Emerging State Business Tax Policy: More of the Same or Fundamental Change?

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New Developments in State Business Taxation
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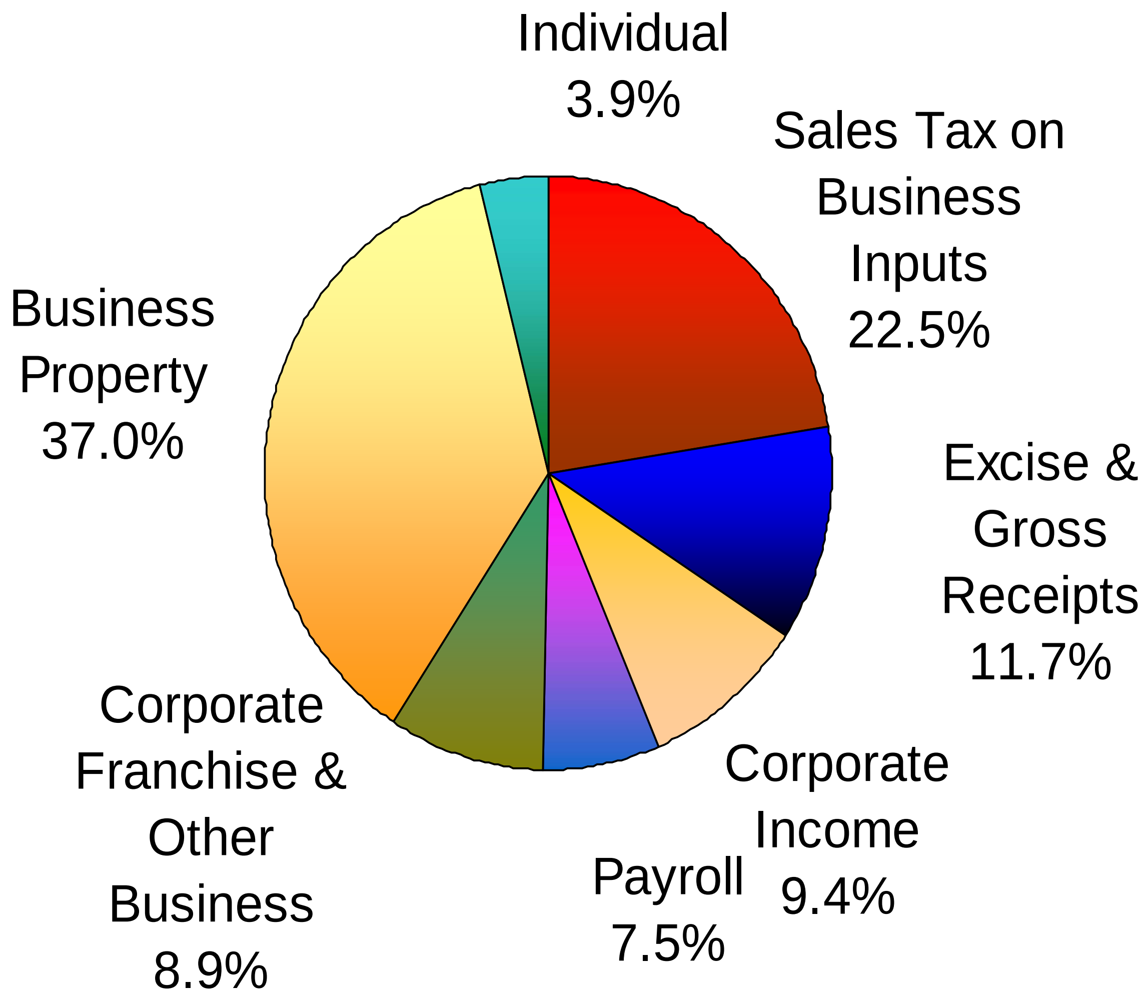
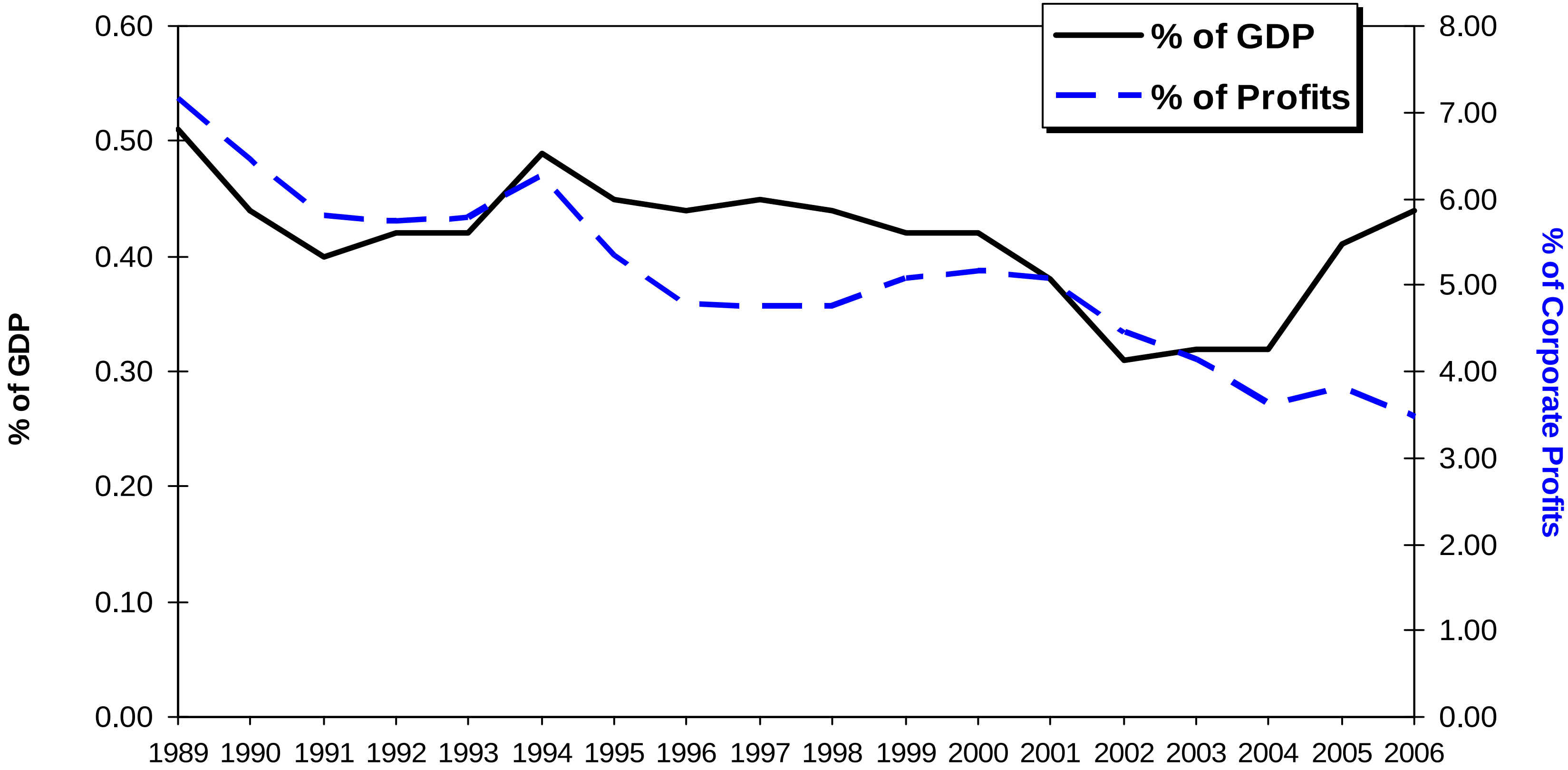
Businesses Pay Many Taxes, FY2006



Ernst & Young, 2007

Corporate Taxes as Share of GDP and Corporate Profits: FY89-FY06



Causes of Corporate Tax Decline

- Cyclical profits downturn
  - Not the only cause, and probably not even the largest cause of decline in effective tax rates

- Trend factors
  - State policy decisions – work both directions
  - Federal base erosion
  - Tax planning

Issues causing states to consider reforms

- Belief that firms are sheltering/planning
- Revenue stability
- ‘Equity’ –
  - Large firms with no liability
  - Firms with economic presence and no liability
- Neutrality and economic development
  - Growing effects of taxes on location (Bruce, Deskins and Fox, 2007)
- Administrative costs

State Responses

- Expand the set of taxable businesses
  - Broaden the nexus standard
  - Entity level tax
- Limit tax planning
  - Combined reporting
  - Disallow deductions/require addbacks
  - Reporting requirements

State Responses

- Amnesties
- Decouple from the federal base
- Alternative bases

Have the strategies worked?

- Most are not really new
- The direction of decoupling from the federal base, disallowing deductions for PICs, etc. is to generate more revenue, but revenues have continued to decline as a share of profits
- Elasticity may be slightly improved
- Equity – economic nexus and combined reporting are moves in the intended direction

19 States with some type of expense disallowance

Narrower → Broader

Royalties	and intangible related interest	and all intercompany interest	and other expenses
North Carolina Oregon	DC Georgia Indiana Mississippi New York Tennessee Virginia	Alabama Arkansas Connecticut Illinois Maryland Massachusetts New Jersey Ohio	Kentucky South Carolina

Some Better Solutions to Combat Tax Planning

- Adopt Mandatory Unitary Combined Reporting
  - Better ensures income is apportioned to the state where it is earned → increasing neutrality
  - At least 6 states with current legislation
- Broaden Nexus Standard
  - Kentucky changed to a "doing business" standard
  - Many states are being aggressive with affiliate and economic nexus.

Amnesties

- 83 amnesties in 42 states, with 35 during 2000s
- 26 states with more than one, led by 4 in LA
- Traditionally for all taxes, but some movement to more selective use in recent years, such as California's VCI
- Normally include incentives for filing and remitting past due liabilities
- Frequently signal expansion of enforcement

Assessment of Amnesties

- Main driver is revenues
  - New York estimates $82.9 million from 2003 amnesty, but is difficult to disentangle
  - Know most of the revenues before the amnesty
- Revenue effect (Fox, Munkin, Murray, 2007)
  - First amnesty increases revenues
  - Latter amnesties, no or negative effect
- Average state may see little or no revenue from another amnesty

Alternative Tax Structures

- ‘Trend’ toward shifting from net income base to one containing a gross receipts component
- Examples
  - Ohio Commercial Activity Tax
  - Kentucky and New Jersey alternative tax
  - Texas “Margins Tax”
  - Michigan and New Hampshire Value Added Taxes

Alternative Tax Structures

- Could argue for eliminating business taxes, but unless that occurs, these alternative tax bases may be best evaluated in the context of what they replace – generally the corporate income tax
- Well understood that gross receipts taxes are not ideal tax instruments, but most discussions evaluate gross receipts taxes by comparison with a theoretically pure tax rather than the tax they are likely to replace
- Corporate income tax can be thought of as excises on
  - 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. Destination based on goods, origin based on services. Is this so different?

Alternative Tax Structures

- No economic rationale for gross receipts as a base – need not be correlated with benefits of public services
- Efficiency Effects
  - Pyramiding is an issue
  - Encourages vertical integration
  - Does it disadvantage instate production? Depends on the tax that is implicit in out-of-state production and structure of the GRT
  - Which causes greater distortions, a 6.5% corporate income tax or a 1.0% gross receipts tax?
- Concerns about transparency
- Effects on financial markets since expense taken before EBITDA

Alternative Tax Structures

- Revenue Implications
  - Base is generally very broad, and can be expected to exceed gross product
  - Sizeable revenue potential, even with low rates – frequently expected to generate more revenue than the corporate income tax
  - More stable than the corporate income tax
- Compliance and Administration
  - Transitional costs such as loss carryforwards
  - Fewer opportunities for planning or sheltering
  - Issues of nexus and sourcing remain
  - Complexity rises if both an income and alternative tax must be calculated, but otherwise probably lower cost

Alternative Tax Structures

- GRT will broaden the set of taxpayers
  - No PL86-272
  - Tax on economic presence basis
- Will states tinker with the taxes?