

Tax Tricks

Corporate Income Tax Evasion in Rhode Island

*A Report by the Campaign for Rhode Island's Priorities * April 11, 2007*

Corporate income taxes are the main tax paid by large businesses for the public benefits from which they benefit. Quality public education and transportation, roads and highways, police and fire services, and state-supported research and business incubators all serve the needs of business. **Yet despite these benefits, many large multi-state corporations that operate in Rhode Island avoid paying millions in corporate income taxes every year.**

In fact, Rhode Island's corporate taxes are among the lowest in the country, declining by 57% between 1989 and 2003 – a decline 17% greater than the national average.¹ Rhode Island ranked 42nd in the nation in 2005 for collection of corporate taxes as a percent of private sector gross state product.² The Poverty Institute at Rhode Island College reports that in 2000, “half of Rhode Island's largest corporations paid less in income tax than the typical Rhode Island family.”³

Large Corporations Fail to Pay their Fair Share

This steep decline in corporate tax collections is partially the result of tax avoidance strategies – popularly called corporate tax loopholes – used by large multi-state corporations, including “big box” retailers such as Toys “R” Us, KMart and Wal-Mart. A 2005 report by Citizens for Tax Justice and the Institute for Taxation & Economic Policy (ITEP) found that 252 of America's largest corporations failed to include two-thirds of their U.S. profits on state tax returns, *avoiding an estimated \$41.7 billion in state corporate income taxes over three years.*⁴ In Rhode Island, the Division of Taxation estimates that corporations evade paying more than \$12 million a year in state income tax payments through the use of just two popular loopholes -- passive investment companies and “nowhere income” – that allow them to shift income to states where they will not be taxed at all.

Closing Corporate Tax Loopholes is Good Economic Policy

In the face of the state's current estimated \$360 million budget deficit, closing corporate tax loopholes makes good economic sense. While Rhode Islanders face growing disparities in income, education and access to health care, state services and programs intended to help offset these disparities are jeopardized by deep funding cuts. The deficit also prohibits efforts by policy-makers to reduce the state's over-reliance on property taxes to fund education and has halted important investments in new economic development, job training and education initiatives.

The Center on Budget and Policy Priorities outlined strategies for states to use in addressing the problem, stating that Rhode Island “could realize increased corporate income tax revenue by enacting laws modeled on those of Alabama, Connecticut, Massachusetts, Mississippi, New Jersey, North Carolina, and Ohio to shut down widespread, abusive, and costly tax-avoidance techniques.”⁵ The Rhode Island General Assembly is currently debating passage of legislation to do just that, including prohibiting the use of passive investment companies that many large corporations use.

While this type of incremental change to Rhode Island’s tax policy will help, the Institute on Taxation and Economic Policy (ITEP) reports that combined reporting is an even simpler, more effective approach to prevent corporate tax avoidance. Under combined reporting, all of the income and expenses of a company and its subsidiaries are added together so that passive investment corporations and other loopholes, such as those used by Wal-Mart that were reported in a recent Wall Street Journal, can not reduce a company’s taxable profits. ITEP argues that, “in the absence of combined reporting, multi-state corporations will always be able to develop new methods of transferring profits from high-tax to low-tax states.”⁶

As an example, Wal-Mart, which operates more than 3,000 SuperCenters and discount stores nationally, and eight in Rhode Island, uses real estate investment trusts (REITs) to take advantage of a corporate income tax loophole that would be closed with combined reporting. Wal-Mart paid just 2.0% of its income in taxes for the year 2002.⁷ In comparison, middle-income taxpayers in Rhode Island paid 10.7% of their income in taxes and the poorest Rhode Islanders, despite earning less than \$16,000 annually, paid 11.5%.⁸

Twenty states have already enacted combined reporting, including Maine, New Hampshire, Vermont and New York. Massachusetts is currently debating enactment of combined reporting legislation.

Closing Loopholes is One Step towards Restructuring for a Fair and Adequate Rhode Island Tax System

Corporate tax loopholes are not generally available to small, locally owned businesses and thus add to the competitive disadvantages Rhode Island’s small retailers and other small businesses face in the marketplace. Closing these loopholes will help level the playing field for small businesses while increasing needed state revenue.

Additionally, as highlighted above, research shows that *low- and middle-income families in Rhode Island pay a higher share of their income in state and local taxes than do the wealthiest Rhode Islanders and the large “big box” retailers here to sell to Rhode Islanders.* The Poverty Institute reports that in 2000, “the median corporate income tax paid by the state’s largest employers was just \$1,825, less than the median personal income tax paid by joint filers.”⁹

Additional Recommendations for a Fair Tax System

In addition to legislation to close corporate tax loopholes, The Campaign for Rhode Island’s Priorities supports legislation that would:

- **Stop the elimination of the 5% capital gains tax** scheduled for 2008. Massachusetts eliminated its own capital gains tax, then rescinded the law and now taxes long-term gains at 5.3%. The elimination of the 5% capital gain may cost Rhode Island as much as \$40 million

in the 2008 tax year. In 2005, 83.7 percent of all capital gains in Rhode Island were reported by the 2.5% of taxpayers with incomes over \$200,000. The average income for this group was \$521,615 – more than ten times the median household income in RI of \$51,548.¹⁰

- **Eliminate sales tax exemptions for luxury items** like private aircraft -- the aircraft exemption costs the state \$1 million annually.
- **Broaden the sales tax to reflect our changed economy** by taxing luxury services such as golf, marina and fitness memberships. These three expansions in sales tax alone would increase state revenue by an estimated \$13.5 million.
- **Freeze the alternative flat tax** – an entitlement benefiting only the 13,119 wealthiest Rhode Island taxpayers. When fully phased in, the flat tax will cost Rhode Island as much as \$73 million.
- **Place a moratorium on the 2006 property tax legislation** that artificially limits the ability of cities and towns to meet their own needs -- despite stagnant state support to cities and towns for education funding.
- **Impose a significant tax on the capital gains from short-term land sales.** This legislation exempts owner-occupied homes but targets short-term investors that flip properties for large profits, driving property rates and rents out of reach for many Rhode Islanders. Estimates on revenue from this change are still pending review.
- And, implement 2006 legislation that will **set up a state office of revenue analysis** and mandate a review of the effectiveness of the state's tax credit policies. *We need to know what tax policies are effective in achieving state goals for job creation and economic development and restructure those that aren't.*

To learn more about the Campaign for Rhode Island's Priorities, visit www.PrioritiesRI.org or call (401) 463-5368.

Citations:

¹ *State Corporate Income Taxes 2001-2003*, Citizens for Tax Justice and The Institute for Taxation & Economic Policy, February 2005

² *Total State and Local Business Taxes: 50 State Estimates for Fiscal Year 2006*, Ernst & Young for the Council on State Taxation, February 2007

³ *Rhode Island's Disappearing Corporate Income Tax* (Tax Facts Issue #3), The Poverty Institute at RI College School of Social Work, March 2006

⁴ *State Corporate Income Taxes 2001-2003*, Citizens for Tax Justice and The Institute for Taxation & Economic Policy, February 2005

⁵ *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue For Many States*, Center on Budget & Policy Priorities, Revised May 23, 2003

⁶ Institute on Taxation & Economic Policy, *Policy Brief #24*, 2007

⁷ *State Corporate Income Taxes 2001-2003*, Citizens for Tax Justice and The Institute for Taxation & Economic Policy, February 2005

⁸ *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2nd Edition*, The Institute on Taxation & Economic Policy, January 2003

⁹ *Rhode Island's Disappearing Corporate Income Tax* (Tax Facts Issue #3), The Poverty Institute at RI College School of Social Work, March 2006

¹⁰ Poverty Institute at RI College, analysis of data provided by the RI Division of Taxation.