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Exploring the role Delaware plays as a domestic tax haven ☆

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ABSTRACT

We examine whether Delaware is a domestic tax haven. We find that taxes play an economically important role in determining whether U.S. firms locate subsidiaries in Delaware and that a Delaware-based state tax avoidance strategy lowers state effective tax rates by between 0.7 and 1.1 percentage points, on average. The tax savings represent a 15–24% decrease in the state income tax burden and translate to an increase in net income of 1.04–1.47%. However, we find that the tax benefits of Delaware tax strategies are diminishing over time in response to initiatives by state governments to limit multistate tax avoidance.

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1. Introduction

The role of tax havens in corporate tax avoidance has been studied extensively in recent academic work (e.g., Dyreng and Lindsey, 2009; Markle and Shackelford, 2012). These studies focus on foreign tax havens used by corporations in the U.S. to reduce income taxes. In aggregate, U.S. firms save billions of dollars in tax liabilities using foreign tax havens. However, opportunities to avoid corporate tax are not restricted to *foreign* tax havens, such as the Cayman Islands or Bermuda. Substantial tax rate variation exists among U.S. states, suggesting that U.S. corporations operating in multiple states can exploit similar tax avoidance opportunities *domestically*. Foremost among U.S. states with a corporate tax code conducive to tax-motivated income shifting is Delaware.

Recently, Delaware has become a target of scrutiny in the popular press and on the world stage. Articles in *The New York Times* and *The Economist* have gone so far as to

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suggest that Delaware is a domestic tax haven.[1] In June 2010, Delaware landed at the top of *National Geographic* magazine's published list of the most secretive tax havens in the world, outpacing more commonly mentioned foreign tax havens such as Luxembourg, Switzerland, and the Cayman Islands.[2] Foreign nations have also voiced concerns about Delaware's exploits as a tax haven. Recently, the government of Brazil considered legislation to officially blacklist Delaware as an abusive tax haven, right alongside other countries perceived to be tax havens, such as Bermuda and the Isle of Man, among others.[3]

In spite of the increased public allegations regarding Delaware's role as a tax haven, surprisingly little academic research has been conducted to evaluate these claims. To examine these claims, we first review the fundamentals of state income tax laws in the U.S. and describe a Delaware-based tax strategy that involves shifting income between subsidiaries of the same firm. Second, we address a number of empirical questions that will help researchers, practitioners, and policy makers better understand whether Delaware is indeed a domestic tax haven. Does Delaware's well-known dominance in parent company incorporation hold for subsidiary incorporations? Do firms organize subsidiaries in Delaware solely to take advantage of legal and governance benefits (as has been argued to be the case for parent corporations), or do tax avoidance strategies also play a role? If taxes play a role, how substantial are the tax benefits? We provide answers to these questions in the analyses that follow.

Prior research has shown that Delaware dominates other states in the "market for incorporation" of parent companies. For example, Bebchuk and Cohen (2003) show that nearly 60% of parent firms are incorporated in Delaware and argue that the drivers of Delaware's preeminence are the significant legal and governance benefits available to firms incorporated there. We find that approximately 58% of domestic *subsidiaries* in our sample are incorporated in Delaware, a pattern that is similar to that observed in parent companies. While at first glance this result may not seem surprising, consider that subsidiaries do not face the same legal and governance challenges, such as hostile takeovers and disclosure rules, as parent companies face. Thus, legal and governance factors may receive less weight in making subsidiary incorporation decisions, which suggests that other factors, including taxes, also play a role.

Our tests reveal that the frequency of subsidiaries located in Delaware far outpaces its economic output as measured by Gross Domestic Product (GDP), which suggests that Delaware subsidiaries are organized for purposes beyond satisfying local demand to produce goods and services. In addition, we show that the frequency of patent assignment to Delaware-based owners per dollar of state GDP is the highest in the country. Placing intangible assets, such as patents or trademarks, in Delaware creates opportunities for within-firm income shifting that ultimately reduce the firm's tax burden.

We find that a firm's decision to locate a subsidiary in Delaware is significantly influenced by tax factors. Sample firms are more likely to locate subsidiaries in Delaware if they both own intangible assets and operate in states that have tax laws conducive to cross-state income shifting strategies. These strategies often involve a Delaware subsidiary in conjunction with operations in states that allow separate filing or lack an economic nexus doctrine.[4] In addition, the likelihood of operating a subsidiary in Delaware is increasing in the average statutory tax rate faced by all the firm's subsidiaries and is increasing in the propensity to operate in foreign tax havens. In terms of economic significance, these tax factors are at least as influential (if not more so) in the subsidiary incorporation decision as factors that have been shown in prior research to affect Delaware parent incorporation.

Next, we show that Delaware subsidiaries play a significant role in corporate state tax avoidance. Firms likely to be using Delaware-based state tax avoidance strategies have state effective tax rates (*State ETRs*) between 0.7 and 1.1 percentage points lower than other firms, on average. The reduction in *State ETRs* translates into a decrease in state income tax payments of 15–24%. In aggregate, we estimate a range of total state tax savings of $6.6–$9.5 billion over the sample period, depending upon our model specification.[5] However, some firms realized far greater tax savings by aggressively pursuing the Delaware-based state tax avoidance strategy (see Section 5 and the online supplement).

Reductions in *State ETRs* also have a direct impact on a firm's accounting earnings. In our sample, the mean (median) firm likely to have a Delaware-based strategy in place could expect to see an increase in net income of between 1.05% and 1.49% (1.07% and 1.52%).[6] Reducing

[1] See http://www.nytimes.com/2009/05/30/business/30delaware.html; http://www.economist.com/node/13382279.

[2] See http://blogs.ngm.com/blog_central/2010/05/guarded-treasure.html.

[3] See http://www.mondaq.com/article.asp?articleid=102806. Foreign governments likely see Delaware as having tax haven characteristics because of its lack of reporting requirements, lack of ownership records, and failure to tax passive income paid to foreign entities (Gravelle, 2009).

[4] We provide details on this popular state tax avoidance strategy and on separate filing requirements and economic nexus doctrines in Section 2.2.

[5] We calculate total tax savings as follows: the coefficient estimates on the *PIC separate* and *PIC NoNexus* variables presented in Table 5 multiplied by total pre-tax domestic income over the sample period of $908.2 billion and $889.8 billion, respectively. $908.2 billion and $889.8 billion represent the total pre-tax domestic income over the sample period for firms included in the *PIC separate* and *PIC NoNexus* variable classifications, which are intended to capture the firms most likely to engage in Delaware-based state tax avoidance strategies.

[6] The percentage is calculated as $(t-t')/(1-t)$ where t is the tax rate before the effect of a Delaware-based tax strategy, and t' is the tax rate after the effect of a Delaware-based tax strategy. In our sample, the observable t' (i.e., the total effective tax rate) is 0.284 (0.297) for the mean (median) firm. Assuming that assets and/or equity remain unchanged, the percentage effect on return on assets or return on equity would be the same as the percentage effect on accounting earnings. Because state taxes are deductible for federal tax purposes, the impact on net income may be up to 35% lower, ranging between 0.68% and 0.98%.

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