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

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Zhong Jin
Tax Research and Program Analysis Section
Iowa Department of Revenue

# Disclaimer

Opinions expressed in this presentation are my own and not the views of State of Iowa or the Iowa Department of Revenue.

# Background

- 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

# Background

- 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

# Assumptions

- 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 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
- Blended tax rate for non-calendar year filers (IR-2018-99, Notice 2018-38):
  - 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 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?