State business tax reforms

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What are states trying to accomplish with business tax reform?

- Improve state and local business tax *system* competitiveness
  - Reduce taxes on mobile capital
  - Shift taxes to “out-of-state” taxpayers: destination-based taxes, combined reporting, expense addbacks, market sourcing
- Find a more stable source of business tax revenue
  - For U.S., state corporate income taxes fell 24% in last recession, increased 115% in 5 years; down more than 20% in this recession
  - SC corporate income taxes fell 17% from FY07 to FY09
- Tax all forms of doing business, not just C corporations: broaden the base, lower tax rates, reduce distortions
- Find an effective way to tax services and cross-border sales – issues of taxing business inputs and protection of *Quill;* OH CAT began as a discussion of an excise tax on services
- Changing business tax rationale from ability-to-pay to benefits-received

Composition of SC state and local business taxes (millions of dollars)

Business taxes	FY 2008	% of total	% of US total
Property taxes on business property	$2,866	47.6%	35.0%
General sales & use tax on inputs	1,033	17.2%	22.0%
Business license tax	637	10.6%	6.1%
Excise taxes	413	6.9%	4.8%
Corporate income tax	320	5.3%	9.9%
Unemployment insurance	288	4.8%	5.4%
Individual income tax	216	3.6%	4.5%
Insurance premiums tax	126	2.1%	2.7%
Public utility tax	105	1.8%	4.7%
Other business taxes	15	0.3%	5.0%
Total business taxes	**$6,020**	**100.0%**	**100.0%**

South Carolina business property taxes

- Minnesota Taxpayer Association 50-state study: property tax effective tax rates in largest cities
  - Large industrial property: 5th highest, 74% above U.S. average
  - Large commercial property: 20th highest, 9% above U.S. average
  - Higher-valued homestead property: 39th highest, 34% below U.S. average
- E&Y 50-state tax study: property tax share of business taxes in South Carolina is 36% higher than the average share in the U.S.

Taxonomy of new and old state business taxes

Tax Base	Examples	Description of Tax Base
General gross receipts tax (GRT)	OH CAT, WA B&O	Gross receipts (GR) with few, if any, deductions
	TX tax base option	70% of GR
Modified GRT	1 of 2 new MI bases	GR minus purchases of *goods* from other firms
Value added tax (VAT)	MI BAT (15 yrs.), CA proposal (BNRT); MI SBT (33 yrs.)	Sum of payments to labor and capital *or* GR minus purchases from other firms
	NH BET (since 1993)	Alternative tax based on modified VA
Gross margin tax	TX tax base option; NJ AMA	Gross receipts minus cost of goods sold (COGS)
Labor-adjust. GRT	TX tax base option	Gross receipts minus labor costs
Business income tax	1 of 2 new MI bases; NH bus. profits tax	GR minus labor costs, depreciation, interest paid, all purchases from other firms
Corporate inc. tax	current CA tax	Same as bus. inc., but limited to corporations

Business tax rate comparisons

U.S.-wide tax rates needed to replace state and local corporate income taxes ($50 billion a year nationally)

Corporate income tax	5.8%
Business income tax	3.3%
Valued added tax	1.1%
Gross receipts tax	0.3%

Value added tax base is over 5 times larger than corporate income tax base; gross receipts tax base is almost 20 times larger than corporate income tax base

Characteristics of new business tax reforms in Ohio, Texas and Michigan

- Adopted broader tax bases than corporate income tax
- Imposed entity taxes on most forms of doing business
- Extended state taxing reach to more out-of-state firms than traditional corporate income tax – states assert that P.L. 86-272 does not apply
- Structured like single sales factor apportioned corporate income taxes or sales tax: 100% destination sales
- Reform packages included substantial property tax cuts ($0.6 to $3.4b) and changes in tax credit programs
- Included changes in multiple business taxes: corporate income, property and net worth taxes
- Included some form of combined reporting

Recent state business tax reforms

- ▶Ohio Reform (2005)
  - New commercial activity tax (CAT): 0.26% times gross receipts in excess of $1m ($150 minimum tax); minimum filing threshold of $150,000
  - Applies to all forms of doing business and most industries; economic nexus adopted
  - Eliminated local business tangible property tax ($1.3b cut) and corporate income tax & net worth tax; cut overall business taxes by $1.4b (-9%)
  - Destination sales concept; P.L. 86-272 not applicable; combined filing or elective consolidation with deduct. for intercompany sales
  - Phased in over five years
  - Revenue in first few years came in 10% above original est.

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Recent state business tax reforms (cont.)

- ▶ Texas (2006)
  - Taxable margin tax: 1.0% general rate (0.5% for whole. & retail) times selected base (70% of GR, GR – COGS, or GR – compensation); taxes most forms of doing business
  - $3.4b increase in business entity taxes offset by $3.4b cut in business personal property tax (-18%)
  - Destination sales apportionment; P.L. 86-272 not applicable; mandatory combined reporting
  - No phase in of new tax
  - First-yr. collections came in 20% short of estimate
  - 2009 legislature increased the minimum filing threshold from $300,000 to $600,000 permanently and to $1m for two years

Recent business tax reforms (cont.)

▶ Michigan (2007)

- SBT ($1.8b) replaced with new system (MBT): business income tax (4.95%) <u>plus</u> 0.8% times modified GRT (temporary 21.99% surcharge)
- GRT provides 2/3 of taxes; minimum filing threshold of $350,000
- Applies to most bus.; destination taxes; economic nexus
- GRT pyramiding reduced by subtract. purchases of tangible property
- New entity taxes of $3.5b with $1.6b of new, targeted credits
- Significant property tax reductions (-$0.6b)
- Overall package shifts taxes from manufacturing to services

Recent business tax reforms (cont.)

- New Hampshire (1993)
  - Adopted business enterprise tax (BET) – modified VAT that excludes rent paid and retained earnings from base
  - Applies to all forms of business (as does profits tax)
  - Firms pay both the BET (at 0.75%) and the business profits tax (8.5%), but the business profits tax (BPT) allows a credit for BET taxes – BET functions as a minimum tax
  - Minimum filing threshold for the BET is $150,000 of everywhere gross receipts or $75,000 of NH “value added”
  - Reasons for adoption: stability, “neutral” consumption tax without economic distortions of profits or sales taxes, broadened base by extending tax to all forms of business and industries (0.5% of CIT firms paid 70% of tax), added new multistate taxpayers (not protected by P.L. 86-272)

CA tax commission reform package recommendations (Sept. 2009)

- The recommended reform package calls for:
  - Major personal income tax changes
    - reduce brackets from 6 to 2 (rates of 2.75 and 6.5%)
    - eliminate itemized tax deductions with a few exceptions and most credits; adopt large standard deduction ($45,000 joint returns)
    - 29% average tax reduction
  - Repeal the corporate income/franchise and minimum taxes
  - Phase-out the state general purpose sales tax (5% rate)
    - state gas & dedicated sales taxes and local sales taxes remain
    - balancing item in the package over 5-yr. phase-in
  - Adopt new business net receipts tax (BNRT) to pay for tax cuts; rate not to exceed 4%
  - 5-yr. phase-in of tax changes beginning in 2012
- Focus on stability and business tax competitiveness

Tax revenue changes in the CA tax commission proposal

Proposal	Revenue estimate, if fully phased in at FY 2012 levels
BNRT	$48 billion
Corporate net income	-$10 billion
Sales use tax	-$26 billion
Personal income tax	-$12 billion

What is the business net receipts tax (BNRT)

- BNRT is a business level tax imposed on most business entities doing business in CA – C corps and pass-through entities
- Tax base is equal to a taxpayer's apportioned CA value added
- The BNRT base would be calculated as a subtraction, consumption-type VAT:
  - Subtracting purchases from other firms from gross receipts to determine net receipts
  - Immediately expensing of capital assets when placed in service
- Net receipts would be allocated and apportioned – 100% sales factor (market based)
- Economic nexus standard and water's edge combined reporting
- $500,000 filing threshold and small business credit; R&D is the only other credit included in proposal
- Continues combined reporting requirement

Key questions raised in the state tax reform debates

- How to think about an entity-level, value-added or GR tax. Are they consumption taxes, business taxes or both?
- How to treat firms that are not earning profits
- How to tax financial institutions and insurance companies
- How to treat capital purchases
  - Retain depreciation (income VAT) or allow immediate expensing of capital assets (consumption VAT)
  - Encourage instate investments with ITC
- Confidence in revenue estimates of new taxes; performance over the business cycle and in the long run
- Winners and losers in terms of business tax liabilities
- Economic incidence of new business taxes
- Impact on state's business tax competitiveness

Lessons learned from other states

- Focus on the system of state-local business taxes
- Important to identify winners and losers due to significant shifts in tax liabilities among firms & households
- Important to involve the business community in the policy debate and the design of alternative business taxes
- Pay attention to the transition issues: phaseins, impacts on balance sheet tax items
- Focus on the long-run economic benefits of a more competitive state-local business tax system; expect targeted tax credits to be continued in new systems
- Invest adequate resources in the administration of new business taxes