Issues with State Corporate Income Taxes

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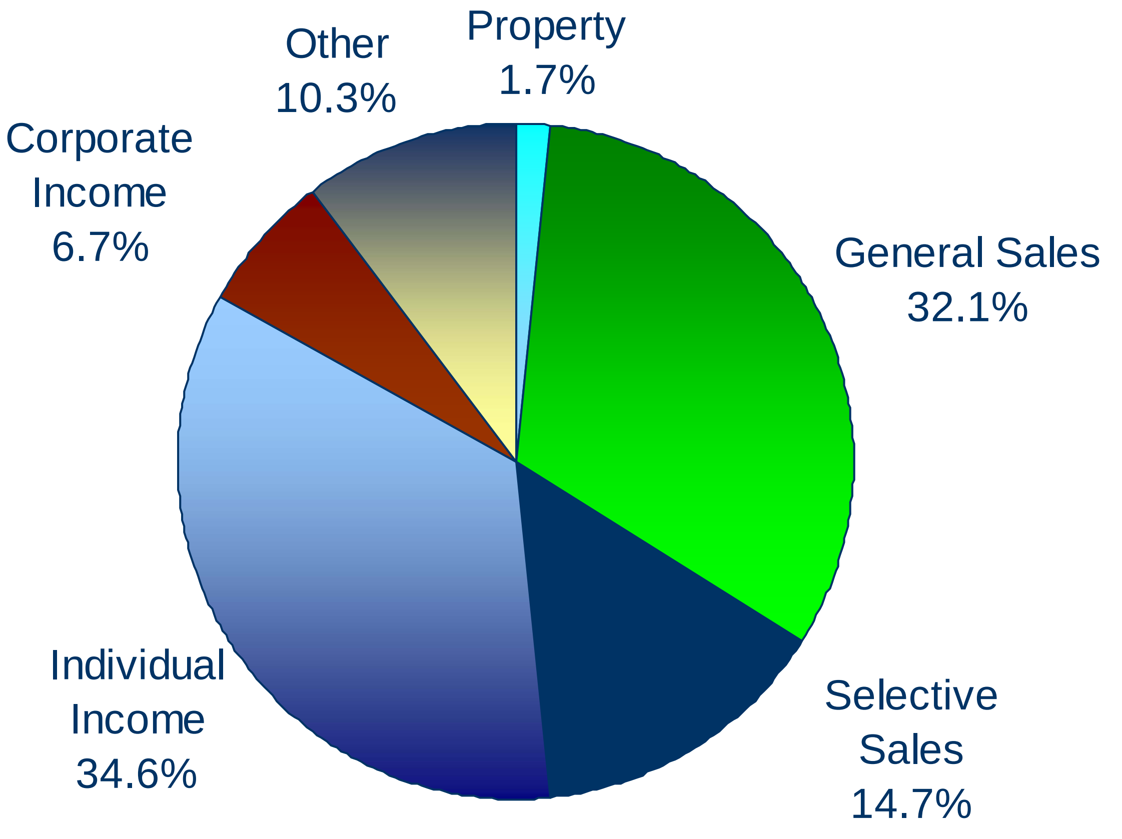
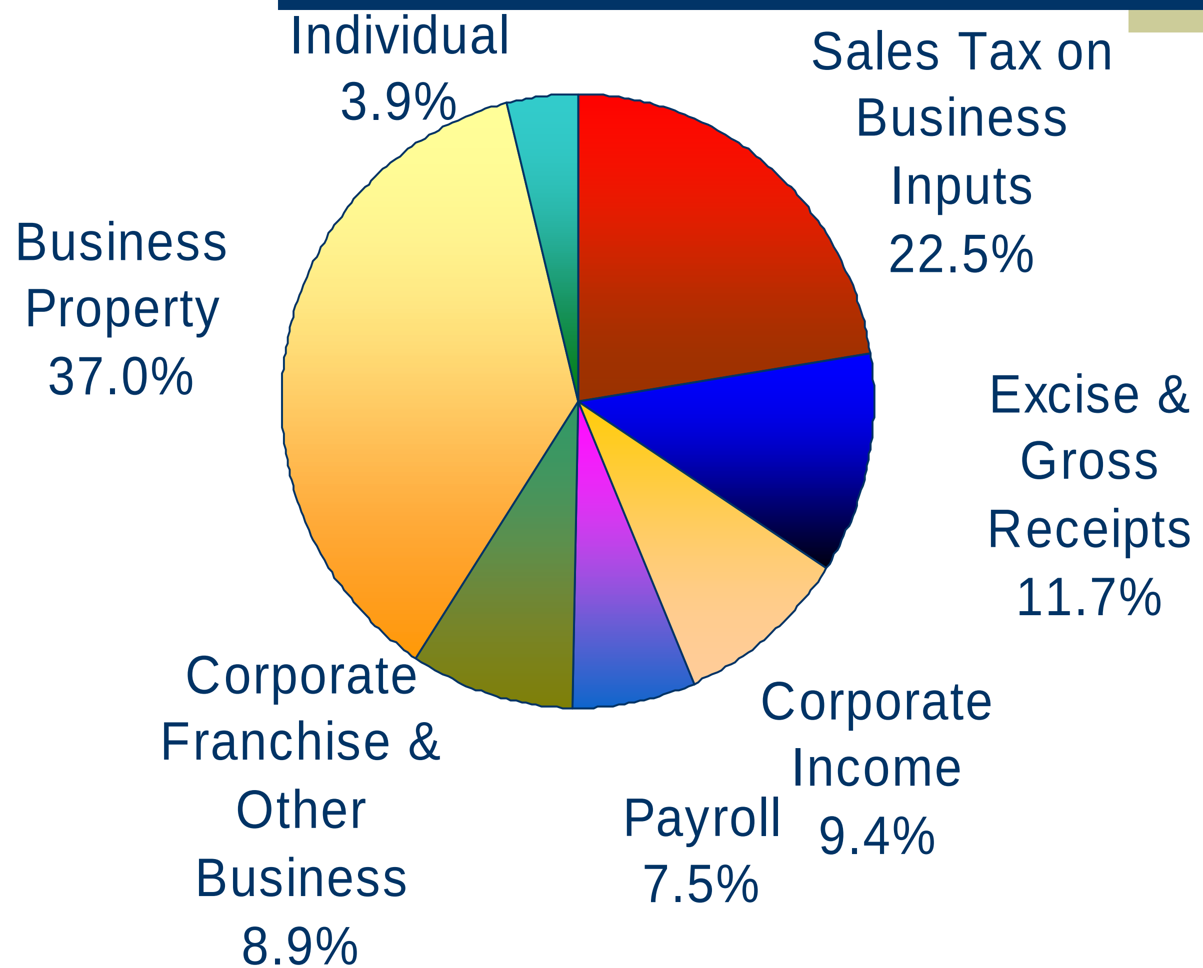
Some Alternatives for Taxing Business

- Corporate Income Tax
- Corporate Franchise Tax
- Value Added Tax – Michigan, New Hampshire; Many economists prefer an origin VAT as the mechanism for state business taxation
- Texas Margins Tax
- Gross Receipts Taxes – Ohio, New Jersey, Kentucky, Washington

PERCENTAGE DISTRIBUTION OF U.S. STATE TAX COLLECTIONS, 2006

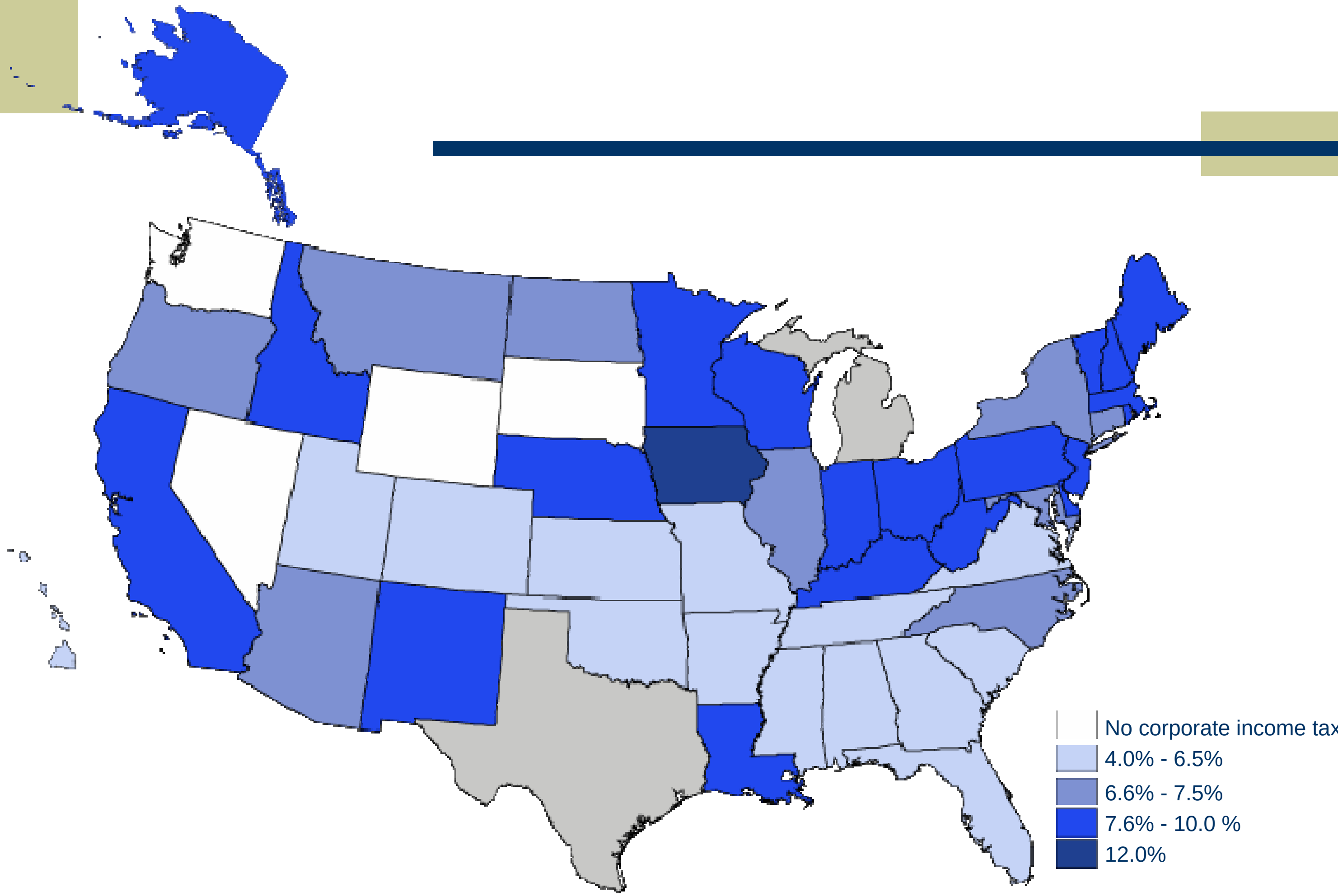


Businesses Pay Many Taxes, FY2006



Ernst & Young, 2007

State Corporate Income Tax Rates

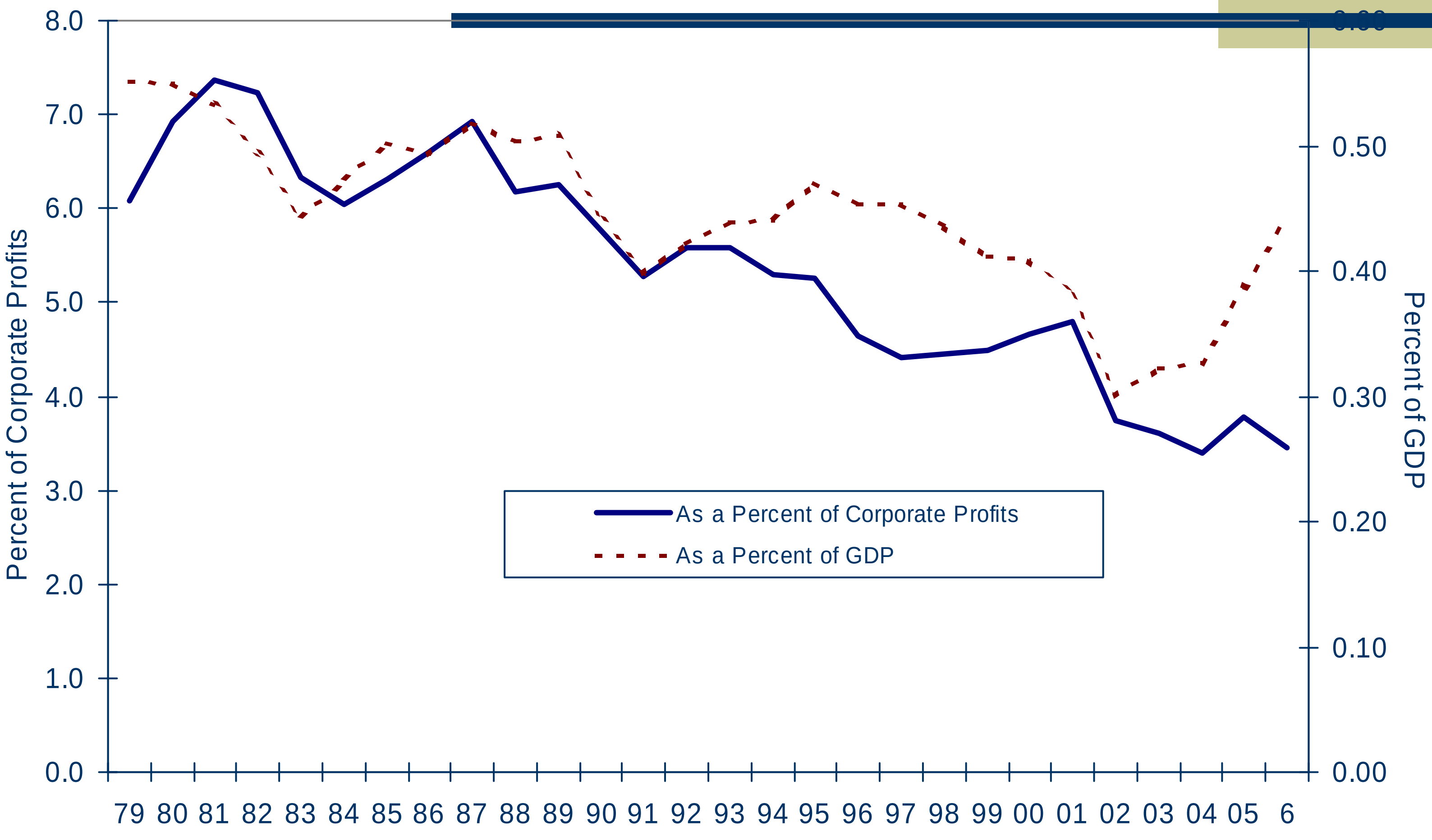


Michigan imposes a single business tax of 1.9% on the sum of federal taxable income of the business, compensation paid to employees, dividends, interest, royalties paid and other items.

Texas imposes a franchise tax of 4.5% of earned surplus of 2.5 mils of net worth.

Source: Federation of Tax Administrators, March 2005.

State Corporation Net Income and License Tax Base



Why has the corporate income tax base been shrinking?

- State policy decisions
  - Concessions
  - Greater weight on sales factor?
- Federal policy decisions
  - Accelerated depreciation
  - Production exemptions
- Tax planning
  - Transfer pricing and intangible holding companies
  - Corporate structure

State Approaches to Tax Planning and Entity Isolation

- Combined reporting
- Disallow deductions between related companies - Massachusetts
- Impose nexus on passive investment companies – South Carolina
- Examine PIC for valid business purposes - Maryland
- Audit transfer prices
- All will be incomplete

Other Business Taxes

- Could argue for eliminating business taxes, but unless that occurs, the alternative base taxes may be best evaluated in the context of what they replace – generally the corporate income tax
- Well understood that gross receipts taxes are not effective tax instruments, but most discussions evaluate gross receipts taxes in context of a theoretically pure tax rather than the tax they are likely to replace
- Corporate income tax can be thought of as three taxes
  - Payroll
  - Property
  - Sales
- As move to greater sales weighting, the corporate income tax is a tax on gross receipts with the rate dependent on the profitability of the firm.

Comparison of CIT and GRT

- Taxpayers
  - Unincorporated businesses
  - No PL86-272 constraint
  - Unprofitable firms
- Evasion/avoidance options –
  - Easier for CIT
  - Effects of marginal rate depends on profitability of company

Comparison of CIT and GRT

- Total tax liability depends on number of stages of production
  - Which causes greater distortions, a 6.5% corporate income tax or a 1.0% gross receipts tax
  - Distorts equity - cascading
  - Encourages vertical integration
  - Hurts transparency, but CIT?
- Differential burdens across firms
  - GRT likely to be larger burden for low margin firms – differential effective rate by industry, but also true to some extent with the CIT

Comparison of CIT and GRT

- Administrative issues
  - Transition costs
  - GRT is an above the line tax
  - Issues of nexus and sourcing remain
  - Complexity rises if both an income and alternative tax must be calculated, but otherwise probably not
- Revenue Implications
  - GRT base is generally very broad, and can be expected to exceed gross product
  - Sizeable revenue potential, even with low rates (0.23% in Ohio)
  - More stable than the corporate income tax