Legislative Fiscal Bureau

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Combined Reporting -- Use of Pre-2009 Net Business Loss Carryforwards (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2011-13 Budget Summary: Page 190, #13]

CURRENT LAW

Although similar to federal law, Wisconsin has specific state provisions governing the determination and use of net business losses for state corporate income/franchise tax purposes. Under state law, a net business loss is generally defined as the excess of business expenses allowed as deductions in computing net income over the amount of income attributable to the operation of a trade or business in the state. Wisconsin law allows net business losses to be carried forward for 15 years to offset income. Federal law permits net business losses to be carried back for two years, but state law does not provide for carry-backs of net business losses.

Individual combined group members that show a positive income amount can offset the income with net business loss carry-forwards. Certain unused business loss carry-forwards generated by members of a combined group after January 1, 2009, can be shared with other members of the group to offset their net income. However, the combined group member may not share all or a portion of its business loss carry-forward, if the net business loss originated in tax years beginning on or after January 1, 2009, and is attributable to combined unitary income included in a combined report.

GOVERNOR

Authorize combined groups to share net business loss carry-forwards that were incurred by group members before January 1, 2009. Starting with the first tax year beginning after December 31, 2011, and for each of the 20 subsequent tax years, for each tax year that a corporation was a member of a combined group and had a net business loss carry-forward from a tax year beginning prior to January 1, 2009, the corporation could use up to 5% of its remaining business loss carry-forward to proportionally offset the income of all other members of the combined group, to the extent that income was attributable to the unitary business. Before

sharing the business loss carry-forward with group members, the corporation would first have to use the loss carry-forward to offset its own income for the tax year. If the full 5% of such business loss carry-forwards could not be completely used to offset the income of other members of the combined group, the remainder could be added to the portion of the corporation's loss carry-forward that could be used to offset the income of group members in the subsequent year. Unless otherwise provided by the Department of Revenue (DOR) by rule, the corporation could not share the loss carry-forward if it ceased being included in the combined group. DOR would be required to promulgate administrative rules to administer these provisions. These provisions would reduce corporate income and franchise tax revenues by an estimated $9,200,000 in 2011-12, and $37,200,000 in 2012-13.

DISCUSSION POINTS

1. Individual combined group members that show a positive income amount can offset the income with net business loss carryforwards. A net business loss carryforward is an attribute of the separate corporation that generated the loss. However, the combined group member may share all or a portion of its business loss carryforward with other members of the combined group, if certain conditions are met. Specifically, the amount of net business loss carryforward that is eligible for sharing with other combined group members is computed and assigned as follows:

a. Each combined group member applies its total available net business loss carryforward against its total Wisconsin income, including net income or loss attributable to separate entity items (income or loss subject to water's edge rules, income or loss attributable to a separate unitary business, nonapportionable income, lottery prizes). The member's carryforward is first used to offset net income from separate entity items, and then its share of combined unitary income.

b. Each member then separates any remaining business loss carryforward into the sharable and nonsharable amounts. Each member's remaining sharable net business loss is aggregated for the combined group as a whole. (A member may elect to exclude some or all of its sharable net business loss from the aggregate sharable net business loss computed for the combined group.)

c. When a combined group member has unitary income that is not offset by that member's net business loss carryforwards, the group's aggregate sharable net business loss is assigned to the member in proportion to its share of the combined unitary income of the group. An amount of the group's sharable business loss carryforwards cannot be assigned to a combined group member whose share of combined unitary income, net of any losses already applied by that member, is zero or less.

d. The aggregate sharable business loss of the combined group is considered to be used proportionally to the individual sharable net business loss carryforwards of the corporations that contributed to the aggregate sharable amount. Any remaining sharable net business loss carryforward is an attribute of the corporation that originally incurred the loss. Consequently, the amount of the unused aggregate sharable business loss carryforwards retained by a combined group member is proportionate to the amount contributed by the member.

A net business loss carryforward is sharable if the following conditions are met:

a. The net business loss originated in tax years beginning on or after January 1, 2009, and is attributable to combined unitary income included in a combined report.

b. The member originally computed the net business loss in the combined report used for the same combined group that will use the shared loss carryforward, regardless of whether corporations have joined or left the combined group in the intervening years.

c. The member is still a member of the combined group for the year for which the loss carryforward will be used.

If a 100% Wisconsin combined group includes members with net income in the unitary business and others with net loss in unitary income, a member's positive income may be offset by other members' business losses.

2. Under the bill, combined groups could share net business loss carry-forwards that were incurred by group members before January 1, 2009. Specifically, starting with the first tax year beginning after December 31, 2011, the combined group could use up to 5% business loss carry-forwards of individual members from tax years prior to January 1, 2009, to proportionally offset the income of all other members of the combined group, to the extent that income was attributable to the unitary business.

3. To illustrate, if a corporation has a pre-2009 loss carryforward of $500,000, then $25,000 (5% x $500,000) may be shared among the combined group members, in addition to any losses the corporation is able to use to offset its own income. Therefore, if the corporation has 2012 income of $200,000, it would offset $200,000 of the pre-2009 loss carryforward against this income (which can be done under current law). Then the other members of the combined group could offset $25,000 of the remaining pre-2009 loss carryforward against their own income. The $25,000 would be allocated to each member of the group based on the member's share of combined group income. If the other members of the combined group were only able to use $15,000 of the pre-2009 sharable loss carryforward, the remaining $10,000 would be included in the corporation's total remaining pre-2009 loss carryforward, and it could be shared in future years. Specifically, for 2013, the corporation's total remaining pre-2009 loss carryforward would be $285,000 ($500,000 - $200,000 - $15,000). Since the other members of the combined group did not use the entire $25,000 of pre-2009 loss carryforward, the remaining $10,000 would be carried forward and included in the subsequent year's sharable amount of pre-2009 loss carryforwards. The amount that could be shared among combined group members would be $35,000 ($25,000 + $10,000).

4. Depending on individual circumstances, it is possible that a corporation could use more or less of its pre-2009 loss carryforwards under combined reporting than under separate entity reporting. Attachment 1 provides an example of a corporation that obtains a greater tax benefit under combined reporting than filing as a separate entity. This can occur when the individual corporation's ratio of apportionable income to sales is lower than the ratio of apportionable income to sales for the entire group. Attachment 2 shows a corporation that cannot claim as much of its pre-2009 loss carryforward under combined reporting as would be the case if it filed as a separate entity. This can occur: (a) if the corporation's ratio of apportionable income to sales is higher than the entire group's ratio of apportionable income to sales; (b) where the corporation has a substantial amount of

intercompany transactions in Wisconsin relative to its intercompany transactions nationwide; or (c) if the corporation is engaged exclusively in intercompany transactions. Under combined reporting, intercompany transactions are eliminated from the apportionment factors used to determine each corporation's share of income in a combined report. Based on a model using 2005 corporate income/franchise tax returns, DOR estimated that the amount of pre-2009 loss carryforwards used under combined reporting would have been 300% higher than the amount used under separate entity reporting.

5. Currently there are 23 states that require some form of combined reporting under the state corporate income or franchise tax -- Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, Texas, Utah, Vermont, West Virginia, and Wisconsin. All of the states allow combined groups to share net business loss carryforwards that were generated since the state's combined reporting law was enacted. Fourteen of the combined reporting states do not allow the sharing of business loss carryforwards that were generated before the state's combined reporting law was enacted. The other nine states do allow it. The chart below shows the states that allow and that do not allow combined groups to share net business losses that originated before that state's combined reporting law was adopted.

Use of Net Business Loss Carryforwards Originating Before Adoption of Combined Reporting Law

States that Limit Sharing of New Business Loss Carryforwards to those Originating after Combined Reporting Law	States that allow sharing of Net Business Losses before Enactment of the Combined Reporting Law
Arizona	Alaska
California	Colorado
Hawaii	Illinois
Idaho	New Hampshire
Kansas	New York
Massachusetts	North Dakota
Maine	Utah
Michigan	Vermont
Minnesota	West Virginia
Montana	
Nebraska	
Oregon	
Texas	
Wisconsin	

6. The tax policy rationale for use of net business loss carryforwards is based on the concept of income averaging. Net business loss carryforwards allow taxpayers whose incomes fluctuate from year to year to receive tax treatment equivalent to those with stable incomes. Many businesses incur losses over several years before becoming profitable. Businesses also generate business losses in recessionary periods. Income averaging, through the use of net business loss carryforwards, mitigates different tax treatments due to the use of an annual accounting system by equalizing the treatment of taxpayers whose incomes fluctuate and those whose income is stable over a given period.

7. A second policy rationale for business loss carryforwards is that an income tax without full loss offsets provides an inefficient penalty to relatively risky investments and a bias for relatively safe investments. In the absence of a loss offset, the yield of an otherwise equivalent investment with a relatively high probability of significant loss will generally be lower than the yield of an otherwise equivalent investment with a lower probability of loss. Thus, investments with the highest prospective yields would be favored. The basic argument is that by allowing full loss carryforwards, a tax system eliminates a bias against relatively risky investments, and also reduces the risk to private investors, making it more likely that they would make socially useful investments in relatively risky ventures. Risk is not eliminated by the allowance of loss carryforwards but, instead, it is shifted to the government.

8. However, loss carryforwards constitute only a partial loss offset, because a deduction of a loss in a future year is less valuable than a current deduction for that loss. Funds generated by current year loss carryforwards can be invested and earn the current rate of return. Losses that must be carried forward to future years do not generate potential earnings until they are used. As a result, the allowance of net business loss carryforwards does not completely mitigate inequities in the treatment of corporate taxpayers due to the annual tax accounting system. Moreover, business loss carryforwards tend to benefit established corporations over new firms because the established firms generally have more stable incomes, and thus can use more of such carryforwards to offset income in more years, Similarly, large consolidated groups can use current losses generated by one group member to offset income earned by another member in the current year.

9. The economic efficiency case for business loss offsets does not call for offsets for all business losses. For example, if a company suffers a loss because the chief executive officer converted company assets to his own use, it would not improve economic efficiency for the government to share in that loss. There are a number of tax provisions, such as accelerated depreciation in excess of economic depreciation, that have policy purposes, but that can overstate losses from the perspective of evaluating the relative riskiness of investments. These provisions can generate a loss for tax purposes that would not be computed under an economic accounting of income and expenses. As a result, there are components of net business losses that would not need to be included to eliminate the income tax bias against relatively risky, but socially useful, investments, (McIntyre, 2009)

10. For the combined groups with pre-2009 loss carryforwards, state corporate income/franchise taxes would be reduced by $9.2 million in 2011-12 and $37.2 million in 2012-13. The corporate income/franchise tax deductions would increase the after-tax cash flow for those groups. Proponents indicate that the increased cash flow could be used by these businesses make capital investments and hire new employees.

11. However, due to Wisconsin corporate income/franchise tax law provisions governing the taxation of multistate corporations, the reduction in state taxes for the combined groups would not be directly related to the group's level of investment or employment in Wisconsin. Wisconsin uses single sales factor apportionment to apportion the income, and a market-based approach to source sales of multistate corporations to Wisconsin. The amount of business income taxable in Wisconsin is generally based on the ratio of the company's or group's sales in Wisconsin to total sales. The level of investment or employment in Wisconsin does not affect this ratio and,

therefore, does not affect the amount of income that is taxable in the state. From the company's perspective, expanding investment or employment in Wisconsin, by themselves, would not affect the company's or group's Wisconsin tax liability, unless it received specific tax benefits, such as state jobs tax credits.

12. DOR tax processing data for tax year 2009 returns, through May 6, 2011, indicates that a total of 40,818 total regular (C) corporate income/franchise tax returns have been filed, with total net tax liability of $464.9 million. Of the total, 3,466 were filed by combined groups, that had a total net tax liability of $383.7 million. Tax processing statistics tax for year 2009 show that a total of 25,992 Form 5 returns were filed. These can only be filed by 100% Wisconsin corporations (generally corporations with their entire business operations in Wisconsin). Approximately 400 combined groups would be able to use pre-2009 net business loss carryforwards to offset tax liabilities. It should be noted that all returns for tax year 2009 have not been processed. DOR will receive tax year 2009 returns through October of 2011. However, tax year 2009 returns provide the only actual data for combined returns. DOR indicates that through May 6, of last year, approximately 89% of tax year 2008 returns had been processed. Because combined reporting first applied to tax year 2009, the Department cannot determine if the same percentage of tax year 2009 returns have been processed. The total tax liability reported for tax year 2009 will differ from total fiscal year 2009-10 collections, because fiscal year collections include estimated tax payments, final payments, settlements, and refunds from a number of different tax year returns, in addition to 2009 returns.

13. As an alternative to the Governor's proposal, the state corporate income/franchise tax rate could be reduced from 7.9% to 7.6%, effective for tax years beginning on or after January 1, 2012. Under this alternative, all corporations operating in Wisconsin, including combined groups, that have tax liabilities would benefit. The rate reduction would increase cash flow for 100% Wisconsin corporations (corporations with their entire business operation and sales in state), which, if they chose to use the additional funds for expanding business operations, would invest and hire employees in Wisconsin. This alternative would reduce state corporate income/franchise tax liabilities by an estimated $9.3 million in fiscal year 2011-12 and $37.8 million in fiscal year 2012-13. Compared to the net business loss carryforward provision in the bill, the alternative corporate income/franchise tax rate reduction would reduce state corporate income/franchise tax revenue by an estimated $100,000 in 2011-12 and $600,000 in 2012-13.

14. Theoretically, changes to the corporate income tax can influence risk-taking behavior and managerial incentives, how companies select investments, how investment is financed and allocated across locations, and how businesses are organized. These effects can vary across sectors and depend upon how the corporate tax change is structured. In turn, these responses may affect wages, output prices, and levels of investment. To further complicate matters, corporate tax changes in one location can trigger changes in other locations. This complex set of economic interactions makes it difficult to measure the impact of corporate income taxation on the returns to capital, land, labor, and the relative prices of goods and services produced in corporate and noncorporate firms. (Altshuler, Harris, & Toder, 2010). There is considerable disagreement over the significance of the effects of taxes on business activity and the economy, particularly at the state level.

15. Chirinko and Wilson (2010) performed simulations that translated legislated changes

in a state's business taxes (for the 48 contiguous states) to resulting changes in the state's stock of equipment and structures capital, its stock of research and development capital, and output. The study found that, for all states, a one percentage point decrease in the state corporate income tax rate would increase equipment and structures capital 1.01% and state economic output 0.53%. For Wisconsin a one percentage point decrease in the corporate income tax rate (from 7.9% to 6.9%) was projected to increase equipment and structures capital 1.07% and state output 0.56%. A 2007 U.S. Treasury report for the Conference on Business Taxation and Global Competitiveness indicated that a reduction in the statutory corporate income tax rate would reduce the tax burden on marginal investment, and encourages additional investment. According to the study, a reduction in the rate would also eliminate the tax penalty for investing in corporate equities, which would equalize the treatment on the return to investment from corporate and noncorporate capital. It would also reduce a corporation's tax incentive to retain rather than distribute earnings, and to finance with debt rather than equity. (Interest on debt financing is a deductible expense.) The Treasury report indicates that this would help improve corporate governance, and reduce the economy's exposure to bankruptcy and financial risk during a period of economic weakness. Arnold et. al. used a panel of 21 OECD countries over 34 years, complemented by industry and individual firm data to estimate the effect of tax structure on economic growth. Results for aggregate growth suggest that corporate income taxes were particularly harmful for growth. Results at the firm level indicated that higher statutory corporate tax rates were estimated to reduce firm level productivity, while lower rates boosted it. A simulation experiment indicated that a reduction in the statutory corporate tax rate from 35% to 30% would increase the long-run investment-to-capital ratio by 1.0% to 2.6%. The authors note that corporate income taxes discourage the activities that are most important for growth-- investment in capital and investment in productivity improvements (Arnold, Brys, Heady, Johansson, Schwellnus, and Vartia, 2011).

16. Bartik (2005) indicates that research shows a statistically significant but modest effect of state and local tax rates on economic development. Reviews of numerous economic studies suggest that the long-run elasticity of a state or metropolitan area's business activity with respect to state and local taxes is between -0.2 and -0.3. The most comprehensive review of research on state and local business taxes and business location decisions indicates that if *all* state and local business taxes are lowered by 10%, the long-run increase in business activity would be 2% (Bartik, 2010). The Oregon Tax Incidence Model projected that a 30% reduction in state corporate income taxes would increase personal income by 0.2%, investment by 0.5% and employment by 0.06%, while the California Dynamic Revenue Analysis Model projected that a 20% reduction in the state corporate income tax rate would increase employment 0.1% and aggregate personal income 0.2%. (McLenaghan, 2011). The Congressional Budget Office (CBO) indicates that, although cutting the corporate income tax rate can improve cash flow and boost investment, it is not a particularly cost-effective method of stimulating business spending. According to CBO, increasing the after-tax income of businesses typically does not create an incentive for them to spend more on labor or to produce more, because production depends upon the ability to sell output. The principal influence of taxes on a firm's decision about investing depends upon the prospective profits from its new investments. (CBO, 2008). It is possible that because of insufficient cash flow and lack of access to credit markets, corporations would have insufficient cash on hand to finance investment needed to increase output. In these situations, increased cash flow from a corporate rate cut could stimulate additional corporate investment. However, national data indicates that corporations have a substantial amount of cash-on-hand. Through July, 2010, nonfinancial corporations had $1.8 trillion

in cash-on-hand (Mazerov, 2010).

17. There are a large number of econometric analyses that attempt to determine the relative impacts of tax reductions compared to government spending on economic growth, particularly in the context of stimulating the economy in the wake of the recent recession. Recent studies by Clemens and Miran (2010), Nakamura and Steinsson (2010), and Shoag (2011) found that state spending had a positive effect on state economies. Romer and Berstein (2009), and Zandi (2009) developed estimates showing government spending more effective than taxes in stimulating economic growth. Conversly, Cogan (Cogan, Cwik, Taylor, and Wieland, 2009), Mountford and Uhlig, (2005), and Blanchard and Perotti (2002) found that tax reductions were more effective than government spending in stimulating economic growth.

ALTERNATIVES

1. Approve the Governor's recommendation to authorize combined groups to share net business loss carry-forwards that were incurred by group members before January 1, 2009, starting with the first tax year beginning after December 31, 2011. Provide that for each tax year that a corporation was a member of a combined group and had a net business loss carry-forward from a tax year beginning prior to January 1, 2009, the corporation could use up to 5% of its remaining business loss carry-forward to proportionally offset the income of all other members of the combined group, to the extent that income was attributable to the unitary business.

2. Delete the Governor's recommendation and, instead, effective for tax years beginning on or after January 1, 2012, reduce the state corporate income/franchise tax rate from 7.9% to 7.6%

ALT 2	**Change to Bill** Revenue
GPR	**-** $700,000

3. Delete the Governor's recommendation.

ALT 3	**Change to Bill** Revenue
GPR	$46,400,000

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Attachments

ATTACHMENT 1

Example of How Combined Reporting Can Increase Use of Loss Carryforwards

Corporations A and B are a unitary business. Corporation A has $500,000 in apportionable income from $2,000,000 total sales, $1,000,000 of which are in Wisconsin. Corporation B has $500,000 in apportionable income from $8,000,000 total sales, $6,000,000 of which are in Wisconsin. Corporation B also has $650,000 in Wisconsin pre-2009 business loss carryforwards available. All sales are of the type includable in the sales apportionment factor.

Computation of each entity's tax under separate entity reporting and combined reporting is as follows:

Separate Entity Reporting

	Corporation A	Corporation B	Totals
Corporation's Wisconsin sales	$1,000,000	$6,000,000	
Divide by corporation's total sales	2,000,000	8,000,000	
Wisconsin apportionment %	50%	75%	
Multiply by apportionable income	500,000	500,000	
Wisconsin income before net business loss offset	250,000	375,000	625,000
Wisconsin business loss carryforward	0	-650,000	
Wisconsin income	250,000	0	
Tax rate	7.9%	7.9%	
Total tax	$19,750	$0	$19,750
Remaining business loss carryforward	0	-$275,000	-$275,000

Combined Reporting

	Corporation A's Shares	Corporation B's Shares	Totals
Corporation's Wisconsin sales	$1,000,000	$6,000,000	
Divide by combined group's total sales	10,000,000	10,000,000	
Wisconsin apportionment %	10%	60%	
Multiply by combined group's apportionable income	1,000,000	1,000,000	
Wisconsin income before net business loss offset	100,000	600,000	700,000
Wisconsin business loss carryforward	0	-650,000	
Wisconsin income	100,000	0	
Tax rate	7.9%	7.9%	
Total tax	$7,900	$0	$7,900
Remaining business loss carryforward	0	-$50,000	-$50,000

Corporation B was able to use a greater share of its Wisconsin business loss carryforward under combined reporting than under separate entity reporting. As a result, the unitary business paid less tax under combined reporting than under separate entity reporting.

ATTACHMENT 2

Example of How Combined Reporting Can Decrease Use of Loss Carryforwards

Corporations A and B are a unitary business. Corporation A has $500,000 in apportionable income from $2,000,000 total sales, $1,000,000 of which are in Wisconsin. Corporation A also has $650,000 in pre-2009 Wisconsin business loss carryforwards available. Corporation B has $500,000 in apportionable income from $8,000,000 total sales, $6,000,000 of which are in Wisconsin. All sales are of the type includable in the sales apportionment factor.

Computation of each entity's tax under separate entity reporting and combined reporting is as follows:

Separate Entity Reporting

	Corporation A	Corporation B	Totals
Corporation's Wisconsin sales	$1,000,000	$6,000,000	
Divide by corporation's total sales	2,000,000	8,000,000	
Wisconsin apportionment %	50%	75%	
Multiply by corporation's apportionable income	500,000	500,000	
Wisconsin income before net business loss offset	250,000	375,000	625,000
Wisconsin business loss carryforward	-650,000	0	
Wisconsin income	0	375,000	
Tax rate	7.9%	7.9%	
Total tax	$0	$29,625	$29,625
Remaining business loss carryforward	-$400,000	0	-$400,000

Combined Reporting

	Corporation A's Shares	Corporation B's Shares	Totals
Corporation's Wisconsin sales	$1,000,000	$6,000,000	
Divide by combined group's total sales	10,000,000	10,000,000	
Wisconsin apportionment %	10%	60%	
Multiply by combined group's apportionable income	1,000,000	1,000,000	
Wisconsin income before net business loss offset	100,000	600,000	700,000
Wisconsin business loss carryforward	-650,000	0	
Wisconsin income	0	600,000	
Tax rate	7.9%	7.9%	
Total tax	$0	$47,400	$47,400
Remaining business loss carryforward	-$550,000	0	-$550,000

Corporation A was not able to use as much of its Wisconsin business loss carryforward under combined reporting as under separate entity reporting. However, as a whole, the unitary business's Wisconsin income is higher under combined reporting than under separate entity reporting.