

State Corporate Income Tax and Multistate Corporations

BY SANTIAGO PINTO

The relative importance of state corporate income tax (SCIT) revenue has been declining over the last few decades. State corporate taxes as a percentage of total state tax revenues declined from 6.6 percent in 1992 to 5.3 percent in 2011. As a percentage of before-tax corporate profits, state corporate taxes declined from 4.4 percent to 2.2 percent during the same period. (See chart below.) As expected, these indicators show a cyclical behavior, but the underlying trend is downward. These trends have been taking place even as corporate profits as a share of national GDP have been rising.

The SCIT plays different roles in different states of the Fifth District. In Maryland, Virginia, and South Carolina, the participation of the SCIT in the state tax revenue is below the state average for the whole country; in North Carolina and the District of Columbia, it is about average; and in West Virginia, it is generally above the average. The long-run behavior also differs by states. The trend has been toward a reduced role for the SCIT in North Carolina and South Carolina, an increased role in Maryland, and an essentially constant one in Virginia and D.C. West Virginia also exhibits a downward trend after controlling for the exceptionally high values achieved during the period of 2005-2009. (See chart on page 41.)

Why has the role of the SCIT been declining nationally and in most Fifth District states? To understand the answers to this question, it may be helpful to have some background on this type of tax.

Understanding the SCIT

Most large corporations consist of a group of related businesses. Typically, there is a parent corporation and a number of subsidiaries owned by the parent. When these corporations operate in multiple states, measuring income earned within each region raises a difficult conceptual problem: How should states determine the appropriate amount of tax to impose on the incomes of such businesses?

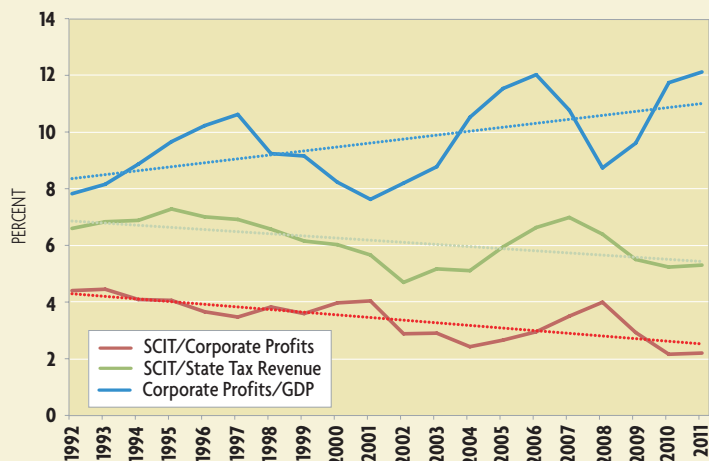
Federal court decisions have limited the power of states to tax out-of-state corporations. A corporation is subject to income tax in the state in which it is organized and in every state where it conducts activities that are sufficient to create what is called a “nexus.” Once nexus is established, the state has the right to impose a tax obligation on the corporation.

The determination of nexus for a multistate corporation can be a major challenge and is a highly contentious issue in state taxation. The “physical presence” standard dictates that a multistate corporation has nexus in the state where it produces — that is, the state where the company has offices and production facilities, in addition to local employees. More recently, however, states have shifted toward the adoption of the “economic presence” standard in determining whether in-state activities create nexus for tax purposes. According to this principle, a company also has presence in the states where it sells its products. The economic presence standard has become the subject of widespread litigation in state courts and the rulings on this matter have been far from uniform.

Reporting methods for multicorporate groups vary across states. While some states require corporations to file separate or consolidated tax returns, a growing number of states are moving toward combined (or unitary) filing. Under the separate entity method, a company with nexus in the state must file its own separate return, ignoring the existence of the corporate group. Each entity is treated as a separate taxpayer. In principle, a company cannot offset profitable subsidiaries with subsidiaries with losses. Since intercompany transactions (that is, transactions between subsidiaries or sister corporations) are treated similarly to transactions between the corporation and third parties for tax purposes, the company has some control over its taxable income. Typically, a separate entity state accepts the company’s statement of its taxable profits derived from its own books, but states have the right to make adjustments if they believe intragroup sales are deliberately used to avoid taxes (transfer pricing). In a few states, including Maryland, separate reporting is the only filing option.

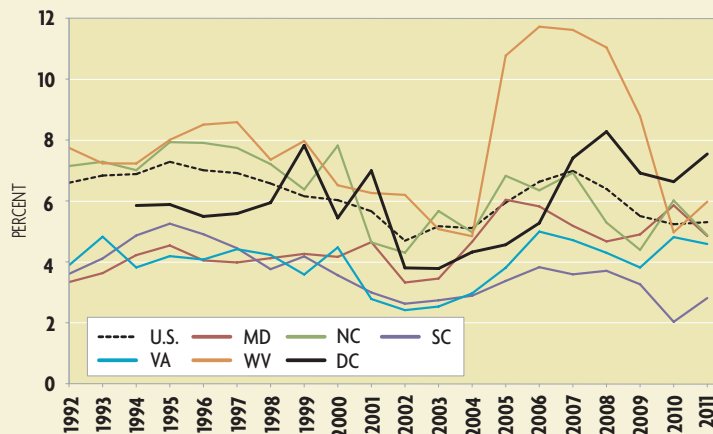
Some states allow corporations that belong to an

State Corporate Income Tax Revenue and Corporate Profits



SOURCES: Bureau of Economic Analysis and U.S. Census Bureau

State Corporate Income Tax Revenue as a Percentage of State Tax Revenue



SOURCE: U.S. Census Bureau

affiliated business group to file one single consolidated tax return (consolidated filing), rather than having each separate entity file a separate return. Generally, companies can only choose this option if they satisfy certain conditions. For instance, the parent company must own at least 80 percent or more of each affiliate, and only the affiliated entities that have nexus with the state can be included in the consolidated return.

Combined or “unitary” filing focuses on the “unitary” economic unit and treats related corporations as one entity. The profits of the parent company and subsidiaries are added together, ignoring geographic boundaries, and the state then taxes a share of the combined income. Combined filing requires the determination of whether a group of corporations can be legally considered a unitary business. This area has also been highly contentious due to the lack of consistency across states.

Supporters of consolidated and combined reporting claim that these options alleviate some of the distortions created by separate-unit filing and reduce tax-avoidance opportunities. Opponents, however, claim that by aggregating the income of all the businesses with different economic profitability regardless of their geographic location, consolidated and combined reporting may not accurately attribute the corporation’s income to the correct state.

Irrespective of the filing requirements, states allow a corporation that operates in multiple states to apportion its business income among the nexus states using a prescribed formula. This method, known as formula apportionment, assumes that the proportion of a multistate corporation’s income earned in a given state is a weighted average of the firm’s total sales, property, and payroll shares in that state. Each state has the ability to choose the weights attached to these factors. The formula apportionment

method is popular in other countries as well, such as Canada, mostly because it is relatively easy to administer.

For tax purposes, a sale must be assigned to one single state. For tangible property, most states follow the “destination rule” principle, which imputes sales to the state where they take place. If the destination states lack the authority to tax the seller (either because there is no nexus or the formula does not weigh the sales portion), sales assigned to those states are not included in the state of origin’s sales factor. When this occurs, a portion of that company’s profits remains untaxed. The untaxed profit is referred to as “nowhere income.” To address this issue, several states have implemented a “throwback rule,” which uses an alternative approach to calculate the sales share of the apportionment formula. Suppose as before that a firm sells part of its production in a

destination state and these sales are not subject to taxation in that location. If the company’s host state has a throwback rule, then the sales in the destination state are added or “thrown back” to the sales share in the formula apportionment of the host, increasing the taxable income in the host state.

About half of the states with corporate income tax have legislated throwback rules. New Jersey and West Virginia use a variant of this rule, but with similar implications, known as the “throwout” rule. Instead of assigning all sales to the states in which the company operates, the throwout rule simply excludes from aggregate sales those sales that are not assigned to any state.

The economic rationale of the throwback rule is questionable, though. From a practical standpoint, it is unclear why the design of the state tax system should depend on whether other states appropriately tax business activities. Additionally, differences in the implementation of the throwback rule can create economic distortions and tax avoidance opportunities. To the extent that some states do not impose throwback rules, companies can reduce their state taxable income by locating their property and payroll in states with no throwback rule and then selling in states where the company does not have nexus.

As of December 2012, all states in the Fifth District had adopted formula apportionment methods that weigh the sales share heavily. Concerning filing options, some states still permit separate filing. However, at the present time these states are planning on shifting toward combined reporting. Finally, most states in the Fifth District do not have a throwback (or throwout) provision, with the exception of West Virginia. (See table on page 42.) The case of North Carolina is atypical in the sense that there is no statutory throwback rule. Still, corporations with nexus in North Carolina that sell their products in

QUICK FACT

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State Corporate Income Taxation in the Fifth District

	DC	MD	NC	SC	VA ⁽¹⁾	WV
Tax Rate	9.975%	8.25%	6.90%	5.00%	6.00%	7.75%
Apportionment Formula	Double-weight sales	Double-weight sales Single-sales factor for manufacturing	Double-weight sales	Single-sales factor	Double-weight sales	Double-weight sales
Filing	Combined	Separate	Separate	Separate (consolidated is allowed under certain conditions)	Combined	Combined
Throwback Rule	None	None	No statutory throwback rule, but similar procedure is used for sales in states in which the corporation is not required to file a tax return	None	None	Throwout

NOTE: ⁽¹⁾Virginia also has a gross receipt tax in addition to the state corporate income tax forms.
 SOURCES: Tax Foundation, state corporate income tax forms

states where they are not required to file a tax return must add those sales to the sales taking place in North Carolina; essentially, this provision works as a throwback rule for that specific situation.

Explaining the Drop in SCIT Revenue

The decline in the SCIT revenue is generally attributed to a variety of factors, including the use of the SCIT for economic development purposes, the development of more aggressive state tax planning methods, and changes in state and federal tax laws. Recent research lends some support to these explanations.

The widespread use of the SCIT as an instrument of economic development to attract businesses and jobs has negatively affected state tax revenue in the short run. Concessions offered through the SCIT system differ by state and include property tax reductions, and investment and employment tax credits. Even though these are common practices, there is no conclusive evidence of their effectiveness in the long run. The tax competition literature offers one possible explanation for this outcome. John Douglas Wilson, an economics professor at Michigan State University, summarized the findings of this literature in an article published in 1999 in the *National Tax Journal*. The main argument is that state competition for businesses triggers a process that leads to a “race to the bottom,” where all states end up imposing inefficiently low tax rates.

A more recent strand of literature focuses on other ways of attracting businesses such as the manipulation of the apportionment formula. In 1967, the Multistate Tax Compact established that the three factors considered in the apportionment formula (property, sales, and payroll) are to be weighted equally. In spite of this recommendation, most states have been systematically deviating toward a formula that weighs the sales portion more heavily. Currently, most states use a formula that assigns a double weight to the sales portion. As more states pass such legisla-

tion, other states may feel compelled to do the same, initiating a “race to the bottom” in which all states end up imposing the same (lower) tax liability. Supporting this view, an empirical research study published in 2009 by economist Sanjay Gupta, also of Michigan State University, and several of his colleagues found that states with a double-weighted sales factor experience lower SCIT revenues than states with an equally weighted sales factor.

An additional issue with the formula apportionment method that may affect the SCIT revenue arises when states are allowed to choose their own formulas. If all states adopt the same formula, then

exactly 100 percent of a corporation’s income will be apportioned across states. Nonuniformity, however, can result in more or less than 100 percent of a corporation’s income being subject to state income tax.

Two related studies — one published in 2005 by William Fox, an economics professor, and LeAnn Luna, an accounting professor, both at the University of Tennessee, and the other one published in 2010 by Luna and Matthew Murray, an economics professor at the University of Tennessee — contended that recently corporations have been adopting more aggressive tax avoidance measures and engaging in what is known as “state tax planning.” The decline in SCIT revenue as a proportion of corporate profits may be indicative of such behavior. Most multistate income tax planning involves various forms of income-shifting among state jurisdictions through intercompany transactions or relocation of production processes to avoid nexus in states with higher taxes. To a large extent, this kind of behavior is encouraged by the separate-entity reporting requirements.

State tax planning also includes other more sophisticated strategies. For instance, companies react to state policies by choosing legal arrangements that would reduce the corporation’s tax exposure. The recent proliferation of S-corporations, partnerships, and LLCs is consistent with such practices. These organizations, unlike shareholders in a corporation, are not taxed as a separate business entity. Instead, profits and losses are “passed through” the business to each member of the corporation, who eventually report profits and losses on their own personal income tax returns. A widespread shift toward legal arrangements of these types is expected to affect the SCIT base negatively.

Another common practice has been establishing holding companies in states with no corporate income tax. This strategy allows corporations to separate the revenues generated by their physical activities from the revenues obtained from intangible property (trademarks, trade names, or other intellectual property). Specifically, the parent company

incorporates a wholly owned subsidiary as an “intangible holding company” in a tax-favored state. Then, the holding company enters into licensing arrangements under which the operating entity pays royalties to the holding company for the use of intangible assets. The operating entity deducts the royalty payments from its taxable income in the states where it files, and the holding company pays no income tax on the royalty income.

Other changes in state laws, such as combined filing and the introduction of throwback rules, may have also contributed to the evolution of the SCIT. In recent years, states have been shifting toward combined reporting. As more and more states adopt this method, it becomes less profitable for companies to engage in tax-avoidance strategies. The net impact of combined reporting on SCIT revenue is ambiguous, however. If the subsidiaries operating out of state incur losses, then the amount of income apportioned to a unitary state could be reduced.

The empirical literature is inconclusive in this respect. While Gupta and his colleagues did not find any significant association between combined reporting and SCIT revenue, Fox and Luna found that combined reporting tends to increase SCIT revenue. Concerning the throwback provision, the conclusions from Gupta and his colleagues indicate that the implementation of this rule has a positive impact on SCIT, but in a 2010 report commissioned by the National Conference of State Legislatures, Fox and Luna claimed that the revenue effects tend to decline as the SCIT rate is higher.

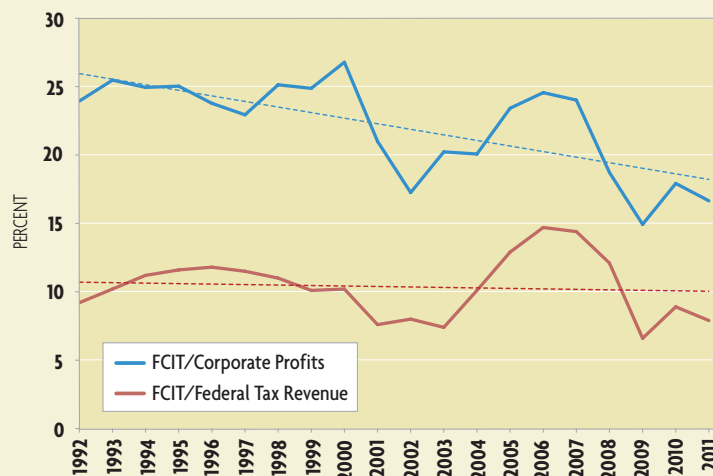
Finally, changes in federal tax laws ultimately affect the SCIT revenue. The calculation of state taxable corporate income generally begins with the amount of federal taxable income reported on the corporation’s federal tax form. States introduce certain adjustments, but state taxable income mostly conforms to the federal tax base. As a consequence, any amendment to federal tax rules (for example, the enactment of more accelerated depreciation methods) would have an effect on state tax collections as well.

During the period 1992-2011, the federal corporate income tax revenue decreased from 9 percent to less than 8 percent as a percentage of total federal tax revenue, and from approximately 24 percent to 17 percent as a percentage of pretax corporate profits. (See chart.) Such behavior does not seem to fully explain the declining importance of the SCIT, however. Research on this topic published in 2005 by Gary Cornia, dean of the Marriott School of Management at Brigham Young University, and some colleagues suggested that changes taking place at the federal level do not appear to be the cause of the decrease in state corporate income taxes.

Implications for the Future

As the SCIT tax base erodes and the performance of the SCIT weakens, state governments are pushed to evaluate alternative ways of financing government expenditures. Pressed by financial needs and state balanced-budget

Federal Corporate Income Tax



SOURCES: Bureau of Economic Analysis, U.S. Census Bureau, Office of Management and Budget

requirements, however, states are unlikely to eliminate the SCIT completely, at least in the short term. If they did so, states would face the major challenge of compensating for the loss in state revenue (in 2011, the SCIT accounted for 5.3 percent of the total state revenue), and there would be no assurance that the new financing alternatives would be less distortive. Moreover, from a political standpoint, the SCIT is still attractive to the extent that it grants state authorities the opportunity to export part of the tax burden to out-of-state residents.

In such context, states have chosen to introduce partial modifications to their SCIT systems. As noted earlier, the literature is ambiguous about the net impact of these changes in SCIT revenue. For example, the recent shift toward a double-weight sales factor tends to reduce tax revenue, the implementation of throwback appears to raise tax revenue, and combined reporting does not seem to affect tax revenue. At the same time, it is not obvious that all states would be willing to adopt the same tax policies. Clearly, a formula that gives a relatively large weight to the sales factor (and, consequently, a low weight to the property or capital portion) essentially penalizes those companies with higher in-state sales, and benefits those that operate and produce within the state’s borders. In contrast, the throwback rule, regardless of its validity, tends to penalize those companies that sell out of state more. Depending on the states’ objectives, some policies may be more appropriate than others.

In the Fifth District, states have already adopted a double-weight sales factor formula, and with the exception of West Virginia (and, to some extent, North Carolina), states do not have a throwback provision. In light of current research, the state governments in the region seeking to increase SCIT revenue could do so by choosing a more balanced apportionment formula and by adopting a throwback rule.

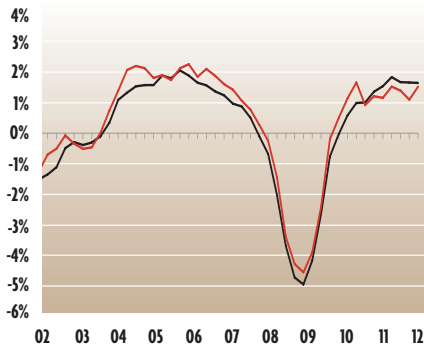
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STATE DATA, Q4:12

	DC	MD	NC	SC	VA	WV
Nonfarm Employment (000s)	734.3	2,586.3	4,022.2	1,872.4	3,744.0	766.9
Q/Q Percent Change	0.6	0.5	0.9	0.9	0.5	0.3
Y/Y Percent Change	0.7	1.3	2.2	1.9	1.1	0.5
Manufacturing Employment (000s)	0.9	105.5	441.8	221.0	232.4	49.1
Q/Q Percent Change	-6.9	-2.9	0.4	0.6	-0.2	0.9
Y/Y Percent Change	-10.0	-5.1	1.9	1.5	0.7	-0.9
Professional/Business Services Employment (000s)	154.5	414.0	538.8	231.9	682.8	65.2
Q/Q Percent Change	1.2	0.9	0.8	-1.9	0.7	0.7
Y/Y Percent Change	1.7	2.2	3.3	0.3	1.8	1.0
Government Employment (000s)	241.7	505.1	715.5	350.7	715.1	154.8
Q/Q Percent Change	0.2	0.1	0.3	1.2	0.7	0.3
Y/Y Percent Change	-1.3	0.1	0.5	2.6	0.2	0.6
Civilian Labor Force (000s)	369.3	3,138.8		2,168.1	4,216.8	807.8
Q/Q Percent Change	1.4	0.5	0.6	0.2	0.3	0.2
Y/Y Percent Change	5.7	1.2	1.7	0.0	0.0	0.5
Unemployment Rate (%)	8.5	6.7	9.4	8.7	5.7	7.5
Q3:12	8.9	6.9	9.6	9.1	5.9	7.6
Q4:11	9.8	7.1	10.0	10.0	6.3	7.5
Real Personal Income (\$Mil)	41,264.2	267,487.5	316,753.3	141,640.5	337,257.0	55,568.0
Q/Q Percent Change	1.3	1.4	1.5	1.3	1.4	0.9
Y/Y Percent Change	2.6	2.8	3.8	3.4	2.7	1.8
Building Permits	1,562	3,886	12,867	4,571	6,847	486
Q/Q Percent Change	20.0	4.4	12.5	-0.9	2.9	8.0
Y/Y Percent Change	1.9	25.0	61.3	7.9	60.3	15.4
House Price Index (1980=100)	598.8	408.1	302.2	305.2	398.0	214.5
Q/Q Percent Change	1.6	0.3	0.4	0.0	0.4	0.2
Y/Y Percent Change	4.5	-0.8	-0.8	-1.3	-0.1	0.1

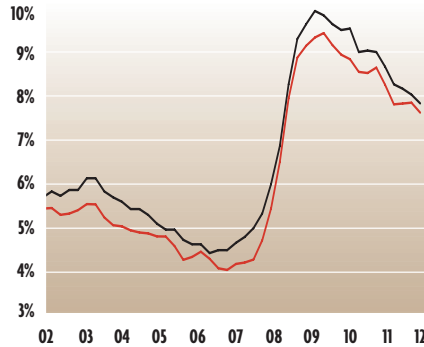
Nonfarm Employment

Change From Prior Year
First Quarter 2002 - Fourth Quarter 2012



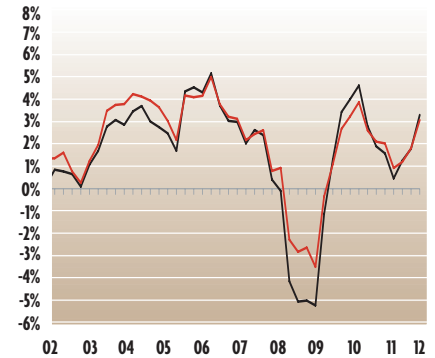
Unemployment Rate

First Quarter 2002 - Fourth Quarter 2012



Real Personal Income

Change From Prior Year
First Quarter 2002 - Fourth Quarter 2012

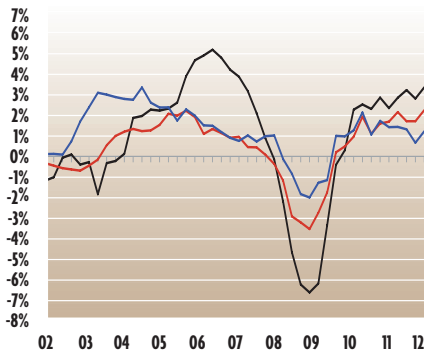


— Fifth District

— United States

Nonfarm Employment Metropolitan Areas

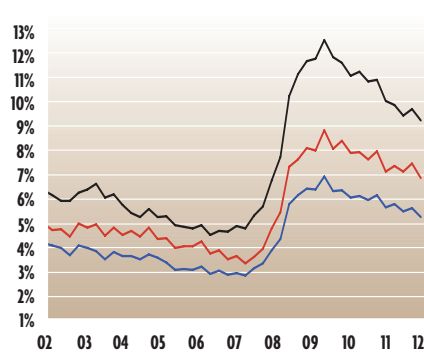
Change From Prior Year
First Quarter 2002 - Fourth Quarter 2012



— Charlotte — Baltimore — Washington

Unemployment Rate Metropolitan Areas

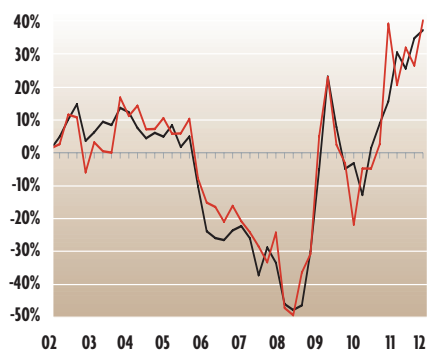
Change From Prior Year
First Quarter 2002 - Fourth Quarter 2012



— Charlotte — Baltimore — Washington

Building Permits

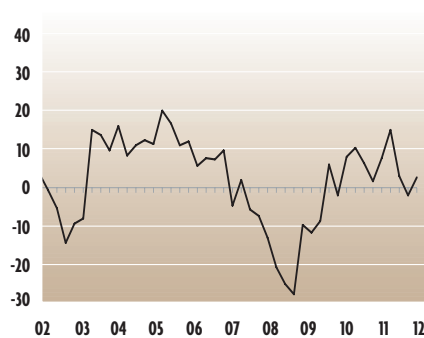
Change From Prior Year
First Quarter 2002 - Fourth Quarter 2012



— Fifth District — United States

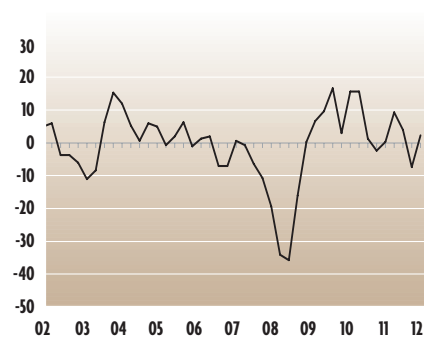
FRB—Richmond Services Revenues Index

First Quarter 2002 - Fourth Quarter 2012



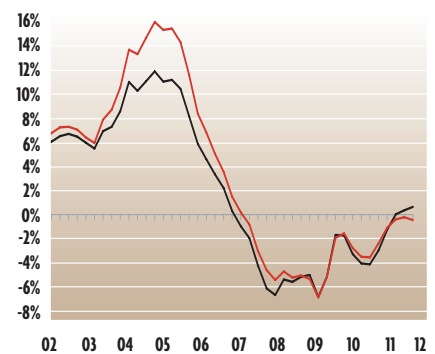
FRB—Richmond Manufacturing Composite Index

First Quarter 2002 - Fourth Quarter 2012



House Prices

Change From Prior Year
First Quarter 2002 - Fourth Quarter 2012



— Fifth District — United States

NOTES:

- 1) FRB-Richmond survey indexes are diffusion indexes representing the percentage of responding firms reporting increase minus the percentage reporting decrease. The manufacturing composite index is a weighted average of the shipments, new orders, and employment indexes.
- 2) Building permits and house prices are not seasonally adjusted; all other series are seasonally adjusted.

SOURCES:

- Real Personal Income: Bureau of Economic Analysis/Haver Analytics.
 Unemployment rate: LAUS Program, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>.
 Employment: CES Survey, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>.
 Building permits: U.S. Census Bureau, <http://www.census.gov>.
 House prices: Federal Housing Finance Agency, <http://www.fhfa.gov>.

METROPOLITAN AREA DATA, Q4:12

	Washington, DC	Baltimore, MD	Hagerstown-Martinsburg, MD-WV
Nonfarm Employment (000s)	2,498.2	1,341.2	104.4
Q/Q Percent Change	1.1	1.9	1.1
Y/Y Percent Change	1.2	2.2	2.1
Unemployment Rate (%)	5.5	7.1	7.7
Q3:12	5.5	7.2	7.8
Q4:11	5.9	7.5	8.5
Building Permits	6,397	1,714	252
Q/Q Percent Change	15.6	-1.6	26.6
Y/Y Percent Change	43.2	12.8	93.8
	Asheville, NC	Charlotte, NC	Durham, NC
Nonfarm Employment (000s)	174.4	868.6	286.6
Q/Q Percent Change	2.3	2.8	1.6
Y/Y Percent Change	2.4	3.3	1.9
Unemployment Rate (%)	7.6	9.4	7.2
Q3:12	7.7	9.5	7.3
Q4:11	8.2	10.3	7.8
Building Permits	265	3,110	519
Q/Q Percent Change	-31.0	-1.3	-55.7
Y/Y Percent Change	21.0	120.1	-19.0
	Greensboro-High Point, NC	Raleigh, NC	Wilmington, NC
Nonfarm Employment (000s)	345.8	528.4	139.7
Q/Q Percent Change	1.7	0.8	0.9
Y/Y Percent Change	0.5	2.8	3.3
Unemployment Rate (%)	9.9	7.6	9.6
Q3:12	10.0	7.7	9.7
Q4:11	10.4	8.4	10.4
Building Permits	396	4,833	674
Q/Q Percent Change	10.0	87.3	-19.7
Y/Y Percent Change	-35.2	183.6	62.0

	Winston-Salem, NC	Charleston, SC	Columbia, SC
Nonfarm Employment (000s)	208.2	306.3	357.7
Q/Q Percent Change	2.1	-0.2	1.6
Y/Y Percent Change	1.6	2.3	1.3
Unemployment Rate (%)	8.9	7.0	7.6
Q3:12	8.9	7.3	8.0
Q4:11	9.4	8.2	8.6
Building Permits	159	1,042	877
Q/Q Percent Change	-8.6	-6.5	-2.0
Y/Y Percent Change	-64.3	-15.9	41.9
	Greenville, SC	Richmond, VA	Roanoke, VA
Nonfarm Employment (000s)	311.2	629.3	160.3
Q/Q Percent Change	1.8	0.3	0.9
Y/Y Percent Change	1.5	1.5	1.6
Unemployment Rate (%)	7.1	6.1	5.9
Q3:12	7.5	6.3	6.0
Q4:11	8.1	7.0	6.6
Building Permits	678	1,245	105
Q/Q Percent Change	15.9	0.1	11.7
Y/Y Percent Change	65.8	86.1	16.7
	Virginia Beach-Norfolk, VA	Charleston, WV	Huntington, WV
Nonfarm Employment (000s)	751.1	147.8	115.3
Q/Q Percent Change	0.3	0.0	2.4
Y/Y Percent Change	1.4	-0.8	0.0
Unemployment Rate (%)	6.3	7.1	7.3
Q3:12	6.5	7.1	7.3
Q4:11	7.1	6.9	7.9
Building Permits	1,120	38	8
Q/Q Percent Change	-24.1	-2.6	33.3
Y/Y Percent Change	13.1	111.1	-68.0

For more information, contact Jamie Feik at (804) 697-8927 or e-mail Jamie.Feik@rich.frb.org