Iowa Corporate’s Short Term Profit Shifting amid TCJA (Preliminary)

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Opinions expressed in this presentation are my own and not the views of State of Iowa or the Iowa Department of Revenue.
Tax Cuts and Jobs Act (TCJA) signed on December 22, 2017 significantly reduced Corporation Income Tax burden of US companies effective Jan. 1, 2018
  ◦ i.e., top marginal tax rate changed from 35% to 21%

In theory, companies have an incentive to shift profits from 2017 to 2018
Iowa’s own Tax Reform Act signed on May 30, 2018

Corporation income tax rates will be reduced

Top marginal rate will be reduced from 12% to 9.8%, effective for tax years beginning on or after Jan. 1, 2021
Motivation

- Understand TCJA’s impacts on short term profit shifting
- Prepare for forecasting the revenue impact of profit shifting in response to the Iowa’s new corporate tax changes
Differences Between National and Iowa Reform Impacts

- TCJA is more complex and has much bigger impacts

- Iowa economy is less diverse

- Affected taxpayers have much more time to prepare for the Iowa Corporation Income Tax reform
Research Questions

- Did companies shift profits from 2017 to 2018 in response to TCJA?

- Next potential question: If so, can the shift be estimated?
General Short Term Tax Planning Tools

- Usual options for corporate planning
  - Defer income
  - Accelerate deductible expense
  - Utilize depreciation through capital investment

- Constraints
  - Make business sense
  - Liquidity
  - Cost
Some Challenges (For Us)

- Incomplete data
- For a small state, a few large companies have outsize impacts on tax revenue
- No perfect control group
Evidence of Short Term Profit Shifting

- Companies with cash method vs. accrual method
  - Cash method of accounting has advantages for tax planning so that companies could benefit from bigger tax savings
  - However, only small companies could use cash method, so it is not enough to forecast revenue impacts with data from these companies
Sample Selection

- Taxpayers whose tax periods end on 12/31/2017 (calendar year filers, close to 3,000 returns)

- Cash vs accrual

- Compare net income of companies using difference‐in‐differences method
Companies using cash method and those using accrual method (similar sizes) would have similar growth in net income from the previous year, without the TCJA.

Due to complexity of the TCJA and timing of the enactment, calendar year corporate taxpayers using accrual method have limited options to shift profits from 2017 to 2018.
Hypothesis

- Corporate taxpayers using cash method whose tax periods ended on 12/31/2017 would have shifted more profits than those using accrual method
Definitions of Some Variables

- Dummy variable for accounting method

- Dummy variable for Tax Year
  - Tax returns filed for the tax year ending on 12/31/2017 are in the “after treatment” group
  - Tax returns of same companies for the tax year ending on 12/31/2016 are in the “before treatment” group

- Dummy variable for the treatment effect: cash method*tax year
Data Selection

- IRS only allows a C corporation with average annual gross receipts under $5 million to use the cash method.

- For the control group, only those companies with annual gross receipts slightly above $5 million or under $5 million were selected.

- Dependent variable is Federal net income before NOL.
## Estimation Results

| Parameter Description                                           | Parameter Estimate | Standard Error | t Value | Pr > |t| |
|-----------------------------------------------------------------|--------------------|----------------|---------|------|---|
| Dummy for accounting method (Cash method=1)                     | (64,762)           | 34,916         | -1.85   | 0.0637 |
| Dummy for tax period (tax year ending on 12/31/2017=1)          | 151,911            | 34,036         | 4.46    | <.0001 |
| Dummy for cash method*tax year                                  | (155,665)          | 47,118         | -3.3    | 0.001 |
Non Calendar Year Filers

- Extend the sample to include non-calendar year filers
  - 1) Calculating their tax for the entire tax year using the graduated tax rates in effect prior to TCJA;
  - 2) calculating their tax using the new 21-percent rate and, then;
  - 3) proportioning each tax amount based on the number of days the different rates were in effect.
# Estimation Results

| Parameter Description | Estimate | Standard Error | t Value | Pr > |t| |
|-----------------------|----------|----------------|---------|------|---|
| Dummy for accounting method (Cash method=1) | (39,644) | 10,038 | -3.95 | <.0001 |
| Dummy for tax period (tax year ending on 12/31/2017=1) | 16,416 | 10,866 | 1.51 | 0.1309 |
| Dummy for cash method*tax year | (26,547) | 13,941 | -1.9 | 0.0569 |
Next Step

- How to estimate larger companies’ tax planning behaviors?
  - Items we should look at: depreciation? Property transactions?
Questions?
Suggestions?