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)

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

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

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

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Rate</th>
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</thead>
<tbody>
<tr>
<td>Corporate income tax</td>
<td>5.8%</td>
</tr>
<tr>
<td>Business income tax</td>
<td>3.3%</td>
</tr>
<tr>
<td>Valued added tax</td>
<td>1.1%</td>
</tr>
<tr>
<td>Gross receipts tax</td>
<td>0.3%</td>
</tr>
</tbody>
</table>

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.
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%) plus 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)
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

<table>
<thead>
<tr>
<th>Proposal</th>
<th>Revenue estimate, if fully phased in at FY 2012 levels</th>
</tr>
</thead>
<tbody>
<tr>
<td>BNRT</td>
<td>$48 billion</td>
</tr>
<tr>
<td>Corporate net income</td>
<td>-$10 billion</td>
</tr>
<tr>
<td>Sales use tax</td>
<td>-$26 billion</td>
</tr>
<tr>
<td>Personal income tax</td>
<td>-$12 billion</td>
</tr>
</tbody>
</table>
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