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# CLOSING THREE COMMON CORPORATE INCOME TAX LOOPHOLES COULD RAISE ADDITIONAL REVENUE FOR MANY STATES

by Michael Mazerov

The current economic downturn has opened up enormous gaps between revenues and expenditures in the budgets of the vast majority of states. Tax revenues are flat or declining, and spending pressures are growing as families with unemployed workers require state-financed medical assistance and income support. New spending demands associated with security and public health concerns are compounding the states' fiscal crises.

As they work to close these budget gaps, state policymakers are facing difficult decisions about whether to cut state services and/or raise taxes.[1] State officials may also wish to consider policy options that could increase the yield of existing revenue sources. In particular, they may wish to scrutinize their tax structures for unintended and unrecognized loopholes that allow some individuals and businesses to avoid paying their fair share of taxes, and then take steps to minimize such tax-avoidance opportunities.

## The Corporate Income Tax Is a Fading Source of State Revenue

State corporate income taxes are long overdue for a thorough examination. The corporate income tax laws of the majority of states are riddled with loopholes that permit many large multistate corporations to avoid paying tax on a significant share of their profits. The growing sophistication of corporations in exploiting these flaws has undoubtedly contributed to the declining significance of the corporate income tax in state tax structures over the past two decades. According to the U.S. Census Bureau, corporate income taxes supplied 10.2 percent of state tax revenue in the states levying them in 1979, but just 6.3 percent in 2000.[2] (See Table 1.)

The steady erosion of state corporate income taxes is revealed as well in estimates of the effective state corporate income tax rate. The effective corporate tax rate is the rate at which corporations actually pay tax on their profits, as opposed to the rate that is nominally imposed. The effective corporate tax rate is measured by dividing actual corporate tax collections by an estimate of "true" corporate profits. Top nominal state corporate tax rates are generally in the range of 6-10 percent; only five of the 45 states imposing corporate taxes (including the District

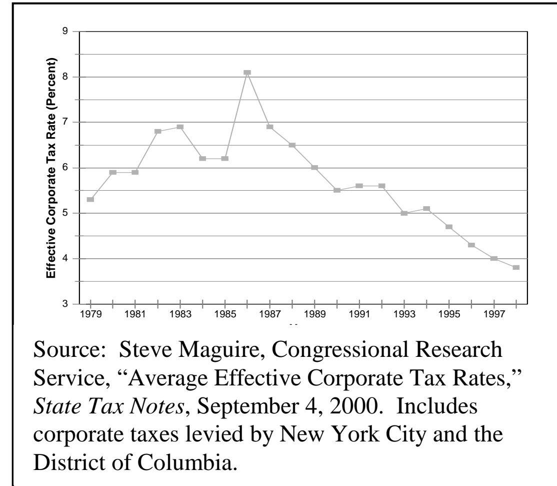
**Table 1**
**Share of Total State Taxes Contributed by Corporate Income Tax, 1979, 1989, & 2000, States with Corporate Income Taxes**

| | 1979 | 1989 | 2000 |
|---|---|---|---|
| All Corporate Income Tax States | 10.2% | 8.8% | 6.3% |
| Alabama | 5.8% | 5.9% | 3.8% |
| Alaska | 31.5% | 32.6% | 30.8% |
| Arizona | 5.9% | 4.9% | 6.5% |
| Arkansas | 8.4% | 5.1% | 4.9% |
| California | 14.5% | 12.3% | 7.9% |
| Colorado | 7.8% | 5.9% | 4.7% |
| Connecticut | 13.5% | 16.6% | 4.2% |
| Delaware | 10.2% | 13.7% | 11.3% |
| Florida | 7.3% | 5.8% | 4.8% |
| Georgia | 9.2% | 8.3% | 5.3% |
| Hawaii | 4.6% | 4.0% | 2.3% |
| Idaho | 8.4% | 6.9% | 5.3% |
| Illinois | 7.7% | 9.1% | 9.9% |
| Indiana | 4.8% | 4.8% | 9.2% |
| Iowa | 8.3% | 6.4% | 4.1% |
| Kansas | 11.9% | 7.9% | 5.6% |
| Kentucky | 7.9% | 7.6% | 4.0% |
| Louisiana | 9.7% | 8.7% | 3.4% |
| Maine | 7.4% | 6.1% | 5.6% |
| Maryland | 5.5% | 5.3% | 4.2% |
| Massachusetts | 13.4% | 13.0% | 8.1% |
| Minnesota | 11.4% | 7.6% | 6.0% |
| Mississippi | 4.9% | 6.3% | 4.8% |
| Missouri | 6.5% | 5.2% | 3.1% |
| Montana | 9.0% | 7.7% | 7.1% |
| Nebraska | 6.7% | 5.6% | 4.7% |
| New Hampshire | 24.2% | 24.8% | 18.4% |
| New Jersey | 11.5% | 12.5% | 7.4% |
| New Mexico | 4.8% | 4.0% | 4.3% |
| New York | 10.5% | 7.6% | 6.6% |
| North Carolina | 8.7% | 10.7% | 6.5% |
| North Dakota | 8.9% | 6.4% | 6.7% |
| Ohio | 10.9% | 6.8% | 3.2% |
| Oklahoma | 6.2% | 3.4% | 3.3% |
| Oregon | 12.0% | 6.1% | 6.8% |
| Pennsylvania | 12.6% | 9.2% | 7.6% |
| Rhode Island | 10.4% | 6.7% | 3.7% |
| South Carolina | 9.2% | 5.9% | 3.6% |
| Tennessee | 10.1% | 9.1% | 7.9% |
| Utah | 4.7% | 5.7% | 4.4% |
| Vermont | 8.9% | 6.0% | 3.0% |
| Virginia | 7.7% | 5.2% | 4.5% |
| West Virginia | 2.2% | 10.8% | 6.5% |
| Wisconsin | 10.0% | 7.0% | 4.6% |

Source: Census Bureau. Texas is omitted because its “earned surplus tax” — the functional equivalent of a corporate income tax — was not enacted until 1991. Texas is discussed in the remainder of this report, however.

of Columbia) have top nominal rates less than 6 percent. A recent report by the Congressional Research Service estimated, however, that the average *effective* state corporate income tax rate declined from 5.3 percent in 1979 to 3.8 percent in 1998.[3] (See Figure 1.)

**Figure 1**



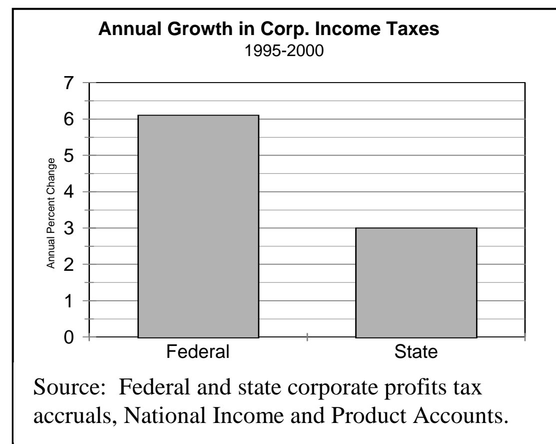

Source: Steve Maguire, Congressional Research Service, "Average Effective Corporate Tax Rates," *State Tax Notes*, September 4, 2000. Includes corporate taxes levied by New York City and the District of Columbia.

Finally, it seems particularly note-worthy that during the strong economic expansion of 1995-2000, state corporate income tax revenue grew at just half the rate of federal corporate tax revenue — an average of three percent annually versus six percent annual growth for the federal corporate income tax. (See Figure 2.) Since corporate income tax rates at both the federal and state level were substantially stable throughout this five-year period, the relatively slow growth of state corporate tax receipts suggests that a significant share of corporate profit that is finding its way into the federal corporate tax base may be falling through the cracks at the state level.[4]

## Closing Three Common Loopholes Could Help Stem the Erosion of the State Corporate Tax

Numerous changes are needed in most states' corporate income tax laws to reestablish this tax as a robust source of state revenue.[5] Three such changes seem particularly worthy of immediate consideration by policymakers, because the revenue that could be gained likely is substantial, the loopholes could be closed without having to make fundamental changes in the structure of the corporate tax, additional revenue could begin flowing relatively quickly, and a substantial share of the additional revenue would arise from the taxation of corporate profits that currently are escaping taxation completely. The three options are:

**Figure 2**




Source: Federal and state corporate profits tax accruals, National Income and Product Accounts.

- Enacting the "throwback rule" to ensure that profits earned in a state in which a corporation may not be subjected to an income tax are taxed instead by its home state.

- Enacting laws to nullify a corporate tax-avoidance strategy based on the use of "passive investment company" (PIC) subsidiaries, such as the well-known Geoffrey, Inc. subsidiary of Toys R Us. Such laws prevent corporations from using payments of

royalties and interest to PIC subsidiaries to siphon taxable income out of the states in which the income is actually earned and into tax haven states like Delaware and Nevada.

- Amending the definition of apportionable "business income" to strengthen the ability of states to tax capital gains realized on the sale of corporate subsidiaries and other major assets, reversions from over-funded pension plans, damage awards in lawsuits, and other irregular or extraordinary income items.

Implementing these three policy changes could make a meaningful contribution to closing current gaps between revenues and expenditures in a large number of states and help stem the long-term erosion of the corporate tax base. Each of these policies has already been implemented in approximately half the states levying corporate income taxes. None of the three are mutually exclusive or overlapping; any or all of them can be implemented in states that have not yet done so. Table 2 summarizes which states have not yet implemented each of the three policy options.

## Option 1: Eliminating "Nowhere Income" with the "Throwback Rule"

When a corporation produces and/or sells goods in more than one state, each state requires the business to pay tax on just a portion of its nationwide profit. That taxable share is calculated by an "apportionment formula" embedded in each state's corporate income tax law. The most commonly used formula assigns some of the profit to the state(s) in which the corporation produces goods and some to the state(s) in which the corporation makes sales. However, a little-known federal law, Public Law 86-272, establishes a threshold level of presence or "nexus" a corporation must have in a state before it can be subjected to a corporate income tax on profit earned in that state.[6] Public Law 86-272 frequently blocks states in which a corporation merely makes sales from imposing an income tax on the states' respective shares of the corporation's profit (as calculated by the formula).

The "throwback rule" is a fallback provision of state corporate tax law that is intended to deal with this conflict between nexus law and state apportionment formulas. The throwback rule effectively allows a state in which a corporation produces its wares to tax the profit on any sales made by the corporation into states in which the corporation has insufficient presence to be subjected to a tax on its profit from those sales. (The sales are said to be "thrown-back" for tax purposes from the state in which the purchaser is located to the state in which the seller is located.)[7] If a state does *not* have a throwback rule in effect, 50-100 percent of the profits of its resident corporations frequently will be what tax officials call "nowhere income" — profit that is earned somewhere in the United States but not subject to tax by *any* state.[8]

Not surprisingly, the multistate corporate community generally opposes the throwback rule. Its spokespersons assert that through the enactment of Public Law 86-272, Congress has implicitly decreed that corporations should not be subject to taxation in states in which they have

**Table 2**
**States that Could Raise Revenue by Enacting Throwback Rules, Closing the PIC Loophole, and Broadening the Definition of Business Income**

| | Enact Throwback Rule | Nullify PICs | Broaden Business Income Definition |
|---|---|---|---|
| Alabama | | | ● |
| Alaska | | | ● |
| Arizona | ● | | ● |
| Arkansas | | ● | ● |
| California | | | ● |
| Colorado | | | ● |
| Connecticut | ● | | See Appendix B |
| Delaware | ● | ● | See Appendix B |
| Dist. of Columbia | | ● | ● |
| Florida | ● | ● | |
| Georgia | ● | ● | See Appendix B |
| Hawaii | | | ● |
| Idaho | | | ● |
| Illinois | | | ● |
| Indiana | | ● | ● |
| Iowa | ● | ● | |
| Kansas | | | ● |
| Kentucky | ● | ● | ● |
| Louisiana | ● | ● | ● |
| Maine | | | See Appendix B |
| Maryland | ● | ● | See Appendix B |
| Massachusetts | ● | | See Appendix B |
| Minnesota | ● | | |
| Mississippi | | | ● |
| Missouri | | ● | ● |
| Montana | | | ● |
| Nebraska | ● | | See Appendix B |
| New Hampshire | | | See Appendix B |
| New Jersey | | | ● |
| New Mexico | | ● | ● |
| New York | ● | ● | ● |
| North Carolina | ● | | |
| North Dakota | | | ● |
| Ohio | ● | | ● |
| Oklahoma | | ● | See Appendix B |
| Oregon | | | ● |
| Pennsylvania | ● | ● | |
| Rhode Island | ● | ● | See Appendix B |
| South Carolina | ● | ● | See Appendix B |
| Tennessee | ● | ● | ● |
| Texas | | ● | |
| Utah | | | ● |
| Vermont | | ● | See Appendix B |
| Virginia | ● | ● | See Appendix B |
| West Virginia | | ● | ● |
| Wisconsin | | ● | ● |

no or limited physical presence. Corporate representatives argue that it therefore is unfair of states to seek to counteract this result by arbitrarily deeming the profits earned from such sales to be earned in the states to which the sales are "thrown back." The state counter-argument is that the throwback rule predates Congress' 1959 enactment of Public Law 86-272 and that Congress neither prohibited the throwback rule in P.L. 86-272 nor has acted to block states from implementing the rule in subsequent years. State representatives also argue that corporations are not entitled to have "nowhere income," and that the throwback rule is a reasonable, second-best solution to unfair restrictions on their ability to impose taxes on corporations that are, in fact, earning profits by selling to their residents. While P.L. 86-272 may prevent states from taxing the profits of some out-of-state corporations making sales to their residents, states can tax profits attributable to sales made in other states by in-state corporations. If all states had the throwback rule in effect, the partial "swap" of corporate tax bases the throwback rule effectuates would be roughly equivalent.

Some 20 states — **Arizona**, **Connecticut**, **Delaware**, **Florida**, **Georgia**, **Iowa**, **Kentucky**, **Louisiana**, **Maryland**, **Massachusetts, Minnesota**, **Nebraska**, **New York**, **North Carolina**, **Ohio**, **Pennsylvania**, **Rhode Island**, **South Carolina**, **Tennessee**, and **Virginia** — could gain corporate income tax revenue if they enacted the throwback rule. (The other 25 states with corporate income taxes already have the throwback rule in effect.)[9] Enacting the throwback rule is a simple change in a state's corporate income tax law that generally entails adding a single sentence to the statute imposing the tax: "Sales of tangible personal property are [deemed to be] in this State [for apportionment purposes] if the property is shipped from an office, store, warehouse, factory, or other place of storage in this State and the taxpayer is not taxable in the State of the purchaser." (The bracketed material has been added to clarify the meaning of the throwback rule but is not part of the rule itself.)

## Option 2: Closing the Trademark Income-Shifting Loophole

Many major corporations have implemented a corporate income tax avoidance strategy that is based on transferring ownership of the corporation's trademarks and patents to a subsidiary corporation located in a state that does not tax royalties, interest, or similar types of "intangible income." The subsidiaries often are referred to as "passive investment companies" — "PICs" — and they are most often established in Delaware and Nevada. (Delaware has a special income tax exemption for corporations whose activities are limited to owning and collecting income from intangible assets. Nevada does not have a corporate income tax at all.) Profits of the operational part of a business that otherwise would be taxable by the state(s) in which the company is located are siphoned out of such states by having the tax-haven subsidiary charge a royalty to the rest of the business for the use of the trademark or patent. The royalty is a deductible expense for the corporation paying it, and so reduces the amount of profit such a corporation has in the states in which it does business and is taxable. Moreover, the "profits" of the PIC often are loaned back to the rest of the corporation, and a secondary siphoning of income occurs through the payment of deductible interest on the loan.

It is not possible to obtain a comprehensive picture of how much otherwise taxable profit is being shifted into tax haven states through the use of PICs, because the information is

confidential. Corporations do not have to flag particular subsidiaries as being PICs nor publicly disclose payments of royalties and interest to affiliated corporations. Data gleaned from individual court cases in which PIC arrangements have been challenged by state tax officials suggest, however, that the sums involved may be enormous:

- The Delaware PIC of Toys R' Us received $55 million in royalty and other passive income in 1990 by charging the company's stores for the use of the "Toys R' Us name, trademarks, and "merchandising skills."[10]

- The Delaware PICs of the Limited/Victoria's Secret/Lane Bryant/Express retail conglomerate earned $949 million in royalty income between 1992 and 1994 by licensing the companies' respective trademarks back to the stores.[11]

- Kmart's Michigan PIC earned $1.25 billion in royalty income from 1991-95 in the same way.[12] (Michigan's Single Business Tax, its alternative to a corporate income tax, exempts intangible income.)

In other words, just three corporate groups out of thousands doing business in the United States have been shifting on the order of $750 million annually into their trademark subsidiaries located in tax haven states.

A wide variety of financial, law, accounting, and consulting firms have made a major business of helping out-of-state corporations set up and operate PICs in Delaware and Nevada. An article by an investigative reporter a number of years ago indicated how little economic substance many of the PICs established by the Delaware PIC industry appear to have:

> For a glimpse into this quiet and lucrative world, head up to the 13th floor of 1105 N. Market St.. Through smoked-glass windows, a visitor can view the high-rise headquarters surrounding Wilmington's prestigious Rodney Square: DuPont and Hercules, Wilmington Trust and MBNA. But turn back, and look inside this slender office tower. Tucked within the building's stark, upper floors, is another, hidden corporate center. Here, more than 700 corporate headquarters make up a vast and quiet business district of their own. The lobby computer lists their names: Shell and Seagram and Sumitomo, Colgate-Palmolive and Columbia Hospitals and Comcast, British Airways and Ikea, Pepsico and Nabisco, General Electric and the Hard Rock Cafe. How do 700 corporate headquarters squeeze into five narrow floors? How do 500 fit on the 13th floor alone? "Frankly, it's none of your business," said Sonja Allen, part of the staff that runs this corporate center for Wilmington Trust Corp. . . . "Some of my clients are saving over $1 million a month, and all they've done is bought the Delaware address," said Nancy Descano, holding company chief of CSC Networks outside Wilmington.[13]

Thanks to the ready availability of "brass plate" headquarters like those just described, passive investment companies can provide enormous state corporate income tax savings at a very small cost.[14] Accordingly, it seems likely that a majority of large U.S. corporations have created PICs. As of the end of 1998, approximately 6,000 PICs had been incorporated in Delaware alone, with new ones being created at a rate of 600-800 per year.[15] It was recently revealed that

there are approximately 132,000 businesses incorporated in Nevada that have no employees; many of these could be PICs.[16] A recent *Wall Street Journal* article on PICs named 50 corporations that have been involved in litigation with states regarding their use of PICs. (See the text box at right.) A recent listing by tax officials in Maryland identified an additional six companies with PICs.[17]

The states levying corporate income taxes can be broken down into three categories with respect to their vulnerability to PICs as a corporate tax avoidance mechanism:

- The corporate tax systems of approximately one-third of the corporate income tax states — Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, and Utah — are not vulnerable to the PIC tax shelter. These states effectively require corporations to add together for tax purposes the profits of the tax haven subsidiary and the corporation(s) paying the royalties and interest. This policy, called "combined reporting," is the most comprehensive approach to nullifying a wide variety of corporate tax-avoidance techniques, including PICs. (See Appendix A.)

- Seven states — Alabama, Connecticut, Massachusetts, Mississippi, New Jersey, North Carolina, and Ohio — have enacted laws that directly address artificial income shifting through the use of PICs. In slightly different ways, all seven states simply deny a deduction from gross income for royalties and interest paid to related corporations.[18]

- The other 22 corporate income tax states — **Arkansas**, **Delaware**, **Florida**, **Georgia**, **Indiana**, **Iowa**, **Kentucky**, **Louisiana**, **Maryland**, **Missouri**, **New Mexico**, **New York**, **Oklahoma**, **Pennsylvania**, **Rhode Island**, **South Carolina**, **Tennessee**, **Texas**, **Vermont**, **Virginia**, **West Virginia**, and **Wisconsin** — and the **District of Columbia** could realize additional corporate income tax revenue if they adopted combined reporting or enacted laws modeled on those of Alabama, Connecticut, Massachusetts, Mississippi, New Jersey, North Carolina, and Ohio to shut down this widespread, abusive, and costly tax-avoidance technique.[19] As discussed in Appendix A,

**Which Corporations Are Known to Have PIC Subsidiaries?**

A recent *Wall Street Journal* article identified 50 corporations that have been involved in litigation with states regarding their use of passive investment companies. The article observes that "in every case, the companies contend they haven't violated state tax laws or regulations." The companies are:

Aaron Rents
ADP, Inc.
American Greetings Corp.
Beatrice
Budget Rent-a-Car Corp.
Burger King
CompUSA
ConAgra Foods, Inc.
Crown Cork & Seal
Dover Elevator
Dress Barn
Eaton Admin Corp.
Gap, Inc.
Gore Industries
Hologic, Inc.
Home Depot USA
Honeywell International, Inc.
J.P. Stevens and Co.
Kimberly Clark Corp.
Kmart Corp.
Kohl's
Lamb Weston, Inc.
Long John Silver's
McCormick & Co.
Mallinckrodt Medical
Marsh Supermarkets, Inc.
Marsh Village Pantries, Inc.
May Dept. Stores
Novacare
Payless Shoesource, Inc.
PF Brands, Inc.
Premark FEG Corporation
R. Scientific Products
Radio Shack Corp.
Sherwin Williams
Snap on Tool
Sonoco Products Co.
Stanley Works
Staples
Sunglass Hut International, Inc.
Syms
The Limited Brands
TJX Cos.
Toys R Us
Tyson Foods, Inc.
United Refrigeration of Del.
Urban Outfitters
Yellow Freight System
York International

Source: Glenn R. Simpson, "A Tax Maneuver in Delaware Puts Squeeze on Other States," *Wall Street Journal*, August 9, 2002.

a state could adopt Massachusetts-style laws as a "quick fix" for the PIC problem and then move to the more comprehensive solution of combined reporting over the subsequent year or so.

### Option 3: Expanding the Definition of Taxable "Business Income" to Encompass Corporate Profits from Irregular Transactions

U.S. Supreme Court decisions have long made clear that the entire profit of a corporation is not necessarily subject to division by formula among all the states in which the corporation is doing business. Certain items of income must be assigned or "allocated" to a particular state for taxation. An example of such an "allocable" income item would be the interest earnings on a pool of cash being held for future corporate acquisitions rather than being used as working capital in ongoing business operations. Non-apportionable income items generally are to be assigned for tax purposes to the state in which corporate employees manage the asset(s) generating the income — often the corporate headquarters state.[20]

In recognition of these Supreme Court decisions, most state corporate income tax laws make an explicit distinction between the share of a corporation's total profit that is "business income" and the share that is "nonbusiness income." "Business income" is that portion of a corporation's annual profit that is to be divided by formula among all the states in which the corporation is taxable; "nonbusiness income" is the portion to be assigned to a particular state for taxation. Under the most common definition used by states, "'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." "Nonbusiness income" simply is defined as all income other than "business income."

Although it might not be apparent to someone not looking for tax-avoidance opportunities, this definition of "business income" has provided aggressive corporations with an enormous loophole they have used to deny many states their fair share of tax on billions of dollars worth of corporate profits. Since the definition provides that in order to constitute business income the income must "aris[e] from transactions and activity in the regular course of the taxpayer's trade or business," corporations have convinced numerous state courts that any profit earned on the disposition of property that is an *irregular* transaction is "*nonbusiness* income."[21] States that year after year have allowed a corporation to deduct from taxable income its payments into an employee pension fund have found themselves blocked by this interpretation of the business income definition from taxing the "reversion" into the corporate treasury of the amount by which the pension plan was over-funded. States that year after year have allowed corporations to deduct from taxable income depreciation expenses for plant and equipment have found themselves blocked from taxing the capital gain realized when the plant and equipment was sold.

The financial damage to states flowing from the poor wording of the standard definition of business income likely extends far beyond the loss of revenue at stake in specific cases that

states have lost in court. Corporations have won court cases in enough states that many probably have been emboldened to treat extraordinary profit items as nonbusiness income even in states in which no such cases have been decided.[22] These corporations gamble that most states in which they are doing business will be reluctant to initiate costly litigation aimed at establishing that the income is apportionable business income. Moreover, corporations are given a powerful incentive to assert that extraordinary income items are nonbusiness income by the fact that about a dozen states do not fully tax nonbusiness income items they would be entitled to tax in their entirety. (See Appendix B.)

A 1992 decision reiterated the U.S. Supreme Court's longstanding position that not all corporate income is subject to formula apportionment.[23] Nonetheless, the decision made clear that states *may* include in corporate profits subject to formula apportionment many of the irregular income items that corporations are asserting to be nonbusiness income under the traditional state law definition. The Court held that states are free to include in apportionable income the profit associated with any asset that serves an "operational function." (For example, such a standard generally would allow a state to include in apportionable business income the profit realized on the sale of a corporate subsidiary that was actively managed by the parent corporation at the time of sale.) Accordingly, leading state tax scholar Walter Hellerstein recently has advised states to bring their corporate tax laws into alignment with this Supreme Court decision through the simple device of amending the definition of business income to read: "'Business income' means all income which is apportionable under the Constitution of the United States."[24]

The states levying corporate income taxes can be broken down into three groups with respect to their treatment of business and nonbusiness income:[25]

- Six states — Florida, Iowa, Minnesota, North Carolina, Pennsylvania, and Texas — have statutes that explicitly or effectively define apportionable business income as all income that may be apportioned under U.S. Supreme Court standards, and define allocable nonbusiness income as all other income of a corporation. These states are already maximizing their ability to tax their fair share of profits arising from irregular corporate transactions.

- Some 26 states — **Alabama, Alaska**, **Arizona**, **Arkansas**, **California**, **Colorado**, **Hawaii**, **Idaho**, **Illinois**, **Indiana**, **Kansas**, **Kentucky**, **Louisiana**, **Mississippi**, **Missouri**, **Montana**, **New Mexico**, **New Jersey, New York**, **North Dakota**, **Ohio**, **Oregon**, **Tennessee**, **Utah**, **West Virginia**, and **Wisconsin —** and the **District of Columbia** could ensure that they obtain their fair share of corporate income tax revenues from irregular corporate transactions by amending their statutes to define as apportionable income all income that they are permitted to apportion under U.S. Supreme Court standards — as recommended by Professor Hellerstein.[26]

- Finally, 13 states — **Connecticut**, **Delaware**, **Georgia**, **Maine**, **Maryland**, **Massachusetts**, **Nebraska**, **New Hampshire**, **Oklahoma**, **Rhode Island**, **South Carolina**, **Vermont**, and **Virginia** — define all corporate income as

apportionable. This ensures that they are able to tax profits realized on most irregular transactions by *out-of-state* corporations. However, as discussed in Appendix B, it may unnecessarily relinquish their right to tax certain income items that truly are “nonbusiness income” under constitutional standards and which they otherwise would have the right to tax in full. These 13 states could realize additional revenues if they restored a distinction in their statutes between apportionable business income and allocable nonbusiness income, defined apportionable income as Professor Hellerstein suggests, and defined allocable income as all other income of a taxable corporation.

## Will Closing Corporate Tax Loopholes Impede a State's Economic Development?

Whenever a state contemplates increasing taxes on businesses through any mechanism, one question almost always arises: will this hurt the state's economy by driving existing businesses away or making the state a less desirable location for future business investment and job creation?

A large body of research suggests that a state's business tax structure — including the design of specific taxes and the aggregate tax burden — has at most a small impact on a state's economic fortunes.[27] Many of these studies look at the impact of state and local business taxes on business formation assuming that all other differences among states that potentially affect economic development — such as the quality of public services, the availability of an adequately-trained labor force, and the cost of energy — are being held constant. In reality, differences in these factors among states can be significantly greater than differences in tax burdens and thus have a much greater impact on the relative attractiveness of different states as a location for new business investments.

Robert Tannenwald, an economist with the Federal Reserve Bank of Boston, conducted one of the more recent studies of the effect of state tax policy on economic development. Tannenwald's study looked at the impact on manufacturing investment in five industries of total state business tax burdens, after controlling for other non-tax factors that seem likely to affect business location decisions. The study measured interstate variation in business tax burdens in a particularly careful and rigorous way. For the 22 states in the study — which included most of the major manufacturing states — Tannenwald found no statistically significant correlation between business tax burdens and the location of new investment.[28]

If — as in Tannenwald's study — *total* business tax burdens do not seem to have a significant impact on business location decisions, policymakers should be even less concerned that closing a few loopholes in just one tax would adversely affect their state's economic development. According to research by Ernst and Young economists Kevin Christensen, Robert Cline, and Thomas Neubig, state corporate income taxes account for only about 10 percent of total state and local taxes paid by corporations.[29] Thus, even if one accepted the premise that interstate differences in business tax burdens affect business location decisions, the corporate tax alone seems unlikely to be a major factor. Moreover, if enacted, the three policy changes discussed in this report likely would affect a minority of corporate taxpayers in most states.

Enacting the three loophole-closing measures discussed in this report seems particularly unlikely to adversely affect a state's attractiveness as a place to retain or locate investment and jobs. The possible change in the definition of apportionable business income addresses state taxation of the profit realized on major, irregular corporate transactions — such as pension reversions, lawsuit awards, and the sale of corporate subsidiaries. Since such transactions are infrequent and largely unpredictable, it seems quite unlikely that corporate location decisions would be affected by how extensively the profits from them would be taxed in a particular state should they occur. With respect to the other two options discussed above — enacting a throwback rule and nullifying the use of PICs — there is some objective evidence that the policies do not seem to harm the economic fortunes of states implementing them. Table 3 ranks the states levying corporate income taxes with respect to their rate of growth in manufacturing jobs — a focal point of state economic development efforts — between 1995 and 2000. (This time period was selected because it does not appear that any states changed their throwback rule policies in this interval, and it is difficult to determine exactly when throwback rule changes were made in earlier years.) Table 3 also identifies for each state whether it had a throwback rule in effect during this period, and whether it nullified the potential tax savings from PICs by mandating combined reporting. (Again, see Appendix A for a brief discussion of combined reporting. Ohio is also included in Table 3 because its anti-PIC law was in effect over this entire period.)

Although it is not a substitute for a rigorous statistical study that would control for other tax and non-tax factors that theoretically could affect relative rates of manufacturing growth among the states, Table 3 does provide some evidence that the existence of a throwback rule and the nullification of PICs does not seem to harm the ability of states to generate manufacturing jobs. Table 3 suggests that states with throwback rules and combined reporting in place are disproportionately represented among the states that experienced net manufacturing job *gains* during the economic boom of the late 1990s. This is particularly noteworthy with respect to the throwback rule, because businesses often explicitly argue that the throwback rule is a disincentive for manufacturing investment in states that adopt it.

As discussed above, there are compelling policy arguments in favor of states enacting the throwback rule, preventing corporations from siphoning profits into tax havens through the use of PICs, and adopting an expansive definition of apportionable business income. If all states with corporate income taxes took these arguments to heart and implemented all three policies, then by definition no state would be at a competitive disadvantage for having done so. Each of these options has already been adopted by approximately half of the states. The remaining states can implement them secure in the knowledge that they will not be identifying themselves as an"outlier" with respect to their corporate tax practices, let alone objectively harming their economic prospects.

**Table 3**
**Manufacturing Job Growth, 1995-2000,**
**Corporate Income Tax States With and Without "Throwback Rule" and Anti-PIC Policies in Effect**

| | Manufacturing Job Growth 1995-2000 (Percent Change) | Had "Throwback Rule" In Effect | Nullified PIC Tax-Shifting |
|---|---|---|---|
| North Dakota | 17.4% | yes | yes |
| Arizona | 10.8 | | yes |
| Kansas | 9.8 | yes | yes |
| Vermont | 8.4 | yes | |
| California | 8.4 | yes | yes |
| Idaho | 8.2 | yes | yes |
| Nebraska | 6.9 | | yes |
| Oklahoma | 6.7 | yes | |
| Colorado | 6.7 | yes | yes |
| Montana | 6.0 | yes | yes |
| Oregon | 6.0 | yes | yes |
| Utah | 5.6 | yes | yes |
| Texas | 5.2 | yes | |
| Iowa | 4.3 | | |
| Minnesota | 3.3 | | yes |
| New Hampshire | 3.0 | yes | yes |
| Kentucky | 2.5 | | |
| Wisconsin | 2.5 | yes | |
| Maryland | 2.1 | | |
| Hawaii | 1.2 | yes | yes |
| Indiana | 0.6 | yes | |
| Georgia | 0.1 | | |
| Florida | 0.0 | | |
| Ohio | -1.5 | | yes |
| Pennsylvania | -1.6 | | |
| Illinois | -1.8 | yes | yes |
| West Virginia | -2.1 | yes | |
| Massachusetts | -2.3 | | |
| Louisiana | -2.4 | | |
| Arkansas | -3.1 | yes | |
| Virginia | -3.5 | | |
| Missouri | -4.1 | yes | |
| Delaware | -4.7 | | |
| New Mexico | -5.1 | yes | |
| Tennessee | -5.7 | | |
| Connecticut | -6.0 | | |
| Maine | -6.5 | yes | yes |
| New York | -7.2 | | |
| New Jersey | -7.4 | | |
| Alabama | -7.9 | yes | |
| South Carolina | -8.0 | | |
| Mississippi | -9.3 | yes | |
| North Carolina | -9.5 | | |
| Rhode Island | -14.1 | | |
| Alaska | -18.3 | yes | yes |

## Why These Three Particular Loopholes May Warrant High-Priority Attention

There are a number of reasons these three particular corporate tax loopholes may warrant higher-priority attention from policymakers than other potential changes in state corporate income tax laws that also could raise additional revenue for states. (Again, Table 2 summarizes the states for which these three possible changes in corporate tax law are relevant.)

- As measured by corporate tax revenue foregone, it seems likely that these provisions are among the most costly loopholes in state corporate tax systems.

- Each of these loopholes can be closed easily, without any alteration of the basic structure of a state's corporate tax. Indeed, two of the three changes — enacting the throwback rule and amending the definition of apportionable business income — usually involve adding or modifying a single sentence of text in the corporate tax law.

- Making these changes in corporate tax law is likely to begin generating additional revenue fairly quickly. There is relatively little ambiguity involved in what the changes require of corporations and thus relatively little discretion for corporations to interpret the new provisions in ways that would allow them to mitigate the impact of the changes on their tax liability. Because the changes are relatively straightforward, corporations are likely to comply on their own rather than being compelled to comply by an audit and, perhaps, litigation. As a result, states may well begin to receive additional revenue from these changes in the first quarterly estimated tax payments made by corporations after the changes go into effect.[30]

Finally, these changes enable states to pull into their corporate tax bases profits that currently are avoiding taxation completely. This is inherently true with respect to enacting the throwback rule and eliminating the deduction for royalties and interest paid to related corporations in "tax haven" states. It is also likely true of the third proposed change — adopting a more expansive definition of apportionable "business income." (Again, see Appendix B for a discussion of how some states are effectively tax havens for nonbusiness income.)

Revitalizing the corporate income tax is likely to be a long-term project for most states, requiring numerous small reforms as well as fundamental changes in the underlying structure of the tax. The current fiscal crisis provides an opportunity and an incentive for states to take some important first steps down this path. The three corporate tax loopholes discussed in this report are among the most egregious provisions of any state tax. All corporations benefit when states educate their future employees, protect their property, maintain the roads they use to get their products to market, and provide the court systems that adjudicate their contract disputes. Before state policymakers deprive citizens of vitally-needed services or ask current taxpayers to pay higher taxes to close current budget gaps, they hopefully will make sure that all corporations are paying their fair share of the cost of state services that make an essential contribution to corporate profitability.

## Appendix A

## "Combined Reporting" Is a Comprehensive Solution to PICs and Other Corporate Tax-avoidance Strategies

Legislation like that adopted by Alabama, Ohio, Connecticut, Massachusetts, Mississippi, New Jersey, and North Carolina to deny parent corporations deductions for royalty and interest payments to their PIC subsidiaries has certain shortcomings. First, corporations may have reasons other than tax avoidance for paying royalties and interest to related corporations — even those in Delaware and Nevada — and it may be difficult to write a law that allows legitimate payments to occur while preventing tax-motivated payments from slipping through. Second, corporations often can realize comparable tax savings by making royalty and interest payments to corporations in a multi-corporate group other than a PIC, and, again, it may be difficult to write a law distinguishing a legitimate from a tax-motivated payment. Some policymakers in Ohio, which has had ten years more experience than the other six states in enforcing an anti-PIC statute, concluded in recent years that too much tax *was* being avoided by royalty payments to corporations other than PICs. Ohio legislators have sought to broaden the anti-PIC law, but so far they have backed down in the face of criticism that the law would invalidate legitimate inter-corporate transactions.

The greater shortcoming of anti-PIC legislation is that it addresses only one mechanism by which corporations seek to minimize their income tax liability; in the words of Maryland Comptroller William D. Schaefer, such legislation "simply treat[s] one symptom of a much larger problem."[31] Corporations can, for example, also shift income across state borders through "transfer pricing" — paying excessive amounts for goods and services purchased from related corporations in low-tax or no-tax states.

There is a comprehensive way to nullify artificial income-shifting strategies used by corporations: mandatory "combined reporting." If a state requires combined reporting, all related corporations that are operated as a single business enterprise, any part of which is being conducted in the state, are essentially treated as one taxpayer for apportionment purposes. For example, if a parent corporation owns dairy farms and a cheese processing plant in Wisconsin, a mail-order subsidiary in South Dakota that sells the cheese, and a subsidiary that operates retail stores throughout the United States that also sell the cheese, the profits of all three related corporations would be added together and apportioned to Wisconsin using its normal apportionment formula if Wisconsin required combined reporting. If one or more of these corporations owned a PIC, the PIC(s) would be included in the combined report as well.

Because combined reporting requires corporations to add together the profit of related businesses before the combined profit is subjected to formula apportionment, the corporation gains little or no advantage by shifting the profit between the various corporations in the corporate group — through PICs or any other mechanism. Sixteen states currently require corporations to determine their state income tax liability using combined reporting — Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana,

Nebraska, New Hampshire, North Dakota, Oregon, and Utah.[32] The U.S. Supreme Court has twice upheld the fundamental fairness and constitutionality of combined reporting as a means of nullifying accounting manipulation by corporations and ensuring they pay their fair share of the costs of state government.

Combined reporting is a more comprehensive long-term solution to the PIC problem than Ohio-style legislation. However, combined reporting does represent a significant change in the structure of a state corporate tax that heretofore has been based on the concept that every individual corporation in a multi-corporate group is taxed as a "separate entity." Accordingly, some policymakers may want to study the change to combined reporting in more depth than they would less sweeping changes in corporate tax law.

The process for addressing PICs and other forms of tax-motivated income shifting on the part of corporations therefore might optimally proceed in two stages. Laws like those developed by Alabama, Connecticut, Massachusetts, Mississippi, New Jersey, North Carolina, and Ohio can be enacted as a tourniquet to stop the hemorrhaging from PICs. States can study and implement a combined reporting system as rapidly as policymakers feel comfortable doing so. Three leading experts on state corporate income taxation have recently written a comprehensive article intended to assist policymakers in addressing many of the issues involved in making a transition from a separate-entity based tax to one based on combined reporting. See: Michael J. McIntyre, Paull Mines, and Richard D. Pomp, "Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana," *Louisiana Law Review*, 2001. Reprinted in *State Tax Notes*, September 3, 2001.[33]

## Appendix B

## Some States Unnecessarily Cede Their Right to Tax Some Nonbusiness Income

Some 13 states levying corporate income taxes do not distinguish in their corporate tax laws between business and nonbusiness income. These states require all multistate corporations that are subject to income taxation to apportion *all* of their income through the use of a formula. This is a beneficial policy with respect to income earned in connection with extraordinary or irregular transactions by multistate corporations that are headquartered *out of state*. In effect, the statutes of these 13 states require such corporations to treat as apportionable income all profits earned in connection with extraordinary transactions that the states are not barred from taxing by U.S. Supreme Court decisions — precisely the policy recommended by legal expert Walter Hellerstein. (See the body of the report.)[34]

Nonetheless, with respect to corporations that are headquartered *within* their borders, these 13 "full apportionment" states may be unnecessarily ceding their ability to tax some corporate profit that they have the legal authority to tax. For example, a multistate corporation headquartered in Delaware but with sales and facilities in other states might have a "35 percent Delaware apportionment factor." This means that Delaware's apportionment calculation results in a finding that 35 percent of this corporation's nationwide income is to be taxed by Delaware. Assume that this corporation earns a large capital gain from the sale of an asset that truly is non-apportionable income under U.S. Supreme Court standards, and assume further that no state other than Delaware would have the legal authority to tax the gain.[35] Delaware would only seek to tax 35 percent of the gain because it treats all income as apportionable. The other 65 percent of the gain would be "nowhere income" — profit untaxed by any state. This result occurs despite Delaware's legal authority to tax 100 percent of the gain on the transaction.

Beyond resulting in an unnecessary relinquishing of revenues they could be collecting, the fact that 13 states do not seek to tax irregular income items received by corporations headquartered within their borders to the fullest extent permitted by Supreme Court decisions arguably has quite adverse consequences for the other corporate income tax states. The tantalizing possibility that a substantial portion of a multi-billion-dollar capital gain could end up as "nowhere income" arguably encourages corporations to engage in much more aggressive tax-avoidance efforts than they otherwise might.

Take, for example, the recent case of Hercules, Inc., a Delaware-based chemical manufacturer. Hercules was subject to a corporate income tax in at least four other states in addition to Delaware — Illinois, Maryland, Minnesota, and Wisconsin.[36] Hercules wanted to get out of the business of manufacturing a particular chemical. It first spun-off the division manufacturing the chemical into a separate corporation, Himont, that was jointly owned with another corporation in the same business. Then, a few years later, Hercules sold its 50 percent share of Himont to its partner, reaping approximately a $1.5 billion gain. Right up to the time Hercules sold its interest, it was actively involved in the management of Himont and continued to purchase large amounts of the chemical from Himont as an input into other products Hercules

continued to manufacture. These facts lead many commentators to argue that the gain was apportionable income under both U.S. Supreme Court standards and the traditional "business income" definition.[37] And, indeed, the court in Wisconsin so held.

Despite facts that strongly supported the conclusion that Hercules' gain on the sale of its Himont stock was apportionable business income, Hercules in fact reported the gain as nonbusiness income to Illinois, Maryland, Minnesota, and Wisconsin.[38] Leaving aside differences in corporate tax *rates* between Delaware and the other states in which Hercules was taxable, if Delaware's corporate tax law had required Hercules to allocate 100 percent of the Himont gain to Delaware as nonbusiness income, Hercules would have been largely indifferent as to whether it treated the gain as apportionable business income or allocable nonbusiness income; 100 percent of the gain would have been taxed in either event. However, the fact that its headquarters state of Delaware was a tax haven with respect to nonbusiness income arguably provided a strong incentive for Hercules to take the aggressive position that the Himont gain was nonbusiness income. If Hercules could block any of the states in which it was taxable from re-categorizing the Himont gain as business income, a portion of the gain would go untaxed by any state. Hercules' aggressive posture paid off; courts in Illinois, Maryland and Minnesota held that the Himont gain was nonbusiness income that those states had no right to tax.

In sum, the states whose laws treat all corporate income as apportionable have — intentionally or unintentionally — implemented a beggar-thy-neighbor tax policy that may well encourage corporations to report as nonbusiness income certain major income items they would otherwise report as apportionable business income.[39] (These 13 states include such major corporate headquarters states as Connecticut, Delaware, Georgia, and Massachusetts.) If these states enacted laws to implement a distinction between apportionable business income and allocable nonbusiness income, together with the expansive definition of business income recommended by Professor Hellerstein, they would realize additional revenue and reduce the amount of untaxed "nowhere income" received by major multistate corporations.

## Notes

1. Two recent reports by the Center on Budget and Policy Priorities document the actions states have already taken to address budget shortfalls. See: Nicholas Johnson, Iris J. Lav, and Rose Ribeiro, *States Are Making Deep Budget Cuts in Response to the Fiscal Crisis*, March 20, 2003; and Nicholas Johnson, *Many Governors Are Proposing Tax Increases and Other Revenue Measures,* March 19, 2003.

2. These are averages for the states levying corporate income taxes in both years. These two years were selected to illustrate the long-term trend because they both represent the same point in the business cycle, specifically, the year before the U.S. economy slipped into a recession.

Many factors affect the trend for a particular state revealed in Table 1, including decisions to implement or increase taxes other than the corporate income tax, to cut the corporate income tax rate, or to enact other mechanisms for reducing the effective rate of corporate taxation (such as targeted tax credits). The exploitation by corporations of structural weaknesses in state corporate tax systems also contributes to the declining contribution of the corporate tax to total state taxes observed in many states, but no suggestion is intended that corporate tax planning accounts for all of the decline.

3. Steve Maguire, *Average Effective Corporate Tax Rates*, Congressional Research Service, 2000. Reprinted in *State Tax Notes*, September 4, 2000, pp. 647-650. This study examines the effective corporate income tax rate of state and local governments combined. The only local corporate income taxes of economic significance are those imposed by New York City and the District of Columbia.

4. During the past decade, there has been a growing trend toward organizing new businesses as (and converting some existing businesses to) limited liability companies, Subchapter S corporations, limited partnerships, and other so-called "pass-through entities." A pass-through entity is a business that is exempt from direct income taxation, with any profits of the business instead passed-through pro-rata to the personal income tax returns of the owners. It is often suggested that the growing use of pass-through entities is a major contributor to the declining contribution of corporate income taxes to state coffers revealed in Table 1. Proponents of this theory assert that corporations are still paying their fair share of state taxes, it is just that the profits are now being reported on the state personal income tax returns of the owners of these businesses rather than on state corporate tax returns. While this is undoubtedly true to some degree, the use of pass-throughs reduces state *and federal* corporate tax receipts. The fact that federal corporate income tax collections grew twice as fast as state corporate income taxes in the late 1990s (as revealed in Figure 2) demonstrates that whatever the contribution of pass-throughs to the figures in Table 1, loopholes that uniquely plague state corporate taxes and state corporate tax policy changes primarily account for the declining contribution of corporate income taxes to state treasuries.

5. One desirable change would be the restoration in eight states of the traditional formula for dividing the profits of a multistate corporation among the states in which it is taxable. See: Michael Mazerov, *The 'Single Sales Factor' Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?*, Center on Budget and Policy Priorities, revised September 2001.

6. State court decisions in a few states also establish a "physical presence" nexus threshold even in cases in which P.L. 86-272 is inapplicable. P.L. 86-272 does not apply to corporations earning income in a state from intangible property (such as bank loans) or the provision of services.

7. The "throwback rule" only comes into operation when a corporation has sales in a state but insufficient physical presence to be subject to corporate income tax in that state. (Most often, the physical presence is "insufficient" because it consists solely of solicitation by salespeople, which is a protected activity under P.L. 86-272.) Sales are not automatically "thrown back" from a state when that state does not levy a corporate income tax at all. For example, if a California corporation has a warehouse in Nevada — which would be sufficient physical presence for Nevada to impose an income tax on that corporation if Nevada in fact levied such a tax — the Nevada sales of that corporation are *not* thrown back to California.

8. For a discussion of how state corporate income tax apportionment formulas, nexus thresholds, and the absence of a throwback rule result in "nowhere income," see pages 1-13 of the report cited in note 5.

9. John C. Healy, Editor, *2001 Multistate Corporate Tax Guide*, Panel Publishers, 2001, pp. 616-621. Massachusetts is treated here as a state without a throwback rule because its non-standard version of the rule can be evaded easily. New Jersey and West Virginia have a variant of the throwback rule in effect — the so-called "throwout rule." An explanation of the difference between the throwback rule and the throwout rule is available from the author.

10. See: *Geoffrey, Inc*. v. *South Carolina Tax Commission*, State of South Carolina Supreme Court, Opinion No. 23886, July 6, 1993. Geoffrey, of course, is the name of the company's giraffe trademark.

11. See: *In the Matter of Secretary of Revenue v. A&F Trademark, Inc. et al*, North Carolina Tax Review Board, May 7, 2002. The Board's opinion in this case also indicates that the PICs loaned their royalty income back to the subsidiaries owning the stores, shifting an additional $237 million in profit into tax-free Delaware through the payment of deductible interest to the PICs. This case and similar cases brought against the companies by Maryland and New York have identified 11 different corporations in the corporate group as using PICs: The Limited, Inc., Abercrombie & Fitch, Inc., Bath & Body Works, Inc., Cacique, Inc., Express, Inc., Lane Bryant, Inc., Lerner New York, Inc., Limited London, Paris, New York, Inc., Limited Too, Inc., Structure, Inc., and Victoria's Secret Stores. Several of these businesses were spun off from The Limited group subsequent to the tax years at issue in these cases.

12. *In the Matter of Kmart Properties, Inc.*, decision of New Mexico Taxation and Revenue Department hearing officer No. 00-04, January 31, 2000. The case further revealed that Kmart's PIC earned an additional $78 million in interest income over the same five year period by lending its royalty receipts back to Kmart, "usually within two or three days from when they were received."

13. Joseph N. DiStefano, "In the War Between the States, Delaware is Stealing the Spoils," Gannett News Service, January 25, 1996. More recently, this same reporter documented Enron Corporation's use of PICs managed by Entity Services Group, one of the many companies that specialize in setting up Delaware PICs for out-of-state corporations. See: Joseph N. DiStefano, "Delaware a Tax Shelter for Enron," Knight Ridder Newspapers, February 4, 2002.

14. A number of states have sought to challenge PIC arrangements through audits and litigation, and private tax practitioners increasingly urge corporations to ensure that their PICs have some economic substance. (See, for example, Peter L. Faber, "Planning for the Use of Intangibles Holding Companies," *State Tax Notes*, June 15, 1998.) Even if corporation decides to protect its PIC by having an employee or two on the PIC's payroll and paying an economic consultant to certify that the PIC's royalty rate is what would be charged to an independent licensee of the trademark or patent, the tax savings remain large in relation to the costs incurred.

15. Statement of William Remington, Director of the Delaware Division of Revenue, at the "Delaware: The First Choice for Financial and Tax Planning Conference," December 15, 1998, Wilmington, Delaware. Delaware requires corporations claiming tax-free PIC status to file a form annually with the state, but the form does not require disclosure of dollar amounts of passive assets held or intangible income received. The forms are not available to the public.

16. "Corporate Fee Bills Aim to Raise $65 Million," *Las Vegas Review-Journal*, May 16, 2001.

17. The Maryland Comptroller has identified six companies as having PICs that were not listed in the *Wall Street Journal* article: A.O. Smith Corp.; Colombo, Inc.; D.R. Horton, Inc.; MCI Telecommunication Corp., Inc; Pep Boys; and SSI Medical Services, Inc.. The listing was an attachment to William Donald Schaefer, Stephen M. Cordi, Linda Tanton, and David F. Roose, *Presentation to the Commission on Maryland's Fiscal Structur*e, October 10, 2002.

18. The key language of the Ohio anti-PIC statute is as follows: “For purposes of computing its net income. . . [a] corporation shall add [back] interest expenses and costs and intangible expenses and costs directly or indirectly paid [to] . . . Any related member whose activities, in any one state, are primarily limited to the maintenance and management of intangible investments. . . “intangible investments” includes, without limitation, investments in stocks, bonds, notes, and other debt obligations. . . interests in partnerships, patents, patent applications, trademarks, trade names, and similar types of intangible assets.” Section 5733.042, Ohio statutes. For the other five states with similar anti-PIC provisions, the citations are as follows: Alabama, 2001 Special Session, HB 2; Connecticut SB 416, adopted 1998, Section 20; Massachusetts Senate Bill 1949, Section 17, adopted 2003; Mississippi, HB 1695, enacted 2001; New Jersey Assembly Bill 2501, enacted 2003; North Carolina, House Bill 1157 enacted 2001. The Massachusetts and New Jersey laws arguably nullify the use of PICs most effectively. Like several of the other state laws, the Massachusetts and New Jersey laws allow deductions for royalty and interest payments to related corporations when taxpayers can demonstrate that the payments are both reasonable and not for tax-avoidance purposes. Unlike those of the other states, however, the Massachusetts and New Jersey laws leave these two determinations to the sole discretion of the state revenue director — blocking review by courts.

19. In the *Geoffrey* case cited in note 10, South Carolina’s Supreme Court upheld the state’s position that Toys R Us’ Delaware PIC was itself taxable in South Carolina on royalties paid to it by South Carolina Toys R Us stores. Most private sector tax practitioners vehemently assert that this decision was inconsistent with U.S. Supreme Court nexus decisions, and it therefore seems questionable that many other corporations using this tax avoidance technique comply with the *Geoffrey* decision in South Carolina. Accordingly, South Carolina would be well-advised to enact a law modeled on that of Massachusetts or New Jersey to avoid the necessity of compelling other corporations’ PICs to pay corporate income tax to the state. The same is true of a few other states in which administrative law judges or lower courts have held that out-of-state trademark subsidiaries have corporate income tax nexus with the state because they license intangible property for use by related businesses present within the state.

20. Just as they include detailed apportionment rules, the corporate income tax laws of most states include detailed rules for assigning particular items of nonbusiness income to particular states. Not all nonbusiness income is assigned to the headquarters state; the assignment depends upon the nature of the income item and the asset generating it. The U.S. Supreme Court has never issued a decision setting out the parameters of which states have the authority to tax allocable, nonbusiness income items.

21. Corporations often have used the second part of the “business income” definition to bolster their position that irregular transactions do not generate business income. The definition implies that for the sale of property to generate business income, “the acquisition, management, *and* disposition of the property [must] constitute integral parts of the taxpayer’s regular trade or business operations.” (Emphasis added.) Corporations frequently have argued that profits arising from the liquidation or sale of an entire corporate subsidiary or division never generate business income since the disposition of property associated with the cessation of business is not part of a corporation’s “regular. . . operations.”

22. Business/nonbusiness income cases are highly fact-specific. Accordingly, even if a state has won a court decision that, for example, pension reversion income is apportionable business income, corporations may well claim in that same state that gains on the sale of a subsidiary are nonbusiness income until there is a specific court decision to the contrary.

23. *Allied Signal* v. *New Jersey*. The Court ruled that profits flowing from a more-or-less “passive” holding of an investment remain subject to direct allocation for tax purposes to the state in which the investment is managed.

24. Walter Hellerstein, “The Business-Nonbusiness Income Distinction and the Case for Its Abolition,” *State Tax Notes*, August 22, 2001. Professor Hellerstein’s proposal to amend the traditional definition of business income seems to be motivated primarily by a desire to put an end to wasteful litigation and inconsistent and confusing decisions from state courts with respect to the business-nonbusiness income distinction. Nonetheless, he acknowledges that “If an asset was used in a taxpayer’s trade or business, there is no reason as a matter of principle why income generated by the disposition of that asset should be treated any differently from the income the asset

generated while it was used in the taxpayer's trade or business, namely, apportioned among the states in which the business was conducted. . . Moreover, insofar as gain from the disposition of property used in the taxpayer's business represents recoupment of expenses deducted from apportionable income while the property was used in the business (e.g., depreciation, advertising, and research and development expenses), it lends additional support to. . . [apportionability of the gain]. It would be incongruous (and, from the state's standpoint, inequitable) for a taxpayer to be able to reduce in-state apportionable income through depreciation or other deductions while the asset was being used in the trade or business and then, when the asset is sold, to avoid "recapture" of that income. . . .[by] treating the income from the sale as nonbusiness income allocable to another state." Professor Hellerstein also points out, correctly, that it is possible for inconsistent state treatment of a particular income item as business and nonbusiness income to result in double taxation of that item, also an undesirable outcome from a tax policy and tax fairness standpoint.

25. The categorization of states in this paragraph requires some subjective interpretation of state corporate income tax statutes. It relies upon and is generally consistent with the categorization of states in the following two sources: John C. Healy, Editor, *2001 Multistate Corporate Tax Guide*, Panel Publishers, 2001, pp. 666-671, and Frederick W. Campbell-Craven, Jack L. Harper, Deborah H. Mayer, and Glenn A. Smith, *Future of the Functional Test*, unpublished paper prepared for the 2000 California Tax Policy Conference.

26. Some of the 26 states that do not define business income as Professor Hellerstein recommends nonetheless have managed to obtain court decisions upholding their ability to include in apportionable income certain profits attributable to irregular corporate transactions, notwithstanding the presence in their tax codes of the problematic standard definition of "business income" discussed above. Others have tried to solve the problem by amending their definitions of business income to read "'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management *or* disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." (Emphasis added.) Still others have non-standard definitions of apportionable income that are ambiguous and arguably fall short of the constitutional limit. All of these states would be well-advised to minimize any potential adverse litigation in the future by amending their statutes to provide explicitly that all income that may be apportioned under constitutional standards is apportionable under their state law — as recommended by Professor Hellerstein.

27. See pp. 27-30 of the source cited in note 5 for a discussion of this literature.

28. Robert Tannenwald, "State Business Tax Climate: How Should It Be Measured and How Important Is It?" *New England Economic Review*, January/February 1996, pp. 23-38.

29. "Total Corporate Taxation: Hidden, Above-the-Line, Non-Income Taxes," *State Tax Notes*, November 12, 2001, p. 529. The estimate covers 1999. A more recent paper by some of the same authors estimates that corporate income taxes represented just 8.3 percent of the total state and local taxes paid by Fortune 1000 corporations in 2002. See: Robert Cline, William Fox, Tom Neubig, and Andrew Phillips, "A Closer Examination of the Total State and Local Business Tax Burden," *State Tax Notes*, January 27, 2003, p. 299.

30. Although these are significant loopholes, the revenue that would be generated by closing them likely would be small in relation to total corporate tax collections in most states. Given normal wide swings in state corporate tax receipts, states generally will not be able to attribute any revenues to these changes until they conduct corporate audits to confirm that the changes were, in fact, complied with. This typically would not occur until several years after corporate tax returns are filed.

31. William Donald Schaefer, Stephen M. Cordi, Linda Tanton, and David F. Roose, *Presentation to the Commission on Maryland's Fiscal Structur*e, October 10, 2002.

32. In addition, Tennessee requires combined reporting by banks.

33. The article is also available at http://www.law.wayne.edu/mcintyre/text/Combined_reporting_LSU.pdf.

34. Of course, the statutes nominally assert that the corporations must even report as apportionable those income items that Supreme Court decisions bar states from treating as such. Since the Constitution trumps state law, however, a corporation that is confident that a particular income item is non-apportionable under Supreme Court standards is likely to refrain from reporting the income to these states in the first place.

35. As noted in note 20, the U.S. Supreme Court has not issued any decisions that give clear guidance as to which state(s) have the right to tax non-apportionable income. It seems likely that the corporate headquarters state would have the sole right to tax certain items of non-apportionable income (such as interest earned on pool of cash being held in reserve for future corporate acquisitions) and that other states might have a right to tax other non-apportionable income items. (For example, the gain on the sale of a factory that has been idle for many years arguably might be non-apportionable income and arguably might be taxable only by the state in which the factory is located rather than headquarters state of the company that owns it.) In order to simplify the discussion, the text in the body of the paper suggests that "full-apportionability" states are ceding their ability to tax only allocable income received by corporations headquartered within their borders. The point of this note is to acknowledge that these 13 states do not necessarily have the right to tax all allocable income received by companies headquartered within their borders. Conversely, however, the 13 states may also be ceding their ability to tax certain items of income that should be allocated to their tax base by corporations *not* headquartered within their borders (e.g., the gain realized on the sale of the long-idle factory if the factory is located within their borders).

36. *Hercules, Inc*. v. *Illinois Department of Revenue*, Illinois Court of Appeals, June 29, 2001; *Hercules, Inc*., v. *Maryland Comptroller of the Treasury*, Maryland Court of Special Appeals, May 1, 1997; *Hercules, Inc*. v. *Minnesota Department of Revenue*, Minnesota Supreme Court, March 12, 1998; *Hercules, Inc*. v. *Wisconsin Department of Revenue*, Wisconsin Tax Appeals Commission, February 26, 1997.

37. For example, Professor Hellerstein has criticized the Minnesota and Maryland court decisions as taking "too narrow a view of the 'operational function' concept," the precondition for finding that the Himont gain was apportionable business income. Hellerstein and Hellerstein, *State Taxation: Corporate Income and Franchise Taxes*, 1999, section 8-133. Cited in *Hercules, Inc*. v. *Illinois Department of Revenue*, Illinois Court of Appeals, June 29, 2001.

38. Hercules initially reported the Himont gain as apportionable income in Maryland, presumably because Maryland is one of those states whose statutes require all income to be apportioned. Hercules later filed an amended tax return in Maryland re-categorizing the gain as non-apportionable income and seeking a refund of overpaid taxes. In the other three states, it treated the Himont gain as nonbusiness income on the originally-filed tax return.

39. Kansas has also enacted a law that allows a corporation to elect to treat all of its income as apportionable.