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Reforming State Corporate Income Taxes Can Yield Billions

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In this installment of Academic Perspectives on SALT, the authors argue that the current crisis is the perfect time to make revenue-raising reforms to state corporate income taxes — reforms that would have been desirable policy improvements even during an economic upturn, but that are even more clearly good policy moves in light of the current and upcoming state economic and budgetary crises.

I. Introduction

The federal government should be providing states and localities with hundreds of billions of dollars in aid.[1] The arguments against such aid, including the claim that the states have somehow been profligate, do not stand up to scrutiny.[2] Nevertheless, it seems unlikely that the federal government will do enough,[3] and it is already the case that the federal government is acting too slowly. States and local governments, which generally operate under balanced budget constraints, are, accordingly, already making sweeping cuts[4] that will deepen the recession and reduce services when they are most needed.

Rather than make these cuts, it would be better to raise taxes on those that can afford to pay.[5] In this essay, we will focus on one such set of taxpayers — large multinational corporations that have long circumvented both the state and federal corporate income taxes. Better yet, the reforms we propose represent good tax policy more generally: They are fair, efficient, and administrable. This essay is a contribution to Project SAFE: "State Action in Fiscal Emergencies"[6] — an academic effort to help states weather the COVID-19 economic crisis by providing policy recommendations backed by research.

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[1] *See, e.g.*, Neil H. Buchanan, "Disaster Relief to States and Cities Is Both Right and Good: Part 1 of 2," *Verdict*, May 14, 2020; Buchanan, "Disaster Relief to States and Cities Is Both Right and Good: Part 2 of 2," *Verdict*, May 18, 2020.

[2] Richard C. Auxier, "McConnell's Attempt to Blame States for COVID-19 Budget Shortfalls Is Wrong and Dangerous," Urban Institute and Brookings Institution, Tax Policy Center, Apr. 24, 2020. Needless to say, there is also extraordinary hypocrisy given that the president and his congressional allies approved deficit-exploding tax cuts during an economic expansion.

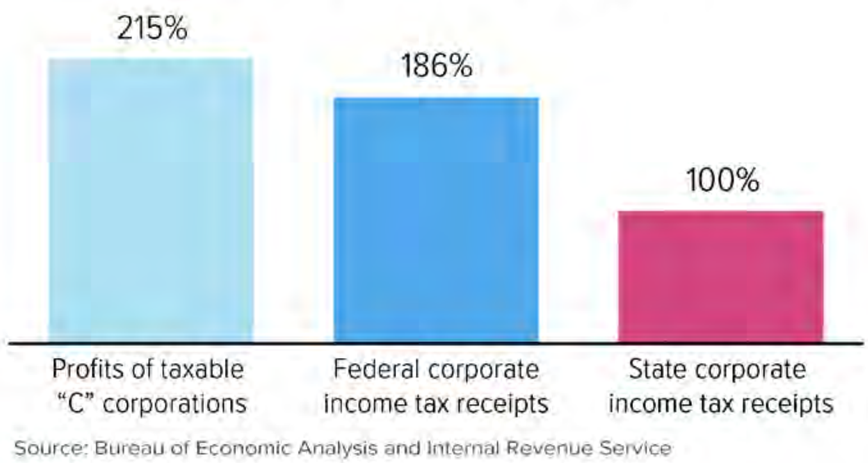
[3] Emily Cochrane, "GOP Split Over State Aid That Could Mostly Go to Democratic Strongholds," *The New York Times*, May 11, 2020.

[4] Amanda Albright, "States, Cities Cut Payrolls by Nearly 1 Million Over Shutdown," *Bloomberg*, May 8, 2020.

[5] David Gamage, "Preventing State Budget Crises: Managing the Fiscal Volatility Problem," 98 *Cal. L. Rev.* 749 (2010). *See also* Gamage and Darien Shanske, "States Should Consider Partial Wealth Tax Reforms," *Tax Notes State*, May 18, 2020, p. 859.

[6] *See* Gladriel Shobe et al., "Introducing Project SAFE (State Action in Fiscal Emergencies)," *Tax Notes State*, Apr. 27, 2020, p. 471.

Figure 1.
State Corporate Tax Receipts Have Significantly Lagged Federal Receipts
Percent change, 1993-2013



Source: Michael Mazerov, "Legislators: Don't Feel Guilty about Taxing GILTI," NCSL Task Force on State and Local Taxation, Nov. 17, 2018.

Before proceeding, a skeptic might note that state corporate income taxes represent only about 3 percent of state taxes, or about $53 billion per year,[7] while estimates of the states' need range from $500 billion[8] to $1 trillion.[9] There is no question that the reforms we propose in this essay will not raise $500 billion. Nevertheless, all the reforms we propose have the potential to raise substantial amounts of revenue. For instance, moving to worldwide combination has been reasonably estimated to have the potential to raise about $17 billion per year for the states.[10] That is a substantial amount on its own. Several of the other reforms below are of similar magnitude. Our back-of-the-envelope estimate for a deemed repatriation tax, outlined below, indicates a revenue potential for the states as high as $25 billion, or even significantly higher.

To be sure, the recession might suppress some of these projections, but maybe not by that much, given that some firms are going to be very profitable during this pandemic. Further, if states put these reforms in place now, their revenues will not only bounce back faster, but they may be able to borrow against this anticipated future revenue right now.[11]

That the numbers here can be large should not be too surprising; the yield of the state corporate income tax has fallen sharply over the last few decades, even relative to the decline in federal corporate income taxes. In a sense, the reforms we propose would serve to partially restore the state corporate income tax bases to their prior levels.

For those still skeptical, here is another — albeit noisy — data point regarding the money that most states have left on the table, from New Jersey's experience:

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[7] U.S. Census Bureau, "2017 State & Local Government Finance Historical Datasets and Tables" (last revised Oct. 30, 2019).

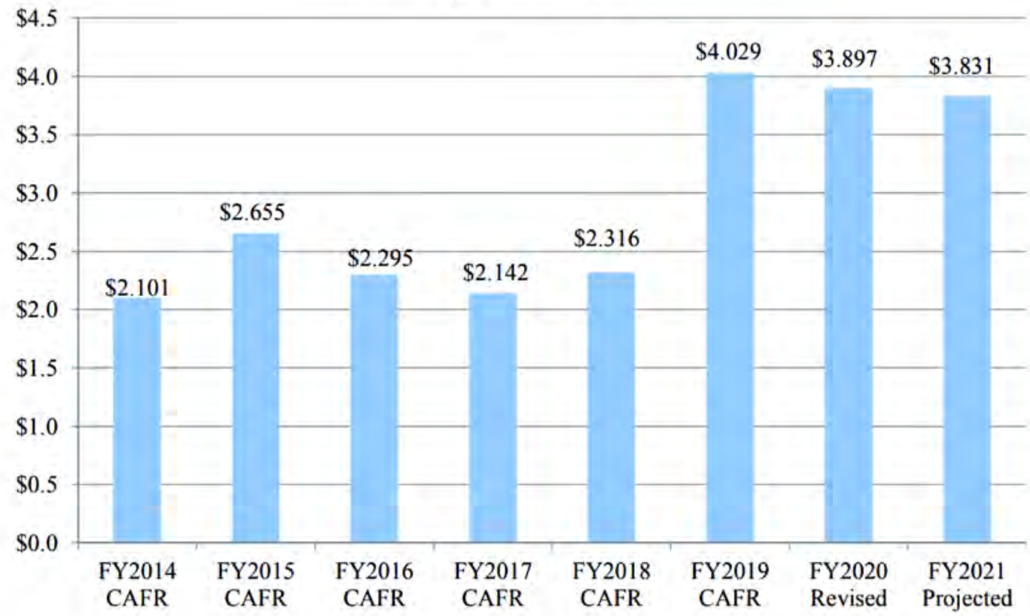
[8] National Governors Association, "National Governors Association Outlines Need for 'Additional and Immediate' Fiscal Assistance to States," Apr. 11, 2020.

[9] Cochrane, *supra* note 3.

[10] Richard Phillips and Nathan Proctor, "A Simple Fix for a $17 Billion Loophole: How States Can Reclaim Revenue Lost to Tax Havens," Institute on Taxation and Economic Policy (Jan. 17, 2019).

[11] We will explore how states might do this in a further essay.

Figure 2.
Corporate Business Tax
(In Billions)



Corporation Business Tax excludes the tax on energy.

Source: State of New Jersey, "Summary of Budget Recommendations for the Fiscal Year 2021: Budget in Brief," at 42-44 (Feb. 2020).

This chart demonstrates some extraordinary growth in New Jersey's corporate income tax after it passed several sensible reforms: In 2018 the state conformed to the global intangible low-taxed income regime under the federal Tax Cuts and Jobs Act of 2017, taxed 5 percent of the repatriation, moved to combined reporting (for 2019), and imposed a 2.5 percent corporate income tax surcharge for 2018 and 2019 (1.5 percent for 2020-21). To be sure, the actual 2020 numbers are likely to be quite a bit lower because of the pandemic, and there are any number of other factors that bespeak caution in extrapolating too far from one state's experience. Nevertheless, we think this chart indicates that — consistent with other data, some of which we discuss below — the state corporate income tax can be reformed in sensible ways that yield significant revenue.

It is not a good thing, in our view, that the states have let their corporate income taxes wither so that there is so much to be gained from straightforward reforms. However, in the current crisis this represents an opportunity. The states need only engage in some ordinary good tax housekeeping to revive their corporate income taxes. Though there may well be a need for stronger medicine that that at some point, it makes sense to start with reforms that are easy and practical.

The reforms we propose, in a thumbnail sketch, are as follows:

1. Tax the repatriation:[12] Multinational corporations stashed $2 trillion in profits abroad. Many of those profits were earned in the United States and should have been taxed by the states.

[12] For a more in-depth version of this argument, see Shanske and Gamage, "Why (and How) States Should Tax the Repatriation," *State Tax Notes*, Apr. 23, 2018, p. 317.

2. Shift to mandatory worldwide combination:[13] Multinational corporations are still shifting domestic profits abroad. The states can counter this by (reasonably) including these foreign subsidiaries in their corporate tax base.

3. Conform to GILTI:[14] The TCJA made a half-hearted attempt to combat income shifting. Though moving to worldwide combination would be better, conforming to GILTI at the state level is the least a state should do.

4. Income tax surcharge: A handful of major corporations will likely be very profitable over the next few years. States should add a temporary income tax surcharge to tax some of these profits.

5. Suspend some tax credits: States have been generous in giving large corporations credits from the corporate income tax. Credits of this magnitude were probably never a good idea, but given the current crisis, it is a particularly apt time to suspend these credits.

6. Reform the sales factor: States generally divide the income of multijurisdictional corporations based on their share of a corporation's sales in the state. Some taxpayers have gotten good at manipulating the location of sales, but there are ways to make the formula harder to game.

7. Expand the corporate income tax to include all large businesses: There has been a shift to the use of noncorporate business entities for decades. It has never made sense that only corporations pay taxes at the entity level. This should be corrected.

II. The Repatriation

Under the international tax law regime that ended in 2018, the United States — at least nominally — sought to tax the profits of multinational corporations on the basis of their worldwide income. At the same time, the regime permitted U.S.-based multinationals to defer payment of tax on profits earned overseas until that money was brought home. Until a foreign subsidiary repatriated its profits to its U.S. parent, the profits were not subject to U.S. tax. Naturally, large multinational corporations left a lot of money — over $2 trillion[15] — stashed abroad.

Much of that money represented profits on sales to U.S. residents and profits from the sale of intellectual property developed in the United States. Under the prior tax regime, U.S.-based multinationals deployed several well-known techniques to strip the profits from sales to U.S. customers and avoid being taxed on those profits by U.S. tax agencies, either federal or state. Those profits were then secreted abroad to escape tax.

The TCJA deemed all the deferred income repatriated and subject to tax. But it then applied special low tax rates to these profits, effectively exempting most of the profits from tax. Even worse, the new rules governing net operating losses under the CARES Act will allow some of the taxpayers that did pay tax on the repatriation to get those taxes back.[16]

But all is not lost: States can still tax this deemed repatriation,[17] and they can then use that money to keep the lights on during this recession. Most state corporate tax laws did not and do not reach the repatriation, but these laws can be changed to do so. Alternatively, and perhaps even better, state governments should subject the repatriation to a special one-time tax surcharge.

There are many reasons why taxing the repatriation is a particularly good way for state governments to raise desperately needed revenue. Consider just four, below.

First, states would be recouping a national loss. The repatriated profits of multinational firms reflect a form of national savings that is now being squandered. While these profits went untaxed for years and years, other taxpayers picked up the slack, and critical national initiatives went

[13] For further development of this argument, see Shanske, "White Paper on Eliminating the Water's Edge Election and Moving to Mandatory Worldwide Combined Reporting," *State Tax Notes*, Sept. 17, 2018, p. 1181.

[14] For further development of this argument, see Shanske and Gamage, "Why States Should Tax the GILTI," *State Tax Notes*, Mar. 4, 2019, p. 751; Shanske and Gamage, "Why States Can Tax the GILTI," *State Tax Notes*, Mar. 18, 2019, p. 967; Shanske and Gamage, "States Should Conform to GILTI, Part 3: Elevator Pitch and Q&A," *Tax Notes State*, Oct. 14, 2019, p. 121.

[15] Jeff Sommer, "A Stranded $2 Trillion Overseas Stash Gets Closer to Coming Home," *The New York Times*, Nov. 4, 2016.

[16] Assuming this is the best use for those net operating losses. *See* Josiah P. Child et al., "A Silver Linings Guidebook: Corporate Planning for Coronavirus Losses," *Tax Notes Federal*, May 18, 2020, p. 1159.

[17] Shanske and Gamage, "Will States Step Up in 2020? We Hope So," *Tax Notes State*, Dec. 16, 2019, p. 977.

unfunded. Now, as the money returns home, its value to the rest of us has been gutted by low tax rates and the predictable use of the repatriated revenues for corporate stock repurchases rather than job creation.[18]

Second, much of the untaxed profits squirreled abroad also escaped state-level taxes. Thus, for states, taxing these repatriated profits reflects satisfaction of an overdue tax bill avoided for years.

Third, since the relevant profits were earned previously and then largely went untaxed, taxing them now should not undesirably affect the corporations' behavior or their competitive position.

Fourth, though we cannot offer precise revenue estimates, subjecting the repatriation to tax can raise large sums of money, which makes sense because even a small slice of $2 trillion is a large number.

Here is a back-of-the-envelope estimate as to the potential for state revenue. Though we think that the states can tax all of the repatriation, let's suppose instead that they tax the 84 percent of the repatriation that many taxpayers have not yet paid tax on at the federal level because the federal tax law gave them a backloaded deferred payment option.[19] That leaves *only* $1.6 trillion. Now states need to estimate what percentage of that revenue was shifted out of the United States and what percentage was really earned abroad. A defensible estimate, based on the relative size of U.S. GDP and empirical work on how much income is shifted out of the United States relative to other countries,[20] might arrive at 35 percent. That leaves us with about $560 billion to be taxed. We think a rate as high as 20 percent could be justified given the taxes these taxpayers avoided over the years, but suppose instead the states went for the approximate median state corporate income tax rate of 5 percent. This would still raise $25 billion for the states.

[18]Michael Smolyansky, Gustavo Suarez, and Alexandra Tabova, "U.S. Corporations' Repatriation of Offshore Profits," Board of Governors of the Federal Reserve System (Sept. 4, 2018).

[19]Section 965(h).

[20]"Why States Can Tax the GILTI," *supra* note 14, at nn.18, 19.

III. Mandatory Worldwide Combination

The states have long confronted the problem of how to tax the income of a multistate business. In general, as a matter of constitutional law, each state can only tax income generated in the state, but how does one calculate that for an integrated multistate business like a railroad or Apple? If one asks the taxpayer to do the calculation, the taxpayer will naturally argue that most of its income is generated in a low-tax state or a no-tax state.

The states arrived at an especially effective solution to this problem. Instead of asking a multistate business to divide up its income, the states asked the business to report all of its income, including income nominally earned abroad, and then apportioned some of the income to each state by means of a formula. The most common modern formula uses the percentage of sales within a state because, among other reasons, the location of a firm's customers is difficult to game. So how much of Apple's total income is generated in a state under this system? The answer is the same percentage as the percentage of Apple's sales in a state.

Note that this method — mandatory worldwide combination — eliminates the incentive to shift income to a low-tax jurisdiction. It does not matter where the income is nominally earned because it all goes in the same pot and is multiplied by the usual formula (percentage of sales) to apportion the income.

The U.S. Supreme Court has upheld mandatory worldwide combination twice.[21] Unfortunately, in the 1980s, our trading partners pressured the federal government, which in turn pressured the states, not to use mandatory worldwide combination. Instead, states offered — and still offer — multinational corporations what is called a "water's-edge" election, which, for the most part, allows corporations *not* to combine income earned abroad. Naturally, the availability of a water's-edge election encourages multinational corporations to shift income abroad to escape state taxation.

[21]*Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298, 321-31 (1994); and *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 196 (1983).

Eliminating this election should therefore allow the states to tax a substantial portion of the income that multinational corporations continue to shift to low-tax jurisdictions. As noted above, one respected estimate is that the states could raise about $17 billion[22] through moving to worldwide combination.

IV. Conforming to GILTI

GILTI is a category of income that was added to the federal tax code by the TCJA. GILTI was nominally earned by the foreign subsidiary of a U.S. corporation that the federal tax law deems to really have been earned someplace else, such as the United States. In other words, by means of a formula, the federal corporate income tax uses GILTI to combat the same income-shifting problem that is the target of worldwide combination.

Though there is some complexity, all a state with a corporate income tax has to do is subject GILTI to state corporate tax, and then that state is also combatting income stripping. The state can use the same formula to divide up the income of a multinational corporation that it would ordinarily use, more or less.

A state cannot conform to GILTI and adopt worldwide combination; they are substitutes because both are attempts to ferret out shifted income. A state could offer taxpayers a choice between them. As between worldwide and GILTI, worldwide is better from the state's perceptive because it simply includes all the income of a multinational corporation without the intrusion of the complicated federal formula for picking out suspect income. That said, conforming to GILTI may well be easier politically, as it requires little more than adding a sentence to the state corporate income tax that the state is taxing GILTI. That conformity would raise a lot of revenue. The Penn Wharton Budget Model estimates $382 billion in total GILTI for 2020.[23] If the states were to follow the federal government and tax half of GILTI and do so at a 5 percent rate, then the taxes would yield almost $10 billion annually. To be sure, this is a pre-pandemic estimate, like all the estimates we provide, and the final number is likely to be less during the recession. That granted, this would still be sound tax policy, and the revenue will likely remain substantial even during the recession given that some firms, quite possibly with a lot of GILTI, will remain profitable.

V. Temporary Corporate Income Tax Surcharge

Many businesses will suffer losses during this recession. A few will prosper. It is not imposing a moral judgment to suggest that businesses that do relatively well should pay more in taxes to offset the increased budgetary costs of the downturn. Put concretely, we may be grateful to Amazon for its delivery service, but it still seems appropriate to tax it on its profits so that there will still be a main street when this is all over. It might be particularly appealing to tax a firm that is profiting during the recession on its "excess" profits,[24] but designing and implementing a new tax would be a heavy administrative lift for a state during a pandemic.

Fortunately, the regular corporate income tax is already something of an excess profits tax, to the extent that by definition it will only tax profitable firms, and those firms are likely to be more rare during the deep recession that we are rapidly entering. As for those few profitable firms, a temporarily higher corporate income tax rate would reflect that we are now in a time when putting a greater share of profits towards the common good is especially urgent. For instance, suppose that a state were to adopt a 3 percent corporate income tax surcharge for the next three years. This could work to raise some extra revenues in the depths of the recession from those most able to pay. This surcharge could be imposed only above a threshold, so as to apply only to larger businesses that are

[22] *See* Institute on Taxation and Economic Policy, *supra* note 10.

[23] Wharton School of the University of Pennsylvania, "Global Intangible Low-Taxed Income, 2020-2030: Estimates for the U.S. and Massachusetts" (Feb. 25, 2020).

[24] Reuven S. Avi-Yonah, "It's Time to Revive the Excess Profits Tax," *The American Prospect*, Mar. 27, 2020. For further detail, see Avi-Yonah, "Taxes in the Time of Coronavirus: Is It Time to Revive the Excess Profits Tax?" University of Michigan Public Law Research Paper No. 671, May 19, 2020.

unlikely to face serious liquidity problems and regarding which the corporate income tax can also serve antitrust-related goals.[25]

VI. Suspension of Some Corporate Tax Credits and Deductions

States offer a multitude of tax credits. The consensus is that these do little to encourage economic development, but this is not the time to fight that battle. What we want to emphasize is that some tax credits have grown so large that they are undermining the state corporate income tax and could dramatically reduce the value of these suggested reforms. Our primary target is state R&D credits. These are expensive, costing California alone almost $2 billion annually.[26] That is about 20 percent of all that California collects in corporate income tax. Even worse, R&D credits can be stockpiled. It is likely that many of the taxpayers shifting profits have also been stockpiling credits. We hope that a time will come to reconsider state R&D credits more wholesale. But, as with the temporary surcharge we proposed above, states especially need to be able to tax actors with greater ability to pay now, in this economic downturn. R&D credits should thus be suspended, for, say, three years.

VII. Reform the Sales Factor

As noted above, states have now shifted to dividing up the income of a multinational corporation by using a formula based on the percentage of sales in a state. This approach has turned out to be expensive. In 2015-16 — the last time it calculated this number — California estimated that it loses about $1 billion per year[27] because of this shift, about 10 percent of its total corporate income tax collection. How can that be? California is a big market state, after all. The reason is that taxpayers have gotten very good at gaming the sales factor. Reforming the sales factor could therefore raise a lot of revenue, especially if some of the other reforms listed above are also adopted. We propose two reforms below.[28]

First, states generally permit sales to be located where a middleman — e.g., a wholesaler — takes title to the goods. The problem with this rule is that it encourages taxpayers to sell to intermediaries in low-tax jurisdictions. The law of the sales factor should thus be refined to apportion a sale to its ultimate destination in all cases, including sales of tangible personal property. For example, a corporation could look to information it retains in the usual course of business, because surely businesses generally know where their customers are. If the corporation does not have this information and cannot obtain it from its wholesalers, then it could use any reasonable method, including population, to fill in the gaps.

A second reform we propose to the sales factor would be for corporations to be required to submit an accounting of where they would locate all their sales using the method they have used for the state in question. The corporation should also report where they are reporting sales to other states with the single sales factor. It might not seem odd to a California auditor, for instance, if California's sales factor for a corporation was only 8 percent — so a bit below the state's share of U.S. GDP — but it would rightfully raise alarm bells if the disclosure of this method revealed a 10 percent sales factor for Nevada — or the Cayman Islands.

VIII. Expand the Corporate Income Tax to All Entities

There has been a shift over the last decades from the corporate form; prominent commentators link the shift to the decline in the productivity of the state corporate income tax.[29] In

[25] Avi-Yonah and Lior Frank, "Antitrust and the Corporate Tax: Why We Need Progressive Corporate Tax Rates," *Tax Notes Federal*, May 18, 2020, p. 1199. Note that pairing progressive tax rates with a state corporate tax base that has been successfully broadened through moving to worldwide consolidation or conforming to GILTI would be a sensible permanent reform.

[26] California Department of Finance, "Tax Expenditure Report 2019-20."

[27] California Department of Finance, "Tax Expenditure Report 2015-16."

[28] A new essay with further details is to come, but if you can't wait, see: Avi-Yonah and Kimberly A. Clausing, "Toward a 21st-Century International Tax Regime," *Tax Notes International*, Aug. 26, 2019, p. 839, 846-47; Shanske, "Expanding State Fiscal Capacity, Part I: Combining an Entity-Level Consumption Tax, Improved Sales Factor Apportionment, and a Tax on a Federal Windfall (the QBI Deduction)," 22 *Fla. Tax Rev.* 448, 487-99 (2019).

[29] William F. Fox and LeAnn Luna, "Do Limited Liability Companies Explain Declining State Corporate Tax Revenues?" 33(6) *Pub. Fin. Rev.* 690, 715-16 (2005).

any event, it does not make much sense for two large business to be subject to different tax regimes if one is a corporation and the other is not. It could be argued that we would not want to pull millions of small businesses into the corporate tax regime, and that makes sense. Yet the corporate tax could be extended to just the largest noncorporate business with little loss of revenue.[30] This is another example of a change that has long made sense and could yield significant revenue, especially as the economy improves.

IX. Conclusion

To start at the beginning, it is the federal government that ought to be the prime mover in this crisis. The fact that the states can raise revenue through sensible reforms of their tax systems should not be seen as somehow excusing the (so-far) inadequate response at the federal level. Yet, against the background of this federal failure, the states should not compound the crisis by engaging in cuts that hurt the least fortunate before raising taxes on the more fortunate. And as to raising taxes on those most able to pay, the states should first seek to broaden their tax bases to raise revenue from taxpayers who have long avoided paying their fair share. This avoidance has gone on for so long and through so many channels that the states stand to gain substantial revenue just by doing what they should have done a long time ago. ■

[30] Matthew J. Knittel and Susan C. Nelson, "How Would Small Business Owners Fare Under a Business Entity Tax?" 64(4) *Nat'l Tax J.* 949, 974 (2011) ("Using a $10 million gross income and deduction test, we find that 99 percent of the entities deemed a business (54 percent of total filers) are also a small business, and they reported 18 percent of total business income and 16 percent of net business income for tax year 2007").