THE TAXONOMIST

State Corporate Tax Follies

By Robert S. McIntyre

If you're unhappy with the mess George W. Bush has made of the federal corporate income tax, you'll be less happy to learn that in the states, things are even worse.

Last September, my group published a study showing that America's biggest and most profitable corporations now shelter more than half of their U.S. profits from federal income taxes. We've since taken a hard look at what corporations pay in state income taxes—and yipes!

Of the 275 *Fortune 500* corporations in our federal study, 252 disclosed their state income tax payments. By 2003, these companies had slashed their state income tax payments to only 2.3 percent of their U.S. profits. That meant that two-thirds of their profits escaped state taxes entirely.

A shocking 71 of the 252 companies managed to pay no state income tax at all in at least one year from 2001 through 2003—despite telling their shareholders they made $86 billion in pretax U.S. profits in those no-tax years. Some companies, such as Toys "R" Us, Boeing, AT&T, Eli Lilly, Merrill Lynch, and ITT Industries, paid no state corporate income tax over the entire three-year period.

How do big corporations get away with paying so little in state income taxes? The federal government deserves much of the blame. Most states use federal taxable income as their starting point for computing state corporate taxes. Since the companies in our survey reported less than half their U.S. profits to the IRS, that puts the states far behind from the outset.

But federal loopholes are just the beginning. Like their federal counterparts, state elected officials have trouble resisting corporate pleas for tax concessions in the name of "economic development." North Carolina, for example, just agreed to give up more than $230 million in corporate tax receipts to attract a $100-million Dell Computer plant. One study found that in 1998, states provided tax "incentives" that wiped out almost a third of the income taxes they otherwise would have collected from manufacturers (versus a 10 percent loss in 1990). Since then, state corporate tax giveaways have continued to proliferate.

Besides extorting state tax breaks, big companies have also become increasingly adept at shifting their profits on paper from the states in which they are actually earned into states that don't tax them. This sleight of hand is enabled in part by the fact that most states treat a company's subsidiaries as separate entities for tax purposes. Zero-state-tax Toys "R" Us, for example, has transferred its logos and trademarks to tax-haven Delaware. On paper, the Delaware subsidiary charges all the stores hefty royalties for the use of the Toys "R" Us name. Those royalties are tax deductible in the states where Toy "R" Us makes its profits, while the royalty income is tax-exempt in Delaware. Court cases reveal that Kohl's Department Stores, Sherwin-Williams and other low-state-tax firms also use this loophole.

Some Texas-based corporations—including SBC Communications and Dell—have transferred ownership of their Texas operations to Delaware partnerships, to take advantage of a foolish Texas Comptroller ruling that this scheme prohibits Texas from taxing most of their income. SBC paid less than 1 percent in state income taxes on its $31 billion in 2001-03 profits—and paid nothing at all in 2003.

What can states do to fix their corporate tax problem? Calling on the federal government to clean up its act is one obvious approach, but that's probably fruitless these days. Treasury Secretary John W. Snow captured the Republican mood in Washington last December when he said that the only limit President Bush will place on new corporate tax loopholes in his upcoming tax-deform program will be to try to avoid "negative income taxes."

But there are some useful steps states can take on their own. For instance, states can curb the Toys "R" Us loophole by treating a company's various parts as a single company—as California and 15 other states do. They also can address the issue of "nowhere income"—profits that aren't taxed by any state. Half of the states already make an effort to do so.

Most important, as Michael Mazerov of the Center on Budget and Policy Priorities points out, "when you find yourself in a hole, the first thing you need to do is stop digging." Chasing after businesses by fighting over who can give the largest tax concessions is a zero-sum game. States should get together and agree to stop this futile, destructive competition.

State corporate income taxes can be a progressive—and popular—way to pay for needed state programs. They ought to be revitalized, not gutted.

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