Broken Partnership

How Wisconsin's Corporate Sector Underpays State and Local Taxes by $1 Billion

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Tax Day 2007 is a timely occasion to call for "accountability" regarding corporate taxes in Wisconsin.

This short report will first cite a number that will make clear why it is so urgent to more closely examine business taxes in Wisconsin.

Then, the report will elaborate on what is meant by "accountability" in the realm of business taxation. This will include discussions of tax reforms such as combined reporting and increased corporate tax disclosure

The bottom line: Too many of Wisconsin's biggest profit-makers are underpaying taxes, compared with their corporate brethren in other states. With fiscal crises afflicting state and local governments, it is time to look to the corporate community to pay its fair share to support the critical public structures on which Wisconsin's prosperity depends.

The number: $1.3 billion

First, the number: Wisconsin's corporate community is underpaying state and local taxes by more than $1.3 billion each year.

This is the difference between what the business sector actually pays in state and local taxes, and what it would be paying if only its share of taxes equaled the average share paid by business nationwide.

In Wisconsin, the business sector pays 35% of all state taxes, according to data from Ernst & Young, the large accounting firm. The nationwide average contribution by business to state taxes is 40%, compared with Wisconsin's 35%.[1]

If Wisconsin's corporate community paid an additional five percentage points, enough to bring it up to the US average, it would mean $800 million annually in additional state revenue.[2]

It's the same story for local taxes. In Wisconsin, the business sector pays 47% of all local taxes, according to Ernst & Young. The nationwide average contribution by business to local taxes is 52%, compared with Wisconsin's 47%.

Table 1: Business Sector Share of state and local taxes (2006)
Source: Ernst & Young

Alaska	82.1%
South Dakota	64.0%
Texas	63.1%
North Dakota	61.5%
Louisiana	60.6%
New Hampshire	56.9%
New Mexico	56.5%
Delaware	53.5%
Washington	52.9%
West Virginia	52.2%
Tennessee	51.7%
Montana	50.9%
Oklahoma	49.5%
Arizona	49.4%
Kansas	48.6%
Mississippi	48.3%
Florida	47.8%
Illinois	47.7%
Nebraska	47.4%
Nevada	47.4%
Iowa	46.6%
Rhode Island	46.0%
Vermont	45.8%
Indiana	45.6%
Maine	45.6%
Kentucky	44.7%
Colorado	44.4%
Alabama	44.2%
New York	43.0%
Minnesota	42.5%
Pennsylvania	42.5%
California	42.3%
South Carolina	42.1%
Michigan	41.9%
Georgia	41.3%
Missouri	41.3%
Idaho	41.2%
Arkansas	40.9%
Ohio	40.3%
Wisconsin	**39.3%**
Massachusetts	38.7%
New Jersey	38.4%
Hawaii	38.0%
Utah	38.0%
Virginia	37.8%
North Carolina	37.4%
Maryland	36.1%
Oregon	36.1%
Connecticut	34.3%

If Wisconsin's corporate community paid an additional five percentage points, enough to bring it up to the US average, it would mean about $520 million annually in additional revenue for schools, counties and municipalities.

The combined underpayment of state and local taxes means that Wisconsin's corporate sector is $1.3 billion short of what it would be paying, if only it brought its share up to the national average.

As a taxpaying partner in supporting state and local services, Wisconsin's corporate sector ranks 41st among all the states, according to Ernst & Young. [see Table 1] This is a Bottom Ten ranking that should embarrass corporate leaders.

What would $1.36 billion mean to state and local public structures? The additional revenue to state government—$800 million annually—would completely eliminate the state's structural budget deficit.[3]

And that would still leave an additional $500 million in revenue for local governments. That's enough to completely fund the entire fire protection budgets in every Wisconsin community. Or it would be enough to completely fund every county and municipal park and recreation activity in the state.[4]

Alternatively, the $1.36 billion underpayment of taxes by the state's corporate sector is enough money to completely fund the kindergarten-through-high-school education of every single child living north of Wausau—99 separate school districts educating more than 115,000 students.[5]

Accountability: The Ernst & Young data

The first measure of accountability is to be clear where the numbers cited above come from.

It is not a straightforward matter to calculate business taxes. For one thing, the taxes are collected in many forms, including the state corporate income tax, state and local sales taxes, and local property taxes of various kinds. Some businesses—those organized as so-called S corporations—pay no tax on their profits but pass the tax liability onto the individuals who own the firm.

A reliable source of data about business taxes is Ernst & Young's annual review of state and local taxes for businesses: *Total State and Local Business Taxes.*[6] Ernst & Young is the second largest accounting firm in the US, and it prepares the books for many of Wisconsin's largest companies. The firm has no inclination to understate tax payments by businesses, and is in a good position to understand the complexities of calculating overall tax levels.

Ernst & Young's calculations include property taxes of all kinds; sales and use taxes paid by businesses on purchases of inputs; corporate income taxes; excise taxes on business purchases; taxes on insurance premiums and utility receipts; unemployment taxes; license taxes; and individual income taxes paid by owners of pass-through entities (such as partnerships, sole proprietorships and S-corporations).

While their data includes all businesses, regardless of size, in this report the focus is on the largest business taxpayers. These include primarily the biggest companies doing business in Wisconsin.

For example, the Wisconsin Department of Revenue reports that in 2003, corporate income tax returns were filed by 4,275 firms whose revenues exceeded $100 million. These very large firms accounted for nearly 60% of all business profits reported that year. According to state data, 62% of these very large firms paid absolutely zero in corporate income taxes.[7]

It is this group of very large businesses that are being referred to in this report by phrases such as "corporate community" or "business sector."

Accountability: Long-term trends

Are the numbers used above taken out of context? Was fiscal year 2006 an unusual year whose data are misleading?

No. The large underpayment of business taxes is completely in line with numerous long-term trends:

- Twenty-five years ago, more than 11% of the state's tax revenue came from the corporate income tax. That dropped to 5% in 2002, before a mild rebound to 6.7% in 2005.[8]
- Thirty years ago, residential property accounted for half of all state property taxes. Today, homeowners pay 70% of all property taxes, as the business contributions have dropped.[9] Many forms of business property are simply exempt from the property tax, including all manufacturing machinery and equipment and all computers, under a definition of "computers" broad enough to include automated bank tellers and computerized cash registers.[10]
- Virtually all services purchased by businesses are untouched by the sales tax. A 5% state sales tax on advertising would generate more than $100 million a year, the Department of Revenue estimates. A sales tax on computer services would yield $123 million. A sales tax on accounting would produce $51 million. A sales tax on advertising would produce more than $100 million.[11]
- There are numerous breaks from the corporate income tax. These include scores of individual business-assistance programs that give tax credits for such things as research ($18 million annually) and investment in so-called development zones (about $14 million).[12]

No wonder that Forward Wisconsin, the public-private organization that recruits out-of-state firms to invest in Wisconsin, brags on its web site: "Wisconsin's business-friendly attitude is reflected in positive business tax changes that have been made in every biennial legislative session since the early 1970s."[13]

Accountability: Corporate tax reporting

A basic form of accountability for business taxes is to expect corporations to account for **all** of their profits from **all** of their corporate components when they figure their state and local taxes. This is known as "combined reporting," and it prevents large firms from avoiding state taxes by shifting profits among a number of corporate subsidiaries, so the profits are always tax-free.

A notorious national example is Wal-Mart, whose complicated method of paying rent for its stores "has saved Wal-Mart from paying several hundred million dollars in taxes" to state governments across the country, according to a recent expose in the *Wall Street Journal.*[14]

Basically, Wal-Mart rents its stores from another company, which happens to be a different firm in the Wal-Mart corporate structure. The Wal-Mart operation that owns the stores and collects rent is set up as what is known technically as a real-estate investment trust (REIT).

The REIT's profits, paid out as dividends to Wal-Mart, are tax-free. And the rent that each Wal-Mart store pays is enough to offset the store's profits. So the stores are, from a bookkeeping point of view, profit-free and hence tax-free.

[See the accompanying sidebar for more details and questions on Wal-Mart's Wisconsin operations.]

Does Wal-Mart Pay Its Share?

Is Wal-Mart paying its fair share of Wisconsin taxes? It's not an easy question to answer, because so much about business taxes is secret. But it's possible to make a plausible estimate that the retail giant is underpaying Wisconsin taxes by millions of dollars each year.

The state's Department of Revenue says that Wal-Mart paid $547,096 in corporate income tax for 2003 (using information obtained as described in endnote 16). The state's corporate income tax rate is 7.9%. Putting the two numbers together allows a calculation of Wal-Mart's declared Wisconsin profits. The total declared profits, on which the firm paid income taxes, were $6.9 million.

Is that a plausible figure? Or is it likely that there were considerably more profits than that, profits that through the use of a variety of tax loopholes went untaxed?

Wal-Mart reports that its total company-wide profits that year were $9.054 billion. Wisconsin, of course, accounts for only a sliver of that. But how big a sliver?

Wal-Mart's web site says that Wisconsin has 49 of the company's approximately 1,100 "super centers;" 28 of the company's approximately 1,950 "discount stores;" and 12 of its approximately 575 "Sam's Clubs."

Combined, this gives Wisconsin 89 Wal-Mart facilities. This is 2.4% of Wal-Mart's US total.

If Wisconsin houses 2.4% of Wal-Mart stores, it's plausible that it brings in on the order of 2.4% of Wal-Mart's profits. Its 2003 company-wide profits were $9.05 billion. So,
Wisconsin's contribution to those profits would be on the order of $220 million.

Yet Wal-Mart's declared profit, as seen above, was only about $7 million. This is only a tiny fraction of the estimated $220 million. If Wal-Mart's Wisconsin profits were actually $220 million, its corporate income tax would be more than $15 million.

Obviously, the $220 million estimate could be in error, for a variety of reasons. Yet even if we were to work with only **one-tenth** of that estimate, it would still yield a profit three times what Wal-Mart reported.

Closer to home, a similar maneuver was used by Kohl's Corporation, the Menomonee Falls-based national retail chain. For a number of years, Kohl's required its department stores in Wisconsin to pay royalty fees to an out-of-state firm for the rights to use various Kohl's trademarks. The out-of-state firm, however, was simply another subsidiary of the parent Kohl's Corp.[15]

In 2002, the state's Department of Revenue demanded Kohl's repay more than $800,000 in unpaid state taxes and interest. The case was ultimately settled in 2003 without going to court, but the terms of the settlement have been secret, as have Kohl's subsequent tax payments.[16]

More recently, the Department of Revenue also cracked down on the widespread use by Wisconsin banks of the so-called 'Las Vegas loophole.' In this maneuver, a Wisconsin bank creates a subsidiary firm in Nevada, a state without a corporate income tax. Through internal bookkeeping arrangements, Wisconsin profits are transferred to the Nevada operation. This leaves the Wisconsin banks profit-free—hence free of any state corporate income tax obligation.

In 2003, the Madison *Capital Times* newspaper reported that the Department of Revenue estimated "over 80% of state banks have established subsidiaries in Nevada."[17]

The state challenged the use of the Las Vegas loophole, and after lengthy negotiations, settlements were reached between many banks and the Department of Revenue. The department said back tax payments were made and bank practices altered, but refused to disclose any settlement details.

All these loopholes—from Wal-Mart's real estate gimmick to Kohl's treatment of trademarks to the Wisconsin banks' use of Nevada subsidiaries—allow the firms to avoid paying corporate income tax to Wisconsin. But all the loopholes would be closed if Wisconsin followed the lead of seventeen other states in adopting a combined reporting approach to corporate taxes.

Combined reporting requires that a state corporate tax return include **all** profits from the **entire corporate family**, before calculating the portion taxable in Wisconsin. Combined reporting doesn't change the tax rate; it simply closes loopholes that currently allow profits made in Wisconsin to go tax-free.

Combined reporting was most recently proposed in Wisconsin by then-Gov. Tommy G. Thompson, a Republican, in 1999. It was not implemented, however. At the time, the state's Legislative Fiscal Bureau estimated that putting combined reporting in place would have generated an additional $70 million in 2001, a figure that would be considerably higher today.[18]

Combined reporting is not an anti-business policy. It is fairer to most businesses, especially smaller and mid-size firms, because it creates a level playing field. As it stands, companies doing business only in Wisconsin are at a disadvantage because they can't use these accounting techniques, so they have no choice but to pay Wisconsin income tax. The current system rewards firms with sophisticated accounting operated and complicated internal structures.

Combined reporting, together with improved disclosure requirements requiring public disclosure of corporate tax payments, tax exemptions and tax credits, would go a long way toward establishing a fairer distribution of Wisconsin's state and local taxes.

Accountability: Who speaks for business?

Spokespeople for Wisconsin's business community should be accountable for the accuracy and completeness of their comments. Honesty in discussing business taxes is found, though too often with little public attention. Forward Wisconsin, for example, advertises on its web site that "Wisconsin business taxes are low—lower than those in 35 other states."[19] That's accurate and forthcoming.

Another example is the recent statement by Edward Zore, chief executive of Northwestern Mutual Life Insurance Co. (NML) that his firm "would bypass Milwaukee today if it were choosing to relocate from elsewhere."[20] NLM is the largest private employer in Milwaukee, and a mainstay of the city's business and philanthropic affairs. Zore's comments, at a business luncheon in February 2007, sent a chill through the city's civic elite.

But Zore stressed his company's intent to stay put and support the city, where its offices anchor the downtown lakefront. Nevertheless, he said, from the perspective of a national site-selection consultant, Milwaukee "at best" would fall in the middle of the pack.

What is Zore's beef? High taxes? Hostile business climate? Overregulation? None of the above.

"Zore repeatedly downplayed Wisconsin's tax burden as one of the impediments," the *Milwaukee Journal Sentinel* reported. Instead, he said, "Taxes for us are not bad."

But the candor about business taxes coming from Forward Wisconsin and NML's Zore is not present in pronouncements coming from the largest, best-funded, and most influential business group in the state: Wisconsin Manufacturers & Commerce. For years, the Madison-based big-business lobby has focused its legislative agenda on plaintive appeals for a reduced tax burden.

WMC spends more money lobbying legislators than any other group in Wisconsin[21]. It supplements its lobbying with a steady supply of press release, op-ed offerings and campaign support for anti-tax politicians.

WMC Chairman Terry D. Growcock has attacked what he called "excessive corporate taxation."[22] WMC President James Haney has called for "eliminating the corporate income tax."

WMC's literature, web site, speeches, literature and political advertisements are explicit about which taxes it wants to see eliminated or reduced: the individual income tax, sales tax, estate tax, business equipment tax, capital gains tax, property tax, and corporate income tax. Are there any it missed?[23]

Tax data from 2004 were obtained from the Department of Revenue for 22 firms with executives sitting on WMC's board of directors. Twelve of the 22, including Chairman Growcock's Manitowoc Company, paid zero state corporate income tax.[24]

With its misleading complaints about high taxes disrupting Wisconsin's business climate, WMC fails the accountability test.

[1] *Total State and local Business Taxes: 50-State Estimates for Fiscal Year 2006,* by Robert Cline, Tom Neubig and Andrew Phillips. Page 9, Table 5. (February 2007; Ernst & Young LLP in conjunction with the Council on State Taxation) Subsequent references to Ernst & Young data also refer to Table 5. Online at: http://www.ey.com/Global/download.nsf/US/Total_State_and_Local_Taxes_-_50_State_Estimates_2006/$file/TotalStateLocalTaxes2006.pdf

[2] This is the calculation: There were $15.1 billion in state taxes. A share of 39.9% (the US average) would be $6.025 billion. Wisconsin's actual share was 34.6%, or $5.2 billion. The difference is $800 million.

[3] "Department of Administration Issues Summary of Agency Requests, Revenue Estimates for 2007-2009 Biennium," Press release from Wisconsin Department of Administration, Nov. 20, 2006. Online at: http://www.doa.state.wi.us/docs_view2.asp?docid=6186.

[4] Wisconsin local governments spent $509 million for fire protection and $495 million for parks and recreation in fiscal year 2004, according to the US Census Bureau. Online at: http://www.census.gov/govs/estimate/0450wisl_1.html.

[5] Roughly the area north of State Highway 29, which crosses the state from Green Bay to Wausau to Eau Claire. Based on total district spending and district membership data from Wisconsin Department of Public Instruction.

[6] See footnote 1 for details.

[7] Communication from Department of Revenue

[8] *The Wisconsin Corporate Income and Franchise Taxes,* published by Department of Revenue, Aug. 25, 2006. Online at: http://www.revenue.wi.gov/report/c.html#corp.

[9] "Property Tax Level in Wisconsin: Informational Paper 13," published by Wisconsin Legislative Fiscal Bureau, January 2007. Table 4. Online at: http://www.legis.state.wi.us/lfb/Informationalpapers/13.pdf.

[10] *Summary of Tax Exemption Devices,* published by Department of Administration and Department of Revenue, February 2007, p.76-7. Online at: http://www.revenue.wi.gov/report/t.html#exempt.

[11] *Summary of Tax Exemption Devices,* p.67.

[12] *State Economic Development Programs,* published by Wisconsin Legislative Audit Bureau, August 2006. Online at: http://www.legis.wisconsin.gov/lab/PastReportsByDate.htm.

[13] Online at: http://www.forwardwi.com/category39/Business-Taxes-and-Costs.

[14] "Wal-Mart Cuts Taxes by Paying Rent to Itself," by Jesse Drucker. *Wall Street Journal,* Feb. 1, 2007.

[15] "State Takes Kohl's Corp. to Court in Pivotal Tax Case," by Mike Ivey. *The Capital Times* (Madison), May 14, 2003. "Black: Expose Corporate Tax Dodge," by Mike Ivey. *The Capital Times* (Madison), April 15, 2004.

[16] It is possible to obtain the net corporate income tax payment of a firm filing a tax return in Wisconsin, by using a Department of Revenue process involving Form P-100. The process, however, is expensive, time-consuming, cumbersome and unworkable for purposes of public policy discussion. For example, it requires knowing the exact name and address of each filing corporation, with a separate request necessary for any subsidiary. For a more detailed look at the P-100 process and some tax data obtained from them, see a PowerPoint presentation, "Wisconsin Tax Heaven: The Corporate Contribution to State and Local Tax Revenue," by Jack Norman, online at: www.wisconsinsfuture.org. Critics of that work argued that it was misleading to identify companies, such as Johnson Controls, Kohl's, Manpower and other leading state firms as having paid zero corporate income tax, because tax data on all of each firm's subsidiaries hadn't been requested. This is an unreasonable

requirement for public access to important data. For example, the *Business Journal of Milwaukee* reported recently that Marshall & Ilsley Corp. sued the federal government to recover 412.8 million in income taxes. The suit argues that the banking giant "mistakenly included some assets of its bank subsidiaries in calculating its tax liability." ("M&I sues IRS seeking $12.8 million in back taxes," by Jennifer Batog. March 16, 2007) If M&I has trouble keeping track of taxes at its own subsidiaries, why should the public be expected to navigate those waters just to obtain basic information about business taxes?

[17] "Tax Shelters Costs States Billions," by Mike Ivey. *The Capital Times* (Madison), July 16, 2003.

[18] Thompson proposed a pair of changes for state business taxes: one to impose combined reporting, the other to implement so-called 'single sales factor' as the method for determining corporate liability for income tax. It was estimated that the increased tax revenue from the former change would be offset by decreased revenue from the latter. Neither change became law. The single sales factor change was implemented under Gov. James Doyle in 2003, without an accompanying change to combined reporting.

[19] Online at: http://www.forwardwi.com/category39/Business-Taxes-and-Costs.

[20] "Insurer would bypass city if relocating today," by John Schmid. *Milwaukee Journal Sentinel,* Feb.22, 2007.

[21] "Total Lobbying Expenditures: 2005-2006 Legislative Session," published by Wisconsin Ethics Board. Online at: http://ethics.state.wi.us/LobbyingRegistrationReports/SLAESummary_AllOrgs_dollars0506.pdf.

[22] For Growcock, see: "Growcock plans to cheerlead, but not run from challenges," by Charlie Mathews. *Manitowoc Herald-Times,* Jan. 15, 2006. For Haney, see WMC press release, June 26, 2006: "A Wake-up Call for Wisconsin from RedPrairie, LoPresti." Online at: http://www.wmc.org/display.cfm?ID=1369

[23] For a recent and fuller discussion of the difference between Forward Wisconsin's accurate appraisal of the business tax climate and WMC's disinformation campaign, see: "Are Wisconsin taxes too high? Business boosters disagree, but it's possible to get to the truth," by Jack Norman. *Isthmus* (Madison). April 6, 2007. Online at: http://isthmus.com/isthmus/article.php?article=6214

[24] Details on tax payments by companies represented on the WMC board of directors are in the PowerPoint referred to in footnote 15.