Discussion of Empirical Evidence on the Revenue Effect of State Corporate Income Tax Policies

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Overview

- State level data from 1982-2002
- Examines likely causes and potential remedies for the decline in SCIT revenues
  - Changes in federal and state corporate income tax bases
  - Changes in organizational form, particularly flow thru entities.
  - Use of state taxes as economic development tool

- See also Fox and Luna, NTJ (2002)
  - Detailed analysis of state corporate income tax revenue over the past 3 decades.
Results

- A 1 percentage point increase in the CIT rate is associated with an increase of 10-12% in revenues.
- But magnitudes of other results appear high:
  - Increasing the sales factor weight from 1/3 to ½ is associated with a 16% decrease in revenues.
  - Adoption of the throwback rule is associated with a 16% increase in revenues.
  - Broadening the definition of income increases revenues 15-22%.
- And combined reporting has very little effect.

<table>
<thead>
<tr>
<th>Gramlich, Gupta, Bruce, Hofmann, Deskins, &amp; Moore &amp; Fox</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependent Variable:</td>
</tr>
<tr>
<td>Independent Variables:</td>
</tr>
<tr>
<td>CIT Rate</td>
</tr>
<tr>
<td>PIT Rate</td>
</tr>
<tr>
<td>Sales Apportionment</td>
</tr>
<tr>
<td>Throwback</td>
</tr>
<tr>
<td>Unitary</td>
</tr>
<tr>
<td>NOL</td>
</tr>
<tr>
<td>Business Income</td>
</tr>
<tr>
<td>Federal Tax Deduction</td>
</tr>
<tr>
<td>AMT</td>
</tr>
<tr>
<td>PIC</td>
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<tr>
<td>Tax Incentives</td>
</tr>
</tbody>
</table>
Other Items to Consider

- Instrumental variables
  - NETEXP and PIGSP
    - Personal Income and GSP are both measures of the state economy
- Should corporate revenues include corporate licenses fees?
- Authors appear to be holding GSP constant
  - Elements of the corporate tax structure could influence GSP and also have independent effects on revenue. (Bruce, Deskins, Fox)
- Also consider interacting policy variables with the tax rate.
  - This structure is helpful because it may be unlikely that firms consider state policy features in isolation but rather consider several policies in conjunction with each other.

Discussion of Did FIN 48 Arrest the Trend in Multistate Tax Planning

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THE UNIVERSITY OF TENNESSEE
Knoxville, Chattanooga, Martin, Tullahoma, Memphis
FIN 48 Should Cause Co’s to Change to a More Conservative Filing Position

- FIN 48 requires complying companies to examine tax positions using a new standard
  - Chance of audit is 100% - government has full knowledge of the tax position
  - Only positions with >50% chance of being sustained at audit can be booked
  - Questionable positions are disclosed in the financial statements, and workpapers could be available to auditors
- New level of scrutiny by both auditors and corporate officers could reduce aggressive planning efforts (e.g., nexus)

Other Explanation for Increase in State ETR

- Increase in federal ETR.
  - Federal taxable income is the starting point for states.
- Increase scrutiny and enforcement across states
  - Improved cooperation between state and federal compliance officers (Duncan and Luna, 2007).
- Increase in state voluntary disclosure programs
- Filing requirements
  - More states require combined filing as standard (24 states + DC)
  - Larger states and states with more headquarters
  - Combined, consolidated, or unitary returns eliminate effect of inter-company transactions
  - Forced combinations in separate company returns when it is to the advantage of the state (e.g., New York)
  - Changes in structures (Michigan, Texas)
- Anti-PIC is almost universal
  - Add-back provisions
  - Economic nexus
  - More disallowance of interest
State and Federal Year to Year ETR Changes

<table>
<thead>
<tr>
<th>Year</th>
<th>State</th>
<th>Federal</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>-9.87</td>
<td>-14.69</td>
</tr>
<tr>
<td>2003</td>
<td>-2.51</td>
<td>-2.68</td>
</tr>
<tr>
<td>2004</td>
<td>-3.18</td>
<td>-3.27</td>
</tr>
<tr>
<td>2005</td>
<td>+3.13</td>
<td>+15.42</td>
</tr>
<tr>
<td>2006</td>
<td>+0.73</td>
<td>-0.78</td>
</tr>
</tbody>
</table>

Federal Factors Affecting State ETR

- Expiring state NOLs from recession years
  - Many states do not allow carrybacks
- Changes in federal tax base
  - Depreciation incentives in 2003 Act expiring
- Crackdown on tax shelters of all types
Growth in Corporate Tax Revenues Following a Recession

<table>
<thead>
<tr>
<th>Year</th>
<th>Growth Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>-7.53%</td>
</tr>
<tr>
<td>1991</td>
<td>-5.54%</td>
</tr>
<tr>
<td>1992</td>
<td>10.58%</td>
</tr>
<tr>
<td>1993</td>
<td>9.96%</td>
</tr>
<tr>
<td>1994</td>
<td>5.81%</td>
</tr>
<tr>
<td>1995</td>
<td>12.89%</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Growth Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>-2.00%</td>
</tr>
<tr>
<td>2002</td>
<td>-18.66%</td>
</tr>
<tr>
<td>2003</td>
<td>11.46%</td>
</tr>
<tr>
<td>2004</td>
<td>5.95%</td>
</tr>
<tr>
<td>2005</td>
<td>25.35%</td>
</tr>
<tr>
<td>2006</td>
<td>20.08%</td>
</tr>
</tbody>
</table>

Other Explanations for Increase in ETR

- Increase in federal effective tax rates.
  - Federal taxable income is the starting point for states.
- Increase scrutiny and enforcement across states
  - Improved cooperation between state and federal compliance officers (Duncan and Luna, 2007).
- Increase in state voluntary disclosure programs
- Filing requirements
  - More states require combined filing as standard (24 states + DC)
  - Forced combinations in separate company returns when it is to the advantage of the state (e.g., New York)
  - Changes in structures (Michigan, Texas)
- Anti-PIC is almost universal
  - Add-back provisions
  - Economic nexus
  - More disallowance of interest
Other Items to Consider

- Small Sample Analysis
  - Truncated sample
  - Selection bias
  - Consider using a panel model

- Regression Assumptions
  - Small firms have more non filing risk because large firms more likely file in all states
  - High growth firms have more non filing risk because nexus grows faster than they file require firms
  - Income shifting from high to low states requires more than 1 state.
  - Tests "old" Delaware Holding Company Schemes

Changes in Holding Companies

- New Generation of Models
  - Service model that accounts for non-routine contributions
  - Supply chain based structural planning
  - These models break out the "value" stuff from the non-value stuff; By outsourcing some of the other stuff, it provides evidence that it is routine.

- Harder to legislate against and harder to use legal arguments
  - Cannot argue lack of economic substance because there is clear economic substance in all entities involved in the transaction
  - Cannot argue "inaccurate reflection of income"
  - Compensation is a payment for services rather than a royalty

- Recent results have been mixed. Taxpayer victories for several reasons.
  - Valid business purpose for IHC
  - Acceptable economic substance
  - Transfer pricing analysis established arm’s length-transfer pricing
  - Holding companies do business with third parties