Corporate Income Tax Cuts

The Need for Combined Reporting

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ARKANSAS ADVOCATES FOR CHILDREN & FAMILIES

Policy Brief

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Introduction

In 2019, the Arkansas General Assembly passed legislation that required remote sellers to remit sales taxes on all purchases made by buyers in Arkansas. This "online sales tax" policy is necessary in a modern economy, but that particular legislation also cut corporate income taxes so deeply that the net effect of the bill will be to reduce state general revenues beginning in 2022.[1] Considering how corporations have responded to the cut to corporate taxes at the federal level in 2017, it appears likely that most of the windfall resulting from the state corporate tax cuts will be passed on to wealthy shareholders.[2]

To rectify this, Arkansas should implement what is known as a combined reporting requirement. Combined reporting would help plug the hole left in our state budget and ensure that large multistate corporations pay their fair share.

Corporate Income Tax Basics

Corporate income taxes are an important source of revenue for state governments to fund the vital public services that businesses rely on — infrastructure, public safety, education, and more. But the fact that corporations can have business activities in multiple states presents some challenges for states that need to determine what share of the business' profits are taxable in their jurisdiction.

When a corporation produces and/or sells goods and services in more than one state, the taxes that a corporation owes to each state are calculated using an "apportionment formula." States largely adopted the "Uniform Division of Income for Tax Purposes," also known as the "three-factor formula." This formula is used to determine what share of the corporation's overall, national or worldwide profits are taxable in each state based on the shares of the corporation's property, payroll and sales located in each state. Although this seems conceptually simple, in practice this apportionment can be complex. This complexity can sometimes lead to corporations utilizing the tax code to reduce their tax burden.

1 http://www.arkleg.state.ar.us/assembly/2019/2019R/Fiscal%20Impacts/SB576-DFA4.pdf

2 https://americansfortaxfairness.org/key-facts-american-corporations-really-trump-tax-cuts/

Combined Reporting

One issue with formulary apportionment is that many multistate corporations are composed of a "parent" corporation and any number of "subsidiary" corporations owned by the parent. Corporations can use these subsidiaries to shelter their corporate profits from state income taxes by "shifting" their profits on paper to another state where they can avoid or reduce their taxes.

Two common examples of subsidiary corporations are Passive Investment Companies (PICs) and Real Estate Investment Trusts (REITs):

- PICs are set up to manage intangible assets like corporate trademarks and patents. PICs are often incorporated in Nevada, which has no corporate income tax; or Delaware, which exempts corporations that derive revenue solely from intangible assets from corporate income tax calculations.
- REITs are set up to manage real estate and related financial instruments, like mortgage loans. An REIT can deduct from its taxable income the dividends it pays to shareholders, making it effectively tax exempt. These are typically owned by thousands of shareholders and function like stock or mutual bonds, but they can be used as a tax shelter if they are effectively owned by a single corporation.

Corporations can shift their profits and avoid or reduce their state taxes when the parent corporation pays a subsidiary to use their trademark or rent their buildings. This payment is tax deductible and, therefore, reduces the parent corporation's tax burden. For example, Walmart transferred the ownership of its physical locations to a subsidiary that qualifies as an REIT. By paying rent to a subsidiary that is effectively tax exempt, Walmart saved $350 million in state income taxes between 1998 and 2001, according to an investigation by the Wall Street Journal.[3]

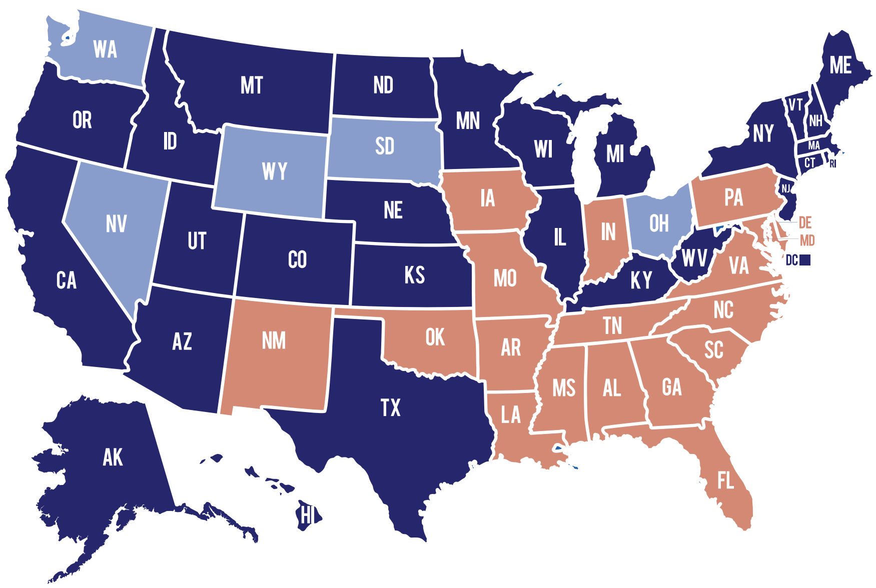
The "Geoffrey Loophole" is even more commonly used. Toys R Us was one of the first corporations to take advantage of Delaware's tax exemption regarding income from intangible assets and created a subsidiary, "Geoffrey LLC," specifically to transfer ownership of their mascot and reduce their state corporate income tax burden.[4]

Combined reporting addresses these issues by effectively disregarding the legal distinction between parent and subsidiary corporations and treats them as a unitary or single business for the purposes of reporting income and calculating income taxes. That means payments to subsidiaries no longer reduce the parent corporation's tax burden, since the subsidiary's income is counted in the calculation of the parent corporation's income. Combined reporting is not just about raising revenue; combined reporting helps ensure that large, multistate corporations cannot reduce their effective tax rate below what smaller, in-state businesses pay simply because of changes to their organizational structure. Since requiring parent companies and subsidiaries to add their profits together nullifies the tax avoidance strategies outlined above, most states that

3 https://www.wsj.com/articles/SB117027500505994065

4 https://money.cnn.com/2008/07/07/smallbusiness/geoffrey_loophole.fsb/index.htm?postversion=2008070712

27 States Plus D.C. Require Combined Reporting



Combined reporting required

Combined reporting not required

No corporate income tax; combined reporting not applicable

Note: Combined reporting treats a parent company and its subsidiaries as one entity for state income tax purposes, thereby helping prevent income shifting.

Source: John C. Healy and Michael S. Schadewald, "2018 Multistate Corporate Tax Guide, Vol. 1" Kentucky HB 487 (2018), effective January 1, 2019, New Jersey AB 4262 (2018), effective July 1, 2019.

have prepared estimates of the adoption of combined reporting have shown that it would increase corporate income tax receipts by 10 to 25 percent.[5] To date, 27 states and D.C. have combined reporting requirements, on the grounds of fairness and efficiency.[6]

Addressing these concerns is especially pressing considering the tax giveaways corporations have received in recent years. In fact, corporate profits have risen far faster than corporate income tax revenues at both the state and federal levels for decades.[7]

Benefits from tax cuts are much more likely to go to executives and shareholders, and not the workers.

Changing Corporate Tax Landscape

This trend accelerated in 2017, when the U.S. Congress passed the "Tax Cuts and Jobs Act," (TCJA), which slashed the corporate income tax rate from 35 percent to 21 percent. This legislation accounts for corporate income tax collections in 2018 falling $135 billion short of the Congressional Budget Office's pre-TCJA projections.[8]

Proponents of the corporate tax cut argued that the benefits of cutting corporate income taxes would be passed on to workers in the form of higher wages or more hires.[9] Part of their argument is that the corporate income tax burden is felt by workers in the form of reduced compensation — a matter of theoretical and empirical dispute.[10] Most independent analysts estimate that labor only bears 15 to 20 percent of the corporate income tax and that the majority of that share is highly skewed toward high-income earners and corporate executives.[11]

Those who directly benefit from corporate income tax cuts are the very wealthy, who derive significant amounts of their income from business investments that are not direct compensation for their work, as illustrated in the following chart:

5 https://www.cbpp.org/research/a-majority-of-states-have-now-adopted-a-key-corporate-tax-reform-combined-reporting

6 https://www.cbpp.org/27-states-plus-dc-require-combined-reporting-for-the-state-corporate-income-tax

7 https://www.governing.com/topics/finance/gov-disappearing-corporate-taxes.html

8 https://www.taxpolicycenter.org/taxvox/did-tax-cuts-and-jobs-act-pay-itself-2018

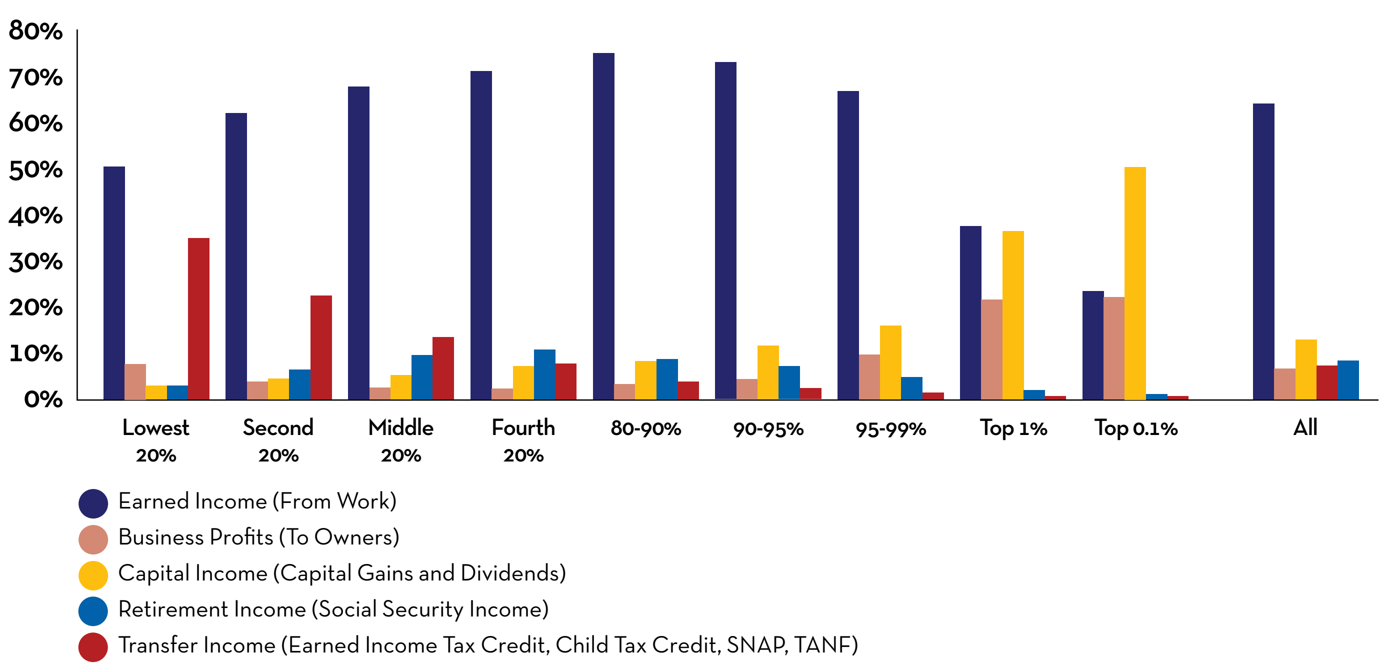
9 https://taxfoundation.org/tcja-economic-growth-effects-testimony/

10 https://www.taxpolicycenter.org/briefing-book/who-bears-burden-corporate-income-tax

11 https://www.cbpp.org/research/federal-tax/corporate-tax-cuts-skew-to-shareholders-and-ceos-not-workers-as-administration

Sources of Income by Percentile, 2019

Percent of Income



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0718-1).

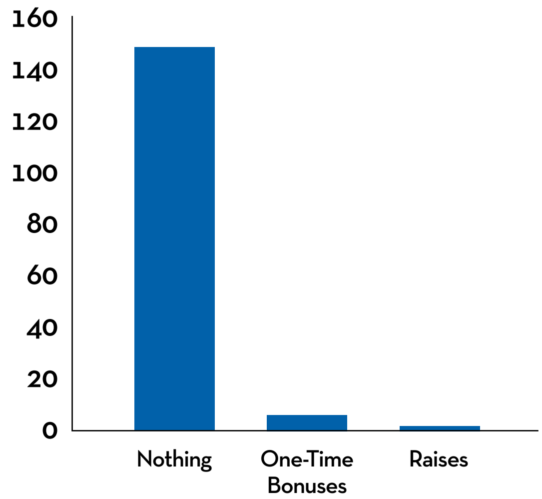
Reduced corporate taxes lead to higher after-tax profits for companies. In the long term, the argument is that corporate shareholders will invest more in their corporations and that the investment would increase productivity, and, therefore, wages, allowing workers to benefit from the corporate tax cut.

While it is too early to rigorously assess this claim, the initial evidence for this argument is not promising. Fewer than 5 percent of the U.S. workforce have received any additional form of compensation at all due to the corporate tax cut, and an even smaller share have received permanent wage increases rather than one-time bonuses.[12]

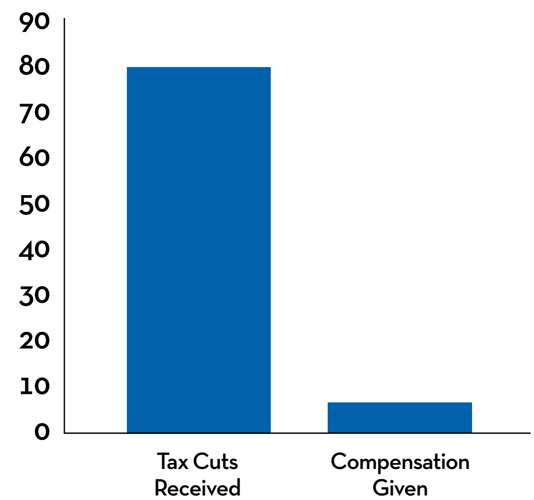
Things don't look much better if analyzed in dollar terms. Americans for Tax Fairness identified 157 companies that received almost $80 billion in tax cuts, but they offered only $7.1 billion in the form of increased wages or one-time bonuses.

By contrast, a report by the Congressional Research Service showed that the TCJA lead to a record-breaking amount of stock buybacks, totaling more than $1 trillion in 2018.[13] In a stock buyback, a company purchases its own shares from the open market. A buyback pushes up the price of that company's stock, which means that shareholders earn more per share of stock they hold. Because the vast majority of shareholder wealth is concentrated at the top of the income distribution, these benefits largely accrue to the already very wealthy.

What Did the U.S. Workforce Get from TCJA?
Number of Workers in Millions



Tax Cuts vs. Worker Compensation
Dollars in Billions



12 https://americansfortaxfairness.org/key-facts-american-corporations-really-trump-tax-cuts/

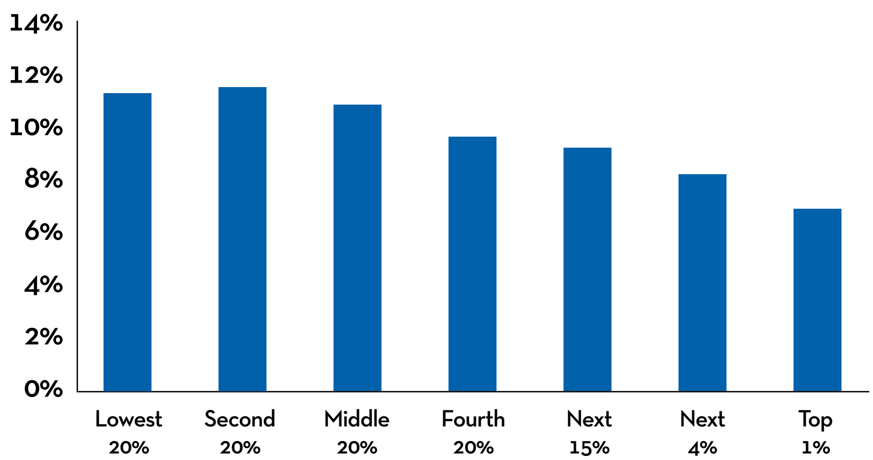
13 https://www.everycrsreport.com/files/20190522_R45736_8a1214e903ee2b719e00731791d60f26d75d35f4.pdf

Corporate Taxes in Arkansas

Prior to 2019, Arkansas already had a highly "regressive" tax code. That means that people with lower incomes pay a higher share of their income in state and local taxes than those with higher incomes. Arkansans making less than $22,000 would have had an 11.3 percent effective tax rate in 2019 compared to just 6.9 percent for Arkansans making more than $456,000, according to the non-partisan Institute on Taxation and Economic Policy (ITEP).

Effective Tax Rates Prior to 2019 Legislative Session

(TY19)



But in 2019 the state legislature made several changes to Arkansas's tax code that further increased the code's regressivity.

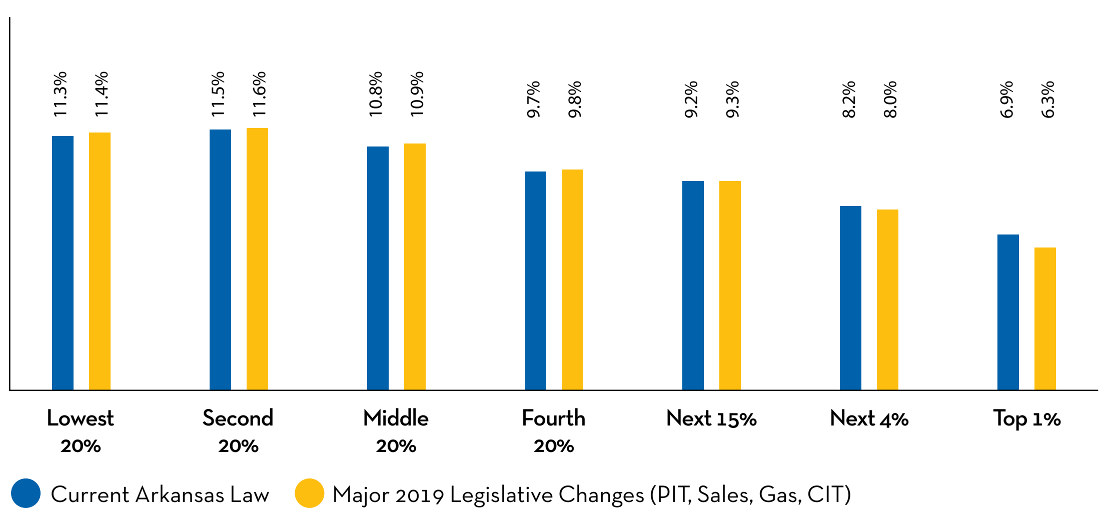
According to an ITEP analysis, the results of the changes to the tax code made in the 2019 legislative session, once fully phased in, will result in an increase in taxes for all Arkansans, except for the top 5 percent of earners.

One of the most significant pieces of legislation was Act 822, which requires out-of-state sellers to collect sales taxes owed on purchases by Arkansas consumers and remit the taxes collected to the state. This policy is often referred to as the "internet sales tax" because the rise of internet sales from sellers with no in-state presence has been chipping away at the sales tax base for states and localities across the country.

Arkansas and other states have been hesitant to require out-of-state sellers to remit sales taxes in the past due to the uncertain legality of such legislation, but a recent U.S. Supreme Court case, South Dakota vs. Wayfair, Inc., ruled it allowable.[14]

However, this same legislation also cut corporate income taxes so steeply that it is projected to reduce general revenues to the state. In the short term, the primary mechanism through which Act 822 cut corporate income taxes was to reduce the top corporate tax rate from 6.5 percent to 6.2 percent in 2021, and then to 5.9 percent in 2022. The other changes made to corporate income tax collection — such as switching the state to single sales factor apportionment and changes to how businesses can use net operating losses — have an ambiguous impact on revenue collections or will not have an impact until farther in the future.

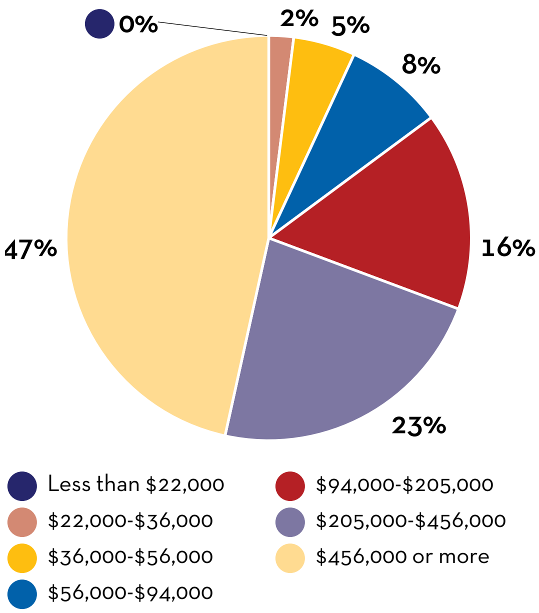
Arkansas Effective Tax Ratios Prior Law vs. with Major 2019 Legislative Changes



14 https://www.aicpa.org/advocacy/state/south-dakota-v-wayfair.html

What does this mean for our tax code?

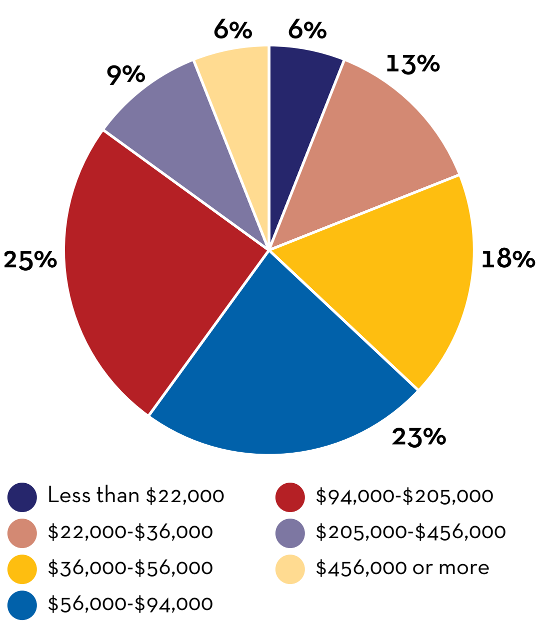
Share of Corporate Tax Cut by Income



According to an analysis by the non-partisan ITEP, 70 percent of the corporate tax cut goes to the top 5 percent of wage earners (those making more than $205,000 annually). Even worse, 81 percent of those dollars leave the state economy and go to out-of-state shareholders. To pay for this, the legislature raised sales taxes on working Arkansans.

Share of Internet Sales Tax Increase

By Income



The sales tax will be felt most significantly by those groups that did not benefit from the corporate tax cut; Arkansans making less than $94,000 annually will pay a larger share of their income on the new online sales tax. Across the board, lower-income households spend a larger share of their income on consumer goods, on which a sales tax is applied, than do higher-income households. People with higher incomes are able to spend a larger share of their incomes on investment vehicles, such as 401(k), individual retirement and education savings accounts, which offer favorable tax treatment but are generally out of reach for workers who struggle with low wages.

Conclusion

Corporate income taxes are an important source of revenue for state governments to fund vital public services, including those on which businesses rely, like education and infrastructure. While there is an unsettled theoretical argument over how much economic growth business tax cuts can induce,[15] any such gains can easily be wiped out by other changes to tax and budget policies. Corporate income tax cuts often lead to state revenue losses and cuts in public services and sometimes result in increases in regressive sales taxes that hurt low- and middle-income consumers, both of which can dampen any pro-growth elements of a business tax cut.[16]

Our tax code got worse for everyday Arkansans in 2019. That's because we increased the sales tax, which is regressive, since lower-income people are likely to pay more as a share of their income in sales taxes than wealthier individuals. At the same time, we reduced corporate tax, which almost exclusively benefits the very wealthy.

One common-sense solution to help balance that would be a combined reporting requirement. It would prevent corporations from gaming our tax system. Arkansas should implement combined reporting as soon as possible, especially given the various tax cuts corporations have been given both at the federal level and in the state of Arkansas.

15 https://www.cbpp.org/sites/default/files/atoms/files/6-17-13sfp.pdf

16 https://www.cbpp.org/sites/default/files/atoms/files/9-14-10sfp.pdf

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