Multistate Tax Commission

STUDY: CORPORATE TAX SHELTERING LINKED TO AS MUCH AS $12.4 BILLION IN LOST STATE TAX REVENUES

Estimate is Equal to 35 Percent of All 2001 State Corporate Income Tax Collections; Lost Revenue Identified in 45 of 50 States & DC, With CA, IL, TX and PA Hit Hardest.

WASHINGTON, D.C. – July 15, 2003 – Corporate tax sheltering reduced state corporate income tax revenues by more than a third in 2001, according to a new national study from the Multistate Tax Commission (MTC). The findings indicate that state corporate income tax revenue, which totaled $35.4 billion in 2001, would have been as much as $12.38 billion (or 35 percent) higher had such widespread tax sheltering of income not taken place.

The MTC analysis comes at a point when many state legislatures face a new fiscal year in which they will struggle with significant budget shortfalls estimated by the National Conference of State Legislatures at $78 billon and the prospect of more budget cuts or higher taxes. The Multistate Tax Commission report states: **"The lost revenue attributable to domestic and international income tax sheltering is adding to the size of state budget deficits while undermining the equity and integrity of state tax systems. It is not enough to say that state corporate tax revenues are declining just because of federal tax law changes or state tax-cutting during the 1990's. It is apparent that various corporations are increasingly taking advantage of structural weaknesses and loopholes in the state corporate tax systems."**

In releasing the national study, South Carolina Department of Revenue Director Burnet R. Maybank said: **"There are very real and very painful state budget deficits in America today and it is apparent that the revenue shortfall in many states is significantly larger because of tax sheltering. This comes at a time when states are struggling to provide quality education for children, safe communities and basic infrastructure to support their economies."**

Utah State Tax Commission Commissioner R. Bruce Johnson commented: **"Tax sheltering by some is unfair to the vast majority of taxpayers — ordinary citizens and tax-prudent companies — who correctly report their income. Tax sheltering also reduces economic growth by shifting capital investment away from its most efficient uses in the economy."**

California State Controller Steve Westly said: **"Officials in many states will seek to restore the equity and integrity of the state corporate income tax as they work to balance the need for public services with efforts to keep taxes as low as possible for all taxpayers. This is not a question of raising rates; it is a simple matter of making sure that the system works to**

ensure every corporation pays what it owes in taxes just as every taxpayer is expected to do."

KEY STUDY FINDINGS

The Multistate Tax Commission study provides a range of estimated state corporate tax collection losses, with a low-end estimate of $8.32 billion and a high-end estimate of $12.38 billion. (All state-specific loss estimates are based on mid-range projections.) Major findings of the MTC study include:

- ***States with biggest dollar losses.*** The hardest-hit state in dollar terms was California, which lost an estimated $1.34 billion. Next was Illinois, with a $693 million loss, followed by Texas ($607 million loss) and Pennsylvania (a $582 million loss).

- ***States with greatest losses, measured as a percentage of revenue.*** While California's loss equates to over 19 percent of its corporate tax revenues, many other states absorbed far greater losses in percentage terms. These included: West Virginia, where the mid-range loss estimates equaled 57.8 percent of collections; Ohio at 56.9 percent, Florida at 48.7 percent; and Mississippi at 43.1 percent.

- ***Average losses for states.*** The typical state suffered a corporate tax collection loss of 31.1 percent. The estimated mid-range losses for states ranged from a low of 10.3 percent for Michigan to 57.8 percent for West Virginia.

The five states with no estimated corporate income taxes losses due to tax sheltering activity are: Alaska, Delaware, Nevada, South Dakota and Wyoming. Additionally, final data for domestic tax sheltering activity targeted at states was not available for this report from Nebraska and New York state.

The full text of the MTC study, including rankings for individual states, is available on the web at http://www.mtc.gov/statebudgetcrisis.html.

DEFINING "TAX SHELTERING"

Tax sheltering as used in this study refers to taxpayer reporting behavior that reduces tax payments to states below what would occur if each corporation calculates its net income through methods reviewed and approved by federal or state tax authorities, and each corporation reports income to each state in reasonable proportion to the business activity being conducted in that state.

The MTC report concludes that the "vast majority of U.S. businesses are not part of the state corporate income tax sheltering problem." Very few small businesses can take advantage of the tax sheltering schemes studied by the MTC. Additionally, some major corporations choose not to engage in aggressive corporate income tax sheltering. The majority of the revenue losses are linked to such “exotic” tax sheltering techniques as: reincorporating strictly for tax income purposes in Bermuda; creating separate corporations to house "intangibles" (e.g., trademarks) and then siphoning profits away from taxation in the states in which the companies actually do business; shifting taxable income away from the U.S. to other nations through the pricing of goods and services involved in transactions between jointly owned companies; and using complex interpretations of tax laws to create so-called “no-where income” that is earned by a corporation but then not reported to states that impose corporate income taxes.

SCOPE OF THE STUDY

The MTC study is based on a conservative look at possible state corporate income tax sheltering activities. The study estimates the impact of tax sheltering in two ways. One part of the study gauges the impact of tax sheltering aimed exclusively at state corporate taxes. This portion of the MTC study estimate was developed using data on the decline of effective state corporate tax rates between the mid-1980s and 2001. Factors that do not qualify as “tax sheltering”— such as state legislative changes to lower rates and the switch of regular corporations to S-corporations — were excluded from the estimate. The remaining portion of the state corporate income tax decline, with a high-end estimate of $7.08 billion for 2001, constitutes the loss of corporate tax revenue attributable to increased tax sheltering activity targeting state corporate taxes only.

The second way the study estimates the impact of sheltering that affects both federal and state tax is through corporations shifting income earned inside the U.S. to other nations. Using conservative national estimates of international income shifting through “transfer pricing,” the study translated estimated federal revenue losses into state revenue losses of $5.3 billion. Because states are affected equally by international income shifting, the national estimate of revenue loss was distributed among the states in proportion to their state corporate tax collections.

The conservative approach taken in the study did not encompass a third type of tax sheltering: purely domestic tax sheltering that simultaneously reduces corporate income reported to both federal and state governments. The absence of an estimate for this type of sheltering is one reason why the study underestimates total state revenue losses attributable to corporate tax sheltering. Other reasons why the study underestimates total corporate tax sheltering include a) using the 1980s as a benchmark for “state-targeted” sheltering fails to account for tax sheltering that was already taking place at that point and b) choosing an estimate of international income shifting that is 40 percent below the high-end estimates made for that form of sheltering.

ABOUT THE MTC

The Multistate Tax Commission was created in 1967 and 45 state governments now participate in the MTC. The Commission encourages States to adopt uniform tax laws and regulations that apply to multistate and multinational enterprises. Greater uniformity in multistate taxation reduces compliance burdens for multistate businesses and helps ensure that interstate commerce is neither undertaxed nor overtaxed.

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EDITOR'S NOTES: A streaming audio replay of a related news event will be available as of 6 p.m. EDT on July 15, 2003 on the Web at http://www.mtc.gov/statebudgetcrisis.html. This is the same location where a copy of the MTC report (including state-specific data) will be available for review.