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The Florida Center for Fiscal & Economic Policy

## TARGETED AND THOUGHTFUL STATE TAX REFORM: THE CORPORATE INCOME TAX

In the current regular session of the Florida Legislature, House Bill 1237 (Gelber) and Senate Bill 2766 (Deutch) were introduced. These bills are designed to begin reducing Florida's "giveaways" in its corporate income tax. Florida has had a decade in state tax reductions without any meaningful relief to those most in need and without correcting inequities. Instead, we ended up eliminating massive amounts of state government revenues that are needed to meet state responsibilities in education, health, public safety, infrastructure and other services. We have estimated that closing the "giveaways" in the state corporate income tax would produce almost \$2 billion annually.<sup>1</sup> Although these bills do not address all loopholes in our corporate income tax, they certainly highlight the most "egregious" ones and will result in a stronger, more equitable state tax structure. The bills propose to use the money raised to increase state support of higher education and public schools (thereby reducing the increased local property taxes mandated by the legislature over the past five years).

The corporate income tax, adopted after an overwhelming vote of Floridians in 1971, is the one tax in Florida's tax structure that places an equitable burden on wealthy and corporate interests.<sup>2</sup> The remainder of Florida's tax structure is highly regressive where the low and middle-income taxpayer pays a far greater percentage of his or her income than the wealthy or corporate interests. The same is true for small local businesses when compared to large corporate taxpayers who are able to use large-scale tax avoidance planning.

In earlier reports,<sup>3</sup> we noted that in recent years the state has repealed, reduced or failed to close loopholes in a number of state taxes. Most tax reductions have lessened taxes on corporate and individual wealth and increased the responsibility for financing local services through higher local property taxes and regressive user fees. These additional state loopholes and tax exemptions currently amount to over \$5 billion annually and are estimated to cost \$30 billion over the next five years.

### REFORMS NEEDED FOR FLORIDA'S CORPORATE INCOME TAX

- Requiring Combined Reporting<sup>4</sup> to shut down a wide variety of abusive corporate income-shifting techniques, with an estimated revenue impact of \$364.5 million (according to 2007 Florida Tax Handbook).
- Enacting an "Add-back" expense rule<sup>5</sup> to assure that corporations cannot use "foreign tax havens" to avoid Florida corporate income tax (no current estimate of revenue impact).

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**The Florida Center for Fiscal and Economic Policy (FCFEP)** is an independent, nonprofit, non-partisan organization engaged in research and education on state fiscal and economic matters with particular attention to their impact on low and moderate/middle income Floridians and local small businesses owned by, and employing, Floridians. FCFEP's mission is to perform and review research on state-level fiscal and economic matters with particular attention to their impact on low and moderate/middle income families and individuals and indigenous small businesses owned by, and employing, such families and individuals.

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- Enacting the “Throwback Sales” rule<sup>6</sup> to assure that corporations are paying tax on their full incomes (estimated revenue impact of \$37.2 million, according to 2007 Florida Tax Handbook.
- Decoupling from 2004 federal § 199 Domestic Production Deduction<sup>7</sup> giveaway (estimated revenue impact of \$ 85-139 million, growing to \$130-210 million by 2010, according to the Center on Budget and Policy Priorities.
- \* Decoupling from the new federal “bonus depreciation<sup>8</sup>” giveaway provided in § 103 of the federal Economic Stimulus Package signed by the President in February.
- \* Decoupling from new federal § 179 Expensing Allowance expansion<sup>8</sup> to \$250,000 (from \$25,000) under § 102 of the federal Economic Stimulus Package signed by the President in February.

\* **Note:** These two issues will be the subject of the annual “piggyback” bill to adopt changes in the Federal Internal Revenue Code that affect Florida’s corporate income tax code. Their combined total impact as estimated by the Consensus Estimating Impact Conference is \$146.8 million for FY 2008-09 and \$76 million for FY 2009-10.

- Of six states with Corporate Income Taxes but no Personal Income Taxes, only AK and FL exempt S-Corps and “limited liability companies” (LLCs) from the regular corporate income tax. This exclusion (taxes are paid through personal income taxes in other states) results in a tax loss to Florida of \$963.6 million for “Subchapter S” corporations and \$249.8 million for Limited Liability Companies.

More details about the options facing states in reforming their corporate income taxes may be found in several recent publications by the Center on Budget and Policy Priorities (as noted in the end-notes) <http://www.cbpp.org>.

## PROPOSED FLORIDA CORPORATE TAX REFORM

The current proposed legislation provides for recovering between \$350-400 million in lost revenues for the state corporate income tax by:

1. Requiring all corporations doing business in Florida to calculate their taxes on the basis of a “combined report” of their business operations within the United States, generally including the parent corporation and most or all its subsidiaries.”

Almost half the states (21) with corporate income taxes have adopted “combined reporting.” Five states have enacted the reform in the last four years, and several others have seriously considered doing so. A major reason for states’ growing interest is their recognition of how badly corporate tax shelters that exploit the lack of combined reporting are eroding state corporate tax payments.

Corporations have devised a wide variety of strategies to artificially shift profits to out-of-state subsidiaries. For example, the Wall Street Journal<sup>9</sup> estimated that “rent” payments to a wholly-owned Real Estate Investment Trust (REIT) subsidiary led to a state tax savings for Wal-Mart of roughly \$350 million over just four years. The varied ways of avoiding state taxes that are stopped by combined reporting are discussed in detail in a recent (October 21, 2007) Center on Budget and Policy Priorities report cited in endnote 4.

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2. Requiring all corporations doing business in Florida to add back to their taxable income expenses that have been taken as deductions (such as royalties paid to passive investment trusts, rent paid to “captive” REITs and premiums to captive insurance companies owned by the parent company) when paid to a subsidiary in a foreign “tax haven” as defined in the bill.

A number of states have enacted “add-back rules” such as these to prevent abusive tax-avoidance in their corporate income tax laws. The provision authorizes the Department of Revenue to add-back expenses that are clearly meant to avoid Florida’s corporate income taxes. A recent opinion by the Alabama Court of Civil Appeals has upheld that state’s “add-back” provision; see endnote 5.

### ADDITIONAL AMENDMENTS THAT ARE DESIRABLE

We recommend that in addition to closing the above loopholes, the legislation should be further amended to address at least these additional shortcomings (several of them resulting from federal tax policy):

3. Stop the ability of corporations doing business in Florida from having “nowhere income” that escapes taxation in all states. This can be achieved by requiring all corporations that “export” sales from the state to treat these sales as if they were made in Florida if the corporation is not taxable in another jurisdiction in which it has customers.

More than half the states (25) with corporate income taxes have adopted this so-called “throw-back sales” rule.<sup>10</sup> 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. 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” and thus profit that is earned somewhere in the United States but not subject to tax by *any* state. See endnotes 6 and 10.

4. Decoupling the state from the 2004 federal § 199 Domestic Production Deduction

Almost one-half the states (18) with corporate income taxes have already disallowed this deduction from their corporate income tax. Initially, the revenue losses were relatively low because the initial deduction was limited to three percent of qualifying income. As of January 1, 2007, however, the percentage rate is rising to six percent, with another increase to nine percent scheduled for 2010. As a result, revenue losses to states likely will double during this fiscal year and will at least triple by 2010.

The resulting loss for Florida is estimated at \$85-139 million this year and climbing to \$130-210 million by 2010. See endnote 7.

**AS ALSO NOTED ABOVE**, the Florida annual “piggyback” bill should be amended to exclude the economic stimulus package’s bonus depreciation and additional expensing limits, thereby, saving the state an estimated \$146.8 million in next fiscal year (FY 2008-09) and \$76.0 million for FY 2009-10 (consensus impact estimates from their 2-14-08 meeting).

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1. “State Taxes in Florida,” October 2007 state policy brief, Florida Center for Fiscal & Economic Policy at [www.fcsep.org](http://www.fcsep.org)

2. In 2003, the Institute on Taxation and Economic Policy (ITEP), a non-profit, non-partisan research and education organization that works on government taxation and spending policy issues, released a comprehensive report entitled, “Who Pays? A Distributional Analysis of the Tax Systems in All 50 States”, 2nd Edition<sup>2</sup>. The following is an abbreviated list of the report’s findings: The 10 Most Regressive Tax States

Ten states — Washington, Florida, Tennessee, South Dakota, Texas, Illinois, Michigan, Pennsylvania, Nevada and Alabama — are particularly regressive. These ten states ask their poorest residents — those in the bottom 20 percent of the income scale — to pay up to a five-and-a-half times greater share of their earnings in taxes than they ask the wealthy to pay. Middle-income families in these states pay up to three-and-a-half times higher a share of their income as the wealthiest families. (These figures are before the benefits the wealthy enjoy from federal itemized deductions and before the plethora of tax eliminations on the wealthy and corporate interests in Florida are calculated.)

### The Ten Most Regressive State Tax Systems

#### Taxes as Shares of Income by Income for Non-elderly Residents, 2002

Income Group	Taxes as a Percent of Income on Income Group				
	Poorest 20%	Middle 60%	Top 1%	Poor/Top 1%	Middle/Top 1%
Washington	17.6%	11.2%	3.3%	537%	343%
Florida	14.4%	9.8%	3.0%	476%	325%
Tennessee	11.7%	8.9%	3.4%	347%	264%
South Dakota	10.0%	8.4%	2.3%	440%	369%
Texas	11.4%	8.4%	3.5%	331%	244%
Illinois	13.1%	10.5%	5.8%	224%	180%
Michigan	13.3%	11.2%	6.7%	199%	168%
Pennsylvania	11.4%	9.0%	4.8%	238%	187%
Nevada	8.3%	6.5%	2.0%	420%	331%
Alabama	10.6%	9.6%	4.9%	216%	195%

*Note:* States are ranked by the ITEP Tax Inequality Index. The ten states in the table are those whose tax systems most increase income inequality after taxes compared to before taxes.

3. See 2007 reports on property tax options listed at our website, [www.floridafiscal.org](http://www.floridafiscal.org).

4. For more information, see Michael Mazerov, “STATE CORPORATE TAX SHELTERS AND THE NEED FOR “COMBINED REPORTING,” October 26, 2007, Center on Budget and Policy Priorities, [www.cbpp.org/10-26-07sfp.htm](http://www.cbpp.org/10-26-07sfp.htm)

5. See recent Alabama case upholding that state’s right to require the “add-back” of expenses in which a subsidiary corporation in a foreign jurisdiction received “royalty” or other expense payments that the Alabama Department of Revenue determined was solely for the purpose of avoiding the state corporate income tax. G. Thomas Surtees, in his official capacity as commissioner of the Alabama Department of Revenue, and the Alabama Department of Revenue v. VFJ Ventures, Inc., f/k/a VF Jeanswear, Inc. Alabama Court of Appeals, February 8, 2008.

6. For more information, see Michael Mazerov, “CLOSING THREE COMMON CORPORATE INCOME TAX LOOPHOLES COULD RAISE ADDITIONAL REVENUE FOR MANY STATES,” Revised May 23, 2003, Center on Budget and Policy Priorities, [www.cbpp.org/5-23-03sfp.htm](http://www.cbpp.org/5-23-03sfp.htm).

7. For more information, see Nicholas Johnson, “STATE REVENUE LOSSES FROM THE FEDERAL “DOMESTIC PRODUCTION DEDUCTION” WILL DOUBLE IN 2007 States Could Save Billions by Disallowing This Deduction,” January 2, 2007, Center on Budget and Policy Priorities [www.cbpp.org/1-02-07sfp.htm](http://www.cbpp.org/1-02-07sfp.htm).

8. For more information, see Nicholas Johnson and Iris J. Lav, “BONUS DEPRECIATION” AND “EXPENSING” WOULD COST STATES BILLIONS OF DOLLARS, January 22, 2008, Center on Budget and Policy Priorities, [www.cbpp.org/1-22-07sfp.htm](http://www.cbpp.org/1-22-07sfp.htm).

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9. Wal-Mart Cuts Taxes By Paying Rent to Itself, By Jesse Drucker from [The Wall Street Journal Online](#) February 5, 2007.

10. 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. 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.