State Value Added Taxes

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Outline

- A broad-based state-level value-added tax
- Reasons cited for adopting a state VAT
- Concerns about a state VAT
- Analyzing a state VAT

A broad-based, state-level VAT

- Flat-rate value-added tax collected from all businesses.
  - Base = payments to the factors of production
  - Base = labor comp. + profits + interest paid + rent
- With a full deduction for capital purchases, it is a form of <u>consumption tax</u>, not an income tax.

Related taxes

- [The late] Michigan Single Business Tax (SBT)
- New Hampshire Business Enterprise Tax (BET)
- Provincial VATs (Canada, India)
  - Keen: "...while VAT is widely heralded as a good tax for countries trading with one another it is also generally regarded as a bad tax to give to lower-level jurisdictions in a federation.... Can the VAT be run in a federal system other than as a federal tax?"

Apportionment matters

- For multi-state enterprises, tax base would have to be apportioned.
  - Apportion by in-state sales: destination-based VAT
  - Apportion by origin factors (payroll, property): origin-based tax
- Is the state-level VAT a tax on consumption or a way to tax businesses for the value of public services?
  - What tax(es) would it replace?

Apportionment matters

- McLure: "A BAT apportioned according to sales only is a tax on all sales made in Minnesota, levied at an effective rate that depends on the statutory rate and the ratio of value added to sales throughout the nation."
- Cline and Wilson: A higher apportionment weight on sales➔more of the burden of a state VAT is borne by the state's consumers.
- New Hampshire's approach
  - Add up the portion of labor compensation that is sited in-state and apportioned dividends and interest.

Reasons cited for considering a VAT

- In theory, the VAT is a neutral tax: it doesn't distort business decisions.
  - Because it's a flat tax on both labor and capital, it doesn't influence a firms' choice between these business inputs.
- The VAT levels the playing field among business firms, because it is levied on all business types, not just C-corps.
- The VAT might apply to a broader range of out-of-state firms than the state corporate income tax.

Reasons cited for considering a VAT

- Possibly more stable revenue (because labor compensation accounts for a large percentage of the base).
  - Compensation is 69 percent of the MI SBT base.
- An immediate deduction for capital expenses might encourage investment.
- An origin-based VAT is perceived as a tax on the value of public services the firm uses.
  - Firms benefit from public services (education, transportation services, etc.) in proportion to the amount of labor and capital they use.

Concerns about a VAT

- Imposing an entity-level tax (other than the minimum fee) on all non-corporate businesses would be novel.
- The base might become less stable as an increasing percentage of labor compensation is made up of relatively volatile bonuses and stocks options.
- Some businesses will have to pay tax in years that they have no income.
- The VAT is sometimes seen as a tax on payroll, and thus unfair to labor-intensive businesses.

Concerns about a VAT

- A state legislature may enact a tax that is not a pure VAT.
  - Depending on how the tax is apportioned, the VAT base may not represent value-added generated within state.
  - If you step away from the immediate capital deduction, as MI has, it is no longer a consumption tax/VAT.
- Uncertain legal status.
- What are the nexus rules for a VAT?
  - Quill: requires physical presence for sales tax.
  - HR 3220: could require physical presence for VAT.
  - Litigation about nexus standard of MI SBT.

Interest in a VAT in Minnesota

- Considered by the MN legislature in 1997.

  ➔Mandated study of replacing the Corporate Franchise Tax (CFT) with a **Business Activity Tax (BAT**)—a form of subtraction-method VAT.

- Growth & Justice proposed replacing the CFT with a 2.5% BAT as part of a package of tax proposals.

- Interest in corporate tax reform, in general.

Nexus issues

Corporate Franchise Tax: C-corps, domiciled anywhere, that conduct a trade or business in Minnesota.

- Not necessarily with a physical presence in MN.
- PubL 86-272 protects companies that have no physical presence and have solicitation of sales as their only activity.

Sales Tax: Businesses that have a physical presence in MN and make taxable sales in MN

BAT: (Assume) Any firm doing business in MN.

Analyzing the effects of a state-level BAT

- Build a dataset that includes the population of firms doing business in the state.
- Identify the current tax liability for these firms.
- Simulate the BAT base for each of these firms from data elements included in the dataset.
- Apportion the BAT base.
- Calculate the revenue-neutral BAT rate equal to current tax liability divided by the aggregate BAT base.
- Apply the revenue-neutral tax rate to the simulated BAT base and calculate the change in tax liability for each firm.

Revenue-neutral BAT rates

	Revenue-neutral rate
All firms	.71%
All firms, 100K exempt amount	.86%
State corporate taxpayers only, 100% sales apportionment	1.58%
State corporate taxpayers, current-law (1999) apportionment	1.45%

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