State Tax Shelters and Taxation of Capital Income

by Joseph Bankman

The tax shelters of the 1990's reduced state and well as federal tax receipts. In addition, states were and are subject to 'state only' aggressive tax planning. This form of tax planning bears a close resemblance to (but can be distinguished from) a typical tax shelter: it is purely tax-driven and shifts income from a high tax to a no-tax jurisdiction. States are also subject to various forms of tax competition.

I believe the battle against federal shelters (including those that affect state revenues) is going well. The only cloud on the horizon is the prospect that the Supreme Court (or a number of appellate courts) might reject the economic substance or business purpose doctrine. I believe that the most common form of aggressive state tax planning – the creation of intangible holding companies – can (and is being) limited through legislation, if not litigation. I am less optimistic about the ability of states to raise corporate tax revenues in the face of tax competition. Morever, the most likely forms of replacement taxes – individual income and sales – are also subject to state tax competition, albeit less so. On the federal level, many scholars have recommended replacing the corporate tax with a progressive consumption tax. That, however, may be a non-started at the state level: it would be difficult to apportion and exacerbate state tax competition.