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Closing Corporate Tax Loopholes to Fund Investments in Kentucky Families

By Jason Bailey

A bill in the 2015 General Assembly that closes several corporate tax loopholes and uses the resources generated to fund a tax credit for Kentucky's working families is a step toward the kind of tax reform Kentucky needs. It would make the state's tax system fairer and allow investments in Kentucky workers and families that will contribute to a stronger state economy.

House Bill 374—sponsored by Representative Jim Wayne and co-sponsored by Speaker Greg Stumbo—would close corporate income tax loopholes that allow large profitable corporations to avoid paying their fair share of taxes, including by stashing their profits in offshore tax havens. The bill targets strategies that major corporations use to artificially shift profits from states where they would be taxed (or taxed at a higher rate) to subsidiaries in no- or low-tax states or foreign tax havens. About half of states have already enacted the measures contained in this bill to combat domestic corporate tax avoidance, and many states are looking at extending these protections to offshore tax havens given their growing use in recent years.

The legislation would level the playing field between Kentucky small businesses that are paying taxes and large multi-national corporations that are avoiding them. At the same time, it would generate \$66 million to fund a state Earned Income Tax Credit (EITC), a proven tool to help lift working families out of poverty.

Corporate tax loopholes cost states like Kentucky millions

Large multi-state and multi-national corporations are using a growing number of accounting strategies to reduce or eliminate their state corporate income taxes. These strategies artificially shift taxable profits to subsidiaries located in tax havens, or otherwise take advantage of loopholes in state and federal laws to avoid paying taxes. The strategies include¹:

Passive Investment Companies (PICs).

PICs are shell corporations set up by banks and accounting firms in tax haven states like Delaware and Nevada. A parent corporation transfers ownership of its patents, trademarks and other intangible property to a PIC, and the PIC licenses back to the parent the right to use this property in exchange for the payment of royalties. These royalties reduce the taxable profits of the parent, while the PIC is not subject to tax on its profit in Delaware and Nevada. The PIC then lends its profit to the parent in exchange for interest payments, which further reduce the parent's profits.

While a comprehensive picture of how much revenue is lost from PICs is impossible because the information is confidential, court records and news stories have revealed that the sums involved are substantial. Toys R Us famously set up a PIC in Delaware named Geoffrey, after the giraffe that serves as the company's logo. Geoffrey held the Toys R Us logo and other intangible assets, for which the company paid the PIC \$55 million in royalties in 1990 alone. Kmart sheltered about \$1 billion in profits over three years in the early 1990s using its PIC.

In Delaware, 6,000 PICs had been set up by 1998, and 600-800 new ones were being established each year with the headquarters of more than 700 PICs located in five floors of one building alone. A 2002

news story indicated there were 132,000 corporations in Nevada with no employees, many of which could be PICs, and Delaware has more corporate entities than it has people.²

Captive Real Estate Investment Trusts (REITs).

Corporations establish REITs and then transfer ownership of real estate, such as stores, to the trust. The REIT then leases the stores back to the parent in exchange for rent—which reduces the taxable profit of the parent. A REIT, in turn, is not subject to tax on its profits. Dividends paid by a REIT back to a parent are either tax exempt in many states or are funneled to a subsidiary in a tax haven state like Nevada or Delaware.

Accounting experts estimated that Wal-Mart's REIT—the subject of a 2007 front-page story in *The Wall Street Journal*—saved the company \$350 million in corporate income taxes over a four-year period.

Other common tax avoidance strategies include:

- Transfer pricing, in which corporations use artificially high or low charges paid between affiliated corporations to shift income from high-tax to low-tax states;
- Intangible asset spin-offs, where financial institutions, in particular, place income-generating assets in out-of-state subsidiaries beyond the legal tax reach of a state.
- Isolating profitable activities from “nexus,” where corporations create separate subsidiaries to conduct sales in particular states to avoid having the entire corporation be fully subject to corporate income taxes in those states.

Tax avoidance also increasingly extends to offshore tax havens like Bermuda and the Cayman Islands. In 2008, American multinational corporations collectively reported 43 percent of their foreign earnings in five small tax haven countries, yet these countries accounted for just 4 percent of their foreign workforce and 7 percent of their foreign investment.³ And the amount of cash that corporations book offshore has doubled since then. Among Fortune 500 companies, 362 have subsidiaries in offshore tax havens, including Pepsi, American Express, Bank of America and Nike. Offshore tax havens cost Kentucky an estimated \$187 million in corporate tax revenue in 2011, and cost all states \$20.7 billion.⁴

Other aspects of tax law also contribute to corporate tax avoidance. A federal law that creates a threshold of activity before a business is subject to corporate income taxes in a state can keep corporations from paying income taxes in states even if they make sales there. That creates “nowhere income,” or corporate profits that aren't being taxed in any state.⁵

How HB 374 closes corporate loopholes

In the past, Kentucky has pursued some piecemeal strategies that attempt to address the problem of multi-state corporations artificially shifting income to subsidiaries to avoid corporate income taxes. In 2007, Kentucky passed legislation intended to nullify corporate tax savings from captive REITs. And the pension-funding legislation in 2013 included a measure limiting payment of management fees between subsidiaries to reduce corporate income tax liabilities.⁶

However, that type of narrow approach does not address the full range of strategies identified above and is more complex to enforce than the straightforward and common-sense fix of treating a corporation and all of its related subsidiaries as a single unit for tax purposes, which is known as “combined reporting.”⁷ By requiring corporations to add together the taxable profits of a parent and its subsidiaries, combined reporting eliminates the ability to shift taxable profits between related in-state and out-of-state entities or to hide income in low- or no-tax states. The Legislative Research Commission (LRC) estimates that Kentucky could collect \$25 million more in revenue annually by adopting combined reporting.⁸ The U. S. Supreme Court has twice upheld its legality.⁹

The ability to capture lost revenue and increase tax fairness in a way that is easy to administer has led 24 states plus the District of Columbia to adopt combined reporting (out of 46 states with corporate income

taxes). They include Texas, West Virginia and Illinois. Nine states have adopted combined reporting just since 2004.

There is no evidence that combined reporting is harmful to a state's economy. In fact, combined reporting states are among the most economically successful; from 1990-2007, nine of the top 10 states with the highest manufacturing job growth were combined reporting states, and four of the top five states since the recovery began in 2010 have combined reporting.¹⁰

States are now looking at ways to extend combined reporting to include foreign tax havens. At one time, many states had worldwide combined reporting that included U. S. earnings booked offshore—which the U. S. Supreme Court has upheld as legal—but under pressure from corporate interests these states weakened their statutes, limiting combined reporting to domestic (or “water’s edge”) corporations in the 1980s. With growing concern about tax havens, five states now have combined reporting laws that require corporations to include income from subsidiaries incorporated in notorious low- or no-tax foreign tax havens: Montana, West Virginia, Oregon, Alaska and DC. The best laws are in Montana, which collected \$4.2 million from the measure in 2008 and \$7.2 million in 2010, and Oregon, which expects to collect \$18 million this year.¹¹

According to a January 2013 Hart Research poll, 73 percent of Americans agree we should “close loopholes allowing corporations and the wealthy to avoid U. S. taxes by shifting income overseas,” and 83 percent said we should “increase [the] tax on U. S. corporations’ overseas profits to ensure it is as much as [the] tax on their U. S. profits.”
Baxandall, “Closing the Billion Dollar Loophole.”

HB 374 identifies 44 well-known foreign tax havens and requires that corporations include subsidiaries in those places in their combined group. While this measure will not address all of the revenue Kentucky loses from tax havens, the LRC estimates that an additional \$25 million per year will be generated. And it will help stem the growing loss of revenue from tax havens in the future.

A final component of HB 374 addresses the problem of “nowhere income” by including a “throwback rule.” Under the rule, nowhere income is subject to taxation in the state where the product is made, in this case Kentucky. Twenty-five states already have a throwback rule, including Indiana, West Virginia and Alabama.¹² The LRC estimates an additional \$16 million in revenue could be collected with this rule.

Investing the resources back in Kentuckians

Under HB 374, the \$66 million generated by closing these corporate loopholes would be used to create a refundable state Earned Income Tax Credit (EITC) valued at 7.5 percent of the federal EITC. Kentucky would join 26 states that have created state EITCs mirroring the federal credit, including Indiana and Louisiana.¹³

The EITC supplements the wages of low-income workers, and is one of the most effective tools available to lift working families out of poverty. Families tend to use their EITC refunds on housing, groceries, childcare, transportation and healthcare costs, as well as to pay off debt and invest in education. EITCs are associated with lasting improvements in the lives of children, including healthier babies, success in school and increased earnings later in life.¹⁴

One in five or 409,000 Kentucky families would benefit from a state EITC.¹⁵ The share of families receiving the federal EITC in Kentucky counties ranges from 11 to 41 percent.¹⁶ Set at 7.5 percent of the federal credit, it would provide an average benefit of \$176 to those eligible. An EITC would also increase the fairness of Kentucky's tax system, where currently the poorest 20 percent of Kentuckians pay 9 percent of their income in state and local taxes while the richest 1 percent pay only 6 percent.¹⁷

- ¹ Michael Mazerov, "State Corporate Tax Shelters and the Need for 'Combined Reporting,'" Center on Budget and Policy Priorities, October 26, 2007, <http://www.cbpp.org/cms/?fa=view&id=777>.
- ² Leslie Wayne, "How Delaware Thrives as a Corporate Tax Haven," *The New York Times*, June 30, 2012, <http://www.nytimes.com/2012/07/01/business/how-delaware-thrives-as-a-corporate-tax-haven.html?pagewanted=all&r=0>.
- ³ Richard Phillips, et al., "Offshore Shell Games 2014: The Use of Offshore Tax Havens by Fortune 500 Companies," U. S. PIRG and Citizens for Tax Justice, June 2014, http://ctj.org/ctjreports/2014/06/offshore_shell_games_2014.php#.VNduGPnF_bB.
- ⁴ Phineas Baxandall, et al., "Closing the Billion Dollar Loophole: How States Are Reclaiming Revenue Lost to Offshore Tax Havens," U. S. PIRG, Winter 2014, <http://www.uspirg.org/reports/usp/closing-billion-dollar-loophole>.
- ⁵ Michael Mazerov, "Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States," Center on Budget and Policy Priorities, May 23, 2003, <http://www.cbpp.org/cms/index.cfm?fa=view&id=1868>.
- ⁶ HB 258, 2007 Regular Session of the Kentucky General Assembly, <http://www.lrc.ky.gov/record/07RS/HB258.htm>. HB 440, 2013 Regular Session of the Kentucky General Assembly, <http://www.lrc.ky.gov/record/13rs/HB440.htm>.
- ⁷ Just as in the current corporate income tax system, those profits would then be apportioned to Kentucky based on a formula that takes into account the share of the corporation's property, payroll and sales that are in the state.
- ⁸ Staff correspondence and Fiscal Note to HB 132, 2015 Regular Session of the Kentucky General Assembly, <http://www.lrc.ky.gov/record/15RS/HB132.htm>.
- ⁹ Mazerov, "State Corporate Tax Shelters and the Need for 'Combined Reporting.'"
- ¹⁰ Michael Mazerov, "A Majority of States Have Now Adopted a Key Corporate Tax Reform—'Combined Reporting,'" Center on Budget and Policy Priorities, April 3, 2009, <http://www.cbpp.org/cms/?fa=view&id=246>. Data since 2010 from Bureau of Labor Statistics.
- ¹¹ Baxandall, "Closing the Billion Dollar Loophole." Niraj Chokshi, "How states can reclaim \$1 billion from offshore tax havens," *The Washington Post*, January 31, 2014, <http://www.washingtonpost.com/blogs/govbeat/wp/2014/01/31/how-states-can-reclaim-1-billion-from-offshore-tax-havens/>.
- ¹² Mazerov, "Closing Three Common Corporate Income Tax Loopholes."
- ¹³ Center on Budget and Policy Priorities, "Policy Basics: State Earned Income Tax Credits," January 28, 2015, <http://www.cbpp.org/cms/?fa=view&id=2506>.
- ¹⁴ Ashley Spalding, "State EITC Would Help Working Kentuckians Afford Necessities," Kentucky Center for Economic Policy, February 5, 2014, <http://kypolicy.org/state-eitc-help-working-kentuckians-afford-necessities/>. Chuck Marr, "Earned Income Tax Credit Promotes Work, Encourages Children's Success at School, Research Finds," Center on Budget and Policy Priorities, April 15, 2014, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3793>.
- ¹⁵ Internal Revenue Service, "Statistics for Tax Returns with EITC," <http://www.eitc.irs.gov/EITC-Central/eitcstats>.
- ¹⁶ Ashley Spalding, "Interactive Map: How a State Earned Income Tax Credit Would Benefit Each Kentucky County," Kentucky Center for Economic Policy, March 12, 2014, <http://kypolicy.org/interactive-map-state-earned-income-tax-credit-benefit-kentucky-county/>.
- ¹⁷ Anna Baumann, "Kentucky's Upside Down Tax System Asks the Least of Those at the Top," Kentucky Center for Economic Policy, January 14, 2015, <http://kypolicy.org/kentuckys-upside-tax-system-asks-least-top/>. Carl Davis, et al., "Who Pays? A Distributional Analysis of the Tax Systems in All Fifty States, 5th Edition," Institute on Taxation and Economic Policy, January 14, 2015, <http://www.itep.org/whopays/>. Ashley Spalding, "State EITC Would Make a Regressive Tax System Fairer," Kentucky Center for Economic Policy, May 15, 2014, <http://kypolicy.org/state-eitc-make-regressive-tax-system-fairer/>.