Eliminate corporate tax loopholes

Each Southern state should review and update its income tax structures for businesses to eliminate corporate tax loopholes to promote fairness.

Background

Southern states have historically taxed corporations on their income, or profits for similar reasons to taxing individuals. Corporations, like people, use government services, such as schools that train the workforce. Forty-six states, including every Southern state, have a corporate income tax to allow corporations to contribute to the cost of schools, universities, courts and other government services. Likewise, every Southern state has corporate income tax loopholes that some companies take advantage of to avoid their corporate tax responsibilities.
services. While the corporate income tax is not as large of a revenue source as the individual income tax or sales tax, it has long been part of tax systems throughout the South and has provided another element of diversity to complement other taxes.

In recent years, state corporate income tax revenue has declined so much that there is considerable debate about whether states should continue to tax corporate incomes at all. There are several causes for the decline of the corporate income tax, including the use of income tax loopholes by some multi-state corporations. Loopholes are anomalies or inconsistencies in a state’s tax system—some intentional, others not—that companies use to escape or lower their state corporate income taxes. These loopholes cause decreases in state revenues. But just as importantly, they cause unfairness in the tax system because companies not using the loopholes have a higher tax burden than those who game the system.

Just like individuals who avoid taxes, corporations that take advantage of weaknesses in the tax code are shifting the burden and cost of state services to other businesses and creating an unfair tax system. If states do away with corporate income tax, that’s one thing. But until they do, businesses across the board should be treated fairly. Small corporations, for example, shouldn’t be forced to pay the same tax that larger corporations or multi-state corporations avoid.

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States need to ensure their corporate taxing structure avoids including anomalies and inconsistencies that can be exploited and cause smaller, in-state businesses to pay more corporate taxes. Southern states have an opportunity to strengthen their corporate income tax by updating their tax code and enacting new requirements to close tax loopholes. While corporate tax reforms will not completely reverse the tax’s deterioration, they will improve the adequacy and fairness of the corporate income tax.

The intentional and unintentional tax decline

State corporate tax revenues have declined nationwide over the past few decades. While state corporate tax collections have fluctuated with the business cycle, they have declined to a fundamentally lower level when measured as a percent of reported corporate profits, falling from 6.6 percent in 1980 to 4.0 percent in 2000. This national trend has hit many Southern states. Recent research found that South Carolina, for example, had a “very large divergence” between the growth in state corporate income taxes and the growth in gross state product from 1980 to 2000.

The causes for the decline in corporate income taxes are numerous, including some that were intentional and others that were not. Two intentional causes include state efforts to provide more kinds of corporate structures and to provide special tax credits to some companies.

First, states across the nation have legislatively encouraged the rise in more pass-through small business structures, such as S corporations, limited-liability corporations (LLCs) and limited-liability partnerships (LLPs). While
states have taxed traditional C Corporations through corporate income taxes, most states have chosen to tax S Corporations, LLCs and LLPs through individual income taxes. These corporations are often called pass-through entities because profits and losses are “passed-through” to the shareholders, who pay income taxes on profits and get credits for losses. As more companies have incorporated as pass-through entities, state revenues have shifted away from corporate income taxes and into the individual income tax collections.

Another intentional cause of decline in corporate income taxes is the use of corporate tax credits by states. States widely have increased the use of tax credits as an economic development strategy to lure new businesses and assist growing establishments. These corporate income tax credits reduce tax liabilities for activities such as job creation or investment, as discussed further in Idea 10.

Corporate tax loopholes diminish tax revenue in every Southern state by at least $72 million a year.

While granting corporate tax credits and promoting the use of more small business structures can be seen as intentional by states, corporate tax loopholes can be viewed as unintentional mechanisms for corporations to avoid corporate income taxes. These tax loopholes allow corporations to escape a portion of their state corporate tax liability by shifting money to states with lower taxes or by finding ways to make money non-taxable. Corporate tax loopholes have diminished the adequacy and fairness of corporate taxes and helped to foster the creation of a costly, inefficient use of resources for tax-planning purposes.
• **Adequacy.** According to estimates by the Multistate Tax Commission, corporate tax loopholes and tax sheltering—the “sheltering” of income from taxation—diminished state tax revenues in every Southern state in Fiscal Year 2001, as shown in Figure 1. The loss in revenue ranged from a high of $554 million in Florida to a low of $72 million in Alabama in 2001. The loss due to tax sheltering was a significant share of possible collections. For example, if Mississippi were able to collect all of the revenue lost to sheltering, the state’s corporate tax revenues would have been 42 percent higher than their actual 2001 levels. These tax losses include multiple tax sheltering schemes, both domestic and international, some of which states corrected since 2001. Southern states can improve the adequacy of their corporate income tax system by correcting loopholes and ensuring compliance with the system.

• **Fairness.** Corporate tax loopholes also allow some corporations to avoid tax responsibilities as other businesses pay their fair share. Historically, the intention of the corporate income tax has been to allow companies to contribute to the cost of government services—the schools, colleges, roads, bridges, courts, police protection, and other infrastructure that provide a marketplace for business. When corporations use loopholes to escape or avoid tax responsibilities, they are not complying with the intentions of the tax. States should strengthen the corporate income tax to promote tax fairness and consistency within the tax code. Getting tough on corporate loopholes would not be the imposition of a new tax. Rather, states would enforce the intentions of a long-standing tax.
**Figure 1: Revenue loss due to tax sheltering and actual tax collections, 2001**

<table>
<thead>
<tr>
<th>State</th>
<th>Estimated revenue loss from tax sheltering, FY 2001 (in millions)</th>
<th>Corporate income tax collections, 2001 (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>$72</td>
<td>$202</td>
</tr>
<tr>
<td>Arkansas</td>
<td>$77</td>
<td>$202</td>
</tr>
<tr>
<td>Florida</td>
<td>$554</td>
<td>$1,591</td>
</tr>
<tr>
<td>Georgia</td>
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<td>$691</td>
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<tr>
<td>Kentucky</td>
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<td>North Carolina</td>
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</tr>
<tr>
<td>South Carolina</td>
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<td>$192</td>
</tr>
<tr>
<td>Tennessee</td>
<td>$280</td>
<td>$673</td>
</tr>
<tr>
<td>Virginia</td>
<td>$151</td>
<td>$364</td>
</tr>
</tbody>
</table>

Source: Multistate Tax Commission⁴; US Census Bureau⁵

**Strengthening the corporate income tax**

States can address various corporate tax loopholes through legislation. While states should undertake a comprehensive review of corporate tax loopholes to promote fairness, the following discussion highlights two of the bigger loopholes: passive investment companies and nowhere income. Numerous states have already taken measures to close one or more corporate tax loopholes, including several Southern states as shown in Figure 2. For a more detailed analysis of how these and other
loopholes work and how states across the nation correct them, see recent publications by Michael Mazerov of the Center on Budget and Policy Priorities and Professor Peter Fisher of the Iowa Fiscal Partnership.6

**Loophole Example 1: Passive Investment Companies**

Corporations avoid paying taxes on some types of income, such as royalties, by creating subsidiaries known as passive investment companies (PICs), or Delaware-holding companies. By locating PICs in states that do not tax royalties and other types of income, corporations are able to shift income to these companies and avoid taxation. Take, for example, a hypothetical Louisiana corporation, LouisCorp. It easily can create a passive investment corporation in Delaware to hold its trademarks. When LouisCorp uses that trademark, it pays a fee to its sister PIC in Delaware, and thus transfers income to the PIC. This income now becomes nontaxable since Delaware does not tax royalties. In addition, the PIC can shift that income back to LouisCorp in the form of a loan. LouisCorp can deduct the interest of the PIC loan from its taxes, which further reduces its tax burden.

**Bottom line:** LouisCorp is easily able to avoid paying a portion of its Louisiana corporate income taxes by creating a PIC and transferring taxable income out of state—all to the detriment of Louisiana’s state government and business owners who pay their taxes in good faith.

**Solution: Combined reporting.** To stop the use of PICs, states can require corporations to report on the profits of PICs along with their own profits in a combined corporate income tax return, a requirement known
as “combined reporting.” This kind of return not only addresses problems relating to PICs, but also restricts the use of other income-transferring mechanisms. The benefits of enacting combined reporting have been noted to be the following:

> “a uniform treatment of corporate groups without regard for differences in their organizational structure, a strong bulwark against the use of tax-haven jurisdictions to avoid state taxation, a significant reduction in administrative burdens on the tax department and on complying taxpayers, and the removal of the competitive disadvantage currently imposed on local firms that are unable to engage in cross-border tax-avoidance.”

Michael Mazerov of the Center on Budget and Policy Priorities, however, notes that combined reporting is a significant change to the corporate tax law and should be studied carefully. He observes that states can precede combined reporting with legislation that only involves passive investment corporations rather than all income-transfer mechanisms. In the South, Alabama, Arkansas, Georgia, Kentucky, Mississippi, North Carolina and Virginia have enacted such legislation to address PICs alone. Georgia estimated it would receive $504.7 million in additional corporate income tax revenues from 2006 to 2015 after enacting Anti-PIC legislation. Virginia estimated closing the Delaware-holding company loophole (anti-PIC legislation) would bring an additional $34.0 million in FY 2005.
While several Southern states have anti-PIC rules with varying levels of effectiveness, none of the Southern states have combined reporting requirements to protect against multiple tax avoidance schemes. The gains from closing this loophole vary greatly. In Kentucky, combined reporting would bring in an estimated $10 million in additional corporate income tax revenue. If Florida had combined reporting in 2006, it would increase revenues by an estimated $494 million.

After enacting legislation to control the use of passive-investment corporations, Georgia estimated it would get an extra $504.7 million in corporate tax revenues over 10 years.

As states consider strengthening their Anti-PIC laws by moving to combined reporting, Southern states can look to several places for guidance. Sixteen states in the U.S. have combined reporting requirements and provide a template for implementing the reform option in Southern states. In addition, several Southern tax commissions throughout the last decade have studied and recommended combined reporting. Finally, the Multistate Tax Commission has added combined reporting to its agenda and provides model legislation for such measures.

Loophole Example 2: Nowhere income

“Nowhere income” involves the apportionment of profits among states by multi-state corporations. Corporations must pay taxes to states in which they have a presence, but only after reaching a certain level of presence, or nex-
us. If the corporation does not reach that nexus, then the profits produced in that state become “nowhere income” since they are not subject to tax in any state.

**Solution: A throwback rule.** States can correct for the problem of nowhere income by enacting a “throwback rule.” Through this mechanism, a corporation’s home state, or rather the production state, can tax the profits that are not taxed in the purchase state. For example, if an Alabama manufacturer makes a sale in Nevada that is not taxed, then the profit from the sale is thrown back to Alabama to be taxed. Alabama, Arkansas and Mississippi already have throwback rules to address this loophole.

Some state estimates of the effects of nowhere income are small in comparison to the combined reporting requirements. For example, Kentucky legislative analysts estimated that the throwback rule would bring in $3 million in additional corporate tax revenue, whereas com-

<table>
<thead>
<tr>
<th>Figure 2: Status of Loophole Closures in Southern States</th>
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<tbody>
<tr>
<td>Combined Reporting</td>
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<tr>
<td>---------------------</td>
</tr>
<tr>
<td>Alabama</td>
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<td>Virginia</td>
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(a) Has Anti-PIC rules (also known as anti-Delaware-holding company rules)
Source: Department of Revenue interviews and websites, State Code websites, Mazerov18 Note: This does not apply to banks, insurance companies, and others which are not subject to the corporate income tax in many states.
combined reporting would increase revenues by $10 million. Likewise, enacting a throwback rule in Florida would bring in an estimated $29.5 million, compared to the $494 million combined reporting would garner. While the throwback rule might not alter corporate tax collections greatly, closing the nowhere income loophole is a reform states should consider when debating whether multi-state corporations and smaller, in-state companies are treated consistently under the corporate income tax.

### Closing tax loopholes to make a fairer tax system

Forty-seven states have a corporate income tax, including every Southern state. Over the years, these corporate tax systems have become riddled with loopholes, which some companies use to avoid income taxes. To ensure that businesses are treated consistently and fairly under the corporate income tax, Southern lawmakers need to continuously review and update corporate tax codes and requirements to close tax loopholes. Reform options include combined reporting to protect against income-transfer schemes and throwback rules to protect against nowhere income. Closing these and other loopholes would improve the tax’s fairness as well as raise funds for education and other business infrastructure, which make states more competitive.

### Talking points

- Almost every state in the union—and every Southern state—currently implements a corporate income tax. Lawmakers originally implemented these taxes to ensure that companies paid their fair share of govern-
ment programs and services they use and benefit from, such as education that schools new workers and roads that allow them to distribute goods to customers.

- Through the years, intentional and unintentional loopholes have developed that allow companies to escape or lower their corporate income tax burden. States are losing millions of dollars due to these tax-avoidance mechanisms.

- State lawmakers should insist upon a prompt review of anomalies and inconsistencies in the corporate tax structure to ensure that large corporations pay a fair share of corporate taxes and to assure smaller, in-state businesses that they are not shouldering an unfair burden.

- As long as Southern states tax corporate incomes, the tax should be administered fairly and not provide preferential treatment to some corporate taxpayers.

**Endnotes**

2 Ibid. 117.
4 Ibid.
8 Mazerov (2003).
11 Florida previously had combined reporting requirements and a throwback rule, but removed both measures in the 1980s in exchange for a higher corporate tax rate.
16 Pierce (2004)