Closing Corporate Tax Loopholes Would Help New Jersey’s Small Businesses & Provide Resources to Build Economy

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Limiting the ability of profitable multistate corporations to use accounting tricks to avoid New Jersey taxes would help level the playing field for the state’s small and local businesses. But that’s not the only benefit. If the Garden State were to follow the lead of a growing number of states that have adopted a common-sense tax accounting method, New Jersey could raise an additional $235 million to $470 million a year to invest in schools, roads and other building blocks of a strong economy.1

The problem hurting New Jersey-based businesses and costing the state money is the ability of large multistate corporations to – on paper – shift profits they make in New Jersey to other states that have lower tax rates, or no corporate taxation at all. Corporations often do this by creating “subsidiaries” that exist only for tax purposes.

States are combating this by adopting what is called combined reporting. It treats the parent company and subsidiaries of multistate corporations as one entity for state corporate income tax purposes. Their nationwide profits are added together and the state then taxes the appropriate share of the combined income. With recent enactment in Rhode Island2 and Connecticut,3 25 out of the 45 states that have some form of corporate income taxation, as well as the District of Columbia, now mandate combined reporting.4
Building on Past Success in Closing Corporate Loopholes

In 2002, when the state was facing a large budget gap despite strongly growing corporate profits, New Jersey policymakers closed some corporate tax loopholes. The New Jersey Business Tax Reform Act banned deductions for royalties paid to related out-of-state companies and required combined reporting by all casinos and any corporation suspected of abuse by the Division of Taxation.\(^5\)

If policymakers had implemented comprehensive combined reporting then, New Jersey could have collected between $2.9 billion and $5.9 billion in additional tax revenue since – money that could have been reinvested in key areas like pre-K expansion, road and bridge repair and job training programs to help strengthen the economy.\(^6\)

Thirteen years later, it’s time to build on 2002’s first step by fully enacting combined reporting to stop profitable multistate corporations from taking advantage of the tax loopholes that remain in place.

Corporate Tax Shelters Have Created a Need for Combined Reporting

While New Jersey has stopped some tax avoidance methods, the state is still vulnerable to others. One such strategy is called the “captive Real Estate Investment Trust,” a sophisticated real estate scheme used by Walmart and other multistate retailers and banks.

Here’s how it works. First, Walmart designates one subsidiary as owner of its stores in about 22 states. This subsidiary then pays rent to a second subsidiary, a Real Estate Investment Trust (REIT). Next, the REIT shifts nearly all of these rental earnings, in the form of dividends, to a third subsidiary based in Delaware, a state with no corporate income tax. That unit then passes the dividends back to the same subsidiary that made the payments to the REIT to begin with. Not only does Walmart avoid paying taxes on any profits recorded in Delaware, it can also deduct the dividends paid back to the parent company, since dividends paid to a corporation by a subsidiary normally aren't counted as taxable income by states.

The shuffling of rent payments reduces taxable profits of the stores by shifting the profits to the REIT and ultimately back to the parent company itself. This allows Walmart to deduct from its state-taxable income the rent paid to the REIT, saving the corporation millions in taxes while depriving the states where stores are located of essential revenue needed for the public services that help keep those stores profitable.\(^7\)
But under combined reporting, the profits of the subsidiary located in a low-tax or no-tax state are combined with the rest of the profits across the entire corporation. The subsidiary can remain in existence and the rent payments can continue to be made, but the tax break for corporations disappears.

Under combined reporting New Jersey could collect a substantial amount of revenue it is legally owed. Combined reporting could boost corporate tax collections by 10 to 20 percent, bringing in hundreds of millions of dollars that would help preserve education, health care and other services that boost the state’s economy.\textsuperscript{8}

**Closing Loopholes Would Help Level the Playing Field for New Jersey’s Small Businesses**

Combined reporting would also reduce the competitive disadvantage faced by small businesses operating in New Jersey. As it stands, local businesses are more likely to have to pay taxes on all their profits, because, unlike multistate firms, they have nowhere to shift them. Even unincorporated businesses not subject to corporate income tax may be at a disadvantage because their profits are subject to the state’s personal income tax.\textsuperscript{9}

Without combined reporting, large multistate corporations end up paying income tax at a lower effective tax rate than small businesses by subdividing themselves into separate corporations and then manipulating transactions within the overall corporate group.\textsuperscript{10} The absence of combined reporting also enables multistate corporations to undercut the prices of, or attract capital at a lower cost than, their small-business competitors.\textsuperscript{11} Combined reporting helps foster a more level playing field for all businesses – a factor that may explain why states that have this policy in place tend to have higher entrepreneurship rates.\textsuperscript{12}

Combined reporting also increases the resources that states need to be able to invest in vital services like education, transportation infrastructure and public safety – services that all businesses rely upon and contemplate when making long-term investment plans. Failing to mandate combined reporting could harm the state’s economy by allowing its corporate tax base to erode and its services needed by the private sector to be undermined.

**Profitable Multistate Corporations Can Easily Comply with New Rules**

Many major multistate corporations oppose combined reporting, claiming it leads to difficult and costly tax compliance burdens. This rings hollow, considering the amount of money firms are willing to spend setting up and running shell companies in low- or no-tax states. These corporations also threaten that combined reporting could lead to job losses if major employers leave the state or reject it for future investments.

These concerns are unwarranted.
In fact, state corporate income taxes represent a tiny share of business costs and are far from being the main driver of business location and investment decisions. Total state and local taxes paid by corporations average less than three percent of corporate expenses, with state corporate income taxes representing less than 10 percent of that three percent, on average. It is highly unlikely that combined reporting would have enough impact on corporate bottom lines to affect decisions about whether to invest in New Jersey. Corporate executives typically rank taxes low on their list of site selection factors, well below the availability of a high-quality workforce and transportation infrastructure – assets that are harder to pay for when states are deprived of revenue through corporate tax avoidance.

Time and again, large corporations have chosen to locate or expand in states with combined reporting. For example, 90 percent of Maryland’s largest 120 employers maintain facilities in at least one combined reporting state. And three-fourths of them have facilities in five or more combined reporting states. The story is the same in New Mexico, North Carolina and Iowa – and there is no reason to think it would be any different in New Jersey. Nor would New Jersey be put in a competitive disadvantage with neighboring or competitor states: New York and Massachusetts require combined reporting and Pennsylvania and Maryland are among those considering the policy.
Closing Corporate Tax Loopholes Would Help New Jersey

Revenue estimates are based on a 10 to 20 percent increase in state corporation business tax revenue, using the five-year average of $2.347 billion (FY2012-FY2016) as a baseline. An increase between 10 and 20 percent is the consensus revenue estimate for combined reporting in most states. Since New Jersey has already closed some loopholes, it stands to reason that the revenue boost in New Jersey would likely be closer to 10 percent, but a boost of 20 percent remains possible, which is why we included a range.

Rhode Island adopted combined reporting, starting in tax year 2015, in June 2014. For more, see: Rhode Island Division of Taxation, Combined Reporting and Related Topics. http://www.tax.ri.gov/Tax%20Website/TAX/combinedreporting/

Connecticut’s budget for Fiscal Years 2016 and 2017, which received final legislative approval on June 3 and will soon be signed by the governor, includes a mandate for combined reporting beginning with tax year 2015.


P.L. 2002, C. 40

NJPP analysis of New Jersey Comprehensive Annual Financial Reports, Fiscal Years 2003-2014


See endnote 1


Ibid 4


See, for example, Area Development magazine’s annual survey of corporate executives about the key factors driving their location decisions. In the most recent survey, as in past years, highway accessibility ranked first, and both access to skilled labor (fifth) and access to major markets (eighth) are ranked higher than state corporate tax rates (tenth) and corporate tax breaks (eleventh).


Ibid 14
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