Research Question

- Multistate tax planning increased in the 1990s
- Aggregate state tax collections and mean state ETRs
  - Tended downward in the 1990s and early 2000s
  - Increased in 2005

- Can we attribute part of the 2005-2007 increase in state tax collections and mean state ETRs to FIN 48?
Motivation

Who cares?

- **Tax administrators**
  - want to know about influence of financial reporting on corporations’ state tax negotiations.
- **Standard-setters: US GAAP / IFRS tax convergence.**
  - If FIN 48 increases state tax payments above what would have been owed, perhaps standard deserves second look.
- **Financial statement users**
  - understand effects of new standard on earnings and cash flows.

Multistate Tax Brief Overview

- Increase in state tax planning and importance of intangible income in the 1990s contributed to reduced state tax ETRs and collections.
- Corporations must file where they have “nexus”.
  - Physical nexus: Bricks & mortar, Employees
  - Economic nexus less clear: Intangibles
- Corporations allocate and apportion income among states.
  - Intangible holding companies.
FIN 48 Brief Overview

- FIN 48 enacted June 2006, effective January 2007
- Prior practice for uncertain tax benefits varied substantially
  - Neither SFAS5 nor SFAS109 gave clear guidance
- 2-stage Recognition & Measurement
  - Assume government knows about uncertain tax benefit and has complete information
  - Recognize benefit only if position MLTN to be sustained on merits (in court of last resort)
  - Measure and record the amount of benefit that is MLTN to be sustained in negotiation (settlement)
- Disclose unrecognized tax benefit
  - “rollforward” schedule aggregated across jurisdictions

Taxpayer / government interactions?

- Firms with current weak positions increase ETRs and tax payments
  - because the disclosed liability would increase government audits and decrease taxpayer payoffs. (Mills Robinson Sansing 2008)
  - BUT…. aggregate disclosures confuse the signal. Detection risk may not increase, and so payments may not increase.
- Firms with previous weak positions and low detection probabilities record additional tax liabilities.
  - If firms want to reduce uncertainty, they may initiate settlements, increasing payments.
What other factors influence managers?

- New information constrains motivated reasoning on the part of CEO’s, boards, and auditors.
  - Prior to FIN 48, contingent tax liabilities often considered detection risk in addition to the merits.
  - Now managers and monitors learn about merits of risky positions.
  - We predict that companies voluntarily increase tax compliance.

Summary of predictions

- Our recent experience [re increased collections] clearly demonstrates that entities with nexus considerations are responding to the responsibilities mandated by the provisions of FIN 48.
  - Mike Mason, Director of Tax Policy, Alabama

- H1: Firms with riskier state tax positions increase state ETRs in response to FIN 48.

- H2: State tax collections increase surrounding FIN 48.
Data for large sample firm-level tests

  - Firms that separately disclose state income tax
  - Firms with positive state tax expense and positive U.S. pretax income (ww if missing). Otherwise, effective tax rates difficult to interpret.
    - Trim top and bottom 2% of StateETR and two-year change in ETR

Explaining Level of State ETRs

- Build a model of state ETRs to validate opportunity/avoidance proxies
- Results: Positive, Negative, Insignificant
  - Federal ETR, Advertising Intensity, RetailTransp, R&D Intensity, Advertising*RetailTransp, ROA, Size, Capital Intensity, Year After 1995
  - MarketToBook, Foreign, OneYrSalesGr
Do risky firms increase state ETRs in 2007?

- **All years’ sample:**
  - **Test variable:** Deviation from statutory tax rate for all years and for 2007.
    - Firms whose ETRs are further below the statutory rate increase ETRs more in 2007.

- **2007 year subsample:**
  - **Test variable:** Dummy for lowest quintile of 1995-2005 ETR changes.
    - Firms in lowest quintile increase 2007 ETR more than other firms.

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**Explaining Changes in State ETRs**

<table>
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<tr>
<th>Variable</th>
<th>Predicted Sign</th>
<th>All years</th>
<th>2007 only</th>
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<tr>
<td>Intercept</td>
<td>-</td>
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</table>

*Other controls not tabulated*
FIN 48 Rollforward Disclosure Tests

- Approximately 40 firms that
  - disclosed no foreign income and
  - decreased state ETR >= 2% points over decade.

- Increases in state ETRs (fr 05-07) are correlated with larger FIN 48 liabilities
- Decreases in state ETRs (fr 05-07) are correlated with releases due to lapsed statutes of limitations

Preliminary conclusions

- Firms with larger FIN 48 tax reserves increase state ETRs in 2007, based on small sample.
- Benchmark regressions fit StateETRs to opportunities for intangible income shifting.
- Deviations from benchmark or large prior decreases explain ETR increases in 2007.
- **We welcome more input from state tax administrators about any FIN 48 effects they observe or hear about.**
Firm-level Tests of Predictions: Concepts and Proxies

Independent “X”

Highly uncertain state income tax positions

IHC (R&D, Adv, MTB, ROA, Retail)
Nexus (Growth, Size, ROA)
Other (relatively low ETRs)

Operational X, Y

Dependent “Y”

Reduced state tax avoidance

Higher (2007 vs 2005) State ETRs and payments

Controls:
Federal ETR, Foreign, Capital Intensity, Year After 1995,