Department of Revenue Washington State

"Working together to fund Washington's future"

Corporate Income/Net Receipts Tax: Microsimulation

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Presentation Preview

- Recap & New Findings
- Data
- Tax Planning Framework
- Tax Planning in Data
- Adjustments to Model
- Other Issues, Questions

Recap & New Findings

Data

Tax Planning Framework

Tax Planning in Data

Adjustments to Model

Other Issues, Questions

Recap and Overview of New Findings

- The corporate macro model overestimated federal tax collections in 2018. This unexplained residual was dealt with by assuming:
  - 50% of residual is attributable to taxable income (affecting a potential WA tax).
  - 50% is attributable to deemed repatriation and other factors outside taxable income (not affecting WA).
- The corporate micro model shows in tax year 2017 corporations reported weak taxable income, but <u>strong growth in taxable income in 2018</u>.

Recap and Overview of New Findings

- The key disconnect in the macro model appears to be that the model didn't account for tax planning in late 2017.
  - Taxpayers filing in Q1-Q3 of 2017 reported only a small decline in taxable income relative to 2016.
  - Taxpayers filing in Q4 of 2017, able to predict corporate tax cuts would occur in 2018, reported a large decline in taxable income in 2017.
- Since tax collections data are reported annually based on the US tax year (Oct. – Sept.), the apparent drop in tax payments occurring in Q4 of 2017 was conflated with 2018.

Recap & New Findings

Data

Tax Planning Framework

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Other Issues, Questions

The Data

<u>IRS Data 2016-18 Tax Years</u>

- Primary data source
- Identifying variables
- Income variables

Gross & Net Receipts	
Dividends	Interest
Rent	Royalties
Net Gain	Other Income

- Deduction Variables

COGS	Compensation
Salaries	Repairs
Interest Ded.	Depreciation
Benefits	Other, etc.

<u>DOR Data 2015-18 Tax Years</u>

- Used to determine WA apportionment
- Identifying variables
  - For matching
- Quantitative variables

Gross income

- Out-of-state sales

- Out-of-state freight

Matching Process (Comparable to VAT/margin tax models)

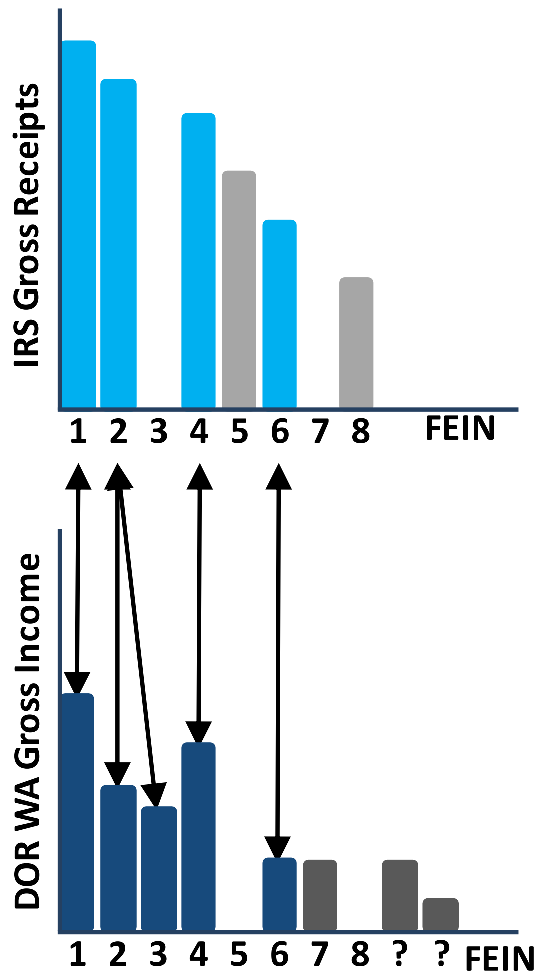
Three-step matching of B&O and IRS records:

1. By FEIN, where possible
2. By name for large unmatched B&O records, accounting for subsidiary relationships where known/possible
3. By name for all remaining unmatched B&O records, ignoring minor differences, such as abbreviations (only counting unique matches)

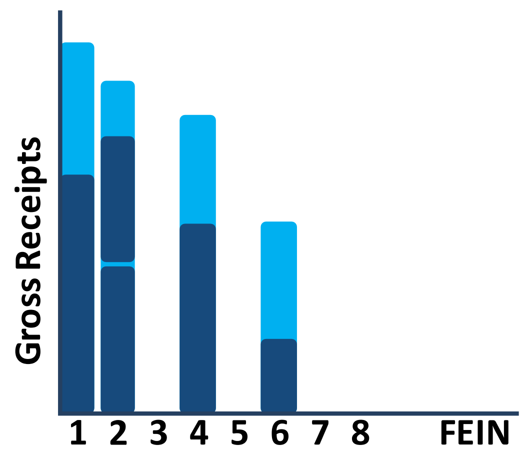
For any <u>leftover</u> gross amounts, apply group apportionment

- By geography
- By NAICS

Matching Process (Comparable to VAT/margin tax models)

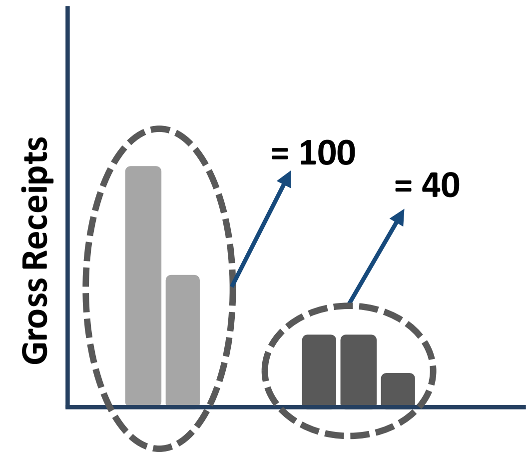


Matched Taxpayers



The dark blue shaded portions represent the percent of each matched taxpayer's IRS total income (and deductions) that is apportionable to Washington.

Unmatched Taxpayers



Within a category of unmatched taxpayers, each taxpayer will have the same apportionment percent (i.e., 40%), based on the ratio of unmatched B&O taxable income to unmatched IRS adjusted federal income.

The Data (Summary Statistics)

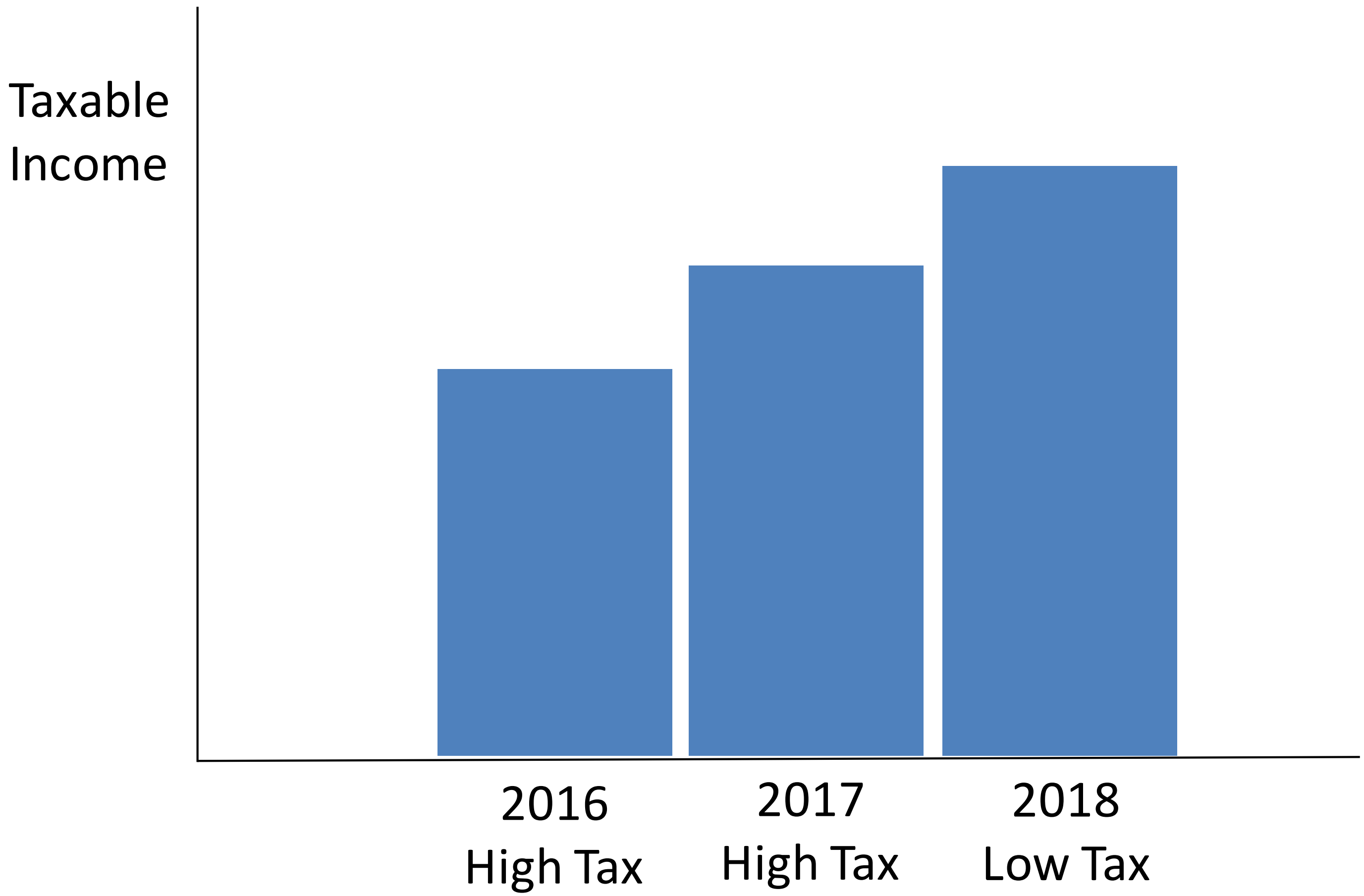
Summary statistics: CINR tax microsimulation model ($ billions)

Washington Amount (Destination-based apport.)	2016	2017	2018
Net Receipts	299	277	368
Cost of Goods Sold	205	189	247
Gross Profit	95	88	121
Other Income	36	33	51
Total Income	131	121	172
Total Deductions	108	99	130
NOLs & Special Deductions	2	2	11
Taxable Income	21	20	31
(2017-19 fiscal biennium) CINR Macro Model Taxable Income: 57			

Recap & New Findings | Data | **Tax Planning Framework** | Tax Planning in Data | Adjustments to Model | Other Issues, Questions

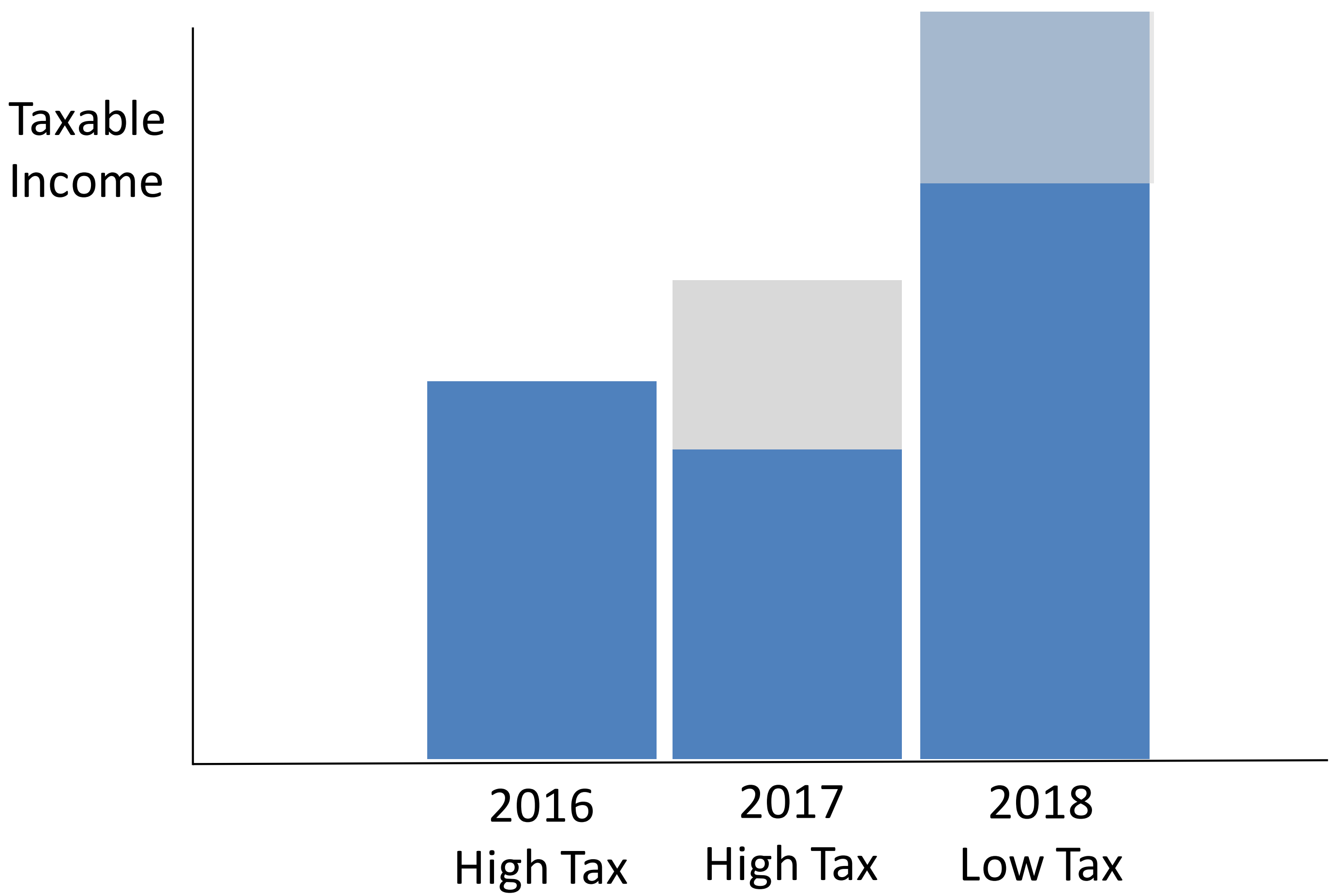
Tax Planning and the Tax Cuts and Jobs Act

If tax planning occurred in 2017, why does that matter going forward?



Tax Planning and the Tax Cuts and Jobs Act

Tax planning may appear in data as a shift in taxable income between years.



Tax Planning and the Tax Cuts and Jobs Act

The amount that businesses engage in tax planning in response to enacted or proposed tax legislation depends on:

Net Benefit of Response: Businesses are more likely to react if it will yield a large net tax impact.

Information: Businesses are more likely to react as the certainty of legislation increases.

Timing: The more time taxpayers have to respond, the greater the expected response.

Tax Planning and the Tax Cuts and Jobs Act

- The Tax Cuts and Jobs Act (TCJA) reduced the top-line corporate income tax rate from 35% to 21% in 2018.
- Tax filers faced a blended tax rate if their 2018 tax year included part of 2017 and part of 2018.

Top-line tax rate (Q1 = Feb 15, Q2 = May 15, Q3 = Aug 15, Q4 = Dec 31)

Tax Filing	2016	2017	2018
Q1	35.0%	35.0%	33.3%
Q2	35.0%	35.0%	29.8%
Q3	35.0%	35.0%	26.3%
Q4	35.0%	35.0%	21.0%

Tax Planning and the Tax Cuts and Jobs Act

- A larger expected reduction in the tax rate in the following tax year provides corporations with more incentive to reduce taxable income in the current tax year.

Tax Rate Incentives on Taxable Income

Tax Filing	2016	2017	2018
Q1	-	-	↓↓
Q2	-	↓	↓
Q3	-	↓↓	↓
Q4	-	↓↓	↑↑

Tax Planning and the Tax Cuts and Jobs Act

September 2016 – September 2017

- Candidate Trump proposes reduction of corporate tax rate to 15%. (Sept. 2016)
- Election of Trump, GOP congress. (Nov. 2016)
- Trump administration releases goals of tax reform. (Apr. 2017)
- First tax reform hearing. (May 2017)
- GOP releases joint statement on tax reform. (July 2017)
- GOP releases tax reform framework. (Sept. 2017)

November 2017 – December 2017

- House releases draft of TCJA. (Nov. 2, 2017)
- Senate releases draft TCJA proposal. (Nov. 9, 2017)
- House passes early draft of TCJA with 20% top marginal rate. (Nov. 16, 2017)
- Senate passes version of TCJA. (Dec. 2, 2017)
- Senate & House pass final bill with 21% top rate. (Dec. 20, 2017)
- Pres. Trump signs TCJA. (Dec. 22, 2017)

Tax Planning and the Tax Cuts and Jobs Act

- In 2017, as taxpayers became more certain that the 2018 corporate tax rate would be cut, they had more incentive to reduce 2017 taxable income.

Informational Incentive on Taxable Income

Tax Filing	2016	2017	2018
Q1	-	-	↓↓
Q2	-	↓	↓↓
Q3	-	↓	↓↓
Q4	-	↓↓	↑↑

Tax Planning and the Tax Cuts and Jobs Act

- In 2017, as taxpayers became more certain that the 2018 corporate tax rate would be cut, they had more incentive to reduce 2017 taxable income.

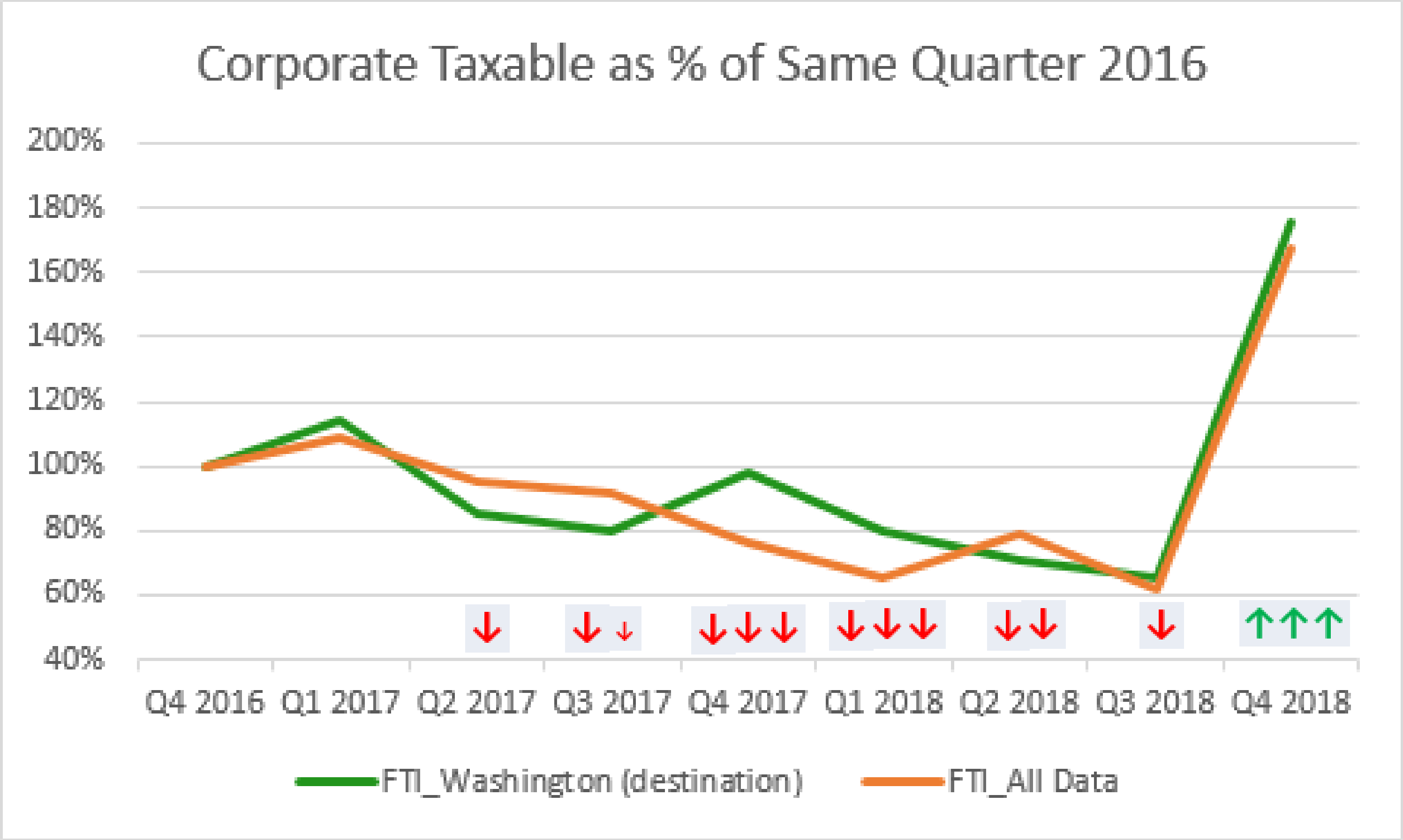
Combined Incentive on Taxable Income

Tax Filing	2016	2017	2018
Q1	-	-	↓↓↓
Q2	-	↓	↓↓
Q3	-	↓↓	↓
Q4	-	↓↓↓	↑↑↑

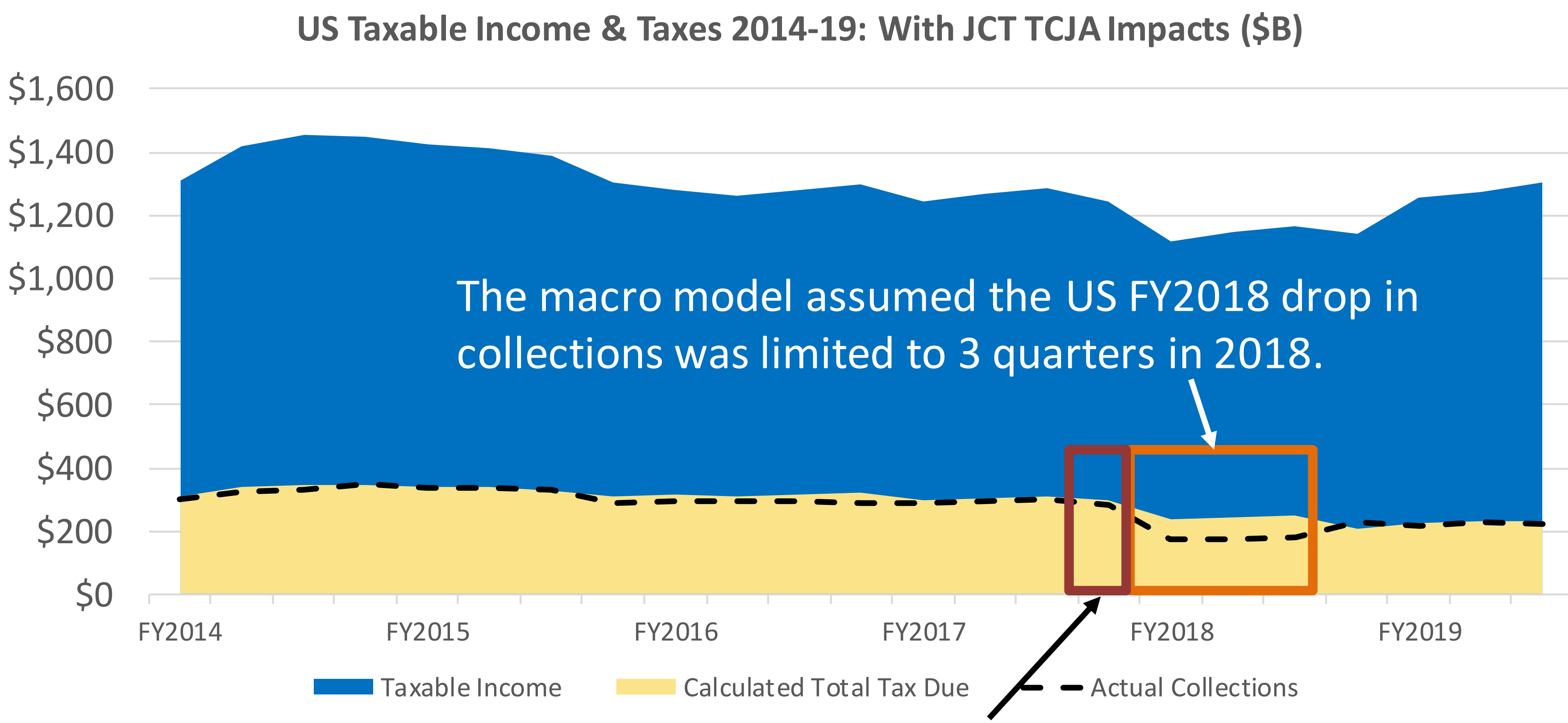
Recap & New Findings → Data → Tax Planning Framework → **Tax Planning in Data** → Adjustments to Model → Other Issues, Questions

Tax Planning and the Tax Cuts and Jobs Act

The trend in taxable between Q4 2016-Q4 2018 is consistent with tax planning.



Reconciling With Macro Model



Micro model suggests tax planning in Q4 of 2017 accounted for bulk of model's US FY2018 corporate collections overestimation.

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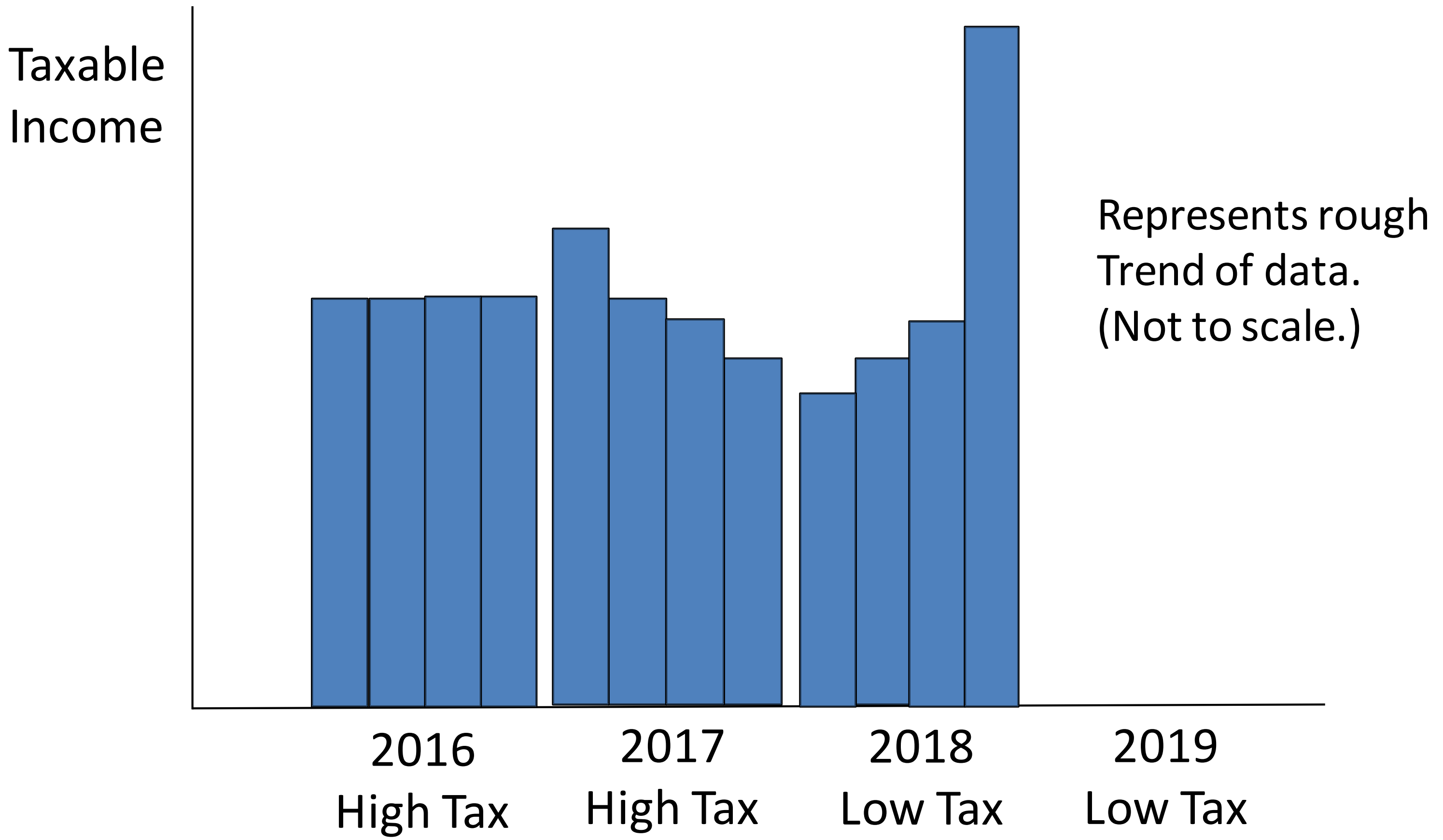
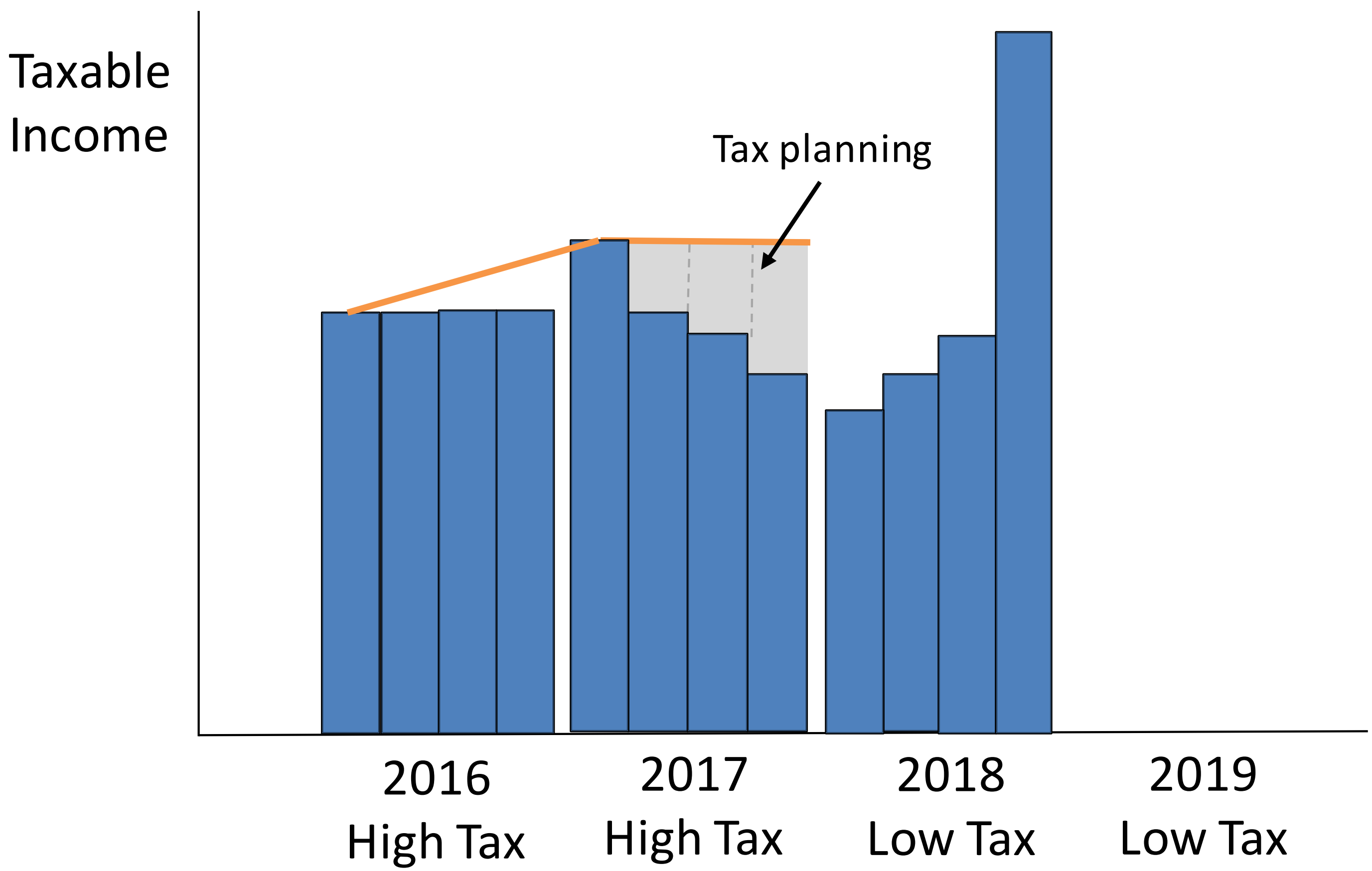
Adjustments to Microsimulation Model

In light of apparent tax planning's impact on results, what is a reasonable base for projecting future tax years?



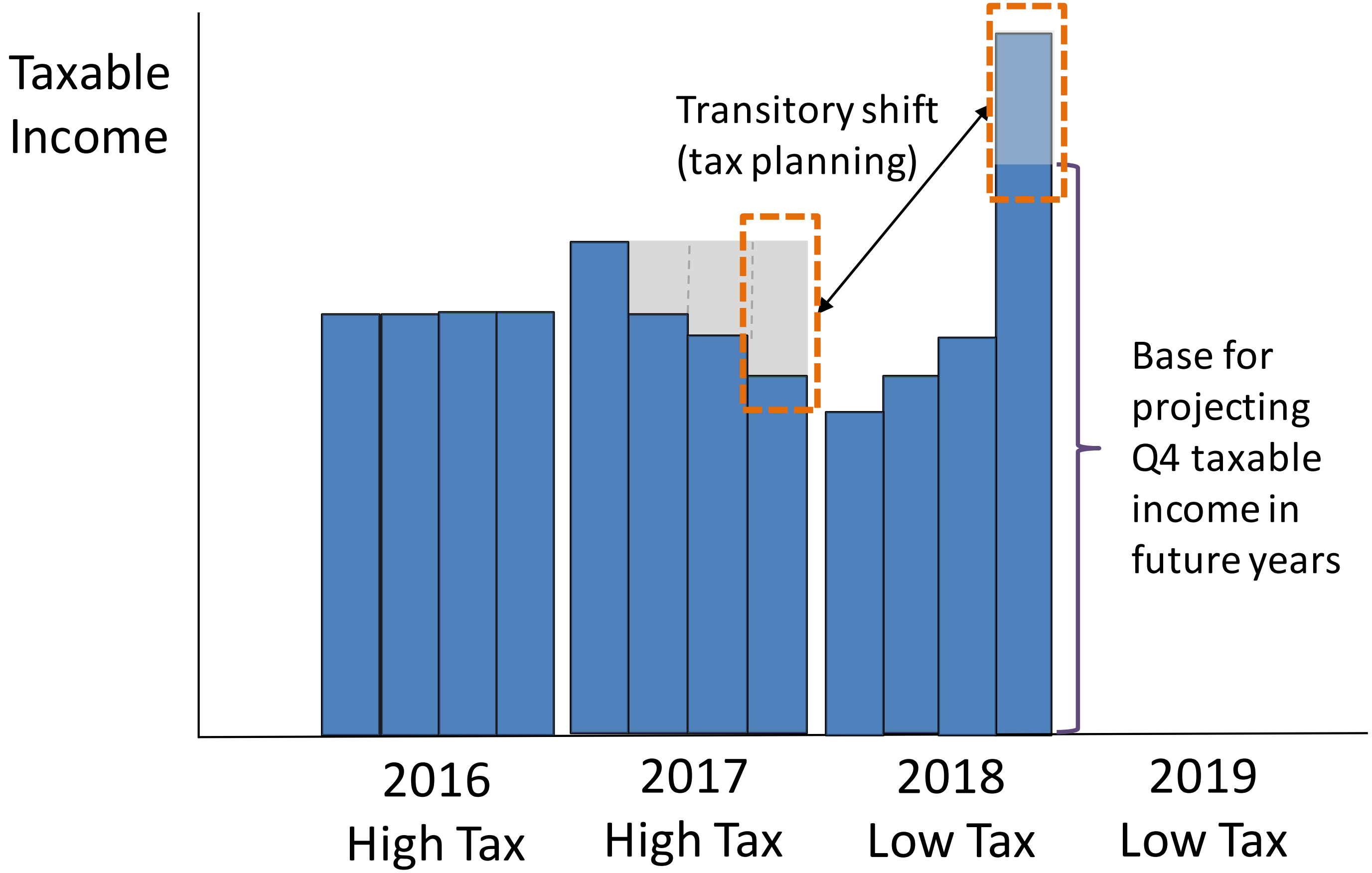
Adjustments to Microsimulation Model

Use aggregate growth for Q1 2017 filers vs. Q1 2016 filers to identify Q2-Q4 2017 tax planning. (8.5% YOY growth in Q1 2017).



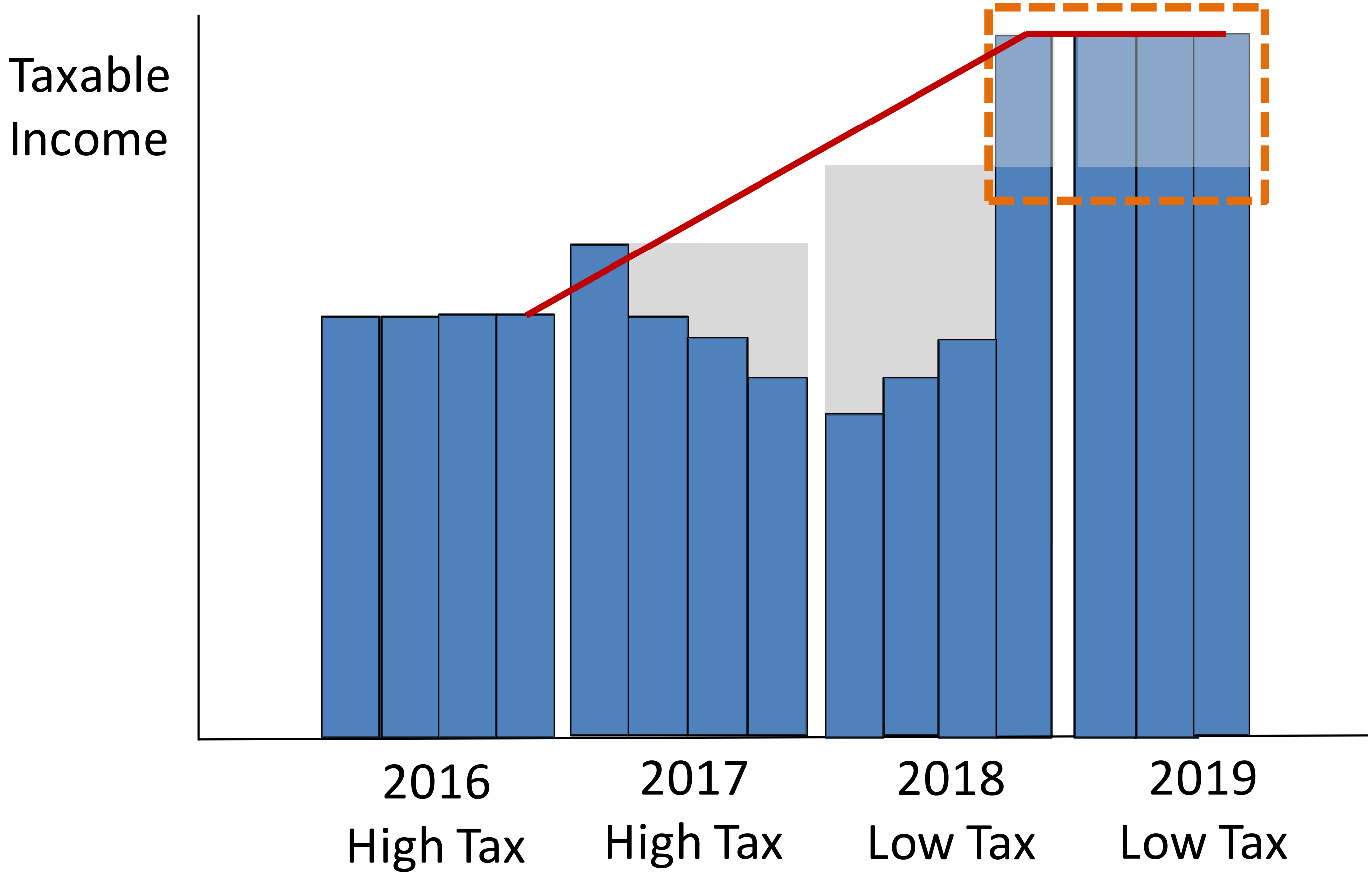
Adjustments to Microsimulation Model

Aggregate Q4 2018 filers' taxable income is two-thirds higher than Q4 2016. Assume a portion of this is transitory, reflecting taxable income shift from 2017.



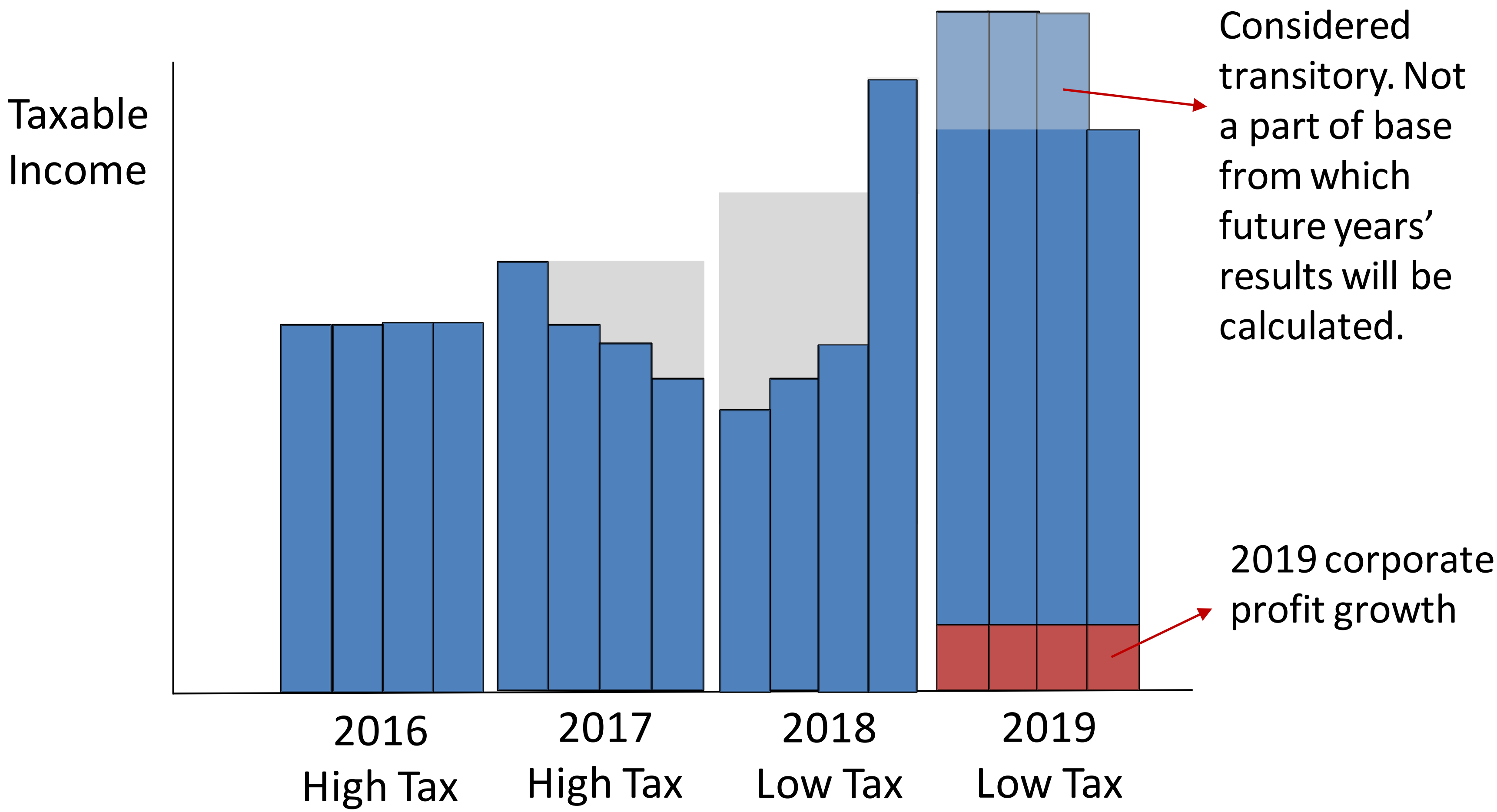
Adjustments to Microsimulation Model

Use Q4 2016 to Q4 2018 aggregate taxable income growth to identify growth of Q1-Q3 2019 taxable income, relative to same quarter of 2016…



Adjustments to Microsimulation Model

… while also factoring in growth of corporate profits from 2018-2019



Adjustments to Microsimulation Model

- The quarterly transitory impacts/adjustments described above will be calculated in aggregate.
- We will adjust the corporate profit growth forecast accordingly, and apply the same across-the board increase (decrease) to the taxable income categories of all taxpayers in that quarter.

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Other Issues / Questions

<u>Growth Forecast-Related</u>

- *COVID-19 and governmental responses (e.g., restrictions, fiscal stimulus) had differential impacts across geographies and industries.*
  - *In light of such differentials, is the BEA's before-tax corporate profit statistic still a reasonable proxy for growth in WA corporate taxable income?*
  - *Should state-specific adjustments be applied to BEA's before-tax corporate profit statistic, which is used to forecast growth?*
  - *Or, are their other relevant Washington-specific measures?*

Other Issues / Questions

Possibility of Corporate Tax Increase

- *No planned adjustment to account for proposed increase in corporate taxes, at least until significantly more information is known.*
  - *Tax planning is possible, but not easily predictable*

Effect of tax planning on VAT/Margins Tax Models

- *VAT/Margins tax bases are less sensitive to federal corporate income tax planning*
  - *Time permitting, forecasts in those models should be adjusted, though.*

Questions for us?