

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.



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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 1/2 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.



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	Gramlich, Gupta, Hofmann, & Moore	Bruce, Deskins, & Fox	
Data	1982-2002	1985-2001	
Dependent Variable:	CIT / GSP	CIT Base	
Independent Variables:			
CIT Rate	+	-	
PIT Rate	na	-	
Sales Apportionment	-	+	
Throwback	+		
Unitary			
NOL	+	na	
Business Income	+	na	
Federal Tax Deduction	-	-	
AMT		na	
PIC		na	
Tax Incentives		-	



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.



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

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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)



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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



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State and Federal Year to Year ETR Changes



Year	State	Federal
2002	-9.87	-14.69
2003	-2.51	-2.68
2004	-3.18	-3.27
2005	+3.13	+15.42
2006	+0.73	-0.78



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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



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Growth in Corporate Tax Revenues Following a Recession



Year	Growth Rate	Year	Growth Rate
1990	-7.53%	2001	-2.00%
1991	-5.54%	2002	-18.66%
1992	10.58%	2003	11.46%
1993	9.96%	2004	5.95%
1994	5.81%	2005	25.35%
1995	12.89%	2006	20.08%



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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



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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



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