The Declining Trend in Corporate Taxes

Presentation of
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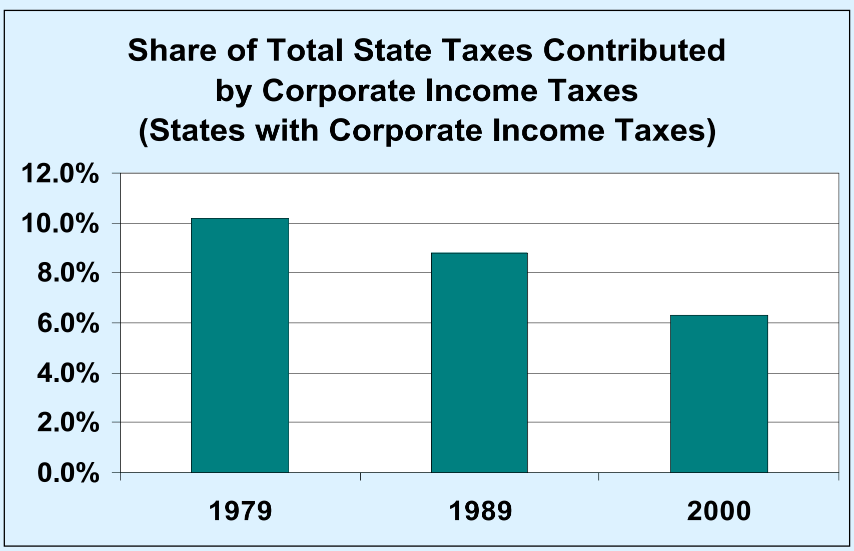
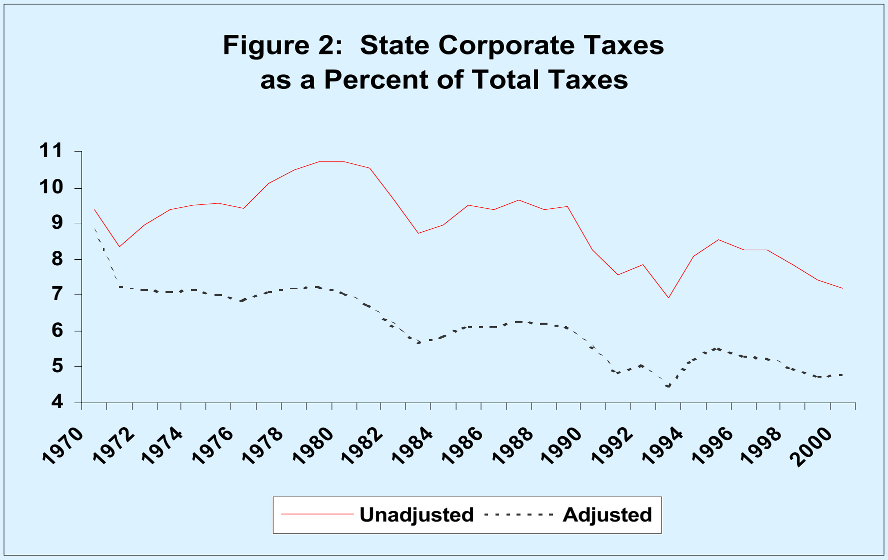


Source: Census Bureau



Source: William F. Fox and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions" , paper prepared for the National Tax Association, Spring 2002 Symposium. "Adjusted" adjusts for changes in tax rates and the imposition of corporate taxes by additional states. I am grateful to Professors Fox and Luna for permission to reproduce their slides.

Share of Total State Taxes Contributed by Corporate Income Tax, States with Corporate Income Taxes

	1979	1989	2000	Change 79-00	Change 89-00
All Corporate Income Tax States	10.2%	8.8%	6.3%	-27.7%	-37.7%
Alabama	5.8%	5.9%	3.8%	-35.9%	-34.4%
Alaska	31.5%	32.6%	30.8%	-5.5%	-2.1%
Arizona	5.9%	4.9%	6.5%	31.1%	9.6%
Arkansas	8.4%	5.1%	4.9%	-5.3%	-42.1%
California	14.5%	12.3%	7.9%	-35.5%	-45.5%
Colorado	7.8%	5.9%	4.7%	-19.7%	-39.2%
Connecticut	13.5%	16.6%	4.2%	-74.8%	-68.8%
Delaware	10.2%	13.7%	11.3%	-18.0%	10.7%
Florida	7.3%	5.8%	4.8%	-18.2%	-35.0%
Georgia	9.2%	8.3%	5.3%	-36.3%	-42.9%
Hawaii	4.6%	4.0%	2.3%	-43.2%	-50.4%
Idaho	8.4%	6.9%	5.3%	-23.5%	-37.1%
Illinois	7.7%	9.1%	9.9%	8.8%	28.3%
Indiana	4.8%	4.8%	9.2%	91.5%	92.5%
Iowa	8.3%	6.4%	4.1%	-35.3%	-50.1%
Kansas	11.9%	7.9%	5.6%	-29.5%	-52.9%
Kentucky	7.9%	7.6%	4.0%	-47.8%	-49.4%
Louisiana	9.7%	8.7%	3.4%	-60.7%	-65.0%
Maine	7.4%	6.1%	5.6%	-6.9%	-24.2%
Maryland	5.5%	5.3%	4.2%	-22.1%	-24.3%
Massachusetts	13.4%	13.0%	8.1%	-38.0%	-39.5%
Minnesota	11.4%	7.6%	6.0%	-21.0%	-47.1%

Source: Census Bureau. Texas is omitted because its "earned surplus tax" — the functional equivalent of a corporate income tax — was not enacted until 1991.

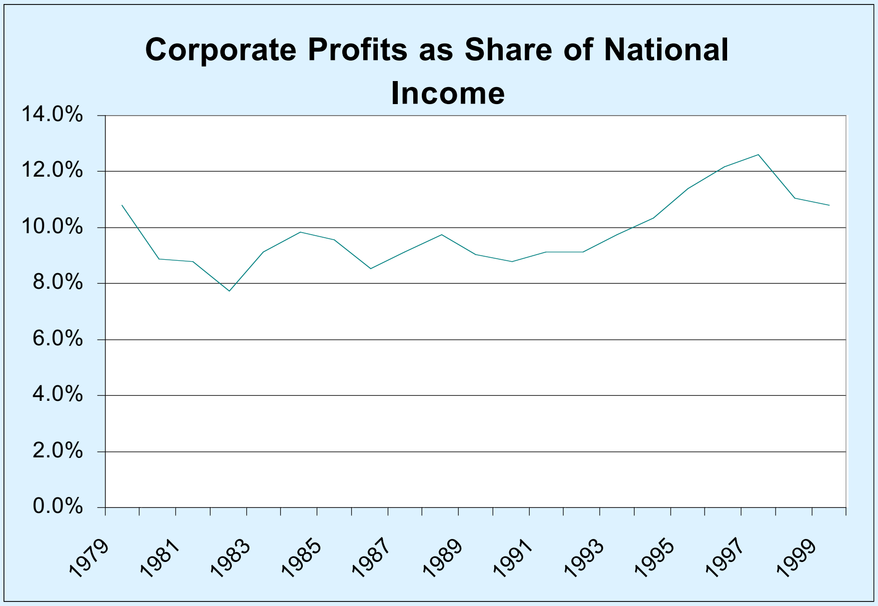
Share of Total State Taxes Contributed by Corporate Income Tax, States with Corporate Income Taxes

	1979	1989	2000	Change 79-00	Change 89-00
All Corporate Income Tax States	10.2%	8.8%	6.3%	-27.7%	-37.7%
Mississippi	4.9%	6.3%	4.8%	-22.9%	-0.9%
Missouri	6.5%	5.2%	3.1%	-40.3%	-52.0%
Montana	9.0%	7.7%	7.1%	-8.3%	-21.5%
Nebraska	6.7%	5.6%	4.7%	-15.5%	-30.2%
New Hampshire	24.2%	24.8%	18.4%	-25.7%	-24.1%
New Jersey	11.5%	12.5%	7.4%	-40.5%	-35.6%
New Mexico	4.8%	4.0%	4.3%	5.3%	-11.2%
New York	10.5%	7.6%	6.6%	-12.1%	-36.8%
North Carolina	8.7%	10.7%	6.5%	-39.3%	-25.6%
North Dakota	8.9%	6.4%	6.7%	4.7%	-24.9%
Ohio	10.9%	6.8%	3.2%	-52.6%	-70.7%
Oklahoma	6.2%	3.4%	3.3%	-2.6%	-46.8%
Oregon	12.0%	6.1%	6.8%	12.2%	-42.9%
Pennsylvania	12.6%	9.2%	7.6%	-18.0%	-40.0%
Rhode Island	10.4%	6.7%	3.7%	-45.1%	-64.6%
South Carolina	9.2%	5.9%	3.6%	-39.9%	-61.3%
Tennessee	10.1%	9.1%	7.9%	-13.2%	-21.4%
Utah	4.7%	5.7%	4.4%	-23.1%	-7.7%
Vermont	8.9%	6.0%	3.0%	-50.0%	-66.2%
Virginia	7.7%	5.2%	4.5%	-14.7%	-41.5%
West Virginia	2.2%	10.8%	6.5%	-39.7%	192.8%
Wisconsin	10.0%	7.0%	4.6%	-33.6%	-53.7%

Source: Census Bureau. Texas is omitted because its "earned surplus tax" — the functional equivalent of a corporate income tax — was not enacted until 1991.

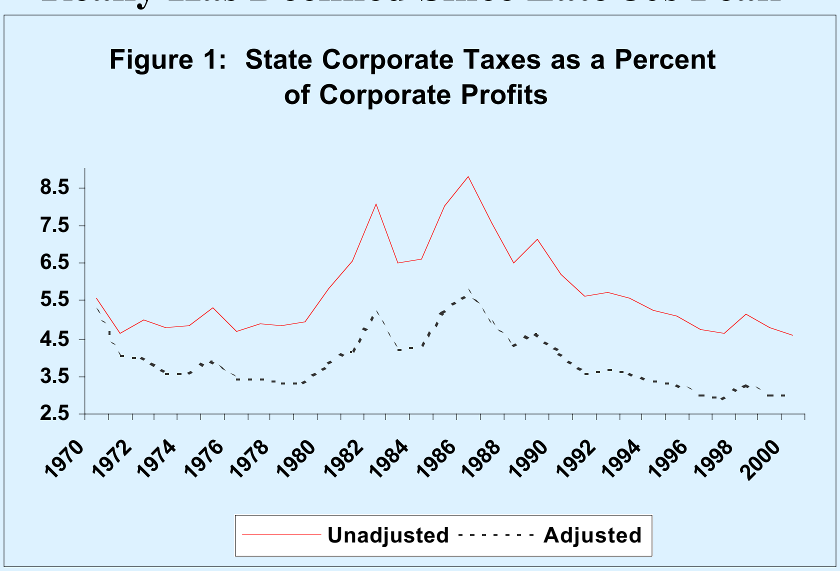
To what extent is declining share of corporate taxes in state tax revenue mix caused by

- Relatively faster growth in effective rates of taxation of consumption and individual incomes, vs
- Declining share of corporate profits in national income, vs
- Actual decline in effective rate of taxation of corporate profits by states



Source: National Income and Product Accounts. Corporate profits measured after inventory valuation and capital consumption adjustments

Effective State Corporate Tax Rate Really Has Declined Since Late 80s Peak



Source: Fox/Luna

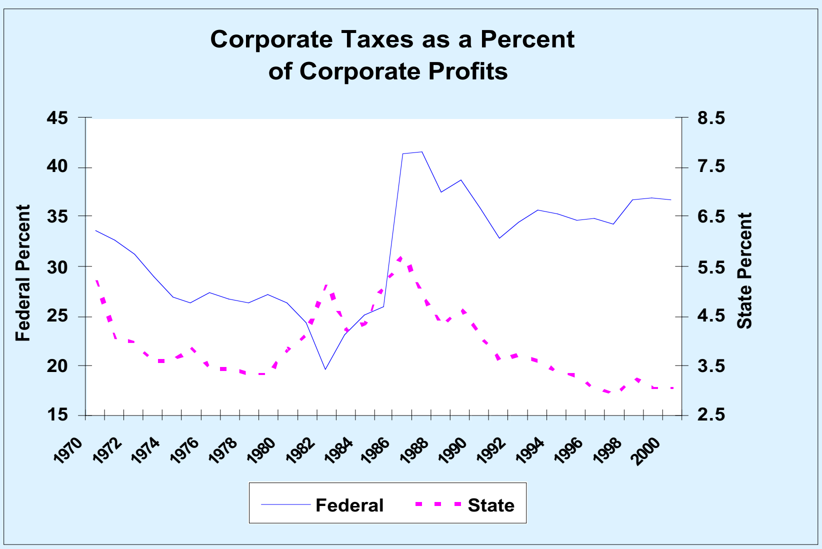
Possible Explanations for Declining Effective State Corporate Tax Rates

- Federal tax base-related factors
- State-specific factors

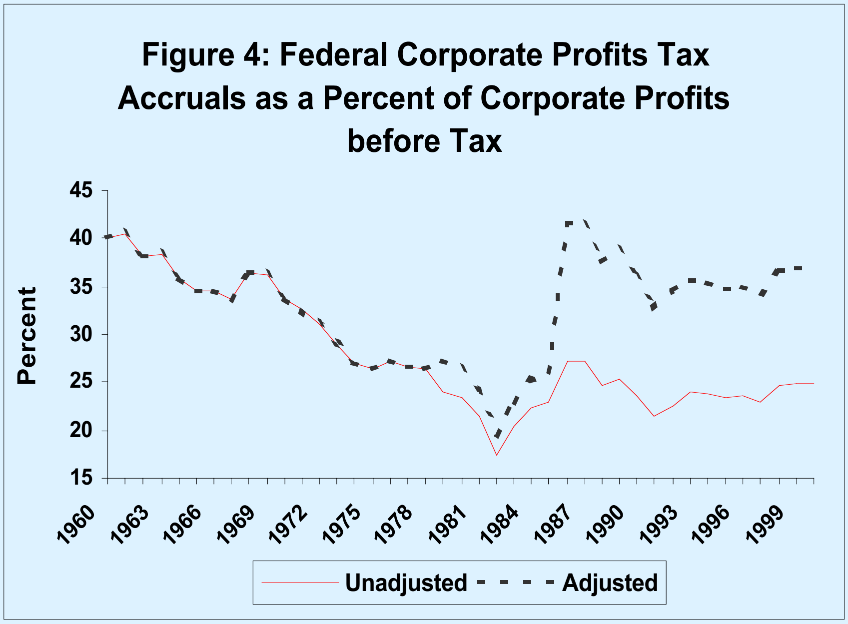
- Federal taxable income of corporations declining as share of “true” corporate profits; states substantially piggy-backed on federal corporate income tax base
  - Federal tax shelters/more aggressive tax planning? under federal law?
  - Stepped-up investment combined with accelerated depreciation under federal law?
  - Growing international transfer pricing problem?
  - Some profits no longer taxable at corporate level due to increasing use of pass-through entities (partnerships, LLCs, S-Corps)? Showing up on personal income tax returns instead?

- States are consciously cutting effective tax rates
  - ➢Cutting statutory rates
  - ➢Enacting economic development oriented tax incentives (e.g., ITCs, R&D credits)
- States are enacting other policies that lead to corporate tax base erosion (e.g., increased weight of sales factor)
- Corporations increasingly exploiting structural weaknesses/loopholes in state corporate tax systems

Erosion of the Federal Corporate Tax Base Is Not the Sole Cause of the Declining Effective State Corporate Tax Rate



Source: Fox/Luna. Effective corporate tax rates shown here have been adjusted to eliminate the effects of tax rate changes and the imposition of corporate income taxes by additional states



Source: Fox/Luna. "Adjusted" line has been adjusted for the effects of federal corporate tax rate changes.

Question:

Previous charts show effective federal corporate tax rates stable/slightly growing since 1993 rate increase;

Why all the hand-wringing about aggressive corporate tax shelters, increased use of stock options, abusive transfer pricing, etc.?

Answers:

• NIPA profits (numerator of effective tax rate measure) already artificially depressed by transfer pricing and tax sheltering

• Actual federal tax base erosion possibly understated by this measure (using NIPA profits in denominator) because taxable profits in numerator boosted by items that do not also boost denominator (capital gains, foreign source dividends)

- See Lillian Mills presentation tomorrow on factors contributing to divergence between book and federal taxable income

- Recent papers on this issue:

  Mills, Newberry, Trautman, Trends in Book-Tax Income and Balance Sheet Differences

  Desai, The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation

  Plesko, Reconciling Corporation Book and Tax Net Income, Tax Years 1996-98

  Mackie, The Puzzling Comeback of the Corporate Income Tax

- Decline in effective state corporate tax rate from ’87-’00 should have boosted federal effective corporate tax rate due to smaller federal tax return deduction

- Effect should have been about 1 percentage point (35% marginal rate times decline in effective state corporate tax rate from 8.0% to 4.6% of profits)

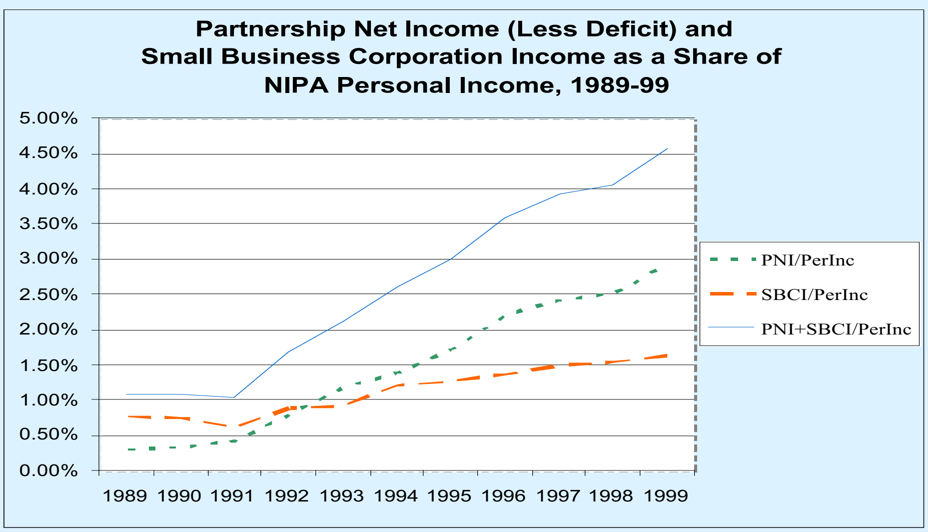
Bottom line:

- Measuring federal and state effective corporate tax rates with NIPA profits in denominator probably understates recent decline in effective tax rates that would be seen with denominator closer to economic concept of profits

- If federal effective corporate tax rate is understated, so is state effective rate.

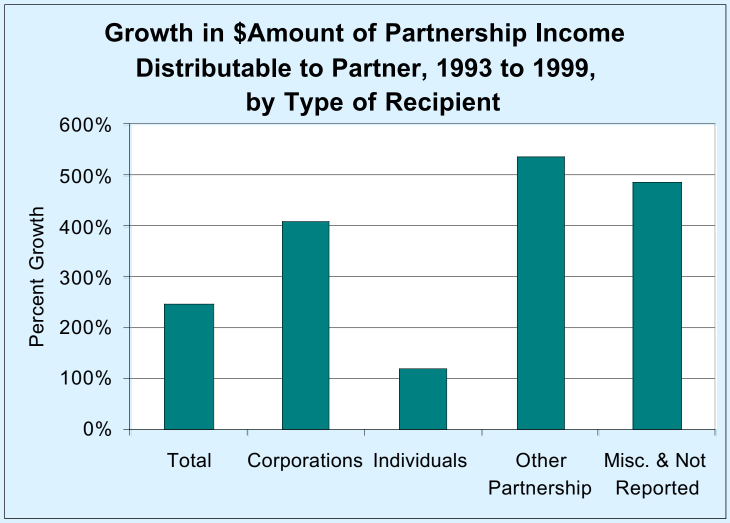
What role are pass-through entities playing in the erosion of the federal corporate tax base?

Pass-Through Entity Income Does Represent a Rapidly-Growing Share of Personal Income

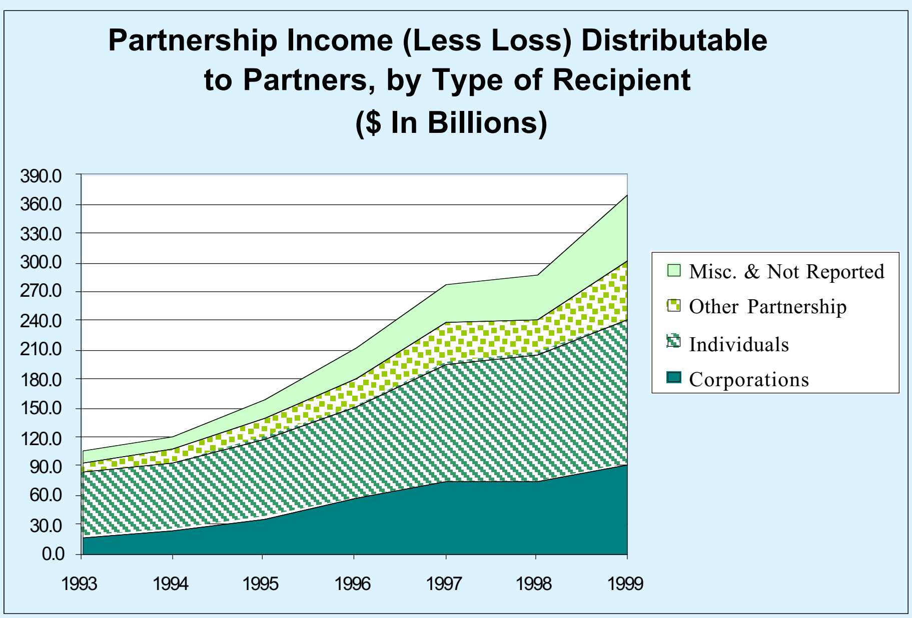


Source: partnership net income: IRS Statistics of Income data. Small Business (Subchapter S) Corporation Income: Bureau of Economic Analysis Reconciliation of AGI and NIPA Personal Income. Partnership figures include LLCs.

But Much Recent Partnership Income Flowed to Corporations



Source: IRS Statistics of Income Data

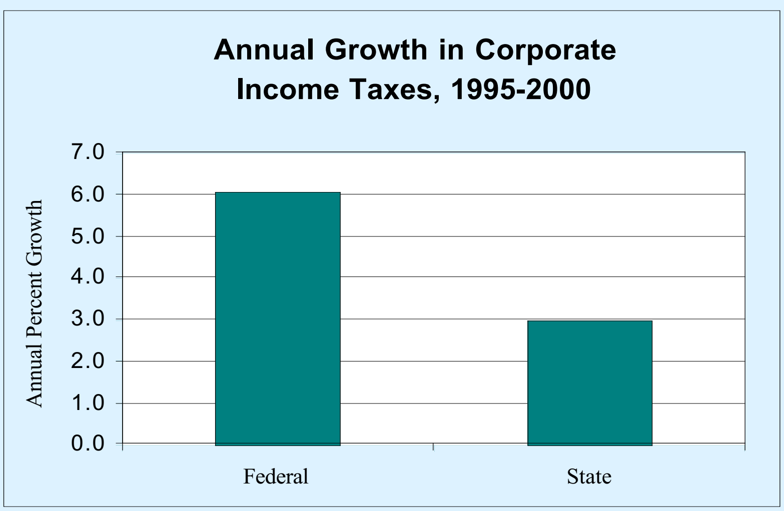


Effects of Pass-through Entities

- May not be eroding federal corporate tax base all that much, because much recent income growth appears to be flowing to corporate partners/LLC members

- May be making independent contribution to state corporate tax base erosion because of inadequate state policy (see below)

Erosion of the Federal Corporate Tax Base is Not the Sole Cause of the Declining Effective State Corporate Tax rate



Source: Federal and state corporate profits tax accruals, National Income and Product Accounts.

- Fox/Luna estimate that decline in federal corporate tax base due to sheltering, etc. explains 30% of decline in state effective rate
- What explains the other 70%?
- See: Peter Fisher, "Tax Incentives and the Disappearing State Corporate Income Tax Base," State Tax Notes, March 4, 2002

Top Marginal State Corporate Income Tax Rates, 1987 and 1999

	1987	1999	
Alabama	5	5	equal
Alaska	9.4	9.4	equal
Arizona	10.5	8	lower
Arkansas	6	6.5	**higher**
California	9.6	8.84	lower
Colorado	6	4.75	lower
Connecticut	11.5	8.5	lower
Delaware	8.7	8.7	equal
District of Columbia	10	9.5	lower
Florida	5.5	5.5	equal
Georgia	6	6	equal
Hawaii	6.435	6.4	lower
Idaho	7.7	8	**higher**
Illinois	4	7.3	**higher**
Indiana	3	3.4	**higher**
Iowa	12	12	equal
Kansas	4.5	4	lower
Kentucky	7.25	8.25	**higher**
Louisiana	8	8	equal
Maine	8.93	8.93	equal
Maryland	7	7	equal
Massachusetts	9.5	9.5	equal
Minnesota	12	9.8	lower

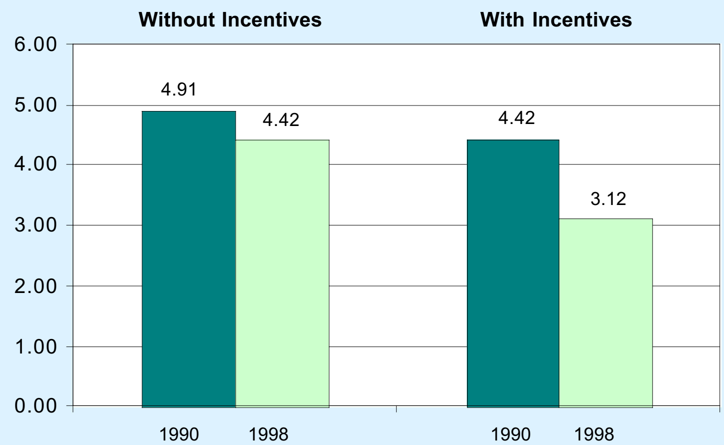
Top Marginal State Corporate Income Tax Rates, 1987 and 1999

	1987	1999	
Mississippi	5	5	equal
Missouri	5	6.25	**higher**
Montana	6.75	6.75	equal
Nebraska	6.65	7.81	**higher**
New Hampshire	8.25	8	lower
New Jersey	9	9	equal
New Mexico	7.6	7.6	equal
New York	10	9	lower
North Carolina	6	7	**higher**
North Dakota	10.5	10.5	equal
Ohio	9.2	8.5	lower
Oklahoma	5	6	higher
Oregon	7.5	6.6	lower
Pennsylvania	9.5	9.99	**higher**
Rhode Island	8	9	**higher**
South Carolina	6	5	lower
Tennessee	6	6	equal
Utah	5	5	equal
Vermont	9	9.75	**higher**
Virginia	6	6	equal
West Virginia	6	9	**higher**
Wisconsin	7.9	7.9	equal

Fisher modeled effective marginal state CIT rates using AFTAX-type model first developed by Papke

- Representative manufacturing firms in 16 industries
- 20 states representing 75% of US manufacturing output
- Compared 1990 vs. 1998 tax policy
- Measured effective marginal tax rate on new in-state manufacturing plant location by comparing pre- and post-investment cash flow
- Accounted for tax rates, major CIT credits (e.g., ITCs, R&D, employment), apportionment formulas, throwback, etc.

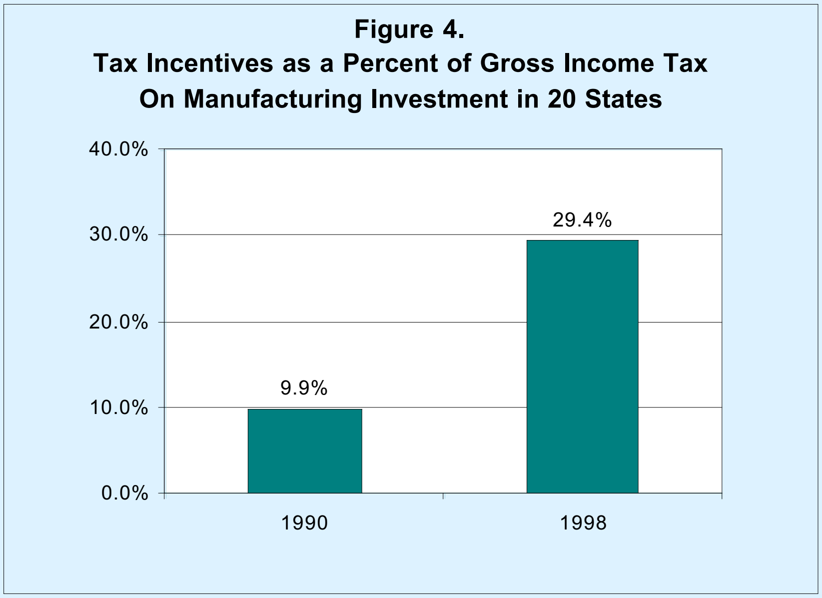
Figure 3
Effective Corporate Income Tax Rates
On Manufacturing Investment in 20 States



Source: Reproduced from Peter Fisher, "Tax Incentives and the Disappearing State Corporate Income Tax," State Tax Notes, March 4, 2002

Fisher's findings:

- Before considering effect of tax incentives, effective state corporate tax rate fell by about 10% from 1990 to 1998 – from 4.91% to 4.42%
- He attributes this decline principally to increasing weight of sales factor (8 of 20 states) and changes in nominal rates (3 raised, 3 lowered)
- Factoring in tax incentives led to much steeper, 30% decline – from 4.42% to 3.12% ("12 of the 20 states enacted significant new incentives between 1990 and 1998")



Source: Fisher

Fisher's findings:

- Tax incentives offset 10% of gross income tax liability in 1990 but almost 30% in 1998
- Fisher actually found negative 1998 effective state CIT rates on marginal investment in at least 2 of the 16 manufacturing sectors in 12 of the 20 states he modeled

Fisher's findings:

- 1998 effective state CIT rate after incentives was considerably lower in 12 states in which manufacturing GSP was lower share of national GDP in 1998 than in 1990 than in the 8 states in which the manufacturing sector had grown
- Concluded that declining effective state CIT rates shown in other studies (like Fox/Luna) NOT due to shift of manufacturing activity to low-tax states

Implications of Fisher analysis:

- Suggests that explicit state policy choices – e.g., increasing sales factor weight and enacting new development incentives – do account for substantial share of decline in effective state CIT rates in 1990s
- But Fisher's methodology cannot account for growing corporate sophistication and aggressiveness in planning around structural weaknesses of state CIT systems

Structural weaknesses:

- Vulnerability of separate entity apportionment states to use of DE/NV passive investment companies (PICs)

- Very costly tax shelter
  - The Limited – shifted $1.2 billion in profits to DE PIC in 3-year period
  - Kmart – shifted $1.0 billion to MI PIC in 3-year period

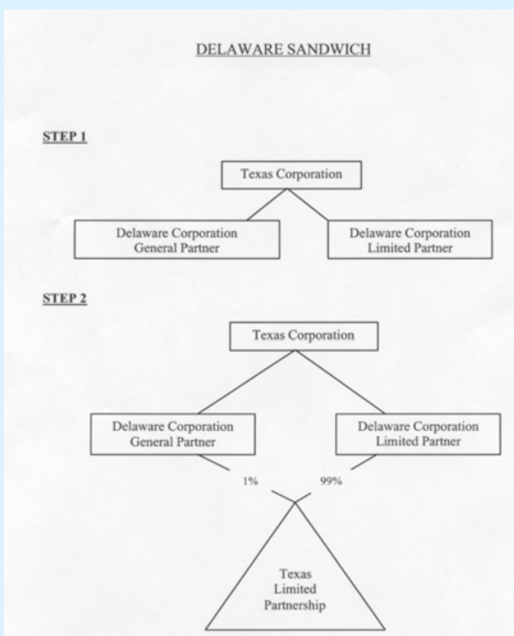
Documented corporate PICs

(see: Glenn Simpson, "A Tax Maneuver in Delaware Puts Squeeze on Other States," Wall Street Journal, 8/9/02, page 1)

Aaron Rents	Home Depot	Snap on Tools
ADP, Inc.	Honeywell	Staples
American Greetings	JP Stevens	Stanley Works
Beatrice	Kmart	Sunglass Hut
Budget Rent-A-Car	Kimberly Clark	Syms
Burger King	Kohl's	Sherwin-Williams
CompUSA	Long John Silver's	Casual Male
ConAgra	May Department Stores	Limited/Victoria's Secret
Dress Barn	Marsh Supermarkets	Tyson Food
Gap	Payless Shoesource	Toys R Us
Gore[tex] Industries	Radio Shack	Urban Outfitters

Structural weaknesses:

- Use of pass-through entities to avoid state corporate taxes
- Tax practitioner community increasingly asserting that states cannot assert nexus over non-managing pass-through owners/members on ownership basis alone
- See forthcoming Fox/Luna paper for Nov. NTA meeting on impact of LLCs
- Example: The "Delaware Sandwich" tax shelter used by Dell and SBC in Texas



Structural weaknesses:

- Lack of throwback/throwout rules combined with increasing weight of sales factor
- Inadequate definitions of business and non-business income
- Nexus avoidance in separate entity states through entity isolation (e.g., media companies do not acknowledge that their local cable TV systems create nexus for their national networks carried by those systems

A recent column headline and accompanying cartoon

"It's Time to Curb Corporate Tax Shenanigans"

from Mother Jones? The Nation?

No! <u>The Wall Street Journal</u>

(David Wessel column 9/19/02)

- The public is fed up with aggressive corporate tax avoidance and evasion.
- The state corporate income tax can be revitalized if the political will and desire is there to do it.
- The policy choices are clear from long state experience.
- Come to tomorrow’s break-out session and let’s explore the options.