Did FIN48 Arrest the Trend in Multistate Tax Avoidance?

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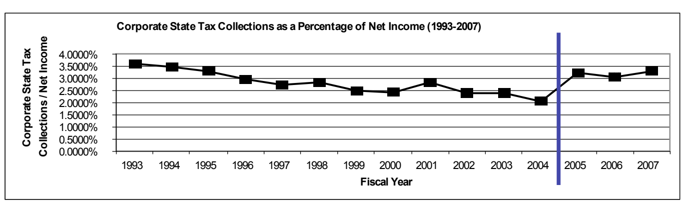
Research Question

- **Multistate tax planning increased in the 1990s**
- **Aggregate state tax collections and mean state ETRs**
  - Trended 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?**

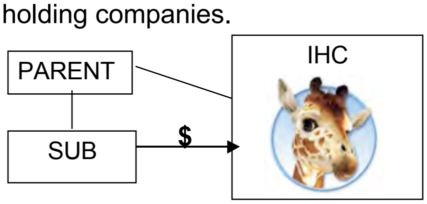
Motivation

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

- **Data requirements for financial statement tests. 1995-2007.**
  - 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

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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**

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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.

Explaining Changes in State ETRs

Variable	Predicted Sign	All years	2007 only
Intercept	-	0.0000	-0.0054
Change Federal ETR 2007 -2005	+	0.055***	0.028***
Lowest quintile state ETR change 1995-2005	+	n/a	**0.0078 *****
Statutory Deviation	+	0.421***	0.493***
Yr2007 Statutory Deviation*	+	**0.045 ***	n/a
Above Dummy	+	0.003***	-0.001
*Yr2007*Above Dummy*	+	-0.004	n/a
*AboveDummy*Statutory Dev*	+	0.146***	0.018
*Yr2007*Above* Statutory Dev*	?	-0.222	n/a

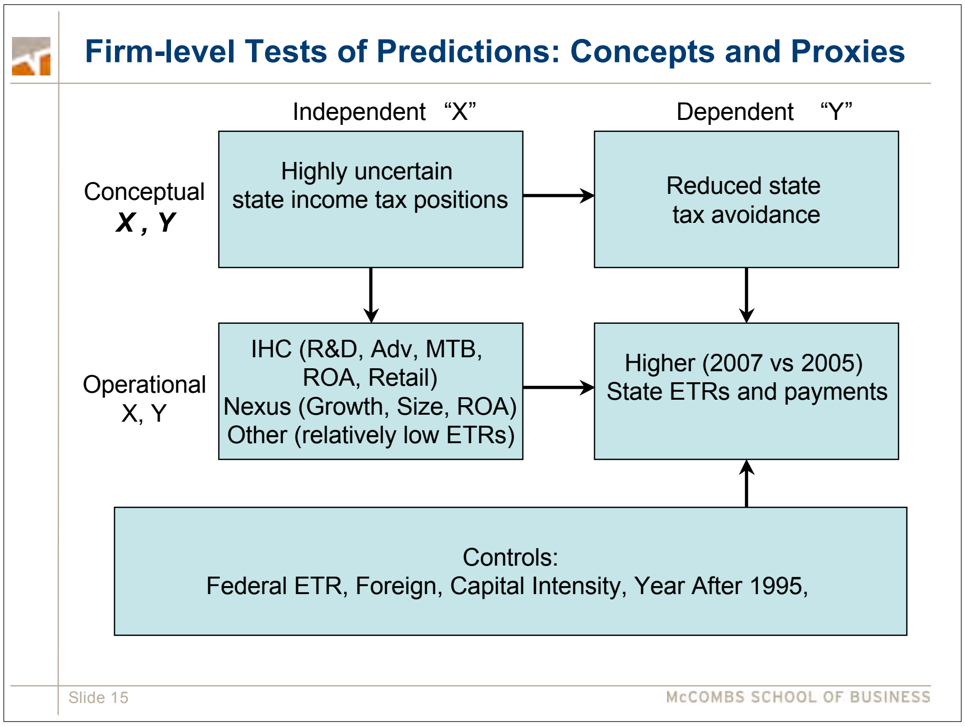
Other controls not tabulated

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

- Aggregate trends suggest declining ETRs and collections reverse in 2005, 2006, 2007.
- 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"
Dependent "Y"
Conceptual
X , Y
Highly uncertain
state income tax positions
Reduced state
tax avoidance
Operational
X, Y
IHC (R&D, Adv, MTB, ROA, Retail)
Nexus (Growth, Size, ROA)
Other (relatively low ETRs)
Higher (2007 vs 2005)
State ETRs and payments
Controls:
Federal ETR, Foreign, Capital Intensity, Year After 1995,
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