The Florida Senate

Interim Project Summary 2004-137 *November 2003*

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WHY DID FLORIDA'S CORPORATE INCOME TAX REVENUE FALL WHILE CORPORATE PROFITS ROSE?

SUMMARY

Florida's corporate income tax has fallen as a percentage of total state personal income, and its contribution to General Revenue has also been declining in recent years. Revenue from this source failed to grow as fast as corporate profits during the recent economic expansion. The failure of this tax source to keep up with economic activity has three major causes: tax exemptions, credits, and subtractions provided in the Florida corporate tax code; tax avoidance behavior by corporations such as creation of passive investment companies and "nowhere income," and changes in federal tax law that affect Florida tax collections.

The single largest exemption to the Florida corporate income tax is the exemption for chapter S corporations, which is estimated to amount to at least $700 million annually. Exemptions for limited liability companies and master limited partnerships account for a loss of $60 million annually.

Taxpayer avoidance activity can be based on separate reporting, such as creation of passive investment companies and use of transfer pricing to hide profits, or can involve replacing taxable business income with nonbusiness income that is not taxable in Florida. Businesses that reincorporate in offshore locations can avoid federal and state income taxes. If Florida tax laws were changed to limit taxpayer avoidance, General Revenue would be increased by $250 million to $500 million annually.

Federal tax policy has affected Florida corporate income tax (CIT) revenue by encouraging the growth of pass-through entities and by providing for accelerated depreciation. The Tax Reform Act of 1986 provided incentives for both C corporations and unincorporated businesses to become S corporations. The growth in S corporations has had a significant effect on Florida CIT revenue because these entities are exempt under the Florida tax code. More recently, other federal actions have led to decreases in the state's CIT revenue. The Job Creation and Worker Assistance Act of 2002 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 contain a provision known as "bonus depreciation," which allows a business to claim an immediate additional deduction of 30 or 50 percent (respectively) of the cost of new equipment put into use in a specified period. While many states chose to de-couple their corporate income tax laws from these provisions to avoid revenue losses, Florida affirmed its intention to adopt bonus depreciation provided by the Job Creation and Worker Assistance Act of 2002 in ch. 2002-395, L.O.F. If Florida adopts the corporate piggyback bill in 2004 (thereby conforming to the additional depreciation provision of the federal law) it will reduce CIT revenue for FY 2003-04 by more than $50 million, with additional losses in subsequent years.

There are several changes in the Florida Income Tax Code that could be made to prevent further erosion from tax avoidance strategies by corporations that are taxable under current law:

1. Adopt combined reporting to nullify the use of passive investment companies and other corporate tax avoidance strategies.
2. Enact a throwback rule to eliminate "nowhere income."
3. Amend the definitions of business income and nonbusiness income to reflect current practices in manufacturing under license.

Based on existing estimates of the impact of adopting these changes, doing this would make it possible to reduce the tax rate to 4.5 percent without reducing tax revenue.

The Legislature should further consider the tax-exempt status of S corporations and limited liability companies.

BACKGROUND

Florida's corporate income tax has been an important source of General Revenue since its inception in 1972, accounting for close to ten percent of the fund through most of the 1970s and 1980s. In recent years, however, corporate income tax revenue has failed to keep up with growth in corporate profits or economic activity in Florida, and its contribution to General Revenue has fallen every year since FY 1996-97. It accounted for less than 5 percent of General Revenue in FY 2002-03.

The corporate income tax rate was 5 percent of net income until 1984, when it was increased to 5.5 percent. Since then it has not changed, so decreases in corporate tax revenue with respect to corporate profits and business activity in the state must be attributed to other factors. Possible causes include tax exemptions, subtractions, deductions, and credits enacted by the state, changes in taxpayer behavior to avoid the tax, and changes in the federal tax code on which Florida's tax is based.

METHODOLOGY

The decrease in corporate income tax revenue as a percent of Florida personal income can be attributed to three broad categories of causes:

- The enactment of tax exemptions, credits, and subtractions from Federal Taxable Income by the Florida Legislature;
- Changes in taxpayer behavior to take advantage of tax avoidance opportunities; and
- Federal actions that have affected Florida tax revenue through the state's adoption of the federal tax code.

This report examines state and national tax revenue statistics to determine the overall magnitude of the revenue loss, and looks at specific causal factors to determine their importance. It also looks at threats to the corporate income tax from potential federal legislation.

FINDINGS

Corporate income tax receipts tend to rise and fall with the business cycle, reflecting changes in the profitability of corporations. Viewed over the past 20 years, however, corporate income taxes have decreased as a percent of other measures of economic activity. Florida personal income, total General Revenue, and U.S. corporate profits have all grown faster than collections from the corporate income tax. This trend is also present nationally in total state corporate taxes, which have fallen relative to GDP and total state taxes since the mid-1980s. State corporate income tax collections have also fallen as a percent of corporate profits since the late 1980s, even though the level of nominal tax rates has not changed since 1987. Rate-adjusted revenues have fallen by about one-third since 1989 compared to corporate profits. During the economic expansion of 1995-2000 state corporate income tax revenue grew at just half the rate of federal corporate tax revenue, suggesting that much of the corporate profit that makes up the federal tax base is escaping state taxation.

How the Florida Tax Code Limits Corporate Income Tax Revenue

The single largest exemption to the Florida corporate income tax is the exemption for chapter S corporations, which is estimated to amount to at least $700 million annually. For federal tax purposes, these corporations are considered "pass-through entities," meaning that their income passes through to the owners and is taxed as personal income. Since Florida has no personal income tax, their income is exempt from all state taxation. (Of the five states that have a corporate income tax or other business activity tax, but little or no personal income tax, only two—Florida and Alaska—exempt S corporations from taxes imposed on other corporations.) Changes in federal law have increased the number of businesses eligible for this category, and it is the now the single largest corporate entity form, accounting for 56.7 percent of all U.S. corporate returns in 2000. The number of S corporations has increased at an annual rate of 9.5 percent since the adoption of the Tax Reform Act of 1986, which allowed many more C corporations and unincorporated businesses to become S corporations. Taxable C corporations have declined by 1.2 percent annually for the same period.

Limited liability companies (LLCs) and master limited partnerships are also exempt from Florida corporate income tax and are treated as pass-through entities by the IRS. An exemption for LLCs was created in the Florida Statutes in 1998. In 1997, there were 5,392 LLCs registered in Florida. By December 2002 this number had grown to 38,639, showing an annual growth rate of 69.6 percent. If LLCs and master limited partnerships were subject to tax, they would pay an estimated $60 million annually.

The 100 percent credit for contributions to scholarship-funding organizations has also significantly reduced

CIT revenue. The 100 percent tax credit was created in 2001 for corporate contributions to scholarship funding organizations. Total credits available each year under this program were capped at $50 million for FYs 2001-02 and 2002-03. In 2003 the cap was increased to $88 million annually, but this increase was delayed by one year in an October 2003 special legislative session.

How Corporations Avoid Florida Corporate Income Tax

Many features of state corporate income tax laws make it possible for multi-state businesses legally to avoid these taxes. State and local tax planning has become more important, and corporations have become more adept at exploiting features of state tax structures that allow them to avoid these taxes. Tax avoidance strategies fall into four main categories: creation of separate but related corporations, avoidance of nexus to create "nowhere income," conversion of apportionable business income to non-apportionable income through the use of manufacturing under license, and offshore incorporation. These tax avoidance strategies take advantage of the ability to create legally separate business entities in multiple states, even though the businesses work together to perform a common business purpose. Corporations that operate entirely within Florida cannot take advantage of these strategies.

Category One: Creation of Separate but Related Corporations

Many major corporations have implemented tax avoidance strategies that take advantage of states' separate reporting provisions. One such strategy 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 income. These subsidiaries are often referred to as passive investment companies (PICs) and they are most often established in Delaware and Nevada where such income is not taxed. Profits from business activity that would otherwise be taxable in the states where it occurs are siphoned out of these states in the form of royalty payments to the PICs. Passive investment companies are only one mechanism by which corporations try to minimize their income tax liability through separate reporting. Corporations can also shift income across state borders through "transfer pricing" that is not arm's length and involve paying excessive amounts for goods and services purchased from related corporations in other states. These tax-avoidance strategies are not possible in those states that require combined reporting for related corporate entities. It is estimated that the revenue impact for Florida of adopting of combined reporting could range from $238 million to as high as $500 million.

Example of How to Avoid Tax Through Separate Reporting

Acme Inc. is a multistate corporation with 10 percent of its payroll, 10 percent of its property, and 30 percent of its sales in Florida. It apportions 20 percent of its income to Florida (10% x 25% + 10% x 25% + 30% x 50%).

Acme Inc. has revenue of $100 million from sales of products. Its costs are labor ($50 million), materials ($20 million) and rent ($20 million). It has $10 million in profits, and the Florida share of profits is $2 million.

Acme's Florida corporate income tax is ($2 million-$5,000) x 5.5%, or $109,275.

If Acme Inc. forms Acme Holding Inc., a subsidiary corporation located in Delaware that holds all of Acme's trademarks and patents, it can avoid Florida's corporate income tax without changing any of its Florida operations. Instead of having $10 million in profits, if it pays $10 million to Acme Holding Inc. in royalties, no taxable income remains in Florida.

Under combined reporting, Acme Inc. and Acme Holding Inc. would be required to report as a single entity. Royalty payments by Acme Inc. would show up as income for the combined business entity, and Florida would tax its apportioned share of that income.

Category Two: Avoidance of Nexus to Create "Nowhere Income"

Another way corporations can avoid state income taxes is through the creation of income that is not taxable in any state. This "nowhere income" often results from the interaction of states' apportionment formulas and Public Law 86-272, which provides that an out-of-state corporation cannot be subjected to a state's corporate income tax merely because it solicits sales within the state's borders. A throwback rule can resolve this conflict between states' apportionment formulas and the federal law concerning nexus by allowing a state in which a corporation makes its product to tax the profit on any sales made by the corporation into those states where the corporation lacks nexus to be subject to tax. Twenty-four states already have throwback rules in their income tax codes, and enacting a throwback rule is generally a simple change in a state's tax law. It is estimated that adopting a throwback rule in Florida would generate $18.7 million in General Revenue.

Example of Effect of No Throwback Rule

Corporations A and B are Florida-based manufacturers of health-care supplies. All their property and payroll is in Florida, and corporation A sells only to Florida customers. Corporation B sells half of its products to Georgia customers, and half to Florida customers.

Each corporation has $100 million in revenue from sales annually. Labor, materials, and rent costs are $90 million, leaving each corporation with $10 million in profits.

For corporation A, since all property, payroll, and sales are in Florida, it apportions 100 percent of its income to Florida, and its CIT= ($10 million-$5,000) x 5.5% = $549,725.

Corporation B apportions 75 percent of its income to Florida (100% x 25% +100% x 25% +75% x 50% and its CIT= ($7.5 million-$5,000) x 5.5% = $412,225. Just because it makes out-of-state sales, corporation B pays $137,500 less in Florida CIT than corporation A.

A throwback rule would tax the profits earned on corporation B's Georgia sales, as long as those sales were not subject to Georgia's CIT because of lack of nexus under Public Law 86-272.

Category Three: Conversion of Business Income to Nonbusiness Income

A third method of tax avoidance by corporations is licensing their manufacturing operations to other businesses, and designating the royalties they receive from these licensees as non-business income. If the licensee is not located in Florida the royalty income is allocated to the state where the licensor is domiciled and is not apportionable to Florida. It is estimated that taxing this income would have generated almost $40 million in 2003-04.

Example of How to Avoid Corporate Income Tax through Manufacturing Under License

Fashionista Apparel is a clothing manufacturer domiciled in South Dakota with operations in Florida. It has 10 percent of its payroll, 10 percent of its property, and 30 percent of its sales in Florida. It apportions 20 percent of its income to Florida (10% x 25% + 10% x 25% + 30% x 50%).

Fashionista has revenue of $100 million from sales of products.

Its costs are labor ($50 million), materials ($20 million) and rent ($20 million). It has $10 million in profits, and the Florida share of profits is $2 million.

Fashionista's Florida corporate income tax is ($2 million-$5,000) x 5.5%, or $109,275.

Fashionista decides to shift one-half of its production to manufacturing under license. Its profit from sales of products falls to $5 million, but it has royalties of $5 million from manufacturers that produce apparel under license. Fashionista asserts that royalties are nonbusiness income that should be allocated to South Dakota (which has no corporate income tax), not apportioned to all the states where Fashionista has sufficient presence to have corporate tax liability. For Florida, this reduces Fashionista's taxable income to $5 million and its corporate tax is ($1 million-$5,000) x 5.5% or $54,725, a reduction of $55,000.

For corporations domiciled in Florida, treating royalties as nonbusiness income could result in higher Florida taxes, since all such income is allocated to Florida, instead of being apportioned among all the locations where the corporation has property, payroll, or sales.

Category Four: Offshore Incorporation

In growing numbers, American businesses have taken advantage of Bermuda and other offshore locations to lower their federal and state income taxes, without making any changes in their actual operations. By incorporating offshore, companies avoid U.S. taxes on their overseas income, and create opportunities to transfer U.S. profits to Bermuda through some of the same methods described above for avoiding state taxes. This movement by businesses to offshore incorporation further complicates states' efforts to tax the economic activity of businesses located in their borders. "Waters Edge" or domestic combined reporting will not allow states to tax their share of the income of a business incorporated in Bermuda or some other offshore location.

How Federal Tax Policy Affects State Corporate Income Tax

The Tax Reform Act of 1986 expanded the opportunity for both C corporations and unincorporated businesses to become S corporations. The growth in S corporations has had a significant effect on Florida CIT revenue because these entities are exempt under the Florida tax code.

More recently, other federal actions have led to decreases in the state's CIT revenue. The Job Creation and Worker Assistance Act of 2002 contained a provision known as "bonus depreciation" that significantly affected the corporate income tax receipts of any state whose tax was based on the federal definition of taxable income. Bonus depreciation allowed a business to claim an immediate additional deduction of 30 percent of the cost of new equipment put into use on or after September 11, 2001, but before September 11, 2004. While many states chose to de-couple their corporate income tax laws from these provisions to avoid revenue losses, Florida affirmed its intention to adopt bonus depreciation in ch. 2002-395, L.O.F. The federal "Jobs and Growth Tax Relief Reconciliation Act of 2003" provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property for property acquired after May 5, 2003 and before January 1, 2005. If Florida adopts a corporate piggyback bill in 2004 (thereby conforming to the additional depreciation provision of the federal law) it will reduce CIT revenue for FY 2003-04 by more than $50 million, with additional losses in subsequent years.

Many major corporations are lobbying for legislation proposed by two Virginia congressmen that would restrict the authority of states and local governments to tax national companies. This proposal, called the "Business Activity Tax Simplification Act," establishes a physical presence standard for nexus for all business activity taxes. The Multistate Tax Commission has estimated that this legislation would cost the states $9 billion in annual revenue in the first few years, with the loss growing as businesses adjusted their operations to take advantage of it.

RECOMMENDATIONS

There are several changes in the Florida Income Tax Code that should be made to prevent further erosion from tax avoidance strategies by corporations that are taxable under current law:

1. Adopt combined reporting to nullify the use of passive investment companies and other corporate tax avoidance strategies;
2. Enact a throwback rule to eliminate "nowhere income;" and
3. Amend the definitions of business income and nonbusiness income to reflect current practices in manufacturing under license.

Based on existing estimates, adopting these recommendations would make it possible for the state to reduce the corporate income tax to 4.5 percent without a loss of state revenue.

The Legislature should further consider the tax-exempt status of S corporations and limited liability companies. These entities have grown much faster than taxable corporations, and their tax-exempt status represents the largest limitation to Florida's corporate income tax revenue.