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

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New Developments in State Business Taxation
Federal Reserve Bank of Chicago
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Businesses Pay Many Taxes, FY2006

- Sales Tax on Business Inputs: 22.5%
- Excise & Gross Receipts: 11.7%
- Corporate Franchise & Other Business: 8.9%
- Payroll: 7.5%
- Corporate Income: 9.4%
- Individual: 3.9%
- Business Property: 37.0%

Ernst & Young, 2007
Corporate Taxes as Share of GDP and Corporate Profits: FY89-FY06

The graph shows the percentage of corporate taxes as a share of GDP and corporate profits from fiscal year 1989 to 2006. The black line represents the percentage of corporate taxes as a share of GDP, while the blue dashed line represents the percentage of corporate taxes as a share of corporate profits.
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

<table>
<thead>
<tr>
<th>Narrower</th>
<th>Broader</th>
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<tbody>
<tr>
<td>Royalties and intangible related interest</td>
<td>and all intercompany interest and other expenses</td>
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<tr>
<td>North Carolina, Oregon</td>
<td>DC, Georgia, Indiana, Mississippi, New York, Tennessee, Virginia</td>
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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?