CORPORATE TAX SHELTERING AND THE IMPACT ON STATE CORPORATE INCOME TAX REVENUE COLLECTIONS

Multistate Tax Commission
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EXECUTIVE SUMMARY

State corporate income taxes as a proportion of corporate profits declined by 34 percent –from approximately 9.0 percent during the period from 1980 to 1989 to 5.9 percent in 2001. This reduction in the effective tax rate on corporate income can be attributed in part to tax sheltering and in part to state tax policy changes.

Corporate tax sheltering reduced state corporate income tax revenues by more than a third of actual collections in 2001. These 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 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.

KEY FINDINGS

- ***Estimated state corporate tax collection losses due to sheltering activity.*** The estimates range from a low-end estimate of $8.32 billion to a high-end estimate of $12.38 billion.

- ***Scope of problem.*** 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 in question. Additionally, some major corporations choose not to engage in aggressive corporate tax sheltering.

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

- ***States with greatest losses, measured as a percentage of revenue.*** While California's mid-range 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.*** Using the mid-point of the estimates, 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.

TAX SHELTERING

The majority of the revenue losses identified in this analysis are linked to such "exotic" tax sheltering techniques as:

- 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;

- 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.

- Reincorporating strictly for tax income purposes in Bermuda, or other "tax havens."

- 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.

Table 1
Estimated Loss of State Corporate Income Tax Revenues Attributable to Tax Sheltering, by State: Fiscal Year 2001[1]

State	Actual	Total State Revenue Loss Due to Tax Sheltering[2]	Estimated Revenue Lost Due to Domestic Tax Sheltering Targeted at States			Revenue Loss Attributable to Int'l. Tax Sheltering	State	Actual	Total State Revenue Loss Due to Tax Sheltering[2]	Estimated Revenue Lost Due to Domestic Tax Sheltering Targeted at States			Revenue Loss Attributable to Int'l. Tax Sheltering
			Low Estimate	Mid-Point	High Estimate					Low Estimate	Mid-Point	High Estimate	
	(millions)							(millions)					
United States	$35,390	$10,353	$3,019	$5,048	$7,078	$5,304	Missouri	$236	$98	$35	$55	$76	$43
Alabama	174	72	26	41	56	31	Montana[4]	82	26	9	15	20	11
Alaska[3]	400	0	0	0	0	0	Nebraska[5]	138	19	n.a.	n.a.	n.a	19
Arizona	541	169	61	96	131	73	Nevada	0	0	0	0	0	0
Arkansas	186	77	28	44	60	34	New Hampshire	350	90	0	42	85	48
California	6,899	1,340	111	404	696	937	New Jersey	1,301	540	194	305	417	235
Colorado	340	106	38	60	82	46	New Mexico	191	79	28	45	61	34
Connecticut	413	172	62	97	132	75	New York[5]	3,199	577	n.a.	n.a.	n.a	577
Delaware[3]	207	0	0	0	0	0	North Carolina	724	301	108	170	232	131
District of Columbia[4]	230	96	34	54	74	42	North Dakota	63	20	7	11	15	9
Florida	1,138	554	170	267	365	287	Ohio	663	378	160	258	356	120
Georgia	691	287	103	162	222	125	Oklahoma	167	69	25	39	54	30
Hawaii	60	19	7	11	15	8	Oregon	323	80	22	36	50	44
Idaho	142	44	16	25	34	19	Pennsylvania	1,401	582	209	329	449	253
Illinois	2,217	693	249	392	535	301	Rhode Island	78	32	12	18	25	14
Indiana	825	343	123	194	264	149	South Carolina	192	80	29	45	62	35
Iowa	167	69	25	39	53	30	South Dakota[3]	43	0	0	0	0	0
Kansas	237	74	27	42	57	32	Tennessee	673	280	100	158	216	122
Kentucky	361	150	54	85	116	65	Texas[6]	1,960	607	154	241	328	366
Louisiana	293	122	44	69	94	53	Utah	163	51	18	29	39	22
Maine	96	30	11	17	23	13	Vermont	45	19	7	10	14	8
Maryland	501	208	75	118	161	90	Virginia	364	151	54	85	117	66
Massachusetts	1,212	503	181	285	388	219	Washington[7]	2,012	372	129	226	323	146
Michigan	2,102	217	69	139	208	78	West Virginia	113	65	17	27	36	39
Minnesota	732	229	82	129	177	99	Wisconsin	537	174	75	85	95	89
Mississippi	203	88	31	50	68	38	Wyoming	0	0	0	0	0	0

1. Some states have acted in 2002 and 2003 to curtail the impact of corporate tax sheltering.

2. Sum of the midpoint of estimated state revenue loss due to domestic tax sheltering targeted at states and international tax sheltering

3. Assumes no change in revenue.

4. D.C. data estimated from 1999 data. Montana data estimated to eliminate temporary increase due to sales of major electric utility plants in that State.

5. n.a. = No final estimates available. Data not included in the U.S. totals.

6. Texas data are for corporate franchise tax. Tax collections for fiscal 2001 from TX Comptroller of Public Accounts.

7. Business and Occupation Tax.

Sources: Bureau of the Census, State Tax Collections in 2001, and Bureau of Economic Analysis, National Income and Products Accounts, Tables 3.3 and 6.17; and Multistate Tax Commission calculations.

Methodology

Scope of Study

Tax sheltering by a relatively small number of corporations has eroded state corporate income tax bases -- contributing to a significant decline in the average effective rate of state corporate income taxes and in the share of state corporate income taxes to state tax revenues. The MTC study classified three types of tax sheltering activities: 1) international tax sheltering; 2) tax sheltering specifically targeted to state corporate income taxes; and 3) domestic tax sheltering that simultaneously reduces corporate income reported to both the federal and state governments. The estimates presented in the study focus only on the first two types of sheltering, hence these estimates do not encompass the losses attributable to the third type of sheltering.

International Tax Sheltering

One way international tax sheltering occurs is when multinational businesses shift income out of the United States into "tax havens" through the use of holding companies located in one or more of these tax havens. For example, a U.S.-based parent company of a multinational business may "sell" its intellectual (intangible) assets such as trademarks, logos, patents, etc. to a holding company that has been created by the parent and established in a tax haven country. This offshore holding company subsequently licenses the use of these intangible assets to foreign affiliates or to foreign-based businesses at prices that minimize the parent company's world-wide tax burden. The parent (U.S.) company's tax liability may be reduced further if the parent company borrows funds from its offshore holding company and claims a tax deductible expense for its interest payments on the loan. Similarly, the parent company may establish offshore Special Purpose Entities (SPE) whose sole purpose is to hold the parent company's debt. Interest payments from the parent company to the SPE are also tax deductible. In addition to the revenue losses, the shifting of income through the use of intercompany transfers results in shifting the location of investment with resulting losses in economic efficiency.[1]

International tax sheltering can also occur when multinational businesses trade actual goods and services with their foreign affiliates. Prices for the goods and services traded between the parent company and a foreign affiliate may not be related to actual market prices for the same goods and services. For example, in order to reduce U.S. taxable income, the parent company may price the goods it sells to a foreign affiliate well below the prices it sells that same good in the U.S. Conversely, it may inflate the price of goods and services the parent company imports from its foreign affiliates.

A relatively new form of international tax sheltering is termed inversion. A U.S. company establishes an offshore holding company in a tax haven country, and then transfers its foreign assets in exchange for stock in the new holding company. In this way, the U.S. company has transformed (inverted) itself from a U.S.-based multinational corporation with holdings of foreign assets to a U.S.-based affiliate of a foreign-based corporation.

[1] Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location," ***National Tax Journal***, Volume 56, No. 1, Part 2, March 2003, p. 239.

In 1990, the Subcommittee on Oversight of the House Ways and Means Committee, chaired at the time by Rep. J.J. Pickle, estimated the federal revenue loss attributable to international tax sheltering at $30 billion annually. Subsequent estimates from other sources have been higher, exceeding $53 billion annually. (See Simon J. Pak and John Zdanowicz, "An Estimate of 2001 Lost U.S. Federal Income Tax Revenues Due to Over-Invoiced Imports and Under-Invoiced Exports," October 31, 2002, available on the web site of U.S. Senator Byron Dorgan.)

Although there is no consensus as to the level of international tax sheltering, we have chosen to use the $30 billion estimate from 1990 as the starting point for the MTC study for 2001, for two reasons. First, it is a conservative estimate because of the decade of economic growth and significant expansion in the number of companies operating internationally. Second, it is confirmed by a recent study by Martin Sullivan that accounts for most of the $30 billion in lost federal revenue in terms of income reporting by U.S. multinationals to 13 "tax haven" nations.[2] Martin Sullivan's study does not include income earned by U.S. multinationals in the U.S., but transferred to nations besides the 13 noted. His study also does not include estimates of income earned in the U.S. by foreign multinationals but assigned to other nations. A case could be made for using an estimate higher than $30 billion; however, we believe this conservative estimate is prudent and reasonable for current purposes.

The estimated $30 billion in lost federal revenue due to tax sheltering translates into an estimated state revenue loss of $5.304 billion.[3] We distribute this estimated state revenue loss among the states[4] in proportion to their actual corporation collections in FY 2001. The rationale for a proportionate distribution without adjustment for the difference between separate entity and combined reporting states is that all states, other than Alaska which used mandatory worldwide combined reporting for petroleum companies, are equally affected by problems in corporate tax reporting at the international level. "Water's edge" combined reporting states are as subject to these international problems as are the separate entity states.

Domestic Tax Sheltering Targeted Specifically at States

The estimates for national and state by state losses due to domestic tax sheltering targeted at states were derived by a three step process. The first step was to develop a national estimate of the extent of domestic tax sheltering. The next step was to allocate the national estimates to the individual states. The final step was to consult state revenue agency personnel with regard to the methodology used and determine whether the states had their own estimates. The national totals were then adjusted in consultation with the state revenue agencies that could provide relevant data.

The national estimates were based on a comparison between 1) the average effective state corporate tax rates for the ten-year period from 1980 through 1989 and 2) the effective state corporate tax rate in 2001. The average effective state corporate tax rate declined from 8.96% in

[2] Martin Sullivan, "Data Show Big Shift in Income to Tax Havens," ***Tax Notes***, November 15, 2002.
[3] State corporate taxes are approximately 19.2% of federal income taxes. This $5.304 billion estimate of state revenue loss reflects an adjustment for the special cases of Alaska and South Dakota.
[4] Except Alaska and South Dakota.

the 1980-89 period to 5.92% in 2001 (see Figure 1). These data were derived by dividing state corporate profits tax accruals by profits before taxes of domestic industries less the profits of Federal Reserve Banks (data are from Bureau of Economic Analysis National Income & Products Accounts – NIPA). To understand these data, please note that these statistics do not include any effect on revenues due to international tax sheltering. That is because these effective rates for all periods are calculated using data which do not include income earned in the U.S. but assigned, instead, to foreign nations. So in analyzing the decline in effective tax rates, we examine the domestic factors that contribute to the decline. In that analysis, the Commission staff has concluded that two categories of factors account for the decline in effective rates:

- Changes in state tax policy including the recognition of "S" Corporations and other forms of "pass-through" entities, rate reductions, use of tax credits and incentives, changes in the weights assigned in apportionment formulas, and other policy actions.
- Domestic tax sheltering.

For the purposes of this analysis, we assumed that domestic tax sheltering was the unexplained residual in the decline in the effective rate of taxes after subtracting out the changes in state tax policy.

Based on a study by Peter Fisher[5], we estimate that a 25% decline in the effective rates of state corporate taxes is attributable to state legislative changes reducing the tax. State legislative changes include reductions in tax rates, passage of tax credits and other incentives, changes in the weights of factors included in apportionment formulas, and other changes not mentioned here. Further, we used national income data on the growth in the income of S corporations between the 1980's and 2001, which indicate that the growth in S Corporations and their income accounted for a $3.4 billion decline in state corporate tax revenues in 2001. After adjusting the effective rate analysis for these two factors, we estimated that between $4.8 and $10.2 billion dollars in revenues were lost in 2001 due to more extensive tax sheltering in 2001 than in the 1980-89 period.

We have considered this estimate of revenue lost to domestic tax sheltering in the light of other research and information on this subject. Evidence from specific tax cases such as the KPI case in New Mexico[6] and the A&F case in North Carolina[7] indicate the strong impact that tax sheltering can have on reducing revenues. Further, our analysis of the categories underlying the decline in the effective rates for state corporate taxes is informed by and consistent with academic research on this subject by Fox and Luna.[8]

We distributed this national estimate among the states in two separate categories: combined

[5] Peter Fisher, "Tax Incentives and the Disappearing State Corporate Income Tax," ***State Tax Notes,*** March 4, 2002, pp. 767-774

[6] Kmart Properties v. New Mexico, No. 21,140 (New Mexico Court of Appeals, Nov. 28, 2001).

[7] A&F Trademark, Inc., et al. v. Tolson, Civil Action No. 02-CV-007467 (Wake Co. Super. Ct., May 22, 2003).

[8] See, for example, the recent article by William F. Fox and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," ***National Tax Journal***, Vol. LV., No. 3. September 2002, pp. 491-509.

reporting states and separate entity states. Combined reporting states are less affected by domestic tax sheltering than separate entity states. Using data provided by Robert Tannenwald, Assistant Vice President and Regional Economist of the Federal Reserve Bank of Boston, we found that the median decline in effective corporate income tax rates between 1986 and 1997 was 38.4 percent for separate entity states and 20.0 percent for combined reporting states.[9] Thus, we adjusted the state by state data to reflect this differential effect. Using data on differential declines in effective rates over a portion of the period under consideration, we were able to calculate an estimated average decline in corporate taxes for separate entity states vs. combined reporting states.

We have adjusted the state by state data for some individual state circumstances. Delaware is not allocated any revenue loss due to tax sheltering due to the unique structure of its business tax system. In South Dakota, its business income tax applies only to financial institutions, with most payments attributed to a few taxpayers. We judged the tax base to be too narrow on which to base any conclusions. So no impact is attributed to South Dakota. Somewhat similarly, the prominence of the oil industry in the Alaska corporate tax base combined with Alaska's use of worldwide combined reporting led us to exclude Alaska from any effect. We adjusted Montana's actual collections and estimated revenue losses for the temporary effect the state experienced do to capital gains on an extraordinary sale of electrical utility plants.

The last step was consultation with state revenue agency staffs. Revenue estimators and policy analysts examined the methodology used to derive the national estimates and the state by state estimates. The study used estimates from state revenue agency personnel whenever the state provided specific input based on state level research. The U.S. totals were revised to account for the changes requested by the state revenue agency personnel. Final estimates of the extent of domestic tax sheltering were not available from two states.

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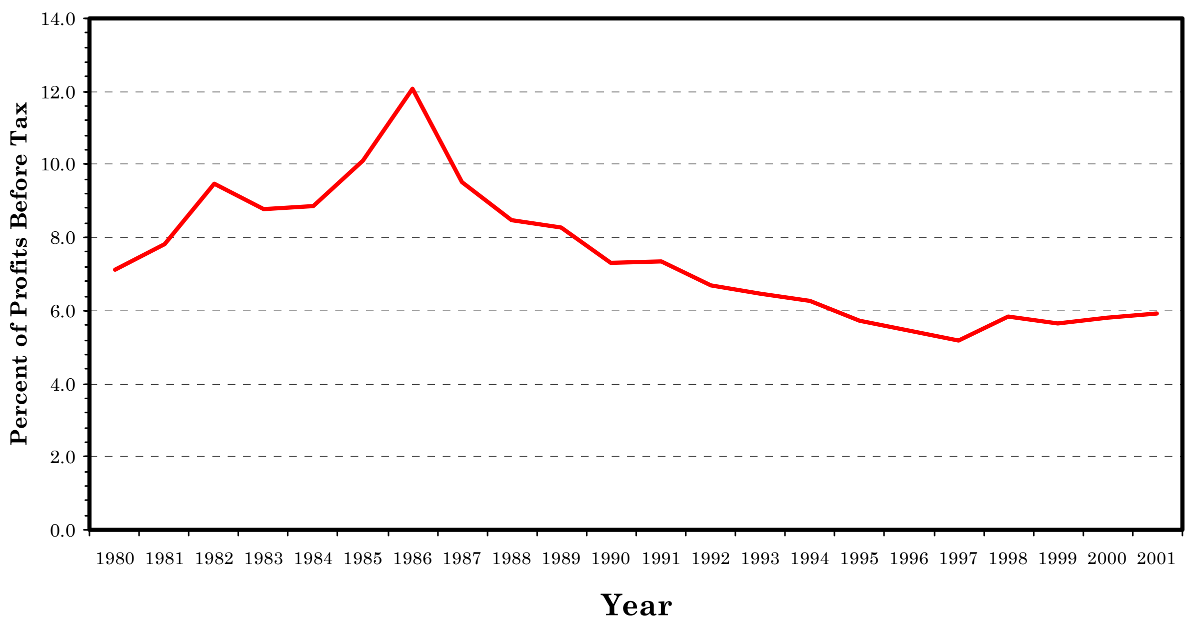
[9] Robert Tannenwald, "Interstate Fiscal Disparity in 1997," ***New England Economic Review***, Third Quarter 2002, pp. 17-34.

Figure 1
State and Local Corporate Profits Tax Accruals as Percent of Corporate Profits Before Tax: 1980 to 2001



Source: U.S. Department of Commerce and Multistate Tax Commission.