

Executive Summary

Rhode Island's corporate income tax has fallen so sharply that in 2000, half of Rhode Island's largest corporations paid less in income tax than the typical Rhode Island family. The median corporate income tax paid by the state's largest employers was \$1825, less than the median personal income tax paid by joint filers.

What's more, by FY 2004, the tax on cigarettes produced 50 percent more revenue (\$117 million) than the tax on corporations (\$76 million). In fact, among the 46 states that collect income taxes on corporations, Rhode Island ranked dead last in corporate tax collections relative to state income. The Poverty Institute estimates that if Rhode Island had simply maintained corporate taxes at the 1989 level, the state last year would have received an additional \$115 million in revenue.

These findings belie the claim that Rhode Island is a "high-tax," "business-unfriendly" state. National studies show that, at least in the area of corporate taxes, Rhode Island has become a very low-tax state – among the lowest in the nation.

Corporate taxes are an important source of state revenues and a fair levy on corporations who benefit from spending on roads, safety, education, health care and other state services. The decline in taxes paid by corporate businesses creates budgetary shortfalls that must be made up by other taxpayers or lead to cuts in vital public services. In an environment of declining corporate contributions to public revenues, it is difficult to consider changes to the state's other taxes

The Poverty Institute's study analyzed information gathered from a number of national and local sources. It identifies two major causes for the decline in corporate tax collections:

- Many corporations that operate in multiple states have taken advantage of a number of tax shelters simply to avoid the already low taxes assessed by state governments.
- Many states, as well as the federal government, have cut business taxes in recent years in hopes of attracting job-producing industries, and Rhode Island has been among the leaders in this movement. Yet state officials have little information on whether the loss of corporate income tax revenue has contributed to creating jobs in a cost-effective manner.

The Poverty Institute makes two recommendations:

- State lawmakers should shut down two kinds of tax shelters—following the lead of New Hampshire, Massachusetts and Connecticut—that allow corporations operating in multiple states to avoid paying their fair share. The Division of Taxation estimated in 2005 that closing two loopholes could produce \$16 million in taxes currently going uncollected.
- The state should continue a process begun recently to improve accountability when tax breaks are used for economic development purposes. In recent years, legislators and economic development officials have moved in the right direction when negotiating tax deals with businesses – tying tax breaks to job creation and good wages, including "clawback" provisions to recoup tax expenditures if companies renege on their obligations, and mandating a bi-annual tax expenditure report. However, data on corporate tax expenditures is still inadequate and the state lacks a well-funded tax policy office to oversee data collection and analysis. Rhode Island needs to do more to make sure that when tax breaks are given to businesses to attract new jobs, new jobs are actually created in a cost-effective manner.

Corporate Tax Payments of Rhode Island's Largest Employers

The Poverty Institute analyzed data on taxes paid by Rhode Island's 64 largest proprietary employers provided by the Division of Taxation. Data was for the year 2000, the peak of the 1990s US economic boom and a record year for corporate earnings in the US. Of these (unidentified) 64:

- 15 firms (23 percent) paid only the minimum \$250 corporate income tax.
- 14 firms (22 percent) paid \$251-\$1000 in corporate income tax.
- 9 firms (14 percent) paid \$1001-\$5000 in corporate income tax.
- 27 firms (42 percent) paid over \$5000 and only 15 of the state's largest employers paid \$100,000 or more in corporate income tax.

The median corporate tax payment was \$1825, less than the median state personal income tax payment for Rhode Island joint filers in 2002.

Rhode Island's Corporate Tax Collections Falling Relative to Other States

During the 1990s, a period of record growth in US corporate earnings, revenues from Rhode Island's business corporation tax (BCT) fell sharply, regardless of how they are measured. Whether looking at corporate taxes relative to the state's general fund, relative to the size of the state's economy, or relative to personal income in the state, the result is the same: when corporate tax collections are compared to other states, Rhode Island ranks near the bottom or dead last.

(a) Corporate tax collections as a share of state revenues. The business corporation tax was once an important contributor to the state's general fund, but today that contribution

has shrunk dramatically. In FY 1989, 6.7 percent of state general revenues came from the business corporation tax. By FY 2004, the business corporation tax contributed only 2.7 percent of state general revenues. If revenues from the corporate tax had grown at the same rate as all other revenues since FY 1989, the state would have collected an additional \$115 million in FY 2004.

While the corporate contribution to state revenues has declined dramatically in all states, a comparative study of state corporate taxes by the Center for Budget and Policy Priorities found that the drop in Rhode Island was among the steepest. Between FY 1979 and FY 2002 (the last year for which complete state data was available at the time of the study), the share of general revenues contributed by corporate income taxes in Rhode Island fell by a dramatic 87 percent.¹

This represented the third sharpest decline in reliance on corporate taxes in the nation; only Kansas and Connecticut saw their corporate tax share fall more sharply. Rhode Island now ranks near the bottom in corporate taxes as a share of revenues (44th out of 46) and ranks significantly below neighboring Massachusetts.²

(b) Corporate taxes as a percent of gross state product. A second way to analyze corporate taxes over time and across states is to compare corporate tax collections to the size of states' economies – measured by the Gross State Product (GSP), which is calculated by the US Department of Commerce. When state corporate taxes are ranked relative to state GSP, Rhode Island's corporate tax collections are the 38th lowest of the 46 states that levy a corporate income tax. Corporate taxes as a percent of GSP in Rhode Island fell from 0.38 percent in FY 1989 to 0.16 percent in FY 2003, (the most recent year for which complete state data was available at the time of the study) according to a joint study by Citizens for Tax Justice and the Institute for Taxation and Economic Policy.³ This was the 10th steepest decline among the 46 states.

Table 1 – Corporate Income Taxes as a Share of State Revenues

	Share of General Revenues Contributed By Corporate Income Tax			Rank*
	1979	1989	2002	2002
Rhode Island	10.4%	6.7%	1.3%	44
Massachusetts	13.4%	13.0%	5.5%	10
US Average	10.2%	8.8%	4.7%	

* Of 44 states with a corporate income tax since 1979

Source: Center on Budget and Policy Priorities, Structural Deficits Threaten States Fiscal Stability, March 2005 and Poverty Institute calculations.



Chart 1 – RI Business Corporation Tax as Share of State General Revenues, 1993 - 2004

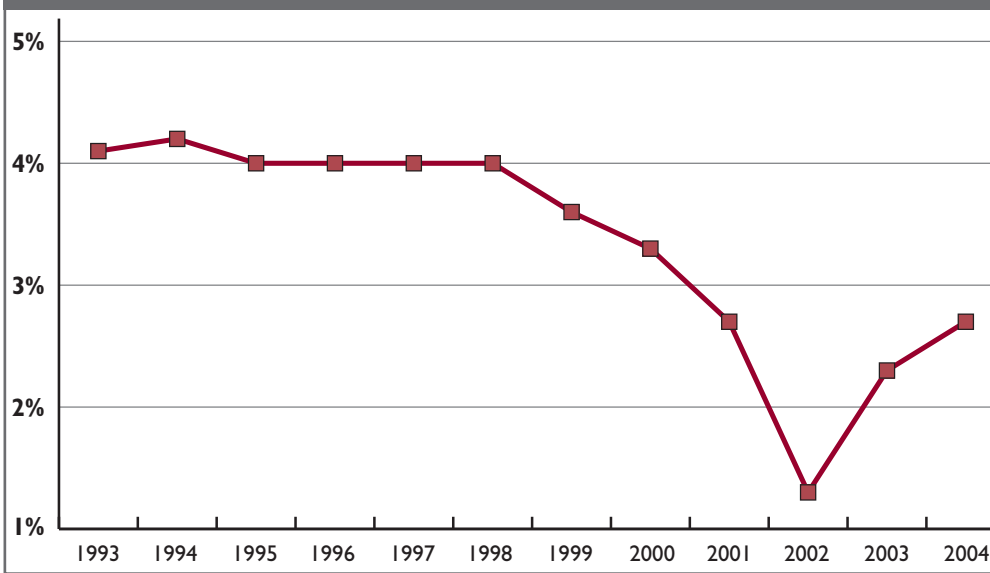


Table 2 – Corporate Income Taxes as a Percent of Gross State Product

	1989	2003	2003 Rank*
Rhode Island	0.38%	0.16%	38
Massachusetts	0.76%	0.40%	7
US Average	0.48%	0.29%	

*Of 46 states with a corporate income tax since 1989

Source: McIntyre and Nguyen, State Corporate Income Taxes, 2001-2003, February 2005 and Poverty Institute calculations.

(c) Corporate taxes as a percent of state personal income.

In comparing state taxes, many analysts measure tax collections relative to the total personal income earned by state residents, also reported by the US Department of Commerce. By this measure, Rhode Island had the lowest corporate income tax burden in the nation in FY 2003, ranking 46th among the 46 states that levy taxes on corporate income. Corporate tax collections represent 0.16 percent of Rhode Island's personal income, compared to 0.33 percent in Massachusetts and 0.32 percent for the US as a whole.

Table 3 –
Corporate Taxes as a Percent of 2003 State Personal Income

	Corporate Income Taxes as a Percent of Personal Income	Rank Among 46 States with a Corporate Income Tax
Rhode Island	0.16%	46
Massachusetts	0.33%	11
US Average	0.32%	

Source: US Bureau of Census, US Bureau of Economic Analysis and Poverty Institute calculations.

State Corporate Tax Collections Declining Nationally

A 2004 joint report by Citizens for Tax Justice and the Institute for Taxation and Economic Policy, two widely-cited non-profit organizations that analyze tax issues, highlighted the pervasiveness of corporate tax avoidance by multi-state firms and the problem it poses for state tax systems. The report, *State Corporate Taxes, 2001-2003*, studied the financial statements of 252 Fortune 500 corporations that had fully disclosed their state and local tax payments.

Of the 252 firms analyzed, 71 paid no state tax during at least one of the three years from 2001 to 2003 and 25 companies enjoyed two to three no-tax years. A number of well-known multi-state firms with operations in Rhode Island such as Toys "R" Us, AT&T, and Merrill Lynch paid no net state income taxes over the full three-year period.⁴ These 252 companies had slashed their effective state income tax rates to an average of only 2.3 percent of their profits. Since the average statutory state corporate tax rate is about 6.8 percent, this means corporations paid only one-third of the statutory rate.

Table 4 – State Corporate Taxes as a Percent of Annual Earnings for Selected Multi-State Companies, 2001 – 2003

	2001	2002	2003
Toys“R”Us	-23.5%	-0.9%	3.9%
Merrill Lynch	-1.8%	-1.8%	-3.1%
AT&T	-10.1%	-0.7%	2.3%
Manpower	0.0%	-5.5%	-1.0%
Sears	1.7%	-0.1%	-0.5%
Walmarts	2.6%	2.0%	3.1%
AVG. STATUTORY STATE TAX RATE	6.8%	6.8%	6.8%

Source: McIntyre and Nguyen, and Nguyen, *State Corporate Taxes, 2001-2003*, March 2005. Note that negative numbers indicate company claimed a tax credit (or negative tax)

The report’s authors estimated that the companies avoided a total of \$41.7 billion in state corporate income taxes over the three years. While data on what taxes these firms paid specifically to Rhode Island is unavailable, it is likely that firms avoiding state taxes generally also avoided much of their Rhode Island tax liability.

How Multi-State Firms Avoid Paying State Corporate Taxes

Corporations have become increasingly aggressive at exploiting weaknesses and loopholes in state tax law. A recent report by the Tax Sheltering Work Group for the Multistate Tax Commission, a joint agency of state governments, identified 13 “high priority corporate income tax sheltering issues.” Many involve the deliberate use of separate business entities to shift revenues between states or avoid establishing a corporate “presence” that would subject a firm to state taxes. Others entail taking advantage of inconsistencies between state rules for apportioning corporate income between states.⁵

In a 2003 study, the Multistate Tax Commission estimated that such techniques had reduced state revenues from corporate income taxes by more than one-third during the 1990s. Rhode Island was estimated to have lost between \$12 million and \$25 million in FY 2001.⁶

The Toys“R”Us Tax Shelter In 1993, the state of South Carolina brought a case against Geoffrey Inc, a Delaware based holding company and wholly owned subsidiary of Toys“R”Us. Geoffrey Inc., which had neither employees or physical property, owned the Toys“R”Us trademarks and logos, including Geoffrey the Giraffe. Each year Toys“R”Us made royalty payments to Geoffrey Inc. for the use of the logo, which it deducted from its taxable income in South Carolina and other states, including Rhode Island. Because Delaware does not tax corporations whose only income

derives from ownership of “intangible assets” like trademarks, Geoffrey Inc. paid no tax to Delaware on its royalty income. Firms like Geoffrey Inc. are called “passive investment companies” (PICs) set up by parent corporations to shield income from state tax authorities by shifting revenues earned in states that levy corporate taxes to states that do not.

Tax cases in a number of states revealed that such prominent multi-state companies as Burger King, Limited and Staples routinely shift hundreds of millions in income each year to PICs located in tax haven states. In a case brought by New Mexico, K-Mart was found to have shifted \$1.25 billion to a passive investment subsidiary over a four-year period. The PIC then lent its royalty

receipts back to K-Mart, usually within two or three days of receiving them. Both royalty payments and interest on the loans were deducted from K-Mart’s reported income in New Mexico, as well as other states that permit such deductions.

Since information about PICs is only revealed by disclosures in court cases, it is impossible to determine how widespread the use of this tax shelter is, but evidence suggests PICs are a large and growing problem. In 1998, Delaware had 6000 PICs incorporated and new ones were being created at the rate of 600-800 per year; according to the Center for Budget and Policy Priorities. Nevada, which does not tax corporate income at all, had 132,000 businesses incorporated in 2001 with no employees; these are presumed to be PICs.⁷

Nowhere Income Federal law establishes a minimum level of presence or “nexus” a corporation must establish in a state before it is subject to state taxes. Under federal law, a multi-state company might have substantial sales in a state, but if it has no physical presence—offices, warehouses, etc.—it is not subject to that state’s corporate income tax.

According to the Multistate Tax Commission’s work group on corporate tax sheltering, firms can create “nexus carve outs” – separate subsidiaries by which multistate corporations can avoid establishing nexus and be shielded from state tax liability.

Furthermore, state corporate tax rules vary. Five states impose no tax on corporate income. States that do levy corporate taxes use different “apportionment formulas” to determine how much of the income of a multi-state corporation is taxable within a particular state. State apportionment formulas generally allocate income based on in-state sales, assets and employment. In recent years, a number of states, including Rhode Island, have modified their apportionment formula.

These factors together have created a growing pool of so-called “nowhere income” – income of multi-state corporations that is not subject to taxation in any of the fifty states, either because the income is earned in a state where the firm has no nexus, the income is allocated to a state with no corporate income tax, or the income is allocated among states in such a way that, due to variation in state apportionment formulas, much of it escapes taxation.

Tax Breaks and Incentives

In a study of corporate taxes in 20 states, University of Iowa economist Peter Fisher reported that state tax breaks had reduced effective corporate tax rates by 30 percent in 1998.⁸ Like their counterparts in other states, Rhode Island lawmakers have enacted a variety of corporate “tax expenditures”—exemptions, deductions and credits against the business corporation tax—intended to promote economic development. At least 27 such business tax breaks were passed from 1993-2003.⁹

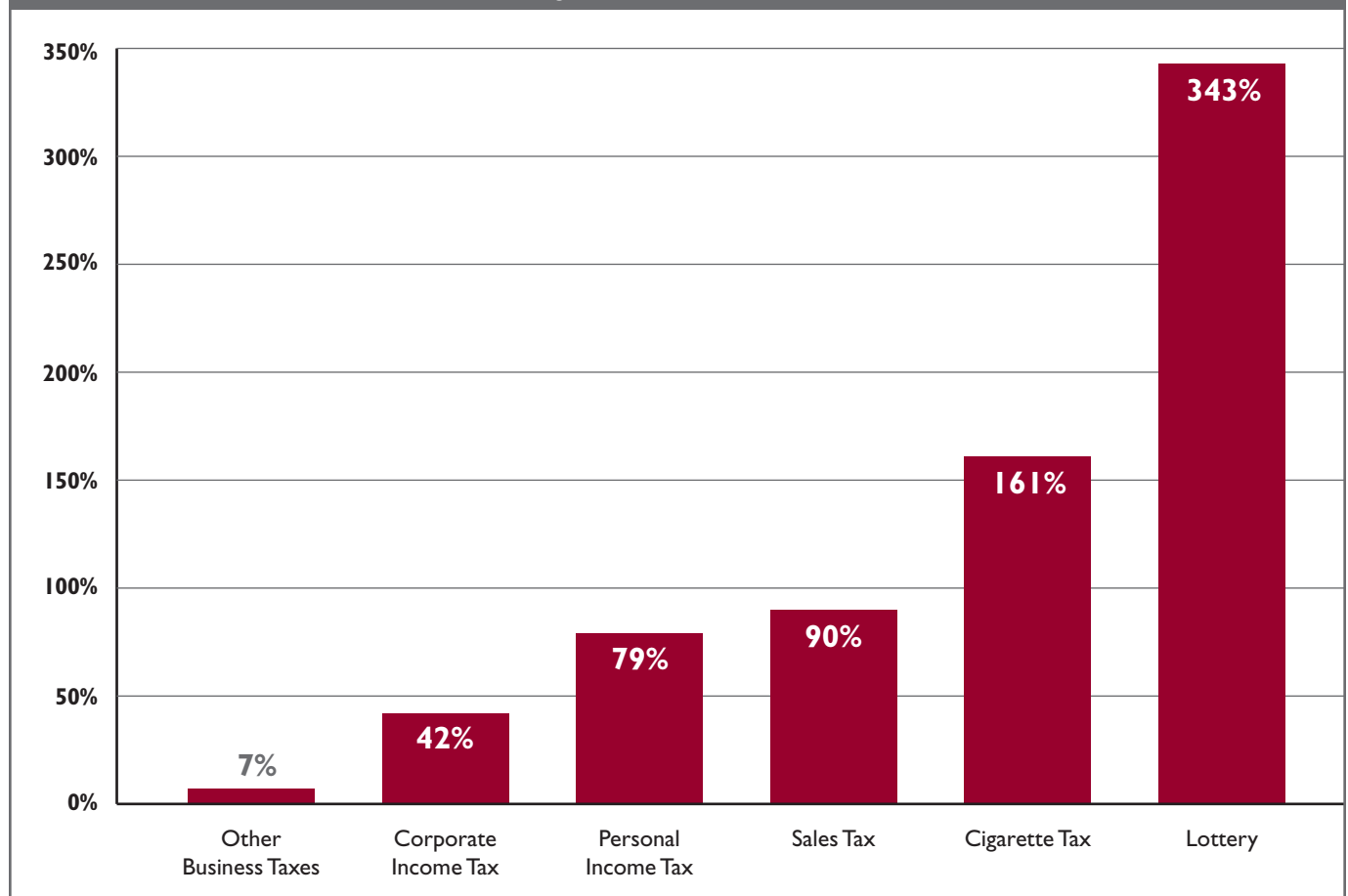
In 2003, the Rhode Island Economic Development Corporation commissioned a study by Harvard University economist James Medoff to evaluate the effectiveness of Rhode Island’s various tax

incentives. Medoff’s major conclusion was that the state lacks adequate data to determine how or whether its tax expenditures are working. He proposed that, “accountability can be achieved via regulations that make the reception of tax benefits by a company contingent upon its willingness to update the state on its financial status on a regular basis.”

Consequences for Rhode Island

In FY 2004, Rhode Island raised \$76 million from the business corporation tax – fifty percent less than the state realized from cigarette taxes. In addition to the business corporation tax, Rhode Island levies separate taxes on utility earnings, on financial institutions and on the gross premiums of insurance companies. All these taxes combined raised \$202 million in FY 2004. In contrast, lottery revenues, at \$281 million, were 39 percent higher. Whereas revenues from the sales tax and personal income tax have been rising at 5-7 percent per year over the past decade—about in line with the state’s economy—revenues from the business corporation tax grew only one percent per year. Other business taxes on utilities, insurance companies and financial institutions have been shrinking.

Chart 2 – Percent Change in Rhode Island Revenue Sources, 1995 - 2005



Disappearing corporate taxes adversely impact state finances and the overall fairness of Rhode Island's tax system. Corporate earnings benefit from state spending on infrastructure, roads, public transit, schools, health care, child care, the environment and public safety. Yet taxes on corporate earnings have declined and been replaced by increased reliance on local property taxes, cigarette taxes, gaming revenues and, most recently, a doubling of the minimum business tax paid largely by the state's smallest business owners. Such policies have shifted the tax burden from corporations and their shareholders toward low and middle income Rhode Islanders. The Institute on Taxation and Economic Policy estimated that the lowest earning fifth of Rhode Island households saw their state and local tax burden increase at 4 times the rate of the top-earning one percent of households, from 1989 – 2000.¹⁰

Recommendations

Close Abusive Tax Shelters Toys “R” Us Loophole. Of the states that levy a tax on corporate income, twenty-two require businesses to combine the earnings of all business units before calculating state tax liability. This requirement, called “combined reporting” effectively curbs the practice of sheltering income through passive investment subsidiaries. Seven other states, including Massachusetts and Connecticut, deny deductions from gross business income for royalties and interest paid to related corporations, sharply curtailing the use of PICs for tax avoidance purposes. Since its “anti-PIC” rule was enacted in 2003, Massachusetts has seen corporate tax revenues rise by \$50-\$60 million per year, approximately a 5 percent increase in corporate tax collections.¹¹

Legislators should bring Rhode Island's treatment of passive investment companies in line with Massachusetts and Connecticut law and effectively prohibit the inappropriate use of passive investment companies. If enacted, such legislation would raise at least \$8 million annually.¹²

“Nowhere Income” Loophole. As noted above, multistate firms can take advantage of mismatches between federal laws on nexus and state tax apportionment formulas by assigning income to states that lack authority to tax it. Twenty-five states, including Massachusetts, Maine, New Hampshire and Vermont, have so-called “throwback” rules that require firms to add untaxed income from out-of-state sales to the state where goods were produced. By passing a throwback rule, Rhode Island can ensure that multi-state businesses based in the state pay taxes on all their activities and not obtain a competitive advantage over local firms by avoiding taxation through the creation of nowhere income. In a legislative hearing on this issue in 2004, Rhode Island's tax administrator estimated that a throwback rule would raise another \$8 million annually.

Evaluate Economic Development Tax Breaks. When Rhode Island lawmakers provide businesses with a credit, exemption or reduction in their taxes, the foregone revenues are rightly called “tax expenditures” because, as with direct expenditures, the state incurs a real cost. Unlike direct expenditures, which are reported and reviewed in each budget cycle and which require annual appropriations, tax expenditures often become permanent provisions of the tax code. Unless business tax breaks are subject to regular reporting and evaluation, citizens and legislators are unable to assess either their costs or benefits.

In 1998, Rhode Island joined 37 other states in requiring regular reporting of tax expenditure by the Division of Taxation. The usefulness of Rhode Island's bi-annual Tax Expenditure Report is limited by two factors:

- Lack of complete data. In 2004, all but one of the 25 tax expenditures involving the Business Corporation Tax received a reliability rating of 5, indicating no reliable basis on which to base an estimate.
- Lack of any information on the purposes, goals or intended benefits of tax expenditures. Data on “preference items for more than one tax” which includes most economic development credits, estimates that these items cost the state \$25.2 million in 2004. But we have little information on how many jobs were created, at what wage or in what industries.

In recent years, state lawmakers and economic development officials have moved in the right direction when negotiating individual tax deals with businesses – tying tax breaks to job creation, specifying minimum wages and including “clawback” provisions to recoup tax expenditures if the company reneges on its obligations.

The state has also begun to establish mechanisms for reviewing the state's tax structure and incentives. In 2005, the General Assembly established a Permanent Joint Committee on Economic Development to look at, among other things, the relation between taxes and the state's economy. The legislature also allocated \$100,000 to establish a tax policy function in state government. The Governor announced his intention in September 2005 to use these funds for an Office of Tax Research and Analysis within the Department of Administration. These are steps in the right direction and the legislature should ensure that the new committee and office have sufficient resources to gather comprehensive data on tax expenditures, job creation and business investment in Rhode Island. Corporate tax data could be improved if Rhode Island, like Connecticut, required that corporations enjoying tax incentives file financial information allowing the policy-makers and the public to evaluate the costs and benefits of the incentives.

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- ¹ It should be noted that corporate tax collections in Rhode Island and in most other states were particularly low in 2002 due to the economic downturn.
 - ² Center on Budget and Policy Priorities, *Structural Deficits Threaten State's Fiscal Stability*. (Draft)
 - ³ Robert McIntyre and TD Coo-Nguyen, *State Corporate Income Taxes, 2001-2003*, Citizens for Tax Justice and Institute for Taxation and Economic Policy, 2005.
 - ⁴ Robert S. McIntyre and TD Coo Nguyen, *State Corporate Taxes, 2001-2003*, Citizens for Tax Justice and Institute on Taxation and Economic Policy, February 2005.
 - ⁵ Multistate Tax Commission, *Corporate Income Tax Sheltering Work Group Report*, June 2004.
 - ⁶ Multistate Tax Commission, *Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections*, July 2003.
 - ⁷ Michael Mazerov, "Closing Three Common Corporate Tax Loopholes Could Raise Additional Revenue for Many States," Center for Budget and Policy Priorities, May 2003.
 - ⁸ Peter Fisher, "Tax Incentives and the Disappearing State Corporate Income Tax," State Tax Notes, March 2002.
 - ⁹ Poverty Institute, *Where Did All the Money Go? Rhode Island's Revenue and Spending, 1993 – 2003*, May 2003.
 - ¹⁰ Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in all 50 States, 2nd Edition*, January 2003.
 - ¹¹ Adopting combined reporting would nullify the PIC shelter as well as other tax avoidance measures, like transfer pricing and nexus shields. Currently New Hampshire and 15 other states treat parents and subsidiaries as one entity for state tax purposes. In 2005, the Massachusetts legislature considered a bill to mandate combined reporting at the discretion of the tax commissioner. By joining New Hampshire, Rhode Island could realize significant revenue gains and vastly improve the fairness and transparency of its tax systems.
 - ¹² This figure was cited by Division of Taxation Administrator Gary Clark in testimony before the House Finance Committee, 2005.