

**GOVERNMENT OF THE DISTRICT OF COLUMBIA**  
**Office of the Chief Financial Officer**

**Natwar M. Gandhi**  
Chief Financial Officer



**MEMORANDUM**

**TO:** The Honorable Linda W. Cropp  
Chairman, Council of the District of Columbia

**FROM:** Natwar M. Gandhi  
Chief Financial Officer

**DATE:** June 17, 2003

**SUBJECT:** Fiscal Impact Statement: "Corporate Income Tax Base Protection Act of 2003"

**REFERENCE:** Bill Number 15-243 as Introduced

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**Conclusion**

Funds are sufficient in the proposed FY 2004 through FY 2007 budget and financial plan as agreed to by the Mayor and Council of the District of Columbia to implement the provisions of the bill. The bill would increase local revenue and could result in additional revenue of approximately \$12.7 million during Fiscal Years 2004-2007.

**Background**

The bill makes two changes to the District's corporate franchise tax law: (1) it disallows deductions for certain kinds of payments to related corporate entities which are not taxed in the District; and (2) it changes the definition of "business income" to conform automatically to U.S. Supreme Court rulings.

1. A number of companies, including some that operate in the District of Columbia, have related holding companies that own the corporate families' patents, copyrights, trade names, and other intangible property. These holding companies are paid royalties and similar payments by the operating companies in the corporate families, for the rights to use these assets. This reduces the net incomes apportioned by the operating companies to the states in which they operate. In some cases, the holding companies lend the payments back to the operating companies and collect interest from the operating companies, further reducing the apportioned net incomes. The holding companies are

typically organized in Delaware or other states that do not tax income from intangible assets, and their incomes are typically not apportioned to the states in which the operating companies conduct business.

The proposal would require D.C. corporate franchise taxpayers to add back, to their net incomes, deductions for payments made to related companies for interest or in connection with patents, trademarks, trade names, copyrights, and similar kinds of intangible property.

2. D.C. law allows corporate franchise taxpayers to exclude "non-business income" from their apportionment calculations for D.C. taxable income. In this respect, D.C. law is similar to the law in most of the states that tax corporation incomes. The formal definitions of "business income" and "non-business income" in D.C. law are taken directly from the Multistate Tax Compact. There has been much litigation in state courts concerning interpretations of these definitions as applied to occasional, non-recurring transactions. Some states' courts have interpreted the definition of business income narrowly. Other states' courts, including D.C.'s courts, have interpreted the definition more broadly. A recent decision of the Supreme Court of the United States may be interpreted as endorsing the broader interpretation of "business income." Professor Walter Hellerstein, a recognized legal authority in this area, has characterized this situation as "a state of utter confusion." He has recommended that the states abandon the previous business/non-business definitions and instead define business income as income "which is apportionable under the Constitution of the United States."

The bill adopts Professor Hellerstein's suggestion by inserting his exact wording into the D.C. Code.

## **Discussion**

1. Some 55 companies have been identified in press reports or other public documents as using the device of transferring their intangible property, such as trade names, to subsidiary holding companies which then charge their related operating companies royalties and similar fees for the use of that property. More than 30 of these companies conduct business in the District.

Several states have used the approach taken in the bill, requiring companies to add the payments to their intangible holding companies back to their net incomes. Ohio was the first state to take this action, in 1992. Ohio requires companies to show the amounts added back on their tax returns. Using that information, analysts in the Ohio Revenue Department have found that the requirement generates a significant flow of revenue to the State.

The District could receive revenues roughly in proportion to Ohio's. To generate revenue equal to the full amount of tax liability, voluntary compliance with this provision should be supplemented by enforcement. This will consume some of the time of the Office of Tax and Revenue's most skilled audit personnel.

Of D.C. corporate franchise taxpayers, 910 reported gross profit over \$10 million, and D.C. tax liability of \$100 on their tax year 2001 tax returns. While some of these cases undoubtedly reflect actual unprofitable conditions, the large number of such cases may also reflect a wasting away of the corporate franchise tax base due to "tax planning," including establishment of intangible holding companies, but including other devices as well. To deal with this more general problem may justify measures—such as combined reporting, or a different type of minimum tax structure, for example—that will require more deliberation and preparation than can be undertaken quickly.

2. Implementing Professor Hellerstein's proposed redefinition of business income will require re-writing some of the instructions for the Form D-20. This effort will be comparatively small. *However, the impact on District revenue will also be small, at most.* The impact of recent Supreme Court decisions related to apportionment of income has already been reflected in tax returns filed by D.C. taxpayers since those rulings were issued. In any case, the D.C. Courts have already adopted the standard endorsed by those decisions. It is not possible to predict the impact of future Supreme Court decisions on D.C. revenue.

### Financial Plan Impact

Funds in the FY 2003 budget and the proposed budget for FY 2004 are sufficient to implement the bill's provisions.

The following table displays the estimated amounts of additional revenue that could result from implementation of the bill's provisions.

Revenue Impact to the Financial Plan				
(\$ in 000s)				
FY 2004	FY 2005	FY 2006	FY 2007	4-Year Total
\$2,356	\$3,319	\$3,465	\$3,570	\$12,709