Why Did Florida's Corporate Income Tax Revenue Fall While Corporate Profits Rose?

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Background

In 1971, the voters of Florida approved a constitutional amendment that allowed the state to levy a tax on the "income of residents and citizens other than natural persons." This tax was limited to 5 percent of net income or such greater rate as is authorized by a three-fifths vote of the membership of each house of the legislature. The Constitution also provides that at least $5,000 of net income shall be exempt from tax. The Legislature subsequently adopted a 5 percent corporate income tax (CIT), which quickly became a major revenue source. In fiscal year 1972-73 it accounted for almost 9 percent of the state's General Revenue.

In 1983, the Legislature significantly changed Florida's corporate income tax by:

- Adopting a worldwide unitary approach for determining income;
- Distinguishing between business and non-business income for taxation purposes;
- Adopting a throwback rule for sales to the federal government and sales into jurisdictions where the corporation was not taxed; and
- Repealing the exemption for profits from foreign sales and foreign-source dividends.

In a December 1984 special session, unitary reporting, taxation of foreign source dividends, and the throwback rule were all repealed, and the tax rate was increased to 5.5 percent.

Since 1984 the corporate income tax rate has remained unchanged, but revenue from the tax has fallen as a percent of Florida personal income and its contribution to General Revenue has shrunk to half of its original position. This report examines how the enactment of various exemptions and credits against the tax has affected corporate tax collections, how corporate tax sheltering has enabled taxpayers to decrease or eliminate their tax liability, and how federal legislation has affected Florida CIT revenue.

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

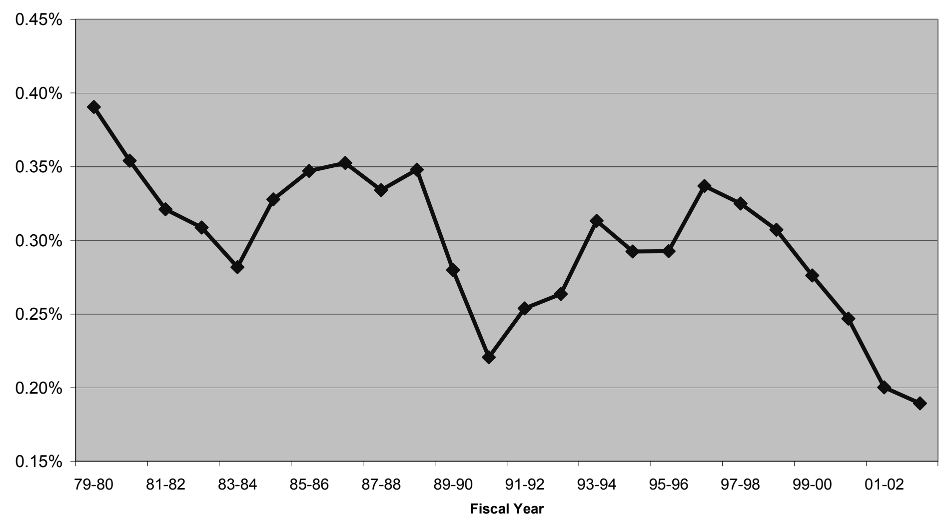
Falling Corporate Income Tax Receipts

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.[1] 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.[2]

[1] William F. Fox and Leann Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," *National Tax Journal*, Vol. LV, No. 3 September 2002 pp. 491-508.
[2] Michael Mazerov, "Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States," *Tax Analysts* Document Number: Doc 2002-10276, 11 April 2002.

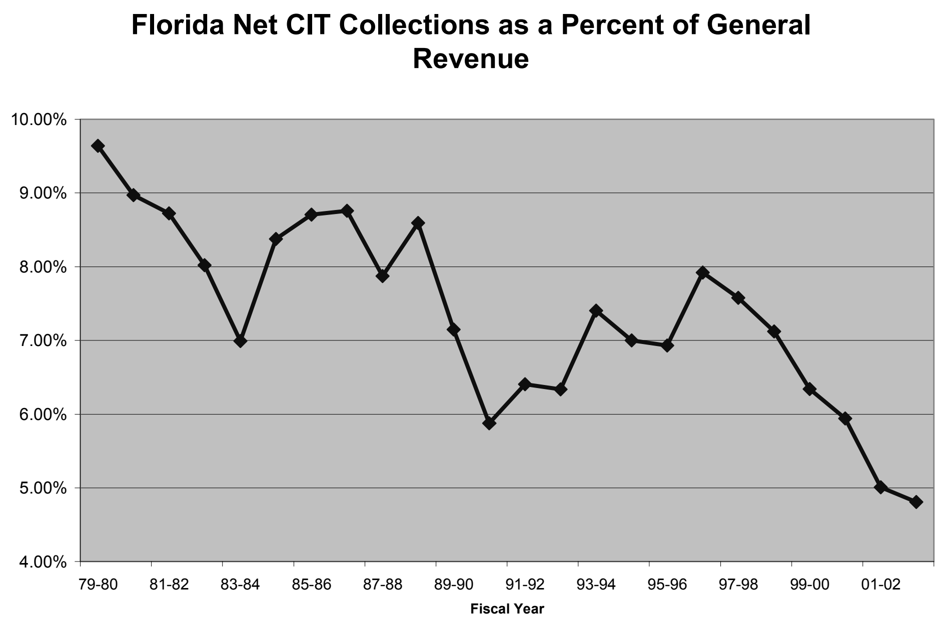
In FY 1979-80, net Florida CIT revenue[3] was equal to 0.39 percent of Florida personal income. For most of the 1980s it remained above 0.3 percent, dipping to 0.28 percent in FYs 1983-84 and 1989-90. In 1990-91 it fell to 0.22 percent of Florida personal income and since then it has been variable, reaching a high of 0.34 percent in FY 1996-97, but the general trend has been lower than the 1980s, and the share for FY 2002-03 is estimated to be 0.19 percent. If CIT revenue had grown at the same rate as Florida personal income since FY1979-80, it would have reached $1,957 million in FY 2002-03, instead of the actual $952 million.

Florida CIT Collections as a Percent of Florida Personal Income



[3] Where the data are available, net corporate income tax revenue is used in this analysis. Net revenue subtracts corporate income tax refunds (refunds of prior year overpayments) from the current year receipts.

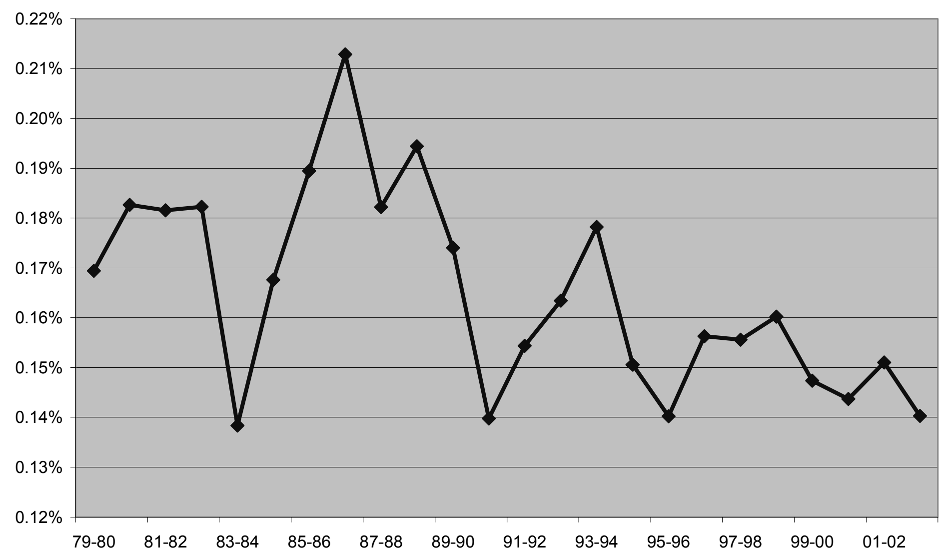
Corporate income tax revenue's contribution to General Revenue has also fallen. One hundred percent of this tax source goes to General Revenue, so losses from this source do not directly affect trust funds or local governments. In FY 1979-80, CIT revenue accounted for 9.6 percent of General Revenue, and this number was above 8 percent for most of the 1980's. In the 1990's the contribution of CIT began to drop, averaging 6.89 percent from FY 1990-91 through FY 1999-2000. Since FY 2000-01, however, CIT has never provided more than 6 percent of General Revenue. Looking at corporate income tax collections for all states, in 1979 these taxes supplied 10.2 percent of state tax revenue in states with a corporate income tax. By 2000 its share had fallen to 6.3 percent.[4]



[4] U.S. Census Bureau, as cited in Mazerov, *op. cit*.

Florida's CIT revenue has not grown as rapidly as corporate profits, an experience that mirrors the across-the-board failure of state and local corporate income tax revenue to keep up with corporate profits. A recent report by the Congressional Research Service estimated that the average effective state corporate income tax declined from 5.3 percent in 1979 to 3.8 percent in 1998.[5] From FY 1979-80 to 2002-03 U.S. corporate before-tax profits grew by 225 percent while Florida CIT revenue grew by 167 percent. (During the same period Florida's share of total gross state product grew from 3.9 percent to 4.8 percent, which would suggest that Florida CIT revenue should have grown faster than total U.S. profits.) If Florida CIT growth had equaled growth in U.S. before tax profits since FY 1979-80, it would have resulted in FY 2002-03 revenue of $1,161 million.

Florida CIT Collections as a Percent of U.S. Profits



[5] Steve Mcguire, *Average Effective Corporate Tax Rates*, Congressional Research Service, 2000. Reprinted in *State Tax Notes*, Sept. 4, 2000, p. 647. (As cited in *Mazerov, op. cit.*

Potential Causes of CIT Decline

The Florida CIT Code: Subtractions from Federal Taxable Income Tax, Apportionment, Tax Credits, and Exemptions

Article VII, section 5(b) of the Florida Constitution prohibits the imposition of a tax upon the income of natural persons who are residents and citizens of the state, and provides a $5,000 tax exemption. Florida's Income Tax Code further limits the tax, providing exemptions for certain entities, and credits, deductions, and subtractions that reduce the tax liability of otherwise-taxable entities. The impact of these statutory reductions in tax revenue has increased faster than the tax base, contributing to the slower growth of CIT revenue.

Subtractions--Computation of a taxpayer's Florida's corporate income tax liability begins with the taxpayer's federal taxable income. This amount is then adjusted by additions and subtractions provided in s. 220.13, F.S. The subtractions from federal taxable income reduce corporate income tax revenue by limiting the income subject to taxation. Many of these subtractions were part of the CIT code adopted in 1971, but subtractions for international banking facilities, net foreign source dividends, and subpart F income under s. 951 I.R.C. were added by the Legislature since then. The Department of Revenue estimates that in FY 2003-04 these subtractions reduced revenue by $65.7 million.

The subtraction for international banking facility income was enacted to provide an incentive for international banks to locate in Florida to serve the needs of businesses engaged in overseas trade and finance. Since the law was enacted, however, interstate branch banking has dramatically changed the American banking system. Major banks now operate in many states, and the subtraction of international banking facility income applies to facilities wherever they are located, so it no longer provides any incentive for Florida-based facilities.

Apportionment--Whenever a corporation operates in more than one state, some method must be used to determine what portion of its total profits is attributable to a particular state. The Supreme Court has affirmed that such apportionment of profits, but not other (non-business) income, is appropriate under the Commerce Clause of the U.S. Constitution.[6] In 1957, the Uniform Division of Income for Tax Purposes Act (UDIPTA) contained a three-factor formula, which was based on equally weighted sales, payroll, and property factors, the intent of which was to share the business income according to a proxy of where the underlying economic activity took place. States have increasingly replaced the equally weighted three-factor formula with formulas that weight the sales factor double or more than the other factors, and, as of 2002, nine states have a single sales factor apportionment

[6]*Northwestern States Portland Cement Company v. State of Minnesota* 358 U.S. 450, *Allied-Signal v. New Jersey*, 504 U.S. 768

formula for at least some taxpayers. (Florida has always double-weighted the sales factor for corporate income apportionment.) Fox and Luna (2002) report, "Some firms are winners and some are losers from changes in the apportionment formula, but the net effect is often to reduce revenues. (Richard) Pomp estimates that the net annual revenue loss (in all states) from deviation from the traditional 3-factor formula is around $500 million.[7]"

Tax Credits and Deductions --Credits against a taxpayer's corporate income tax liability have been offered as an incentive for various activities since 1980, when the Legislature enacted credits for Community Contributions and Enterprise Zone wages and property taxes. Other credits were added to encourage corporations to create jobs in rural and urban high-crime areas, provide child care facilities for employees, rehabilitate contaminated sites, operate hazardous waste facilities, and make large capital investments in certain targeted industries. The fiscal impact of these credits was limited, and their total combined revenue loss for FY 2003-04 is estimated to be $12.5 million. In 2001, a 100 percent tax credit was created for 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 the increase was delayed for one year during an October 2003 special legislative session.

In 1998, a deduction from apportioned income was created for sponsored university research and development. Real or tangible property located in Florida that is dedicated exclusively to research and development activities performed as sponsored research at a Florida university is not included in the property factor used to apportion a corporation's income to Florida. The revenue impact of this deduction is estimated to be $3 million.

Exempt Entities--The Florida Corporate Income Tax Code exempts three types of business entities from tax: S corporations, master limited partnerships, and limited liability companies. The first two are exempt as a result of Florida's use of federal taxable income as the basis for calculating tax liability. For federal tax purposes, these entities' income is passed through to their owners and is taxed as personal income. The business entities have no federal taxable income *per se*, and therefore have no Florida tax liability. The income of limited liability companies was exempted from Florida corporate income tax in 1998. The Florida Constitution also provides a $5,000 exemption for each taxpayer, (Article VII, Section 5(b)), which exempts about 20,000 corporations from all tax liability, and reduces CIT revenue by an estimated $14.4 million.[8]

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[7] Fox and Luna, *op.cit*. p. 500.

[8] Unless otherwise noted, most estimates of the revenue impact of existing exemptions and hypothetical tax law changes have been taken from the Florida Tax Handbook and indicate approximate values. They have not been adopted by the Revenue Estimating conference.

In its October, 15, 2000 issue, the National Association of State Legislatures' *State Budget and Tax News* noted a decline in state corporate income tax collections despite strong corporate profits.[9] This article notes that strategic tax planning may be behind the emerging trend of forming businesses as or converting them to S corporations or limited liability companies.

S corporations are regular corporations that receive special treatment for federal tax purposes if they meet all the criteria in Subchapter S of the Internal Revenue Code and file form 2553. Generally, an S corporation must be a domestic corporation with no more than 75 shareholders. Only individuals, estates, certain trusts, and exempt organizations can be shareholders, there can be no nonresident alien shareholders, and there can be only one class of stock. Electing to be treated as an S corporation allows the corporation's income and expenses to pass through the corporate structure to the shareholders, who are responsible for any resulting tax liability and avoids double taxation at the federal level. Since Florida does not tax personal income, S corporation income is not subject to any Florida tax. (Of the five states that have a corporate income tax or other business activity tax but little or no personal income tax—Florida, Alaska, New Hampshire, Tennessee, and Texas—only Florida and Alaska exempt S corporations from CIT or business activity tax.)

S corporations are the single largest corporate entity form, accounting for 56.7 percent of all U.S. corporate returns in 2000. The businesses are typically smaller than other corporations, their receipts amounted to 17.5 percent of total receipts, and they made up 3.8 percent of reported assets. S corporation filers have increased at an annual rate of 9.5 percent since the Tax Reform Act of 1986, which provided incentives for both C corporations and unincorporated businesses to become S corporations.[10] The number of taxable corporations has declined by 1.2 percent annually for the same period. Based on information from 1999 U.S. tax returns adjusted for growth, taxing S corporations in Florida could generate between $700 and $850 million in revenue in FY 2004-05, although the corporations could avoid some of this tax by increasing the salaries of employees who are also owners.

Master limited partnerships are business organizations with some characteristics of partnerships and some features of corporations. Like other limited partnerships, the limited partners may not participate in the control and management of the limited partnership, and can have no personal responsibility for the obligations of the limited partnership, risking only their investment. (A limited partnership must have at least one general partner who is personally liable for obligations of the partnership.) Master limited partnerships are publicly traded

[9] "Where Have All the Corporate Income Taxes Gone?" *State Budget and Tax News*, Vol. 19, No. 20; October 15, 2000 National Conference of State Legislatures.
[10] Susan M. Whitman and Amy Gill, "S Corporation Elections After the Tax Reform Act of 1986," *Statistics of Income Bulletin* Spring 1998, Internal Revenue Service.

on stock exchanges, making them more liquid than other limited partnerships. Master limited partnerships, like other limited partnerships, are not subject to federal income tax. Income flows through the partnership to the partners, and is taxed as personal income. Since Florida has no personal income tax, this income is not subject to state taxation. If these businesses were subject to Florida CIT they would have generated approximately $26.7 million in 2003-04.

Limited liability companies (LLCs), unlike S corporations and master limited partnerships, are specifically exempted from Florida's corporate income tax by s. 220.02(1), F.S. In 1997, the year before this exemption was enacted, there were 5,392 of these entities registered in Florida. By December 2002 this number had grown to 38,639, showing an annual growth rate of 69.6 percent. An LLC is treated as a partnership for federal income tax purposes, with income passing through to shareholders and taxed as personal income. Unlike a master limited partnership, an LLC is not required to have a general partner who is liable for the business's debts. An LLC may elect to distribute income without regard to shareholder interest and is subject to fewer ownership limitations than S corporations. The Florida CIT exemption for limited liability companies is estimated to reduce state revenue by $33.5 million in FY 2003-04.

Limited liability companies are business entities created under state statutes, using a structure that combines the attractive features of both partnerships and corporations. This organizational form has existed abroad since the 19th century, but is fairly recent in this country. In 1982 Florida became the second state (after Wyoming) to permit LLCs, and by 1996 all states plus the District of Columbia had adopted LLC statutes. The number of LLCs increased from a negligible amount in 1990 to about 2 percent of businesses in the mid 1990s and to more than 5 percent of businesses in 2000.[11]

LLCs offer opportunities for multi-state businesses to shift income and avoid tax liabilities. As described by Fox and Luna,[12] in a state such as Florida, which imposes no corporate tax on LLCs, a common tax planning practice among multi-state businesses is to form a Florida LLC that includes all Florida operations. A Florida corporation would own 1 percent of the LLC and the remaining 99 percent would be owned by a Delaware corporation. Delaware does not tax the ownership of intangibles, and the LLC ownership interest is an intangible asset under Delaware law. Because Florida CIT taxes only corporations, the technique effectively removes 99 percent of the Florida income from the tax rolls. By transferring operations to a Florida LLC, a business that was previously organized as a regular corporation is able to escape state taxes on 99 percent of its profits, merely by changing its organizational form. Other businesses can simply form as LLCs rather than as corporations and avoid all Florida corporate taxes.

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[11] William F. Fox and Leann Luna, "Does the Advent of LLCs Explain Declining State Corporate Tax Revenues?" Working Paper. 2002. p 4.
[12] *ibid.*.

Changes in Taxpayer Behavior to Avoid Taxation

Many features of state corporate income tax laws make it possible for multi-state businesses to legally 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. As reported by Fox and Luna, "Corporations have devised ways to avoid nexus and have also aggressively exploited the Delaware holding company and the classification of income from business income to nonbusiness income as ways to minimize their corporate income tax liability."[13] 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.

The prevalence of corporations' tax avoidance behaviors has been widely noted in the last few years, first among tax analysts and recently in the general media. At the 2002 annual meeting of the Southeastern Association of Tax Administrators, Multistate Tax Commission executive director Dan Bucks noted the decline in state corporate income tax collections and said "(t)he lion's share of the decline is due to increased effectiveness of tax planning action."[14] In that same year, research reports highlighting the decline in state corporate tax revenues and identifying tax avoidance strategies as a cause of this decline were published by Fox and Luna[15] and Mazerov.[16] More recently, articles about tax avoidance strategies have appeared in newspapers,[21,22] and several states have at least considered ways to cut down on corporate tax avoidance, with New Jersey changing its tax laws to keep businesses from shifting profits to affiliates in low tax states.[23]

Tax avoidance strategies fall into four main categories: creation of separate but related corporations, avoidance of nexus to create "nowhere income," conversion

[13] Fox and Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," p. 501.
[14] Dan Bucks, "Shelters May Force Requirement of Combined Returns," *Tax Analysts* Document Number Doc 2002-17199 24 July 2002.
[15] Fox and Luna, *op. cit.*
[16] Mazerov, *op. cit.*
[21] "Md. Court Assails Use of Tax Shelters," *The Washington Post* Tuesday, June 10, 2003
[22] "WorldCom May Have Dodged Millions in Taxes Via Delaware Sub," *The Wall Street Journal* August 14, 2003
[23] Jason White, "States Reaching for Corporate Profits," Stateline.org. May 9, 2003.

of apportionable business income to non-apportionable income through the use of manufacturing under license, and use of offshore incorporation. Each of these strategies is described below.

Passive Investment Companies (PICs) and Transfer Pricing Made Possible by Creation of Separate Business Entities

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 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. These royalty payments are often loaned back to the rest of the corporation, and a second siphoning of income occurs through the payment of deductible interest on these loans.

In a case which has become the eponym of the passive investment company strategy, Toys R Us incorporated a subsidiary (Geoffrey, named for the company's giraffe logo) in Delaware and transferred various intangibles to it. These included trademarks and the name "Toys R Us." This subsidiary licensed the intangibles back to the parent company, allowing their use in 45 states in exchange for a royalty based on net sales in each state. Geoffrey had no presence in these 45 states, and the payment of the royalty created a tax deduction for the parent company which was apportioned to the states where Toys R Us had stores. Since Delaware does not tax intangible income, Toys R Us could convert its profits into untaxed royalty payments. The state of South Carolina challenged this tax avoidance mechanism[24] and the South Carolina Supreme Court held that the taxpayer (Geoffrey) had established nexus in the state through the use of its intangibles. Fewer than half of all corporate income tax states are asserting that they would seek to uphold the Geoffrey decision, and few state courts have actually ruled on the issue. It may be difficult for states actually to know when such arrangements exist.[25]

Florida does attempt to tax the income of "Geoffrey"-type companies. Rule 12C-1.011 (1)(p), F.A.C., applies the Geoffrey decision to the Florida Corporate Income Tax and says that a corporation that licenses the use of a trade name or patent to a business entity located in Florida is subject to the corporate income tax. This rule is based on the intent language in s. 220.02, F.S., but it does not prevent corporations of taking advantage of all the tax avoidance opportunities created by separate reporting.

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[24] *Geoffrey, Inc. v. South Carolina Tax Commission*, 114 S. Ct. 550 (1993)
[25] Fox and Luna, *op. cit.* p. 502..

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 involves excessive amounts paid for goods and services purchased from related corporation in other states.

Twenty-four states, including Florida, allow separate reporting, where each separate corporation is treated as a separate taxable entity, even if they are parts of a unitary business. Mandatory combined reporting is used by 22 states to nullify artificial income-shifting strategies. In states that require domestic (or "Waters Edge") combined reporting, the United States income of all related corporations that are operated as a single business enterprise, any part of which is being conducted in the state, is treated as accruing to a single taxpayer for apportionment purposes. Under combined reporting, there is no advantage gained by shifting profit between various corporations in a corporate group, through PICs or any other means.

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. If it pays 10 percent of its total sales to Acme Holding Inc. in royalties, Acme Inc.'s costs equal its revenue, and no taxable income remains to be taxed by Florida.*
>
> *Under combined reporting, Acme Inc. and Acme Holding Inc. would be required to report as a single entity. The costs of Acme Inc.'s royalty payments would cancel out Acme Holding Inc.'s royalty income, and Florida would tax its apportioned share of the income of the combined businesses.*

According to Eugene Corrigan, former legal counsel for the Illinois Department of Revenue and executive director of the Multistate Tax commission, "Combination can enable a state to cope with any situation in which a corporation is using a unitary affiliate to immunize income from the state's tax. The concept simply takes into account the activities and profits of unitarily related corporations in determining the state income tax liability of a corporation that is subject to the taxing jurisdiction of the state."[26]

The U.S. Supreme Court has twice upheld the constitutionality of mandatory combined reporting. Estimates of the revenue impact for Florida adopting of combined reporting range from $238 million[27] to as high as $500 million.[28]

Nowhere Income

When a corporation produces or sells goods in more than one state, each state is entitled to tax only a portion of its profits, and the taxable share is calculated by an apportionment formula. Most apportionment formulas are based on payroll, property, and sales of the corporation in a state, although some states apportion on the basis of sales only. Florida apportions on the basis of payroll, property, and sales, but the sales factor is "double-weighted" so that it is twice as important as the other factors. A federal law, Public Law 86-272, 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. This law can interact with the sales factor in the apportionment formula in a way that allows a corporation with out-of-state sales to receive large amounts of "nowhere income." A corporation with all its sales in Florida, on the other hand, is taxed on all its income.

A throwback rule can resolve this unequal treatment of multistate and Florida-only corporations by imposing tax on the profit on any sales made by corporations into states where they lack nexus to be subject to tax on those sales. According to a 2001 report, if a state does not have a throwback rule in effect, 50 to 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.[29]

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.[30] It is estimated that adopting a throwback rule in Florida would generate $18.7 million

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[26] Eugene Corrigan, "'The Long View': Combination Revisited" Tax Analysts Document Number: Doc 2003-12842, May 19, 2003.
[27] *Florida Tax Handbook*
[28] Kim Eisenbart, "Florida's Corporate Income Tax Base Erosion and Proposed Solutions," (unpublished research report) 2003, pg. 28.
[29] Michael Mazerov, "The Single-sales-Factor Formula: A Boon to Economic Development Or a Costly Giveaway?" *State Tax Notes*, April 24, 2001.
[30] Michael Mazerov, "Closing three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States," Tax Analysts Document # Doc 2002-10276, 11 April 2002.

in General Revenue.[31]

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.*

Business v. Nonbusiness Income

The Florida CIT Code follows the standard UDITPA (Uniform Division of Income for Tax Purposes Act) distinction between business income, which is apportioned, and non-business income, which is allocated to the state in which the corporation is domiciled. Rule 12C-1.003(4), F.A.C., defines business income as 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. Further, Rule 12C-1.016, F.A.C., defines "nonbusiness income" to mean all income other than business income.[32]

In recent years, manufacturing businesses have expanded their operations by hiring other companies to manufacture their products under license. Licensing involves granting permission to a company (licensee) to manufacture and sell one or more of the licensor's products within a defined market area. The company that obtains these rights (the licensee) usually agrees to pay a royalty fee to the

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[31] *Florida Tax Handbook*

[32] Florida Department of Revenue, *Survey of Corporate Income Tax and Emergency Excise Tax,* General Tax Administration Program Training, August 2001.

original owner.[33] For consumers, products manufactured under license are indistinguishable from products manufactured by the licensor. As businesses have turned to licensees to manufacture their products, they have asserted that income arising from royalty fees is not apportionable business income, but instead is nonbusiness income that should be allocated to the state (or foreign location) where the licensee operates, since their regular course of trade or business is manufacturing, not the licensing of intangible assets. 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.

Use of Offshore Incorporation

In growing numbers, American businesses have incorporated in Bermuda and other offshore locations to lower their federal and state income taxes, without making any changes in their actual operations. According to reports in the New

[33] *Product Licensing*, http://www.cbsc.org/alberta/search/display.cfm?Code=4018&coll=FE_FEDSBIS_E

York Times,[34] becoming a Bermuda company is a paper transaction that involves little more than securing a mailing address there and paying fees. There is no requirement that any business actually be conducted in Bermuda, and no company officers need to relocate there. Moving a business's address to Bermuda is being recommended by many legal, accounting, and investment advisers. 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.

Insurance companies were among the first American companies to move offshore, where they can avoid most insurance regulations and reduce their tax bills, but manufacturing companies have also followed the trend. Stanley Works estimated that by moving to Bermuda it could reduce its tax bill from $110 million to $80 million, Ingersoll-Rand announced that it would save at least $40 million a year, and Tyco International said that its move to Bermuda incorporation saved it more than $400 million in 2001.

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. At the 2003 Annual Meeting of the Federation of Tax Administrators, Richard D. Pomp said, "If you don't have (worldwide) combined reporting, you don't have control of your tax base; tax planners control your tax base…. Worldwide combined reporting would stop the reincorporating offshore. All that is needed (by states) is some backbone, but that's in short supply."[35]

How Federal Corporate Tax Law Changes Have Affected State Tax Collections

As mentioned above, 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. On March 9, 2002, the Job Creation and Worker Assistance Act of 2002 became law. This act, also known as the Economic Stimulus Package, 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

[34] David Cay Johnston, "U.S. Companies File in Bermuda to Slash Tax Bills " *The New York Times* February 18, 2002, and "Now, a Corporate Push to Avoid State and Local Taxes," *The New York Times* July 18, 2002.
[35] Karen Setze, "Expert at FTA: Adopt Combined Reporting, Save Corporate Tax," *Tax Analysts* Document Number Doc 2003-14642.

deduction of 30 percent of the cost of new equipment put into use on or after September 11, 2001, but before September 11, 2004.

Many states that had previously followed federal depreciation rules decoupled from the federal code, disallowing the new bonus depreciation. In 23 states the decoupling resulted from, or was confirmed by, explicit legislative action following enactment of the federal law. Six states decoupled automatically under pre-existing tax law and one state decoupled under a ruling from the state tax commissioner. Some states have historically not conformed to federal depreciation, and three states have no corporate income taxes. Three states (including Florida) passed laws to conform to bonus depreciation. Thirteen states' statutes provided for automatic conformation.[36] The current revenue estimating conference estimate of the impact on Florida revenue of conforming to the federal law is a loss of $85.8 million in FY 2003-04 and $31.8 million in FY 2004-05.

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. This is similar to the bonus depreciation provision of the Job Creation and Worker Assistance Act of 2002, except that the additional deduction is 50 percent (instead of 30 percent) and it applies to 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.

Proposed Federal Legislation

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.[37] This proposal, called the "Business Activity Tax Simplification Act," establishes a physical presence standard for nexus for all business activity taxes.[38] It would expand the provisions of P.L. 86-272, currently limited to soliciting sales of tangible personal property, to activities related to soliciting sales of services. It would also go beyond P.L. 86-272's current application to state and local income taxes and would apply these physical presence standards to all business activity taxes, even those not based on income. The physical presence standard would mean that states could not assert nexus over companies that have only intangible assets in the state, providing further legal

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[36] Nicholas Johnson, "Many States Are Decoupling from Federal "Bonus Depreciation" Tax Cut," Center on Budget and Policy Priorities, Washington, D.C. September 26, 2002.
[37] David Cay Johnston, "Now, a Corporate Push to Avoid State and Local Taxes,*" The New York Times*, July 18, 2002.
[38] "Business Activity Taxes," presentation before the Task Force on State and Local Taxation of Telecommunications and Electronic Commerce, Co-chairs: Senator Steve Rauschenberger, Illinois and Senator Letitia Van de Putte, Texas

justification for the use of passive investment companies. The Multistate Tax Commission 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.

Despite the decline in state corporate income tax revenue in recent years, one of the sponsors of this proposed legislation has said that "(i)t will curb the tax frenzy on the part of those states imposing unreasonable taxes" on companies that do sales, nominal advertising or sell online into a state.[39] This bill is being driven by the growth of electronic commerce and the sales of intangible products and services, and by corporations wanting more opportunities to use the tax avoidance schemes described previously, such as passive investment companies and creation of nowhere income.

Recommendations

There are several changes in the Florida Income Tax Code that the Legislature should consider 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 preliminary impact estimates, adopting these changes would allow a revenue-neutral tax rate reduction to 4.5 percent.

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 most important limitation to Florida's corporate income tax revenue.

[39] David Cay Johnston, *op. cit*.

Appendix

Appendix A - Florida Corporate Income Tax Revenue and Related Measures

Fiscal Year	Florida Corporate Income Tax Revenue ($ millions)	Florida Corporate Income Tax Refunds ($ millions)	Net Florida Corporate Income Tax Revenue ($ millions)	Net CIT Revenue ans a Percent of Gross CIT Revenue	Florida Personal Income ($ millions)	Net Florida Corporate Income Tax as Percent of Florida Personal Income	U.S. Corporate Before-Tax Profits ($ billions)	Net Florida Corporate Income Tax as Percent of U.S. Corporate Before-Tax Profits	Florida General Revenue ($ millions)	Net Florida Corporate Income Tax as Percent of Florida General Revenue
					28,972					
79-80	371.4	14.8	356.6	3.98%	91,318	0.39%	210.5	0.17%	3,699.4	9.64%
80-81	402.5	25.6	376.9	6.36%	106,460	0.35%	206.4	0.18%	4,202.3	8.97%
81-82	419.5	35.8	383.7	8.53%	119,497	0.32%	211.3	0.18%	4,398.5	8.72%
82-83	424.1	25.5	398.6	6.01%	129,172	0.31%	218.7	0.18%	4,971.4	8.02%
83-84	471.1	67.2	403.9	14.26%	143,279	0.28%	291.9	0.14%	5,778.4	6.99%
84-85	555.0	29.9	525.1	5.39%	160,167	0.33%	313.3	0.17%	6,268.1	8.38%
85-86	644.0	41.8	602.2	6.49%	173,545	0.35%	317.8	0.19%	6,919.4	8.70%
86-87	738.3	79.0	659.3	10.70%	186,964	0.35%	309.8	0.21%	7,528.4	8.76%
87-88	798.7	108.3	690.4	13.56%	206,645	0.33%	379.0	0.18%	8,769.9	7.87%
88-89	898.5	100.1	798.4	11.14%	229,459	0.35%	410.7	0.19%	9,288.8	8.60%
89-90	808.1	108.1	700.0	13.38%	250,011	0.28%	402.2	0.17%	9,789.1	7.15%
90-91	701.6	119.5	582.1	17.03%	264,018	0.22%	416.5	0.14%	9,906.4	5.88%
91-92	801.3	106.2	695.1	13.25%	273,809	0.25%	450.4	0.15%	10,850.8	6.41%
92-93	846.6	90.7	755.9	10.71%	286,901	0.26%	462.5	0.16%	11,925.2	6.34%
93-94	1,047.4	96.4	951.0	9.20%	303,576	0.31%	533.6	0.18%	12,844.2	7.40%
94-95	1,063.4	118.5	944.9	11.14%	323,133	0.29%	627.6	0.15%	13,494.6	7.00%
95-96	1,162.7	155.1	1,007.6	13.34%	344,367	0.29%	718.7	0.14%	14,533.4	6.93%
96-97	1,362.3	129.5	1,232.8	9.51%	366,016	0.34%	788.7	0.16%	15,565.2	7.92%
97-98	1,395.7	124.4	1,271.3	8.91%	391,215	0.32%	817.0	0.16%	16,772.7	7.58%
98-99	1,472.2	205.2	1,267.0	13.94%	412,432	0.31%	790.8	0.16%	17,789.4	7.12%
99-00	1,406.5	217.2	1,189.3	15.44%	430,607	0.28%	806.9	0.15%	18,752.5	6.34%
00-01	1,344.8	206.3	1,138.5	15.34%	461,382	0.25%	792.2	0.14%	19,159.7	5.94%
01-02	1,218.5	255.2	963.3	20.94%	480,847	0.20%	637.7	0.15%	19,228.2	5.01%
02-03*	1,228.1	267.1	961.0	21.75%	507,189	0.19%	685.1	0.14%	19,982.5	4.81%

*U.S. Corporate Before-Tax Profits is an estimates