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A Closer Look at

Corporate and Business Tax Proposals

in

"Florida's Fiscal Crisis: The Prescription"

Background

The basic rationale for levying business taxes is to pay for government services that directly and indirectly benefit businesses. Are businesses paying their fair share of taxes in Florida and how do they compare to other states? Is Florida tax policy affecting the many different businesses and corporate entities equally and fairly?

Nationally, all state and local taxes paid by corporations represent less than 2.5% of their total expenses on average, and the state corporate income tax represents on average less than 10 % of that amount — or less than one-quarter of one percent of total costs.[1]

Florida's corporate tax structure consists of a flat rate of 5.5% on all corporate income, which ranks 40th lowest among states that tax corporate income.[2] Corporate income taxes in other populous states, such as California and New York, are higher. California's rate is 8.84% and New York's is 7.1%.[3]

Equity in business taxes in Florida is lacking. For example, there is a significant tax advantage now available to corporations that operate multi-state as compared to corporations that operate only in Florida. Also, current tax policy provides an advantage to corporations that operate under some legal forms compared to others.

Recommendations

The Center suggests several proposals to improve the equity, fairness, and vitality of the corporate income tax. For example, the state should end the tax advantage now available to corporations that operate multi-state as compared to Florida corporations, and end the advantage of corporations that operate under some legal forms compared to others. If

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[1] "ALMOST ALL LARGE IOWA MANUFACTURERS ARE ALREADY SUBJECT TO "COMBINED REPORTING" IN OTHER STATES Fears of Job Flight from Reducing Corporate Tax Avoidance Are Unwarranted By Michael Mazerov and Katherine Lira, April 2008.

[2] US Department of Commerce, Tax Foundation 2007.

[3] Ibid.

these proposals are adopted, it should be possible to allow all corporations to enjoy a lower tax rate (potentially dropping the rate from 5.5% to 4.5%) and at the same time increase revenue over $1.2 billion.

1.) Implement Combined Reporting (Revenues raised = $376.3 million)

Combined reporting is a policy adopted by twenty-two states that treats a multi-state corporation legally structured as one "parent" and numerous "subsidiaries" as if it were a single corporation. This would nullify numerous techniques that companies have devised to artificially shift profits earned in Florida into subsidiaries located in low-tax or no-tax states.

Florida levies a corporate income tax at the rate of 5.5 %. The base is computed with a three factor formula; 1) sales – 50 % weight in the formula; 2) payroll – 25 % weight; and 3) property – 25 % weight. This means that corporations operating solely in Florida pay tax on 100% of their net income. Those corporations operating in Florida and also in other parts of the United States pay taxes depending on the portion of their total sales, payroll, and property located in Florida and exclude portions outside of the state.

Combined reporting prevents profits from business activity that would otherwise be taxable in the states where it occurs from being siphoned out of the state's apportionment calculation. A common tax avoidance strategy that can be used by large multi-state corporations is to shift income to passive investment companies or separate but related subsidiary companies in other states without a state corporate income tax. For example, a profitable business with sales, payroll, and property in Florida could transfer ownership of the corporation's trademarks and patents to a subsidiary corporation located in a state that does not tax royalties, interest, or similar type of income such as Delaware and Nevada. Combined reporting requires that the income shifted to subsidiaries in other states along with any income in the entity in Florida are treated as a combined business entity and Florida would tax its apportioned share of that income

Almost half of the states with a corporate income tax require corporations to compute their state taxable income on a combined basis. Six states have enacted this reform in the last five years, and several others are seriously considered doing so. The states' growing interest in combined reporting flows from recognition that corporate tax shelters that exploit the absence of combined reporting are badly eroding state corporate tax collections. States also understand that the absence of combined reporting places their wholly in-state businesses at a disadvantage in competing with multi-state corporate groups that can shelter their profits in tax haven states.

Consequences: The recommendation is expected to have a positive revenue impact of $376.3 million.

Revenue Calculations for Combined Reporting

1. Current estimate for value of exclusion:[4]	$376.3 million
2. Projected FY 2009-10 General Revenue:[5]	$188.1 million
3. Projected FY 2010-11 General Revenue:	$376.3 million

Compliance with Guiding Principles: Equity will be enhanced as the recommendation would level the playing field for Florida only businesses in competing with large multi-state corporations. **Progressivity** would be improved, because although the incidence of the state corporate income tax is a matter of dispute, it is likely that a significant share of it falls on shareholders. The recommendation would also have a positive influence on **Stability.**

2.) <u>Remove the exemption of Limited Liability Companies and Subchapter S corporations from Corporate Income taxes</u>. (Revenues raised = $1.1 billion)

Limited Liability Companies (LLC's) and Subchapter S Corporations pass through their income to owners and shareholders and the shareholders pay taxes through the individual income tax. Since Florida does not have an individual income tax, these companies fully escape taxation of their profits at the state level. Most other states without an individual income tax (i.e. seven out of nine) require LLC's and Subchapter S Corporations to file and pay corporate income tax.

LLC's are similar to S Corporations for federal tax purposes and do not pay tax themselves. Rather they are treated as tax-exempt pass-through entities with their profits passing through to the federal income tax returns of their owners. But if a state does not have a personal income tax, it does not tax the passed-through business income when the individual owners receive it. This is why most of the other states that don't tax the income of the individual owners tax S Corporations and LLC's directly through application of the state corporate income tax. Of the nine states without a personal income tax, only Florida and Alaska do not levy a state corporate income tax on S corporations and LLC's.[6]

S corporations were already treated as pass-throughs and were not subject to the corporate income tax when in the early 1980s Florida became the second state to authorize the formation of limited liability companies ("LLCs"). Now, more than 471,000 LLCs exist in Florida.[7] This exclusion results in a very substantial loss in corporate tax revenue in Florida.

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[4] 2008 Florida Tax Handbook, the Florida Legislature
[5] Assumes policy change is effective 1/1/2010.
[6] This count includes the District of Columbia which does have a personal income tax but is barred by a federal law from imposing it on non-resident owners of pass through entities doing business in the District.
[7] "Yearly Statistics," Division of Corporations, Florida Department of State.

Consequences: By removing the exclusion from taxation, this recommendation will create additional revenue of about $1.1 billion - $848 million from "Subchapter S" Corporations and $257.9 million for Limited Liability Companies.[8]

Revenue Calculations for Subchapter S Corporations

1. Current estimate for value of exclusion:[9]	$848.0 million
2. Projected FY 2009-10 General Revenue:[10]	$424.0 million
3. Projected FY 2010-11 General Revenue:	$848.0 million

Revenue Calculations for Limited Liability Companies

1. Current estimate for value of exclusion [11]	$257.9 million
2. Projected FY 2009-10 General Revenue:[12]	$129.0 million
3. Projected FY 2010-11 General Revenue:	$257.9 million

Compliance with Guiding Principles: **Equity** will be enhanced as the recommendation would level the playing field among businesses in Florida. **Progressivity** would be improved, because although the incidence of the state corporate income tax is a matter of dispute, it is likely that a significant share of it falls on shareholders. The recommendation would have a positive influence on **Stability**.

3.) <u>Decouple the state from the 2004 federal Domestic Production Deduction</u> (Revenues raised = $50 million)

This is a federal tax giveaway that many states have decided not to allow to flow into their own tax codes. Florida loses revenue by allowing this deduction, which often subsidizes job creation in other states. The annual loss of revenue in Florida is estimated at $39 million in Fiscal Year 2009[13]

Created in 2004 by Congress, the domestic production deduction costs Florida and 27 other states millions of dollars of revenue. Since Florida and most other states base their own tax codes on the federal tax code, this corporate tax break typically exists at the state level without any explicit consideration by legislators.

The domestic production reduction holds no inherent incentives for businesses to create jobs in a state and is not good economic policy; corporations taxable in Florida can

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[8] Florida Tax Handbook, 2008 published by the Florida Legislature.
[9] 2008 Florida Tax Handbook, the Florida Legislature
[10] Assumes policy change is effective 1/1/2010.
[11] Ibid.
[12] Assumes policy change is effective 1/1/2010.
[13] States Can Opt Out of the Costly and Ineffective "Domestic Production Deduction" Corporate Tax Break By Jason Levitis, Nicholas Johnson, and Katherine Lira, Center on Budget and Policy Priorities, July 2008.

benefit from the deduction even if the production activity and associated jobs are located outside Florida. The main beneficiaries are large, profitable corporations with little benefit for Florida-only businesses, especially those that may be struggling in the current economy.

Consequences: The recommendation will result in a revenue increase of up to $50 million in FY 2010.

Revenue Calculations for Domestic Production Deduction

1. Current estimate for value of exclusion:[14]	$50.0 million
2. Projected FY 2009-10 General Revenue:[15]	$25.0 million
3. Projected FY 2010-11 General Revenue:	$50.0 million

Compliance with Guiding Principles: **Equity** will be enhanced as the recommendation would level the playing field for small independent Florida only businesses. **Progressivity** would be improved, because although the incidence of the state corporate income tax is a matter of dispute, it is likely that a significant share of it falls on shareholders. The recommendation would have a positive influence on **Stability.**

4.) <u>Adopt the throwback rule</u> (Revenues raised = $38.4 million)

This is a policy adopted by approximately half the states with corporate income taxes that ensures that all corporate profits earned in the United States are subject to taxation.

When a corporation produces and/or sells goods in more than one state, each state requires the business to pay tax on just a portion of its nationwide profit through an apportionment formula. Typically, the formula assigns some of the profit to the state or states in which the corporation produces goods and some to the state or states in which the corporation makes sales. However, federal law establishes a threshold level of presence or nexus a corporation must have in a state before it can be subjected to a corporate income tax on profit earned in that state. The throwback rule is a provision that is intended to deal with this conflict between nexus law and state apportionment formulas. A recent report published by the Center on Budget and Policy Priorities describes the throwback rule as follows:

> "*The throwback rule effectively allows a state in which a corporation produces its wares to tax the profit on any sales made by the corporation into states in which the corporation has insufficient presence to be subjected to a tax on its profit from those sales. (The sales are said to be "thrown-back" for tax purposes from the state in which the purchaser is*

[14] The Florida Senate Interim Project Summary 2004-137, November 2003
[15] Assumes policy change is effective 1/1/2010.

located to the state in which the seller is located). If a state does not have a throwback rule in effect, 50-100 percent of the profits of its resident corporations frequently will be what tax officials call "nowhere income" and thus profit that is earned somewhere in the United States but not subject to tax by any state." [16]

Consequences: This recommendation is estimated to have a revenue impact of $38.4 million

Revenue Calculations for Throwback Rule

1. Current estimate for value of exclusion:[17]	$38.4 million
2. Projected FY 2009-10 General Revenue:[18]	$19.2 million
3. Projected FY 2010-11 General Revenue:	$38.4 million

Compliance with Guiding Principles: **Stability** will be improved as a fairly routine tax source. In addition, **Equity** is affected in a positive fashion as the recommendation will enhance competitiveness for smaller independent businesses, especially businesses struggling in the current recession. **Progressivity** would be improved, because although the incidence of the state corporate income tax is a matter of dispute, it is likely that a significant share of it falls on shareholders.

5.) Reduce Corporate Income Tax Rate after creating greater equity and closing Loopholes (Revenues Lost = $317.7 million from lower rate, but net increase is $648 million in FY 2009 – 2010 and $1.3 billion in the following year)

If the Legislature enacts the recommendations for closing corporate income tax loopholes and creating greater equity that expands the base of entities subject to the tax, it is possible to lower the rate of taxation (potentially dropping the rate from 5.5% to 4.5%) and increase net revenue by about $648 million in FY 2009 – 2010 and over $1.3 billion in the following year.

Revenue Calculations for Corporate Income Tax Rate Reduction (FY 2010)

1. Current law estimate @ 5.5%[19]	$1,509.7 million
2. Recommendation Reduction to 4.5%	$1,235.2 million

[16] "Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States. Michael Mazerov, Center on Budget and Policy Priorities, March 2003.
[17] 2008 Florida Tax Handbook, the Florida Legislature
[18] Assumes policy change is effective 1/1/2010.

[19] Source is the November 21, 2008 General Revenue Estimating Conference.

3. Gross Reduction: ($274.5) million
4. Reduction effective 1/1/10 ($137.3) million
5. Allocation of decrease:
General Revenue ($137.3) million

Revenue Calculations for Corporate Income Tax Rate Reduction (FY 2011)

1. Current law estimate @ 5.5%[20] $1,747.4 million
2. Recommendation Reduction to 4.5% $1,429.7 million
3. Gross Reduction: ($317.7) million
4. Allocation of decrease:
General Revenue ($317.7) million

Compliance with Guiding Principles: **Stability** will be improved because with a lower tax rate avoidance will be lessened. E**quity** and **Progressivity** would not be affected.

Summary

The business and tax proposals discussed above will close loopholes and reduce competitive disadvantages among Florida's different corporate entities. Stability, equity and progressivity are improved. In addition, if these suggestions are implemented, the state's corporate tax structure is fairer. At the same time, the base of the corporate income tax is appropriately expanded which supports the potential for lowering the rate. Considered comprehensively, these suggestions should allow Florida's businesses to prosper and create more jobs in our economy. Further, these suggestions provide significant new revenue to meet the state's needs.

Estimated Revenue Generated From Center's Business Tax Proposals
Total by Fiscal Year $ in Millions[21]

Revenue Source	FY2009 - 2010	FY2010 - 2011	TBD
Combined Reporting	$188.1	$376.3	
Subchapter S	$424.0	$848.0	
Limited Liability Companies	$129.0	$257.8	
Domestic Production Deduction	$25.0	$50.0	
Throwback Rule	$19.2	$38.4	
Reduce Tax Rate to 4.5%	($137.3)	($317.7)	
Total	$648	$1.253	

[20] Source is the November 21, 2008 General Revenue Estimating Conference.

[21] Assumes implementation on January 1, 2010

Note: The recommendations in this report and the resulting revenues are derived from an independent analysis of information contained in the "2008 Florida Tax Handbook" and from the November 21, 2008 General Revenue Estimating Conference. As more current information becomes available, the recommendations may be updated to reflect this new information.

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Florida Center for Fiscal and Economic Policy
2245 S. Monroe St., Tallahassee, Florida 32301
850-325-6480
john@fcfep.org