May 5, 2017

INSTITUTE ON TAXATION AND ECONOMIC POLICY REPORT MISLEADS POLICYMAKERS AND THE PUBLIC

On April 27, the Institute on Taxation and Economic Policy (ITEP) released a report (hereinafter "ITEP study") claiming that 240 of America's largest and most profitable corporations "…avoided a total of $126 billion in state corporate income taxes over the eight years [from 2008-2015]." *["3 Percent and Dropping: State Corporate Tax Avoidance in the Fortune 500, 2008 to 2015"]* The ITEP study repackages and rebrands a 2014 study ITEP released in conjunction with its sister organization, Citizens for Tax Justice *[see "90 Reasons We Need State Corporate Tax Reform: State Corporate Tax Avoidance in the Fortune 500, 2008 to 2012" (*available at www.ctj.org)*]*. These reports are deeply flawed in both their analysis and conclusions.

The latest ITEP study, like the earlier version, focuses exclusively on a decline in state and local corporate income taxes as driving the need for "tax reform," and decries corporate tax "avoidance" generally. In so doing, it distorts the true composition of business tax payments to state and local government, and misleads policymakers and the public regarding the overall picture of corporate contributions to state revenue systems. It is unfortunate that the report, purportedly a comprehensive research paper, is so overtly political in its scope and message. It is equally unfortunate that the authors decided to republish much of their material in the face of our criticism of the earlier version [see *"Updated Citizens for Tax Justice Report Misleads Policymakers and the Public"* (Council On State Taxation; March 31, 2014)].

1) What the Authors Deliberately Left Out:

As is the case with any study, **readers should ask themselves what the study excludes**. In the case of the ITEP study, the answer to this question is enlightening:

- The ITEP study looks at only state and local corporate income taxes. The study does not include franchise, net worth, capital stock, gross receipts, excise or other similar business taxes paid to state and local governments. Perhaps more importantly, the study also excludes all property taxes, sales taxes (paid by companies on their business purchases, not on consumer sales), and state payroll taxes paid by companies during those eight years.

- **In FY 2015, businesses paid over $707.5 billion in total state and local taxes.** Of that amount, total state and local corporate income and other business activity tax revenue was **$67.3 billion**.[1] Thus, the taxes ITEP chose *not* to mention are **over 10 times larger** than the taxes ITEP chose to include in the study. In other words, **the ITEP study covers only about 9.5% of total state and local business taxes** even factoring in gross receipts taxes imposed in lieu of corporate income taxes in certain states.

- **The remaining $640 billion paid to state and local governments by businesses in FY 2015 are distributed as follows:**

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[1] See "Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2015"; December 2016; p. 3. Ernst & Young LLP and Council On State Taxation; http://www.cost.org/WorkArea/DownloadAsset.aspx?id=94697

- $258 billion in property taxes to state and local governments;
  - $150 billion in general sales taxes on business inputs (exclusive of amounts collected and remitted on behalf of the states on consumer purchases);
  - $193 billion in business license taxes, premiums taxes, and public utility, severance, excise, and other business taxes; and
  - $39 billion in in individual income taxes on business income.[2]

- **Why is this important?** By neglecting to include a full accounting of all the taxes businesses *do* pay to states and localities, the ITEP study can falsely make the claim that corporations are "shirking their tax responsibilities to state and local governments" (p. 18). Their omission also facilitates the study's implication that certain businesses are not "paying their fair share" of state and local taxes (p. 17). And while reasonable persons may disagree on that issue (although businesses pay on average about 45% of all state and local taxes year after year), it is quite misleading to deny readers of the study sufficient data to make that determination themselves.

2) The Study Ignores the Primary Reason for the Decline in Corporate Income Taxes:

- The ITEP's eight-year study of specific corporations is framed by the assertion that state corporate income taxes have long been declining due to three "broad causes:" 1) federal corporate tax cuts; 2) "ill-advised" tax incentives; and 3) "tax shelters created by corporations armed with creative accounting staffs." The study ignores perhaps the greatest reason for the decline in state corporate income taxes – the tremendous growth in the use of limited liability companies (LLCs) and other pass-through entities whose owners report their income and pay taxes through state *personal* income tax returns. Most states did not recognize LLCs until the mid-90s. Since then their use has grown exponentially as business owners recognized the benefits of a single-level tax coupled with limited liability protection. Since 1980, the number of C corporations has been on the decline while the number of pass-through entities has almost tripled.[3] Accordingly, their contribution to U.S. business income jumped from 21 percent in 1980 to 54 percent in 2011.[4] Indeed, flow-through businesses account for over 90 percent of all business entities – in 2014, 28.3 million out of 30.8 million business entities were pass-through enterprises that employed 57 percent of the private sector workforce.[5]

- Thus, when the ITEP study (p. 4) calls on state policymakers to increase the corporate income tax burden on large corporations in order to "creat[e] a level playing field between large businesses and 'mom and pop" businesses" it is grossly misleading, **since the vast majority of "mom and pop" businesses pay no state corporate income taxes whatsoever.**

3) The Study Labels as Tax "Avoidance" Ordinary Deductions and Credits Approved by the Legislature:

- To reach its alarmist conclusions, **ITEP ignores laws enacted by democratically elected legislators**. For ITEP, a company whose corporate effective tax rate is lower than the top statutory rate is somehow "avoiding" taxes. ITEP conveniently fails to acknowledge those deductions and credits that legitimate tax policy experts would not question, such as the deductions for net operating

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[2] Id.
[3] Pomerleau, Kyle, "An Overview of Pass-Through Businesses in the United States;" Tax Foundation; January 2015.
[4] Belsie, Laurent; "Who Owns U.S. Business? How Much Tax Do They Pay?" The National Bureau of Economic Research; January 2016.
[5] Greenberg, Scott; "Pass-Through Businesses: Data and Policy;" Tax Foundation; January 17, 2017.

losses. If ITEP had conducted a similar analysis on individual income taxes, **it would ignore child care credits, personal exemptions, the home mortgage interest deduction,** and a myriad of other deductions and credits. It would then argue that individuals who claim these deductions and credits were somehow "avoiding" taxes they should have been paying.

4) ITEP Is Apparently Unconcerned with Economic Development:

- **Economic development is discussed only as a negative** in the ITEP study. The study bemoans "elected officials often find it difficult to resist entreaties from corporations for tax breaks." This negative impression of economic development demonstrates a serious disconnect between ITEP and the overwhelming majority of state policymakers. Most of those policymakers make informed decisions to willingly trade lower corporate income tax collections for **job and investment growth**, which in turn drives other state and local tax revenues. As noted above, state and local tax revenues derived from non-income-based business taxes dwarf state corporate income tax collections.

- **The study also takes a distorted view of state tax incentives**. As noted above, public officials offer tax incentives to corporations because they believe the incentives will benefit the jurisdiction by increasing *jobs*. Those jobs can have a dynamic multiplier effect on state revenues – by increasing personal income taxes, sales taxes, property and other taxes, and by stimulating additional economic growth through increased economic activity. The ITEP study focuses solely on whether the incentive is a "giveaway" to the recipient. That is not the point. Reasonable persons may certainly disagree over the systemic value of state tax incentives, but it is misleading and demagogic to focus solely on the incentives' benefit to the recipient.

5) The ITEP Study Distorts the Details:

The study takes advantage of the public's lack of awareness of the complexities of the state corporate income tax system and information available from company financial reports. The following are but a few of the additional ways that **ITEP plays on public ignorance to distort the facts**.

- **Cherry-Picking the Data**. The study purports to include only companies with earnings over the eight-year period, but the authors admit they have manipulated those audited book earnings to adjust for accounting methods the authors disagree with – despite the fact that companies are required to follow such accounting methods under Generally Accepted Accounting Principles (GAAP). These adjustments, by their very nature, will **always** increase the book income measure.

- **False Assumptions.** The study admits to making the false assumption that the company's annual report data on state taxes equals the state income taxes actually "paid" in any given state or even in total for that year. The financial provision for state tax expense, under GAAP, includes the results of prior year audit settlements occurring in the current year, other deferred tax expenses, and any other items from prior years that impact the current financial statement. Accordingly, comparing the state income tax provision on the financial statements to a percentage of "U.S. Profits" as determined by the authors is a comparison of apples and oranges.

- **Legitimate Deductions.** The ITEP authors fail to acknowledge the legitimate impact of net operating loss (NOL) carryovers created during the latest recession. When a corporation incurs a loss, state and federal tax laws allow the company to offset that loss against future (and past) earnings. NOL provisions are designed to avoid penalizing companies for the artificial difference between the annual tax reporting cycle and the normal business cycle. Thus, a significant loss in one year can impact the amount of tax a company pays in both prior and subsequent years.

- **Outdated Methods.** The study, astonishingly, recommends mandatory worldwide combined reporting – a reporting methodology that was thoroughly discredited in the 1990s when our foreign trading partners threatened retaliatory taxation against the US for states' use of the methodology. No states currently impose mandatory worldwide combined reporting against general businesses.

- **Skewed Data.** The study's findings are skewed by the fact that seven states – Michigan (until 2012), Nevada, Ohio, South Dakota, Texas, Washington, and Wyoming – did not impose a state corporate income tax during the years in question. However, four of those states – Ohio, Michigan (until 2012), Texas and Washington, imposed a version of a gross receipts tax that was, in effect, a stand-in for a state corporate income tax. None of the revenues collected under those taxes appear to have been considered under the study. Further, even among states with a corporate income tax, such taxes are imposed on vastly different entity and income bases. Thus, to extrapolate an "average" tax rate from an aggregate number in company financial reports is meaningless.

- **Improper Disclosure.** The study calls on states to "require corporations to disclose publicly, on a state-by-state basis, the amount of corporate income tax they pay and the major factors determining that liability (or lack thereof)." Taxpayers have a justifiable expectation of privacy. The proposition that confidential tax returns should be made available for public inspection so the public can determine whether a taxpayer is paying a "fair share" is fundamentally wrong. Under IRC Sec. 6103, federal income tax returns and tax return information are confidential and not subject to disclosure. In addition, even the sharing of federal tax return information with a state or local government is prohibited unless that state or local government is likewise required to protect the information.

- **Flawed "Tools."** The report recommends several "tools" to close what the authors perceive to be "corporate loopholes" in the state corporate income tax -- including combined reporting and "throwback" of sales receipts in the apportionment formula – but fails to note that states have been addressing these issues for decades. The report fails to mention that the majority of states without combined reporting have enacted "addback statutes" that effectively prevent income shifting between corporate entities. The report also fails to note that the throwback rule has been derided by leading public policy economists as a policy that taxes "the wrong income, by the wrong state, at the wrong rate."[6]

Conclusion:

ITEP's exclusive focus on state corporate income taxes is likely to resonate with uninformed readers, particularly individuals whose primary contact with our federal tax system is through the personal income tax. The informed reader, however, should understand that the study ignores over-taxation at the state and local level of many businesses through income and non-income taxes. These non-income taxes are more than 10 times greater than the state corporate net income tax, and must be included in any responsible and serious discussion of state business tax burdens. **ITEP's proposals to collect more corporate income taxes are decades old and have been duly considered and rejected by legislatures in many states**. Most legislators, unlike ITEP, are more concerned with job and investment growth than adopting policies that would make their states less competitive in our global economy.

Questions regarding this rebuttal should be directed to Doug Lindholm at 202/484-5212.

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[6] Fox, Luna and Murray, "How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?", *National Tax Journal*, March 2005.