predictability may be more important than special concessions.

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40. To the extent that other costs of a business are also deductible, the relative differentials between such costs and taxes would be unchanged.

41. Robert G. Lynch, *Weaknesses in the Common Arguments for State and Local Tax Cuts and Incentives*, 32 ST. TAX NOTES 597, 598 (2004).

42. *See* C. Tiebout, *A Pure Theory of Local Expenditures*, 54 J. POL. ECON. 416 (1956).

43. *See* W. Oates, *The Effects of Property Taxes and Local Public Services of Property Values: An Empirical Study of Tax Capitalization and the Tiebout Hypothesis*, 77 J. POL. ECON. 957 (1969).

Seventh, a state tax incentive that is granted by way of incorporating a similar federal provision may have no impact on a firm's decisionmaking if the future of the federal provision itself is in jeopardy. For example, states have been urged to adopt the recent federal provisions on bonus depreciation in order to provide a tax incentive to businesses. It is highly unlikely that any business would make a major investment decision on the basis of whether a state had adopted bonus depreciation.[44]

Eighth, state tax incentives may contain their own seeds of destruction. If incentives are effective at all, a state will gain only a short-lived advantage over other states because the latter can be expected to adopt similar ones.[45] A tax incentive that is adopted by all states is equivalent to no incentive at all, except that tax revenue is needlessly lost. In reality, however, states are afraid of letting any other state obtain an advantage, and thus tax incentives are often adopted without evaluating the results that occurred elsewhere.

Ninth, some executives charged with the locational decision may be uninformed about the existence of tax incentives. For example, one researcher found that most firms were unaware of whether tax incentives even existed when making their locational decisions. The major accounting firms, however, now have groups that advise their clients about existing incentives.

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44. For a general discussion, see REPORT BY THE STAFF OF THE LEGISLATIVE COMMISSION ON THE MODERNIZATION AND SIMPLIFICATION OF TAX ADMINISTRATION AND THE TAX LAW, THE ARTICLE 9-A FRANCHISE TAX: SHOULD NEW YORK ADOPT ACRS? (Dec. 31, 1984). The issue of whether a state should adopt the new federal bonus rules on depreciation also illustrates a significant difference in perspective between federal and state tax law. When Congress enacts special tax provisions designed to encourage investment, it is indifferent to where within the United States such activity occurs. A particular state does not share this perspective, however. If state law mirrors federal measures designed to encourage investment regardless of where it occurs, a state may lose revenue to support investment occurring beyond its borders, the benefits of which may not sufficiently rebound to that state. If the policy question is phrased as whether a state should adopt a tax incentive that results in a loss in revenue for investments made in other states, most officials would answer with a resounding 'No.' Yet, if a state were simply to adopt the federal bonus depreciation, as has been proposed by many persons, a corporation would receive the benefits of the faster depreciation for investment occurring both within and without the state. Indeed, most of the revenue loss might be attributable to investments made in other states. *See id.* It is probably unconstitutional for a state to limit bonus depreciation to only in-state investment. *See* Cuno v. DaimlerChrysler, Inc., No. 00-07247, 2004 WL 1944019 (6th Cir. Sept. 2, 2004); R.J. Reynolds Tobacco Co. v. City of New York Dep't of Fin., 643 N.Y.S.2d 865 (Sup. Ct. 1995); Beatrice Cheese, Inc. v. Wis. Dep't of Revenue, Nos. 91-I-100, 91-I-101, 91-I-102, 1993 WL 57202, at *3 (Wis. Tax App. Comm'n, Feb. 24, 1993); Enrich, *supra* note 25; Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 CORNELL L. REV. 789 (1996).

45. For example, shortly after New York adopted its double-weighted receipts factor Massachusetts and Connecticut adopted similar provisions. *See* REPORT BY THE STAFF OF THE LEGISLATIVE COMMISSION ON THE MODERNIZATION AND SIMPLIFICATION OF TAX ADMINISTRATION AND THE TAX LAW, THE ARTICLE 9-A FRANCHISE TAX: THE DOUBLE-WEIGHTED RECEIPTS FACTOR (May 1985).

In the case of those firms that were aware, only a small portion claimed that they would have located in another state in the absence of the incentives. Further, most firms making new investments did not even consider locating in any state other than their final choice.[46]

Finally, there are relatively few footloose firms that can be affected by tax incentives.

Professor Enrich has summarized the debate over taxes and economic development as follows:

> [R]elative to other costs of doing business, state taxes are simply too small to have a major influence on business decision-making. Other factors with far greater impacts on costs, accessibility of raw materials and markets, and regulatory stringency, are far stronger determinants of location decisions and of economic growth. The literature on economic development incentives is filled with examples of business acknowledging that their decisions were not guided by the available state fiscal incentives. Often business decision makers were unaware of the incentives until after their decision; in other cases, the incentives were candidly acknowledged as what one executive called 'a little extra cream on top.' At best, incentive packages only become relevant in breaking a tie between sites that do not differ significantly on more important dimensions.[47]

If all the evidence suggests that rate cuts and tax incentives are an ineffective tool for development, why have they proliferated?

> In a political atmosphere dominated by concerns about economic vitality and jobs, elected officials face intense pressure to engage in the incentive competition. In such an atmosphere, each state strives to match other states' efforts and to make itself more attractive to

46. Some economists argue that business accounting and organizational structures can reduce the effectiveness of a tax incentive. Tax incentives operate at the overall company level by reducing the company's final tax. But the problem that generated the need for a tax incentive is often focused at the plant level, where the plant manager is faced with the decision to purchase equipment that would otherwise be unprofitable without the tax incentive. Consider, for example, the investment tax credit (ITC). Unless the tax savings at the overall level are allocated within the company to the particular plant, that plant manager might be saddled in the company's books with a high pre-ITC cost for the equipment. *See* STANLEY S. SURREY ET AL., 1 FEDERAL INCOME TAXATION 271 n.21 (1972). Further, the plant manager or other persons in charge of purchasing equipment may be unaware of the credit. A staff member of Minnesota's Taxation Committee expressed a similar sentiment: "We've learned that accountants are better at discovering tax breaks than managers." *See* D. Frey, Economic Development Tax Incentives: A Staff Perspective, Paper Presented at the National Conference of State Legislatures (July 22, 1984).

47. Enrich, *supra* note 25, at 391–92.

businesses than its neighbors and competitors. Failing to do so is perceived as the equivalent of unilateral disarmament in the face of a first-strike attack.[48]

[E]lected officials are often as interested in the symbolic content of their actions as in their concrete effects. By taking visible steps to encourage economic growth, they can take credit for subsequent economic successes, whatever their actual causes, and avoid blame for any losses of jobs to other states that otherwise would have been attributed to them if they failed to act. From a political perspective, doing something is almost always better than doing nothing, particularly in regard to an issue about which voters care deeply. That other states are actively engaged in the competition strengthens the political arguments for joining in, both by providing cover, with which officials can justify their own actions, and by fueling the perception that a failure to act would be either negligence or folly.[49]

Even if the likelihood of a positive impact is understood to be slim, the potential benefits of a visible success, even when discounted for its low probability, may far outweigh the political costs of a measure whose burdens, in the form of reduced government revenues, are indirect and widely dispersed. Moreover, those constituents who will be directly and positively affected by a favorable location decision (or injured by a negative one) will typically be far more vocal on the issue than those state citizens who bear the diffuse costs, and far more likely to base their ultimate assessments of decision makers on their performance in this sphere.[50]

The businesses that stand to benefit from state incentives have learned to fuel the interstate competition. As incentives have become more and more common, businesses have come to expect governmental sweeteners as routine fringe benefits of their siting decisions. Businesses have become increasingly adept at playing the states off against one another to stimulate more attractive offers. A former New York state tax commissioner, for example, describes businesses' "conducting highly publicized 'negotiations' with another state or buying an option on office space in another state" solely to create the impression that they needed to be wooed. And, because business leaders and their lobbyists typically have ready access to elected officials, business advocates' self-serving assertions about the

48. *Id.* at 393.
49. *Id.* at 394.
50. *Id.*

> importance of state tax policy to the business climate and to business location decisions carry substantial weight in the political process.[51]
>
> Given the powerful political impetus to participate in the incentive competition, tax breaks offer state officials a particularly convenient mechanism for the delivery of incentives. Because tax breaks involve a reduction of public revenues, rather than an expenditure of public funds, they do not directly compete with other programs demanding scarce governmental resources. They are typically adopted through a process independent of the appropriation machinery, and they ordinarily do not require annual re-authorization, as direct budgetary outlays do.[52]

The above discussion represents the longstanding view that state taxes have an insignificant effect on economic development. Is there any reason to abandon this view in light of recent studies? Professor Lynch, who reviewed these recent studies, acknowledges that although state tax cuts and incentives might theoretically create jobs in a cost-effective manner, in practice they are unlikely to do so. He criticizes some of the well-known studies that have concluded otherwise on the grounds that: they failed to take into account the interrelationship between taxes and public services and assumed that taxes can be cut without a reduction in services; the studies suggested only small effects of taxes on economic activity and the results were often inconsistent with each other, not reproducible, and unreliable; the negative effects of state and local taxes were exaggerated; contrary to the assumptions of the econometric studies, state and local taxes may be irrelevant to business investment decisions; and most of the studies measured their explanatory variable tax burdens inaccurately. After reviewing the recent studies, Professor Lynch concluded that:

> The only thing that can definitely be concluded from the body of research on tax cuts is that the effects of tax cuts are small at best, and zero or negative if one takes into account the need to cut public services when taxes are cut. At minimum, policymakers should be wary about making economic policy based on the inconsistent results of econometric studies.[53]

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51. *Id.* at 394–95.

52. *Id.* at 395.

53. Robert G. Lynch, *The Effects of State and Local Taxes and Public Services on Economic Development*, 32 ST. TAX NOTES 767, 771 (2004).

Professor Lynch also determined that the recent econometric research suggests that state and local tax cuts and incentives are a cost-ineffective way of creating jobs. If the amount of forgone tax were spent by the public sector, more jobs would be created than by implementing the tax cuts and incentives. He describes the recent econometric studies as "nearly unanimous in concluding that state and local tax incentives fail to attract a significant number of new businesses, create numerous jobs, or substantially enhance state economic performance."[54]

To the contrary, recent studies suggest that increases in taxation that financed increased spending on education and infrastructure actually encouraged economic growth. Some public services, such as roads and highways, stimulated economic activity by making it cheaper for firms to transport goods. Other services, such as education and health, increased the productivity of labor. Consequently, tax reductions may hurt growth and employment by reducing public services.

That public spending might stimulate the economy more than tax cuts is not surprising. When taxes are increased to fund public services, the additional spending occurs locally. But a cut in taxes will not necessarily result in increased local spending. Some of the tax cut might be saved and not spent, but if spent, might not be spent locally. Indeed, the net effect of a tax cut is likely to be a loss of employment. Any jobs that might result from cutting taxes are likely to be offset by the jobs lost because of reduced public services.

Tax cuts and incentives can also undermine other factors that contribute to a good business climate. Business climate is a slippery concept. Attempts to measure a state's business climate often suffer from the problems encountered in measuring a state's tax burden: Most business climate studies are not industry-specific and are thus too general to be very useful. Disparate industries are likely to have very different impressions of a state's business climate, and a general study that ranks various aspects of doing business in a state cannot reflect the priorities of every sector of the economy.[55] In discussing the psychological effects of investment incentives on a state's business climate, Professor Bird notes that "unfortunately, about all one can do about such matters is to note their existence and our inability to say anything definite about them."[56]

However defined, tax incentives and tax cuts, by reducing revenue, can actually undermine a state's business climate. As Professor Lynch notes:

54. *Id.* at 768.

55. *See* Pomp, *supra* note 4, at 403 n.63.

56. RICHARD BIRD, TAX INCENTIVES FOR INVESTMENT 49 n.10 (1980).

> Businesses need to know that they can rely on high-quality, well-administered public services to facilitate the conduct of their enterprises. Roads, bridges, and highways must be maintained in good repair; ports and airports must be large enough to handle transportation needs; sewage systems must be adequate to meet the needs of existing firms and be expandable to service prospective businesses; snow removal and flood control must be reliable and timely; fire protection and police services must be ready when needed; the justice system must be professional, impartial, and quick to resolve contract disputes; and the schools and colleges must help to generate a skilled and well-trained workforce. A relatively crime-free state with high-quality public services, including a good infrastructure and a high educated workforce, will have an excellent business climate.[57]

The data indicate that most incentives provide money to projects that would have taken place anyway. In many cases, the money forgone by the cuts and incentives could have been better spent to enhance the "business climate" by investing in public service improvements.[58]

The above are general observations, not specific to the economic effects of combined reporting, which has not been studied with any degree of rigor because of empirical constraints. There is, however, nonrigorous evidence about the effects of combined reporting on economic development that tends to support the literature reviewed above and that rebuts the negative claims of the business community that its adoption would be harmful to a state's economy. For example, the combined reporting states are disproportionately among the most economically successful. Since manufacturing employment peaked in the United States in 1979, combined reporting states constituted: four of the top five states in manufacturing job growth, seven of the top ten states in manufacturing job growth, and ten of the seventeen states with positive manufacturing job growth.[59] From 1990 to 1995, manufacturing jobs in New Hampshire, a combined reporting state, grew 3% while manufacturing jobs in Massachusetts, a separate entity state, fell 2.3%. Intel has located more jobs and investment in Oregon, a combined reporting state, than in any other state over the past 25 years. Finally, being the most aggressive practitioner of combined reporting did not stop California from becoming the high-tech capital of the country. These statistics are particularly impressive given that only approximately 16 states use combined reporting.

57. Lynch, *supra* note 41, at 601.

58. Lynch, *supra* note 41, at 603.

59. Data supplied by Michael Mazerov of the Center on Budget and Policy Priorities.

These observations, when combined with the robust literature on taxation and economic development, point in the same direction: that a state probably should not fear adverse economic effects from the adoption of combined reporting. The debate will never be conclusive but certainly the burden of proof should be on the business community, which is advocating a position that is belied by approximately 30 years of studies plus anecdotal evidence.

Moreover, Wisconsin would seem to have less reason to fear than other states. According to a recent study commissioned by the Council on State Taxation ("COST"),[60] Wisconsin is not a particularly high business tax state. When arrayed by "business share of all taxes," Wisconsin ranks dramatically lower than the rest of the country, and hence much lower than its four contiguous neighbors (45th in the country for Wisconsin, compared to 14th for Illinois, 25th for Iowa, 27th for Michigan, and 41st for Minnesota). "Business taxes per employee" shows the same trend (40th for Wisconsin compared to 14th for Illinois, 37th for Iowa, 22nd for Michigan, and 31st for Minnesota). These numbers should be comforting for those who are the type to take comfort in statistical aggregates. Politically, they are useful, which is why many organizations generate such data.

Personally, however, I do not find them very useful, notwithstanding that these types of tax burden comparisons have become a standard feature of debates over state tax policy. Too often these studies have been used without any candid discussion of their inherent weaknesses. This lack of discussion is unfortunate because the utility of interstate tax comparisons for state policymakers is problematic, and serious questions can be raised concerning their use and abuse.[61]

60. ROBERT J. CLINE, WILLIAM F. FOX, THOMAS S. NEUBIG & ANDREW PHILLIPS, TOTAL STATE AND LOCAL BUSINESS TAXES (2004).

61. Professor Zubrow issued a similar warning more than 40 years ago:

> The measurement of comparative State and local tax burdens constitutes one of the more formidable if not wholly intractable tasks in the field of public finance. This is usually recognized by students of taxation despite the fact that special tax committees, industrial development agencies, representatives of business and sundry other special interest groups are continually 'proving' that the tax burdens in their respective States or communities are either higher or lower than those prevailing elsewhere.

REUBEN A. ZUBROW, SOME DIFFICULTIES WITH THE MEASUREMENT OF COMPARATIVE TAX BURDENS, PROCEEDINGS OF THE 54TH ANNUAL CONFERENCE OF THE NATIONAL TAX ASSOCIATION 151 (1961). The temptation to continue to misuse such studies is apparently irresistible.

2. Uses and Misuses of Interstate Tax Comparisons[62]

a. Are Taxes Too High or Too Low?

One of the most common uses made of interstate comparisons is to determine whether taxes paid by individuals or businesses are too high. Although simple to state, the 'too high' question is exceedingly difficult to answer. In the abstract, most businesses would have little difficulty agreeing that taxes are too high. Who would not like a tax reduction? On a more concrete level, however, the relevant inquiry is whether the amount of taxes paid represents fair value for the level of governmental goods, services, and transfer payments received by a state's residents. More specifically, how does the level of taxation compare with the quantity and quality of the goods, services, and transfer payments that such taxes finance? How do these goods and services compare with those that are desired by the electorate? If taxes were lowered, what would be the impact, if any, on the quality of life or business climate in a state?

These are critical questions in determining whether taxes are too high, but not ones that are explicitly addressed by interstate tax comparisons.[63] By their nature, such comparisons deal only with the revenue-raising side of the budget and not with the spending side. Without examining interstate differences in public goods and services, however, comparisons limited only to taxes provide an incomplete picture.

First, differences in taxes might reflect differences in the scope or quality of governmental goods, services, and transfer payments. State and local governments differ from each other in terms of their size, location, demographics (e.g., population density, the number of families below the poverty level, the number of elderly), the degree of urbanization, commercial development, tax bases, and social philosophy. Not surprisingly, businesses in Wisconsin may prefer a higher level of goods, services, or transfer payments than do residents of jurisdiction Y. A study can determine that taxes are higher in Wisconsin than in Y, but by itself, no inference could be drawn that taxes were 'too high' in Wisconsin. After all, taxes are what we pay for civilized society and jurisdictions differ in their views about what constitutes a civilized or just society.

Second, differences among states in levels of taxation may not necessarily represent differences in the scope or quality of government goods and services, but rather of nomenclature. For example, businesses in a Wisconsin

62. *See* Richard D. Pomp, *The Use and Misuse of Interstate Tax Comparisons,* 5 J. ST. TAX'N 3 (1986), *reprinted in* 33 TAX NOTES 87 (1987).

63. *See id.*

jurisdiction may "pay" for garbage collection, water, or sewerage through their property taxes, whereas businesses in another state might pay for a similar level of services through user charges paid to either the public or private sector. Although Wisconsin appears to have the higher taxes, such a conclusion would be misleading.

Third, differences in taxation might represent differences among the states in the cost of government. Businesses in Wisconsin might pay more in taxes than businesses in State Y for the same level of goods and services because Wisconsin must pay more to provide those services than State Y. Costs can vary among states because of differences in climate, topography, demographics, the age and condition of the infrastructure, the degree of urbanization, or the amount of bureaucratic waste and inefficiency. To take just one illustration, the cost of maintaining a highway is likely to be greater in Wisconsin, which is subject to extremes in weather conditions, than in a state having a temperate and more stable climate.

In the abstract, the "too high" question provides little useful information for Wisconsin policymakers. For the 'too high' question to be useful, the taxpayers of interest must be specifically identified. Are taxes too high for individuals or corporations? If the former, what types of individuals are of concern? Commuters? Retired persons? Chief executive officers? Middle management? Blue-collar workers? Young professionals? People living at the poverty level? Taxpayers with capital gains, interest, or dividends? Married couples with two income earners?

Which corporations are of concern? Multistate corporations or intrastate corporations? Capital intensive or labor intensive? High-tech or old-line manufacturing? Those that are part of a family of related corporations? Corporations selling primarily within or without the state? Those that lease rather than own their property? As various studies have made abundantly clear, a state tax structure can treat taxpayers with the same economic income very differently so that the 'too high' question cannot be answered without clearly defining the taxpayer. Put differently, the taxpayers of interest will vary, depending on why policymakers are asking whether taxes are too high in the first place.

Even once the relevant individuals or corporations are defined, studies of comparative tax burdens cannot answer the question of whether taxes are too high relative to the quantity and quality of publicly provided goods, services, and transfer payments. Taxes represent but one-half of that question. Because the other half—comparing the level and quality of government expenditures—is fraught with methodological difficulties, the temptation is to focus only on the tax side of the question. Nevertheless, a systematic analysis of public expenditures is required before the 'too high' question can be

properly evaluated.

Instead of using interstate comparisons to determine whether taxes are 'too high,' sometimes they are used to determine whether taxes are 'too low.' Typically, the 'too low' question is phrased in terms of whether an underutilized source of revenue exists. To be sure, in some cases the underutilization of a tax base represents a conscious policy decision, such as the lack of a broad-based income tax in New Hampshire or Florida, the absence of a corporate income tax in Nevada, or Delaware's favorable rules on the taxation of income from intangibles. In other cases, however, policymakers may be unaware that they are relying less heavily upon a particular tax base than are their neighboring states. In any event, the 'too low' question raises the same range of issues as does the 'too high' question.

b. Are Taxes Discouraging Economic Development?

A second use of tax comparisons is to determine the effect of a state's tax system on attracting and maintaining businesses and their employees—an issue that is related to the 'too high' (or 'too low') question. This issue has been addressed above.

c. Are Taxes Out-of-Line with Other States?

A third use made of interstate comparisons is to determine whether a state is out-of-line with other states because its taxes are too high (or too low). As a matter of logic, a state can be out-of-line either because its taxes are too high or because the taxes in other states are too low. In many cases, however, the out-of-line question is another way of asking whether a state's taxes are too high and expresses concern over the negative impact that the tax system might be having on a state's economy. In other cases, the out-of-line question is another way of identifying a potentially underutilized tax base.

Occasionally, the out-of-line argument is used as evidence of waste or inefficiency in government. For example, if State X has higher taxes than State Y, but taxpayers in State X receive less in government goods and services than taxpayers in Y, the difference might be attributable to waste and inefficiency. Before this conclusion can be reached, however, differences in the cost and quality of government goods and services and the reliance on user charges need to be evaluated.

d. Are Taxes Fairly Distributed?

A fourth, though less frequent, use of interstate tax comparisons is to evaluate the fairness of the distribution of a state's tax burden. This inquiry has at least two aspects: the distribution of the tax burden between businesses

and individuals and the distribution of tax burdens among individuals or businesses. Theoretically, issues of fairness involve value judgments that should be independent of those reached by other states. Realistically, however, some constraints are imposed on policymakers. For example, many persons view a progressive tax as a fair tax. A conflict may arise, however, between the progressivity of a state tax system and the need to attract businesses and employees. At some point, a state tax system may be so progressive that it encourages middle- and high-income persons to live elsewhere, a consideration that might be especially relevant for states having metropolitan areas located within commuting distance from other states. Similarly, a state is not unconstrained in the proportion of its taxes that it can raise from businesses. Ultimately, however, the economic effects of how a state distributes its tax burden cannot be determined without taking into account who benefits from the provision of public goods and services.

3. Preferred Approach to Interstate Tax Comparisons

Legislators are often being told that making a change in the corporate income tax is the key to economic growth. Without it, corporations will abandon the state; with it, Wisconsin can compete with the rest of the country. While a legislator should be very skeptical about finding the Holy Grail in such a convenient manner, the temptation for legislators to do something to help the economy is strong. So how should Wisconsin policymakers evaluate the effect that a proposed change might have on business?

My preferred approach is to measure the effects of a tax change on a corporation's after-tax rates-of-return. After all, that is one of the key ways that businesses use to evaluate their own investment and locational alternatives. Using after-tax rates-of-return has a number of advantages over the use of more aggregate measures. (One disadvantage of this approach is that it ignores the value of state and local services to the business, and more generally, to the state as a whole. A few researchers, however, addressed this weakness.)[64]

First, the use of after-tax rates-of-return allows tax differentials to be completely isolated from other factors that may influence a firm's profitability. This approach allows a state or firm to determine how significant other cost advantages have to be to overcome a tax disadvantage (or vice versa). Because the more aggregate studies cannot isolate tax differentials, they present a less accurate picture.

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64. *See, e.g.*, ALAN H. PETERS & PETER S. FISHER, STATE ENTERPRISE ZONE PROGRAMS: HAVE THEY WORKED? (2002); Robert Tannenwald, *State Business Tax Climate: How Should It Be Measured and How Important Is It?*, NEW ENG. ECON. REV. (Jan./Feb. 1996).

To illustrate the weaknesses in some of these other more aggregate studies, consider those that use total tax collections divided by total business costs as their measure of tax burden. One problem with this approach is that costs and profits vary extensively by state and by industry. A high ratio of aggregate tax-to-business costs may not mean that a state is taxing heavily relative to other states; it may simply mean that nontax costs are low. A more fundamental defect in this approach, however, is that taxes and business costs are not always independent of each other. If government-provided goods and services reduce costs that a corporation would otherwise incur, a state with a high tax-to-cost ratio may actually be a better place to do business than a state with a low tax-to-cost ratio.

Another approach that can be misleading is to compare tax burdens by dividing business taxes by total tax receipts. The resulting ratio indicates only the proportion of state taxes paid by businesses and not the overall level of taxation. A state with a high ratio may actually impose a lower tax on business than a state with a low ratio. Finally, any aggregate type of measure, whether taxes-to-business costs or business taxes divided by total taxes, cannot possibly reflect the range of special tax provisions that exemplify state tax structures. As one group of researchers stated, "it makes little sense to talk of State A being a higher taxing State than State B except in terms of particular firms and then only in relation to specific marginal investments."[65] Using after-tax rates-of-return eliminates these defects.

A second major advantage of using after-tax rates-of-return is that it precisely captures the federal offset. For a firm subject to a 35% federal marginal rate, a $10,000 local property tax results in a net out-of-pocket cost of only $6500 ($10,000 – 35% × $10,000). Conversely, a state investment tax credit of $10,000 increases the firm's after-tax profits not by the full amount of the credit, but by only $6500. This interaction between the federal corporate tax and state and local taxes is particularly important when considering policy changes. Unless this interaction is considered, the benefits to the firm cannot be accurately weighed against any revenue forgone.

Indeed, the federal offset highlights an inherent inefficiency in the use of state tax incentives. By lowering a corporation's state taxes, a tax incentive has the effect of increasing the corporation's federal taxes. For a corporation subject to a 35% federal marginal tax bracket, every $100 of state tax savings increases its federal taxes by $35. In other words, a state forgoes $100 in tax

65. Thomas Vasquez & Charles W. deSeve, *State/Local Taxes and Jurisdictional Shifts in Corporate Business Activity: The Complications of Measurement*, 30 NAT'L TAX J. 285, 293–94 (1977). *See also* James A. Papke & Leslie E. Papke, *The Competitiveness of Indiana's Business Tax Structure*, *in* 2 INDIANA'S REVENUE STRUCTURE: MAJOR COMPONENTS AND ISSUES (James A. Papke ed., 1984).

revenue but the corporation receives only $65 ($100-$35) in net benefit, with the federal government receiving $35 of increased revenue. Put differently, to reduce a firm's overall taxes by $100, a state must forgo $154 in taxes, with the federal government benefiting by $54. This "reverse revenue sharing," which is inherent in using state tax incentives, is fully captured by the use of after-tax rates-of-return.[66]

Third, the use of after-tax rates-of-return helps determine whether tax provisions may affect different firms in different ways. Different firms earning identical before-tax profits may pay different taxes in the same jurisdiction. Tax liabilities may vary with asset composition (personal vs. real property), the location of sales (in-state vs. out-of-state), or the size of the firm. As an example, the recently adopted federal bonus depreciation provides significant advantages to firms with a large proportion of their assets in depreciable property. "Decoupling," that is, not incorporating bonus depreciation into state tax law, thus affects some firms more than others.[67] Similarly, single weighting the apportionment formula will affect firms very differently depending on whether they export from Wisconsin or import into Wisconsin. In formulating state policy, it is important to know whether the tax system favors or disfavors firms with particular characteristics or firms in specific industries. Unlike the more aggregate measures of corporate tax burden, the use of after-tax rates-of-return is designed specifically to capture these differences.

Fourth, after-tax rates-of-return capture both the level and patterns of tax liabilities over time. A firm contemplating a new investment is concerned not only with the taxes it will pay in the first year of its investment but also with its tax liabilities over time. A one-year measure of tax liability is misleading because taxes vary from year to year. A corporate income tax, for example, will not be paid during loss years (typically occurring during a start-up period), whereas property and sales taxes will. After-tax rates-of-return readily account for the level, pattern, and duration of the firm's tax liabilities.

Fifth, the effects of changes in the tax law on the profitability of firms can be evaluated using after-tax rates-of-return. Changes in parameters such as depreciation rates, apportionment formulas, tax credits, or tax rates can be simulated and the impact on profits—often surprisingly small—can be measured.

66. A reduction in the rate of the franchise tax would also have the effect described in the text. A state program that was structured to provide a tax-free benefit to a corporation would not have such an effect if the program did not reduce a cost that a business would have otherwise incurred.

67. For a general discussion, see REPORT BY THE STAFF OF THE LEGISLATIVE COMMISSION ON THE MODERNIZATION AND SIMPLIFICATION OF TAX ADMINISTRATION AND THE TAX LAW, THE ARTICLE 9-A FRANCHISE TAX: SHOULD NEW YORK ADOPT ACRS? (Dec. 31, 1984).

Sixth, a corporation considering a new investment in one state is concerned with the effect of the investment on its tax liabilities in other states. Because of the various ways in which the states divide the income of a corporation for income tax purposes, the taxes paid in State A can be affected by a corporation's expansion into State B. A calculation of after-tax rates-of-return will capture this interaction, whereas a one-year snapshot of the taxes paid to State B will not.

The final advantage is that an after-tax rate-of-return analysis requires a state to model the types of corporations that are of interest. For example, a sensible approach to economic development would be to determine what Wisconsin's strengths and comparative advantages are over other states. What kinds of businesses and activities make sense for the future of the state? How can Wisconsin build on its advantages? After all, not every type of economic activity makes sense for a state.

Once Wisconsin policymakers determine the types of activities or industries they are trying to attract, the next logical step would be to determine the existing obstacles or hurdles. What will the CEO of a corporation in a targeted industry that Wisconsin wishes to attract consider to be the impediments to moving or expanding in the state? While I am skeptical that the corporate income tax would rank high on that list, let alone some feature like the lack of single-factor apportionment, the firm can nonetheless be modeled and its after-tax rates-of-return can be determined. Various changes in the corporate income tax can then be simulated and their effects on after-tax rates-of-return evaluated. Certainly this approach provides more useful and focused information than relying on the types of statistical aggregates discussed above.

I was not privy to how Wisconsin debated its future shift to a single-factor apportionment formula. I suspect that the shift will save a few in-state corporations sizable amounts of tax, so that the shift was possibly advocated based on economic development grounds. I also suspect that the fact that out-of-state corporations will experience a tax increase might have been attractive to some legislators. I would not be surprised if legislators were told they had to match what other states were doing with their apportionment formulas. As I have argued elsewhere, the shift to single-factor apportionment may actually discourage, not encourage, as is often argued, out-of-state corporations from expanding in Wisconsin.[68]

In debating the shift to a single sales factor, I doubt the legislature first

68. POMP & OLDMAN, *supra* note 10, at 10–13. *See also* MICHAEL MAZEROV, THE SINGLE SALES FACTOR FORMULA FOR STATE CORPORATE INCOME TAXES: A BOON TO ECONOMIC DEVELOPMENT OR A COSTLY GIVEAWAY? (2001).

asked the question about what types of corporations Wisconsin is looking to attract, and then concluded that the obstacle to their coming to Wisconsin was the apportionment formula. But even if they had, the next question would be whether the change in the apportionment formula would have the desired effect. And that question should be answered in terms of the effect the shift to single-factor apportionment will have on after-tax rates-of-return, not based on self-serving anecdotes by business, as is so often the case.

III. REFORMING THE WISCONSIN SALES TAX

I am sure that insiders at this Conference have a panoply of suggestions for cleaning up defects in the Wisconsin sales tax. I will leave it to them to discuss improvements in the existing statute. I would like to address a more global issue: entity isolation.

The problem of entity isolation can be easily described. Suppose a corporation owns at least one store in Wisconsin. No one disputes that this so-called brick and mortar nexus requires that the corporation collect the Wisconsin sales tax on transactions occurring at the store. Similarly, if the same corporation were to sell over the Internet, through the mail, or via the telephone and ship those goods into Wisconsin, it would also have to collect the state's sales (use) tax. But what if the corporation attempts to isolate its brick and mortar nexus by creating a new related entity for its remote selling? Does the existence of brick and mortar nexus by a related entity mean that the remote vendor, not having nexus itself with Wisconsin, nonetheless has to collect the state's use tax?

This description of what is known as entity isolation is critical to Wisconsin's fiscal policy. Many of the largest retailers in the country use some type of corporate structure to isolate their brick and mortar nexus. Most corporations have created new dot.com entities for doing business over the Internet. Even prior to the growth of the Internet, brick and mortar companies were placing their mail-order operations in a separate entity.[69]

Any legal analysis of whether a dot.com entity can be made to collect the Wisconsin sales or use tax must start with *Quill v. North Dakota*.[70] The U.S. Supreme Court in that case endorsed two safe harbors. The first is based on the Court's holding in *National Geographic v. California Board of Equalization*.[71] That case held that a vendor has nexus with a state if it has a

69. *See e.g.*, SFA Folio Collections, Inc. v. Bannon, 585 A.2d 666 (Conn. 1991), *cert. denied*, 501 U.S. 1223 (1991); SFA Folio Collections, Inc. v. Tracy, 652 N.E.2d 693 (Ohio 1995); Bloomingdale's By Mail v. Comm'r Dept. of Revenue, 567 A.2d 773 (Pa. Commw. Ct. 1989).

70. 504 U.S. 298 (1992).

71. 430 U.S. 551 (1977).

physical presence in that state, which is not de minimis. The second safe harbor is based on *National Bellas Hess, Inc. v. Department of Revenue.*[72] That case held that a vendor does not have nexus if it does not have a physical presence in the state, and its only connection with customers in the taxing state is by common carrier or the United States mail. Neither *Quill* nor *Bellas Hess* addressed parent-subsidiary structures.

According to *Quill*, these safe harbors are "a means for limiting state burdens on interstate commerce."[73] Like other bright line tests, "this test appears artificial at its edges: Whether or not a state may compel a vendor to collect a sales or use tax may turn on the presence in the taxing state of a small sales force, plant, or office."[74]

The *Quill* Court was influenced by the existence of more than 6000 local sales and use tax jurisdictions in the country.[75] The Court was concerned about the imposition on interstate commerce that would result from a remote vendor having to master the sales and use tax laws of all of these jurisdictions. The Court protected what it viewed as the legitimate interests of vendors that relied on *Bellas Hess*. The Court was also concerned about the retroactive application of a state victory in *Quill*.

Is entity isolation protected by *Quill*? Such a remote vendor is doing more than merely selling to customers in Wisconsin through a common carrier or the U.S. mail. Accordingly, the safe harbor would not automatically apply to immunize the vendor from collecting the Wisconsin use tax.

Although the safe-harbor might not literally apply, and certainly the vendor could not argue that it had any reliance interests to be protected because there is no Supreme Court decision on point, would the Court nonetheless be solicitous of the burden that would be imposed on interstate commerce if the vendor were forced to collect the use tax? But how much of a burden exists when the remote vendor is part of a corporate family that has already mastered the sales and use tax laws of the market state? After all, it is one thing for a vendor sitting in the basement of her home in Utah, who has carved out a niche for a specialty product that she is selling over the Internet, to have to master the sales and use tax laws all over the country, and quite a different imposition for a vendor that is part of a corporate family that has already acquired the necessary expertise.[76]

72. 386 U.S. 753 (1967).

73. 504 U.S. at 313.

74. *Id.* at 315.

75. *Id.* at 313 n.6.

76. See Michael J. McIntyre, *Taxing Electronic Commerce Fairly and Efficiently*, 52 TAX LAW REV. 625 (1997), who first proposed the argument discussed in the text.

Put differently, the brick and mortar store has already mastered the intricacies of the Wisconsin sales tax. It is already collecting the sales tax from customers at its stores. If the brick and mortar entity started a new Internet division operated under the same corporate umbrella, there would be no doubt under existing law that sales or use tax would have to be collected. But if the Internet division were incorporated, there would be no new imposition on interstate commerce. The new entity would have the same access to the collective experience and expertise of the brick and mortar corporation in collecting the Wisconsin sales and use tax.[77]

Some states have recently adopted statutes that require a remote vendor to collect a state's use tax if it is selling goods into a state that are similar to goods sold by a brick and mortar related entity. Wisconsin should analyze these statutes and adopt the best features of each.

None of these recent statutes has yet been challenged. There have been, however, a few state cases that raise the issue of entity isolation in the context of a sales tax. Although taxpayers have won most of these,[78] only one involved the interpretation of a statute, similar to what I am proposing. The state supreme court's analysis in that case has been described as "baffling."[79] Although the court refers to constitutional issues, the case is ultimately one of statutory interpretation.

With a tightly drawn statute and a carefully crafted argument, I think the U. S. Supreme Court would be likely to uphold the obligation to collect the Wisconsin sales/use tax. Besides the logic of the argument, as elaborated above, I think the Court will be sympathetic to a state for two reasons.

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77. The U.S. Supreme Court has indicated in other contexts that the line between a division and a corporation should not have constitutional significance. For example, in *Electric Bond & Share Co. v. SEC*, 303 U.S. 419 (1938), the Court declared that:

> The findings of the District Court . . . leave no room for doubt that these defendants are engaged in transactions in interstate commerce. That they conduct such transactions through the instrumentality of subsidiaries cannot avail to remove them from the reach of the federal power. It is the substance of what they do, and not the form in which they clothe their transactions, which must afford the test. The constitutional authority confided to Congress could not be maintained if it were deemed to depend upon the mere modal arrangements of those seeking to escape its exercise.

Id. at 440. *See* McIntyre, *supra* note 76, at 643. The issue of combined reporting is another context in which the Court has treated a related entity the same as a division. *See* John A. Swain, *Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?*, 75 S. CAL. L. REV. 419 (2002). Issues involving local sales and use taxes might impose a greater burden on the dot.com corporation than on the brick and mortar corporation.

78. *See, e.g.*, Bloomingdale's By Mail v. Comm'r Dept. of Revenue, 567 A.2d 773 (Pa. Commw. Ct. 1989).

79. McIntyre, *supra* note 76, at 649.

First, *Quill* was a highly unprincipled decision.[80] The *Quill* Court had a political agenda. The Court wanted to protect the reliance interest of the mail order industry that had structured itself around the holding of *Bellas Hess*. To avoid having to collect a use tax, many remote vendors structured themselves so that they did not have a physical presence in the market state and limited activities there to common carriers and the U.S. mail.

Second, the Court wanted to remove any doubts about the constitutionality of congressional intervention. Whenever Congress had previously considered enacting bills that would require remote vendors to collect the use tax if certain conditions were met, the argument was raised that earlier Supreme Court decisions, especially *Bellas Hess*, were grounded on considerations of due process. The orthodox view is that Congress can expand due process protections but cannot contract them. Consequently, if *Bellas Hess* and the physical presence safe harbor were viewed as implementing due process safeguards, there would be doubt about whether federal legislation could require a use tax to be collected where the Court had ruled otherwise.

The Court skillfully finessed this dilemma by bifurcating, for the first time, the concept of nexus. The *Quill* court held that there were actually two concepts of nexus, one located in the Due Process Clause, and one located in the Commerce Clause. This novel approach, without support in the case law, allowed the Court to pursue its agenda. By holding that Quill had Due Process contacts with North Dakota, the Court cleared the way for federal legislation. By holding that Quill did not satisfy Commerce Clause nexus, the reliance interests of remote vendors would be protected.

Justice White chided the majority for its unprecedented approach.[81] The Court was willing to engage in such unprincipled behavior because, as parts of the opinion make clear, it viewed Congress as being the appropriate body to deal with this complicated issue. In more than one place in the opinion, the Court invited Congress to act.

Twelve years have passed since *Quill* was decided and while Congress is still debating the issue, no action has been taken. Moreover, the revenue threat to the states is much more severe because of the growth of the Internet. My guess is that should the Court grant certiorari in a dot.com situation, its frustration with Congress will make it more favorably disposed toward the states.

Second, the world has changed in another fundamental way: the existence

80. *See* Richard D. Pomp & Michael J. McIntyre, *State Taxation of Mail-Order Sales of Computers After Quill: An Evaluation of MTC Bulletin 95-1*, 11 ST. TAX NOTES 177 (1996).

81. Quill v. North Dakota, 504 U.S. 298, 325 (1992) (White, J., dissenting).

of the Streamlined Sales Tax Project ("SSTP"). One of the brightest rays of hope for state sales tax reform, the SSTP was instituted by state governments in 1999 with the assistance of the Multistate Tax Commission, the Federation of Tax Administrators, the National Conference of State Legislatures, and local governments. The SSTP has surprised skeptics by making substantial progress toward modernizing, unifying, and simplifying sales and use tax collection and administration. Diane Hardt, Wisconsin's gift to the SSTP, has been a moving force, so it is ironic that Wisconsin has yet to adopt the conforming legislation. The accomplishments of the SSTP will help assuage the Court's concerns in *Quill* about the imposition on interstate commerce from the then messy world of state and local sales taxes. If the SSTP's successes continue, it becomes more likely that the Court will uphold the type of statute suggested above.

The problem may also be mooted by recent changes in the marketing of electronic commerce. The emphasis is currently on blurring the lines between the brick and mortar and the dot.com businesses. Internet orders can increasingly be placed, picked up, or returned at the brick and mortar. This marketing goal of a seamless web should create nexus for the dot.com.

IV. TAX-EXEMPT PROPERTY

Representatives of local governments at the Conference raised concerns about the revenue lost because of tax-exempt property. The subject of the proper treatment of tax-exempt property can be broken down into three parts: (1) whether the existing exemptions ought to be continued and, if so, for which activities; (2) which level of government ought to bear the costs of the exemption; and (3) what are the alternative ways of subsidizing the activities of organizations that the state wishes to encourage.[82]

Some at this Conference will object to the word "subsidize," arguing that certain organizations are not properly taxable because they are nonprofits. The lack of a normative model of the property tax makes it difficult to debate this issue. Compared to the income tax, where there is general agreement about the Haig-Simons normative model, which enables us to talk meaningfully about "subsidies" in the income tax, called tax expenditures, debate around the property tax suffers from the lack of any comparable consensus.

For the present purposes, we need not get bogged down in semantics. However it is phrased, the fundamental issue is to determine the appropriate contribution of these properties toward the costs of local government and how

82. *See* Richard D. Pomp, *The Collision Between Nonprofits and Cities over the Property Tax*, *in* PROPERTY-TAX EXEMPTION FOR CHARITIES (Evelyn Brody ed., 2002).

best to accommodate and balance the interests of the cities or other jurisdictions that contain a disproportionate percentage of tax-exempt properties.

The first question, whether the existing exemptions ought to be continued and, if so, for which activities, is obviously controversial. It does, however, have a noncontroversial aspect. Even if Wisconsin legislators are content to continue the existing general pattern of statutory exemptions for nonprofits, better drafting could eliminate a number of ambiguities in the law. These problem areas are well identified in the legal literature, and a systematic distillation of situations encountered by assessors would also help focus on the troublesome issues. Many of the problems could be corrected administratively, through the promulgation of regulations, similar to the regulations that are issued under most state corporate income taxes or sales taxes.

Our experience with the federal income tax indicates quite clearly that continual vigilance is necessary to prevent circumvention of the law. Again, the property tax is no exception. Once the law provides an exemption, taxpayers will restructure their transactions to bring themselves within the exempt category. The stakes are high and consequently definitional lines come under enormous pressure. The greater sophistication of the tax bar today means that definitions of nonprofits adopted in the 19th and early 20th centuries cannot be allowed to continue without a meaningful review.

Resolving the ambiguities in the statute is of course desirable, but what is necessary is a wholesale evaluation of the scope of existing exemptions. When tax rates were low and when the cities were thriving, we could live with broad, generous, wide-reaching exemptions. We cannot today. If I were a Wisconsin legislator, I would grant an exemption only if the activity or service were one that the state would have to perform if a private entity did not, and only if the exemption were required in order to provide the service to all needy members of the public. I realize that representatives of the nonprofits at this Conference will find my criteria too narrow for their tastes, but as long as the cities—home to a disproportionate amount of exempt property—are going to finance the cost of the exemption, I think that a narrow test is entirely justified. I would be content with a broader test for the exemption if the cities were to be compensated adequately for their lost revenue. In any event, I think that most persons would agree that the case for an exemption becomes weaker if the activity in question can command sufficient fees to pay for local services, if the activity is one lacking in quasi-public features, and if the activity is directed toward middle- and upper-income individuals. If such activities are exempt, then the state is, in effect, redistributing income away from the poor.

Opinions will obviously differ about where on a continuum particular activities will fall. A strong candidate for exemption under my criteria would be the Red Cross, the Salvation Army, a hospital that treated the indigent, or a library; a strong candidate for denial of an exemption might be property owned by a medical, dental, or bar association. An apartment building owned by a hospital and rented to interns and residents would not, under my criteria, present a very strong case for exemption, though such a building is currently exempt in some states.

Assuming that some subsidy is in order, the next question is to decide the appropriate level of government that should provide that subsidy. I have already suggested that many exempt properties provide general and diffuse benefits to areas beyond the jurisdiction in which they are located. This is clear for the Capitol and other state-owned buildings, but is also true for many other properties. For example, a Connecticut study found that less than half of the patients treated in tax-exempt hospitals in Bridgeport, Hartford, New Haven, and New London actually lived in these cities. The results were even more pronounced for colleges and universities located in these cities.

Perhaps in the 1800s, more of an overlap existed between the jurisdiction where the property was located and the jurisdiction where the beneficiaries lived. But the growth of the suburbs and the increased mobility of individuals have now produced a situation in which many of the benefits and services generated by tax-exempts are provided to residents of other jurisdictions. Where is the justice of a state law that forces the city to subsidize those who live in the suburbs?

This injustice is recognized for state-owned property by a payment-in-lieu-of-taxes ("PILOT") program, which exists in some states. Under the PILOT program, the state provides municipalities with payments intended to offset the revenue lost because of state-owned property. Although these payments represent only a small percentage of the lost property tax revenue, the state at least recognizes the unfairness of forcing certain municipalities to subsidize state government. Why not recognize the unfairness in forcing certain municipalities to subsidize another state objective—the encouragement of nonprofit activities?[83]

If a subsidy is to be provided to certain organizations, what form should it

83. At the suggestion of the author, Connecticut instituted a PILOT program for schools and hospitals. See Richard D. Pomp, *Tax-Exempt Property and the Cities: Striking a Balance*, 7 REAL EST. TAX'N 50 (1979), a revision of Testimony Before the State Finance Committee's Subcommittee on Tax-Exempt Property, in Property Tax Exemptions for Non-Profit Institutions: Problems and Proposals 1 (1978), *excerpted as Some Pay . . . Some Don't: Evaluating Property Tax Exemptions*, 6 PEOPLE & TAXES 4 (1978); *reprinted in* STATE AND LOCAL TAX REVOLT: NEW DIRECTIONS FOR THE 80'S 178 (D. Tipps & L. Webb eds., 1980).

take? The present treatment, an exemption from property taxes, is probably one of the least rational methods. Consider, for instance, two organizations, X and Y. X is a young organization, that is struggling financially and can afford only to rent office space. Y is well established and known for its generous salaries and opulent headquarters located on prime downtown real estate. Has Wisconsin consciously chosen to ignore X, the struggling organization, but to grant benefits to Y, the less needy organization? Has Wisconsin consciously chosen to increase its subsidy in proportion to the amount of land and buildings that an organization owns? In a period of high unemployment, would it not make more sense to dispense a subsidy based on the number of persons employed by a charitable organization, rather than based on real estate owned?

To point up yet another irrationality, suppose that X is located in a jurisdiction that makes wide use of service charges. Assume that X and Y use the same amount of water, sewer services, refuse services, and so forth. X however, pays for these services in the form of a service charge, whereas Y's jurisdiction finances these services through its property tax. Has Wisconsin intentionally decided that Y is to be insulated from costs that X bears? To put it another way, if Wisconsin legislators were to grant cash subsidies to organizations that are presently exempt, would it purposely adopt a program that gave nothing to organizations so poor that they could not afford to own real estate and, instead, distribute money based on how much real property they owned? That is the effect of the existing law, except that the local jurisdictions grant the cash subsidies by not collecting the property tax they otherwise would.

Because of these irrationalities, my own preference would be to replace the property tax exemption with an explicit cash subsidy. If a system of cash grants were adopted, I have no doubt that the state would narrow the existing law in order to channel money only to the neediest of organizations. But if the state would not grant a cash subsidy in the same amount and to the same organizations that are now benefiting from the statutory exemptions, why should the existing system be continued? Is the answer because the local jurisdictions are footing the bill?

I have no illusions about a wholesale change in the law, but understanding the defects in the existing system helps identify areas in which a better balance can be reached among the interests of the tax-exempts, the cities, and the state. The following options attempt to strike a better balance while staying within the present structure.

Option 1: Require the permission of the local jurisdiction before any taxable property can be bought by a tax-exempt. Hartford used this approach to bring the nonprofits to the table and force them to become players in

fashioning a program that would reduce the financial pressures on the cities. This approach places the decisionmaking power at the level of government that bears the cost of the exemption. Option 1 is hardly radical, because it is the very approach used in many states with respect to industrial and commercial property. In these states, a jurisdiction has the power to grant a property tax exemption in order to attract industrial and commercial property. Before granting an exemption, a jurisdiction must evaluate whether the benefits of having such property outweigh the loss of tax revenue and assure itself that the business would not locate within the jurisdiction without the exemption. Option 1 merely extends this approach to property currently exempt under state law.

A municipality would be free to evaluate whether the presence of a particular institution was worth the granting of an exemption. The analogy with commercial property is useful in highlighting another similarity. A state has a valid interest in both industrial property and in tax-exempts. A state has an interest in encouraging nonprofit activities and also in attracting new industry; yet most states do not require local jurisdictions to grant an exemption to businesses moving into the state. That decision is properly left to the local jurisdictions. A state is not helpless in attracting industry because it has a wide variety of incentives and inducements that can be offered as part of a package. These incentives and inducements are paid for by the state, however. Why should a similar approach not be used for hospitals, colleges, museums, and other quasi-public organizations?

Option 1 also allows the local jurisdiction to offset the leverage that a tax-exempt organization has in bidding against other potential purchasers of land. Because a tax-exempt organization does not have to pay the property tax, one of the carrying costs associated with the ownership of property that all other purchasers must take into account, it can afford to pay a higher purchase price and thus outbid other potential buyers. In a jurisdiction having high property taxes, typically a city, this leverage is increased. Option 1, however, allows a jurisdiction to offset this advantage.

Moreover, Option 1 allows a jurisdiction to exercise rational land-use planning. As an illustration, a city could refuse permission for a tax-exempt to buy property in the heart of the financial or shopping district, but welcome expansion into an area undergoing urban renewal. Furthermore, permission to expand could be conditioned on a host of subsidiary agreements concerning the creation of new jobs, affirmative action programs, or any other priorities of the city. Proper safeguards could provide that the benefits of the exemption would be paid back to the city if these conditions were not satisfied.

Option 2: Phase in the exemption whenever taxable property is bought by a tax-exempt. This option cushions a jurisdiction against an abrupt decline in

revenue in the year of purchase. Option 2 is feasible for established organizations and for property being bought by the state. It would be improper to phase in the exemption for property bought by a newly created organization because it is during the start-up period that the organization is likely to be short of funds and thus most in financial need.

Option 3: Phase out the exemption after a certain period. A time limitation would enable new organizations to get started without the burden of the property tax but would also recognize the jurisdiction's interest in not being burdened with a perpetual exemption. A specific phase-out date would allow an organization to plan adequately for the eventual imposition of the property tax.

Option 4: Limit the number of acres qualifying for the exemption. Like Option 3, this approach attempts to balance the interests of the tax-exempts against the revenue loss incurred by the jurisdiction. An acreage limitation recognizes that once some reasonable level of property ownership has been exempted, further expansion should not be at the expense of the local government.

Option 5: Set a dollar limit on the amount of property that can be exempt. A dollar ceiling on the exemption is another means of balancing the interests of the tax-exempts with those of the jurisdiction. Owning property in excess of the ceiling indicates that the organization has a level of wealth or ability to pay, which does not justify any further exemption.

Option 6: Impose a user charge. A user charge recognizes that tax-exempts consume local services and should therefore contribute to the costs of local government. Recall from my earlier example that Option 6 exists in jurisdictions that already provide some services on a user charge basis, such as the supplying of water. Applying Option 6 to all tax-exempts, regardless of where they are located, would end the discrimination that currently exists between tax-exempts located in jurisdictions that have user charges and those that are located in jurisdictions that "charge" for similar services through the property tax. More important, a service charge removes an incentive for a tax-exempt to hold vacant or idle land that it no longer needs, a tendency that a land-starved city can ill afford. A user charge will also curtail the incentive for tax-exempts to over invest in real estate; Option 6 should therefore result in a more efficient allocation of resources.

A user charge need not involve the elaborate metering of various municipal services, although such a procedure might be feasible in certain situations. A simple means of implementing a user charge is to estimate the percentage of the jurisdiction's total budget that is devoted to supplying property-related services, such as fire and police protection, traffic control, and garbage collection, and to apply that percentage of the mill rate to the

value of the tax-exempt property. If 35% of the budget were estimated as attributable to the provision of these services, for example, and if the mill rate were 60, then the assessed value of the tax-exempts would be subject to a user charge of 21 mills (.35 × 60). A "circuit breaker" could be used to grant relief to organizations that could not afford the increased cost. Tax-exempts would still be receiving a subsidy under Option 6, measured by the difference between the user charge and the full mill rate (39 mills difference in my example).

Option 7: State payments to jurisdictions containing tax-exempt property. Option 7 recognizes the unfairness in a jurisdiction's bearing the entire loss in property taxes attributable to the presence of tax-exempt property. Option 7 extends the state's PILOT (payments-in-lieu-of-taxes) program to nonstate-owned property, on the theory that the exemption from the property tax implements state objectives and goals. In order to channel state funds where they are needed most, payments might be made only to jurisdictions having more than the statewide average of tax-exempt property. Alternatively, jurisdictions might be reimbursed not for all of their tax-exempt property, but only for the amount in excess of the statewide average.

The above options are not mutually exclusive; various combinations could be adopted to deal with special situations. Nor is there any reason to apply the same approach to all categories of property. For example, Option 4, an acreage limitation, might be more suitable for some types of organizations, such as cemeteries, than for others. Or, a different acreage limitation could be applied to different categories of property. Similar flexibility exists in the other approaches. Payment by the state, Option 7, could be combined easily with any of the other approaches. A different combination of approaches would allow for a different balance in the sharing of the costs of the exemption. The user charge option, for instance, could be adopted in conjunction with a state contribution to the jurisdiction that was equal to a percentage of the difference between the user charge and the full property tax. The percentage contributed by the state could vary from a nominal amount to 100%. If it were felt that the tax-exempt provided benefits that were spread throughout the entire state, the percentage would be closer to 100%; if it were felt that most of the benefits were distributed to residents of the jurisdiction, the percentage could be reduced accordingly.

A combination of approaches introduces a degree of sophistication and a balancing of the competing interests that is unattainable under the present system. Indeed, in view of the flexibility that is possible with the various options, the existing statutory scheme of exemptions is a crude and inequitable approach to a difficult problem.

V. CONCLUSION

As this Article went to press, the July 25, 2004 *Wisconsin State Journal* defended the exploitation by the banks of the state's lack of combined reporting:

> [T]he banks aren't the villains in this tale. That role actually belongs to the Legislature and the Revenue Department.
>
> Wisconsin Banks are doing what lots of businesses in lots of states do: They are using out-of-state subsidiaries as tax shelters. The strategy calls for a company to create a subsidiary business, place some income-producing assets in that business and locate it in a state where the income can avoid taxation. Nevada and Delaware are common choices.
>
> It's perfectly legal, and smart, for a company to employ the strategy, as long as the company's home state tax law permits it.
>
> However, it's not smart for a state to permit it. It's not good economic policy because creating such tax-sheltering subsidiaries adds no value to the economy. Nor is it good fiscal policy because it costs the state money.
>
> To Wisconsin's discredit, state tax law generally permits the tax sheltering strategy.
>
> There is a simple way for Wisconsin to stop the practice: The Legislature should adopt a tax policy called combined reporting. In combined reporting a corporation is required to combine profits from all related subsidiaries, regardless of their location, to determine tax liability.
>
> Sixteen states, including neighboring Minnesota and Illinois, require combined reporting. However, the Wisconsin Legislature has steadfastly refused to adopt combined reporting, even when it was supported by Gov. Tommy Thompson.
>
> The Legislature's rejection of combined reporting is a costly mistake. A Legislature Audit Bureau study estimated that this oversight cost the state $70 million in revenue in 2001. And the use of the tax shelters has increased dramatically since the study was conducted.
>
> The defeat of combined reporting is a loss for the Revenue Department. But the department can't correct the Legislature's mistake on its own. Bureaucrats carry out laws. They don't make

> them. Yet, the department's pursuit of the state's banks suggests that the bureaucrats are trying to make combined reporting the law.[84]

The criticism of the Revenue Department is wide of the mark. The lack of combined reporting does not mean that the Department has to acquiesce in blatant tax avoidance. But without combined reporting, the Department is forced to engage in case-by-case litigation, which is a waste of its limited administrative and judicial resources, when the legislature has the solution at hand.

Many of the burning social problems of the day have no known solutions. In contrast, the problems confronting the Wisconsin tax structure have knowable solutions. The issue is not a lack of knowledge but rather a lack of political will. The Wisconsin Legislature has the tools for regaining control of its tax base. What is unknown is whether enough vertebrae exist to constitute a political backbone. Given the public's disgust with big business in the wake of corporate scandal after scandal, deft politicians should be able to mobilize public sentiment in favor of tax reform. Tax reform is never easy; in good times, politicians are told "not to rock the boat," and in bad times, they are told not to make things even worse. I hope the information discussed above can stiffen the legislative backbone and allow Wisconsin Legislators to seize the moment.

84. *Bad Law, Not Banks, To Blame*, WIS. STATE J., July 25, 2004, *at* http://www.madison.com/archives/read.php?ref=wsj:2004:07:25:380260:OPINION.

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