

Changing Business Tax Systems: Something New?

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Outline

- Current system of state-local business taxes
- What are states trying to accomplish?
- Taxonomy of new taxes
- Comparisons of the new systems: Ohio, Texas and Michigan
- Lessons learned

States Are Changing Business Tax *Systems*

- Current system of state-local business taxes
 - E&Y 50-state business tax study, prepared in conjunction with the Council on State Taxation
 - FY06 taxes totaled \$554b, 45% of all state-local taxes and a 10% increase in FY06
 - Business taxes increased 40% in last 4 years vs. 32% growth in non-business taxes
- Property tax is most significant business tax (37%); key component of business tax reform

State-Local Business Taxes FY06 (\$billions)

Business Tax	FY2006	% of Total	1-Yr Growth
Property taxes on business property	\$204.8	37.0%	9.0%
Sales and use tax on business inputs	124.7	22.5	11.6
Corporate income tax	51.8	9.4	23.1
Unemployment insurance	36.4	6.6	2.5
Excise taxes	25.7	4.6	4.7
Public utility taxes	24.5	4.4	-2.2
Business and corporate license	22.4	4.0	7.4
Individual income tax on business income	21.4	3.9	13.1
Insurance premiums tax	14.8	2.7	5.3
Other business taxes	27.0	4.9	25.2
Total State and Local Taxes	\$553.7	100.0%	10.2%

What Are States Trying to Accomplish?

- Increasing business tax competitiveness is an important overall objective – *open-border world*
 - Legislators want to know if system A is more competitive than system B, not whether tax X is good or bad evaluated in isolation. *Challenge of applying tax theory in the political setting*
 - Dynamic impact analysis is getting more attention in the state tax policy process – combination of economic theory & data and forecasting art.
 - Reforms affected by the debate between proponents of targeted business tax relief and of lower overall tax rates (MI example)

Reducing Business Taxes on Capital

- Business taxes fall heavily on capital – property, income and net worth taxes, sales taxes on business purchases
- Problem of *origin-based taxes*
 - Business property taxes are 4 times higher than corporate income taxes
 - Sales taxes on business purchases are, in effect, origin-based taxes if passed forward in higher prices to purchasers
- States are:
 - Reducing taxes on mobile capital and shifting from origin to destination tax systems: lower TPP taxes, 100% sales factor apportionment formulas, elimination of corporate income taxes
 - Changing perspective from *ability-to-pay* (profits) to *benefits received* justifications for business taxes

Other Tax Reform Objectives:

- Reducing volatility of business taxes by adopting more stable tax bases: minimum fees; gross receipts, and value-added taxes (in theory)
- Finding an effective way to tax service sector: early issue in Ohio reform debate; Michigan governor's 2% service tax proposal; IL proposal
- Adopting more uniform taxes that apply to all forms of business and industries: corporate and non-corporate entities, service and manufacturing industries – important dimension of business tax “fairness” debate

Other Tax Reform Objectives: (cont.)

- Avoiding P.L. 86-272 constraints
- Increasing taxes on “out-of-state” companies:
 - economic nexus
 - 100% sales factor apportionment (16 states)
 - disallowing “bad” intangible expense deductions
 - combined reports (OH, TX, MI, NY, VT)
- Finding new sources to pay for health care – could generate large tax increases
 - Minnesota experience
 - Proposals in CA and IL

Taxonomy of New State Business Taxes

Tax Base	Examples	Description of Tax Base
General gross receipts tax (GRT)	OH CAT, WA B&O; IL proposal	Gross receipts with few, if any, deductions
	TX base option	Gross receipts minus 30% of GRs
Modified GRT/VAT	New MI base	GRs minus purchases of TPP
Value-added (VA) tax	Old MI SBT NH BET	GR minus purchases from other firms Minimum tax based on modified VA
Gross margin tax	TX tax base option; NJ AMA, KY AMC/LLET	Gross receipts minus cost of goods sold (COGS)
Labor-adjust. GRT	TX tax base option	Gross receipts minus labor costs
Business income	New MI base	GR minus labor costs, depreciation, interest, purchases from other firms (deductions may be limited)
Corporate inc. tax	Traditional tax	Same as bus. inc., but limited to corps

Tax Base Comparisons

State Tax Rates Needed to Raise \$1 billion

- Corporate income tax 9.0%
- Business income tax 5.5%
- Valued added tax 1.0%
- Gross receipts tax 0.25%

Comparing the New Systems

- New business entity taxes:
 - OH is phasing out net worth, net income and TPP taxes and replacing with GRT
 - TX replaced income/net worth tax with modified GRT
 - MI replaced modified VA tax with combination of business income (25%) and modified GRT (75%)
- Legislation asserts that the GRTs are not income taxes – P.L. 86-272 does not apply
- All 3 systems adopt unitary combined reporting
- New taxes apply to most business entities

Comparing the New Systems (cont.)

- Destination-based systems – tax imports and exclude exports
- Physical presence nexus standard (MI,OH)
- Significant property tax relief for business (OH and MI) and homeowners (TX: “Largest tax cut in TX history” -- \$6.6b property tax cut)
- “Revenue neutrality” (overall tax system) was not a binding constraint in Ohio and Texas – business tax vs. total tax neutrality

Fiscal Comparison of Reforms

Large property tax reductions, big new taxes and some overall cuts.

State	Bus. Property Tax Change	New Bus. Tax	Other Bus. Taxes	Net Bus. Changes	Total Tax Changes
Ohio (FY'10)	-\$1.3	\$1.3	-\$1.4 ¹	-\$1.4	-\$3.4
Texas (FY'08)	-\$3.4	\$6.0	-\$2.5 ²	\$0.0	-\$2.5
Michigan (FY'08)	-\$0.6	\$2.5 ³	-\$1.6 ⁴	\$0.2	\$0.2

1. Includes cuts in sales tax on business inputs & personal income taxes; elimination of corporate franchise tax
2. Elimination of franchise tax
3. MBT after non-property tax credits; credits are \$1.1b; gross MBT is \$3.4b
4. Elimination of SBT

Lesson: Watch Out for Large Tax Changes

Examples illustrate potentially large swings in tax liabilities under new MI system (MBT), including property tax rate reductions

Example Firm Profiles (C-corps)	Manufacturing	Services
Gross Receipts	\$97.1m	\$28.6m
Modified Gross Receipts	41.7m	26.9m
Modified Gross Receipts as % of Gross Receipts	43%	94%
Michigan Business Income	\$352k	\$197k

MBT Tax Examples *(continued)*

I. Impact of the MBT	<u>Manufacturing</u>	<u>Services</u>
Elimination of Single Business Tax	-\$25,100	-\$13,900
Adoption of MBT:		
Tax on Net Income	\$17,400	\$9,700
Tax on Modified Gross Receipts	13,900	13,200
Other Credits (ITC, Compensation and R&D)	-9,300	-4,300
Refundable Property Tax Credit	-1,700	0
Adoption of MBT	\$20,300	\$18,600
Net Change in Business Entity Taxes	-\$4,800	\$4,700
II. Personal Property Rate Reduction	-\$4,100	-\$200
III. Net Change in Taxes	-\$8,900	\$4,500
<i>Change in Business Entity Tax</i>	<i>-19%</i>	<i>+34%</i>
<i>Change in Personal Property Tax</i>	<i>-46%</i>	<i>-23%</i>
<i>Net Change in Taxes</i>	<i>-26%</i>	<i>+29%</i>

Final Observations

- Focus on the system
- Integrate longer-run competitiveness analysis into the short-run policy process – focus on private-sector benefits of reform
- Need to answer legislators' questions: 1) What is an out-of-state firm and how should it be taxed?, 2) Who bears the burden of business taxes?, 3) How do you determine business tax “fairness”?
- Importance of business involvement in the tax policy process