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Future State Business Tax Reforms: Defend or Replace the Tax Base

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The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP.

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I. Introduction

Since the end of the recession in 2001, numerous state governments have begun to reexamine and change the design of their business tax structures. Two trends have emerged. A handful of states have enacted new business taxes with broader tax bases in the last three years to replace or reduce some existing business taxes. The second trend includes states that are attempting to strengthen or defend their existing corporate income tax bases.

State policymakers are trying to attract additional economic development by making their jurisdictions more attractive to businesses. Globalization has made companies more cost conscious, and the increasing mobility of labor, capital, and consumers, combined with lower communication and transportation costs, has made it easier for companies to relocate their operations in the most attractive locations. Companies are motivated to operate in competitive taxing jurisdictions and jurisdictions with strong infrastructure and education. For that reason, some states has responded with measures designed to attract capital investment, increase competitiveness, and encourage economic growth through lowering business tax rates, changing state apportionment rules, and providing targeted employment and investment incentives.

At the same time, many states are facing budget deficits and increased spending needs and thus are looking for ways to strengthen their business tax bases. Some states have sought to broaden their corporate income tax bases by mandating combined reporting, disallowing some deductions, asserting economic nexus, and increasing enforcement. Those changes have been aimed at closing perceived tax loopholes. The Streamlined Sales Tax Project illustrates states' efforts in developing more uniform rules to potentially achieve an expansion of the sales tax base to include remote sellers.

Major reforms in Michigan, Ohio, and Texas have enacted new broad-based business taxes to substitute for or significantly reduce business property taxes and other business taxes. Those new taxes apply to both corporate and noncorporate businesses and have less volatile bases than net income. It is the position of the states that the new taxes are not subject to the restrictions of Public Law 86-272. Other states will be evaluating the effects of those new taxes.

This report highlights some of the critical points arising from the conference "The Future of State Business Tax Reforms," held at the Federal Reserve Bank of Chicago in mid-September 2007 and hosted by Ernst & Young, the Chicago Federal Reserve, and the University of Michigan's Office of Tax Policy Research.

The report reviews the current landscape of state and local business taxation, explains why the tax structure matters to business, describes some of the recent state business tax changes, and discusses implications and lessons learned from these developments for business taxpayers.

II. The Current Landscape of State and Local Business Taxes

State and local business taxes are a significant cost of doing business and are growing rapidly. In 2006, state and local business taxes exceeded $ 550 billion and increased 10 percent from the previous year./1/ In addition to actual taxes they pay, businesses incur significant compliance costs. One estimate has state corporate income tax compliance costs at almost 6 percent of tax collections./2/

Figure 1. Composition of State and Local Business Taxes by Type of Tax, Fiscal 2006

[Image Omitted]

Source: Ernst & Young, "Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2006."

Figure 1 shows the composition of state and local business taxes. Business property taxes account for the largest share at 37 percent, followed by sales taxes on business inputs at 22 percent. Corporate income taxes account for less than 10 percent of total state and local business taxes.

Why Business Taxes Matter

Economists argue that people, not businesses, pay taxes, because taxes are ultimately passed on in higher prices to consumers or in lower factor payments to employees or capital owners. However, the shifting of taxes paid by businesses is often incomplete, uncertain, and can occur over several years.

Because of nonuniformity in taxes by industry and type of business and market limitations on shifting tax increases to consumers or workers, variations in state and local taxes may result in owners of a company experiencing lower after-tax rates of return. For example, if in-state industries are competing with out-of-state industries without nexus (or necessary connection to a state), variations in state business taxation can place an in-state company at a competitive disadvantage to an out-of-state competitor. Industries with large capital investments and regulated industries may be limited in their ability to pass the tax along in the short run, which is often many years.

If state and local business taxes were equal to the value of the benefits business receives from state and local services, taxes would not influence business location decisions. However, if state business taxes are in excess of the value of benefits received, an additional cost of doing business exists in that jurisdiction and can affect companies' choice of locations. Rick Mattoon and William Testa of the Federal Reserve Bank of Chicago estimated the relationship of state and local business taxes compared with government services most likely to benefit businesses./3/ For 2005 they found that, on average, businesses paid 3.7 times more in state and local business taxes than a rough estimate of the benefits (measured by expenditures) they received./4/

Table 1. Ratio of Business Taxes to Business Expenditures by State, 2005
(U.S. average = 3.7)

Ratio Range	States
Greater than 5.0	WY, GA
	TX, NH, AK, NJ, IN, MN, IL, OK, PA, TN,
ME,	
4.9 to 4.0	SC, WV
	MS, VT, WA, OH, AR, NE, NY, SD, CO, CT,
MI,	
	MO, AL, DC, NC, ND, KS, DE, IA, MA, RI,
WI,	
3.9 to 3.0	CA, KY, MD
2.9 to 2.0	HI, ID, LA, MT, NM, AZ, VA, OR, UT, FL,
NV	

Source: Richard H. Mattoon and William A. Testa (2007).

Table 1 shows the state-by-state distribution of the ratio of state and local business taxes to estimated business benefits reported by Matton and Testa. In all states, businesses are shown to be paying at least two times more in taxes than the cost of the government services they receive. Two states, Wyoming and Georgia, have tax-expenditure ratios that exceed 5, while 11 states have ratios less than 3.0.

The important tax policy implication from that analysis is that state and local business taxes are not neutral in their effects on business location decisions. States and localities have been shifting to increased user fees, such as toll roads, for which the revenue and benefits are more closely linked. Businesses in some states, such as Virginia and Illinois, have argued for higher taxes earmarked for improved infrastructure spending, particularly transportation, because they see the direct benefits to their business. Further, states with government expenditure to tax ratios closer to 1 may have a competitive advantage in attracting and retaining investment and jobs.

A broader policy implication is that the business tax reform debate should include consideration of the overall level of business taxes (compared with benefits of government services received by business) in addition to the structure of business taxes. For example, in the Ohio tax reform debate in 2005 (described in more detail below), changes in the structure of the business tax system were debated simultaneously with the overall level of business taxes.

In today's economic environment, in which firms are increasingly pressured by global competition and with the increasing importance of trade in services, intangibles, and electronic commerce, relatively high state and local business taxes matter more than ever. Companies' decisions regarding the location of their headquarters, research and development facilities, manufacturing plants, call centers, and other facilities will include state and local taxes as one of the significant determinants. States and localities can choose to compete for economic development opportunities on the basis of their overall tax structure, including tax bases and general tax rates, targeted incentives, strong infrastructure, and an educated workforce.

III. Business Tax Reform Gains Momentum

Recent state tax legislation affecting business taxes can be divided between states enacting new business taxes as part of major tax reform packages and states that are attempting to preserve and expand their existing tax bases. While fiscal pressures are driving some states to increase overall corporate income taxes, economic development concerns are simultaneously pushing states to shift taxes increasingly to out-of-state firms. Those opposing forces produce combinations of tax changes, including the disallowance of subtractions for payments to affiliated nontaxpayers, increased use of targeted tax incentives for in-state economic activity, and the adoption of 100 percent sales apportionment formulas for the corporate income tax.

Table 2. Fiscal Comparison of Recent State Tax Reforms (in $ billions)

State	Business Property Tax Cuts	New Entity Business Tax	Other Business Tax Cuts	Net Business Tax Changes	Total Tax Changes/a/
Ohio (2010)	-$ 1.3	$ 1.3	-$ 1.4/b/	-$ 1.4	-$ 1.3
Texas (2008)	-$ 3.4	$ 6.0	-$ 2.5/c/	$ 0.0	-$ 2.5
Michigan (2008)	-$ 0.6	$ 2.4/d/	-$ 1.8/e/	$ 0.0	$ 0.0

FOOTNOTES TO TABLE

/a/Includes changes in taxes on households as well as business.

/b/Includes cuts in Ohio sales tax on business inputs and personal income taxes, as well as the elimination of corporate franchise tax.

/c/Elimination of Texas franchise tax.

/d/Michigan business tax (MBT) of $ 3.4 billion less tax credits of $ 1 billion.

/e/Elimination of Michigan single business tax.

END OF FOOTNOTES TO TABLE

The broader business tax reforms began with the adoption in 2002 of the temporary New Jersey alternative minimum assessment (AMA), a minimum corporate income tax. The objective of the AMA was to maintain a level of corporate tax collections despite the sharp reduction in profits as a result of the recession. The only way to achieve that objective was to adopt a new tax base related directly to gross receipts, not profits. That change was followed by a new permanent corporate minimum tax, also based on gross receipts, in Kentucky in 2005./5/

The changes in New Jersey and Kentucky can be categorized as attempts to shore up the existing state corporate income tax; however, they set the stage for broader business tax reform. Beginning in 2005 three large states, accounting for almost 15 percent of U.S. gross state product, made more fundamental changes in their business tax systems by replacing their entity-level business taxes with tax systems that eliminated or substantially reduced the role of business profits taxes.

Recent Major State and Local Business Tax Reforms

Major tax reforms have been enacted in Ohio (2005), Texas (2006), and Michigan (2007). Those reforms enacted a new broad-based tax to replace existing business taxes and to reduce business property taxes. Each of those reforms was designed to make the states' companies more competitive while making important structural changes in business taxes. The new tax bases are much broader than the corporate net income tax base; they have lower tax rates, extend to noncorporate businesses, and apply to out-of-state businesses selling goods and services into the state. All three states use 100 percent destination sales factor apportionment formulas to determine the share of the U.S. tax base taxable in a state.

Table 2 provides a picture of how extensive the tax changes were in Ohio, Texas, and Michigan. Ohio's 2005 reform package, when fully phased in by 2010, reduced total taxes (for households and businesses) by $ 3.3 billion annually compared with current-law projections. The package includes a $ 1.4 billion reduction in business taxes, primarily from the phaseout of business tangible personal property taxes. For most business taxpayers, the tax reforms eliminate the corporate income tax and business personal property taxes and adopt a new business tax, a 0.26 percent commercial activity tax (CAT). The CAT is a gross receipts tax with some subtractions for intercompany sales with affiliated companies to reduce tax pyramiding.

Texas in 2006 enacted a $ 2.5 billion tax cut for individuals, with a revenue-neutral change in business taxes. The new Texas business tax, the so-called margin tax, will raise $ 6 billion annually to pay for a $ 3.4 billion reduction in business property taxes and a $ 2.5 billion elimination of the Texas franchise tax. The new business tax gives companies a choice of three tax base options:

o 70 percent of gross receipts;

o gross receipts less cost of goods sold; or

o gross receipts less compensation.

The tax rates are 0.5 percent for retail and wholesale firms and 1 percent for all other taxpayers. The choice of multiple bases was designed to mitigate redistributions of business taxes in going from the old to the new system.

In 2007 Michigan replaced the single business tax (a modified value added tax) with the Michigan business tax (MBT). The MBT applies to corporate and noncorporate taxpayers and consists of two separate taxes: a modified gross receipts tax with a deduction for purchases of tangible personal property at a 0.8 percent rate and a business income tax at a 4.95 percent tax rate. Taxpayers pay both taxes. The gross receipts tax will generate two-thirds of the new business-entity taxes before credits. The Michigan reform package reduced business property taxes by $ 600 million annually through credits and rate reductions and provided an additional $ 1 billion in targeted tax credits for investment, compensation, and R&D spending in Michigan. Overall, the business tax reform package was designed to be revenue neutral./6/

Objectives Underlying State Business Tax Reforms

What are states trying to accomplish in their efforts at tax reform? Property tax reductions for business (in Michigan and Ohio) and for business and households (in Texas) have been an important component in the states adopting major tax reforms. Annual business property tax reductions ranged from $ 600 million in Michigan to $ 3.4 billion in Texas. Business property taxes are the largest state and local business tax -- 37 percent of total state and local business taxes -- falling on in-state capital investments in real and personal property. By substituting a destination-based tax for an origin-based tax on business capital, states can make their in-state companies more competitive. State taxes on business tangible personal property (40 states tax some form of business tangible personal property) are a particular concern from a competitiveness perspective. Those origin-based taxes are more likely to fall on mobile capital investments.

Property tax reductions are one component of the broader tax policy objective of increasing business tax competitiveness, which in turn is expected to increase jobs and investment in the state. Coming out of the 2001 recession, states have placed economic development high on their policy priority list. As a result, more states are attempting to quantify the potential private-sector benefits, including increased jobs and incomes, of a more competitive business tax system. Also, the states are identifying the positive feedback effects on state and local taxes from stronger economic growth triggered by reductions in business taxes./7/

Incremental Base-Preserving Tax Changes

In contrast with the new systems adopted by Ohio, Texas, and Michigan, many states have enacted tax changes to try to preserve and expand their traditional corporate income tax bases. Those have included moving from separate return filing to combined reporting, disallowing deductions for transactions between affiliated companies, and increasing tax enforcement. Those incremental changes have also included, in some states, expanded tax credits and changes in apportionment formulas that tend to redistribute tax burdens from in-state to out-of-state taxpayers.

Figure 2 identifies the 23 states that require combined reporting currently or by 2009. Vermont and West Virginia recently adopted combined reporting for their corporate income taxes, while New York broadened the requirement for filing combined returns by mandating such filing when there are substantial intercompany transactions./8/ Combined reporting raises the complex, and often controversial, issue of which companies are part of a unitary group and has uncertain revenue effects. Depending on the state-by-state distribution of apportionment formula factors and unused net operation losses and credits for the different companies, combined reporting can increase or decrease income taxes for companies now filing in a state.

Another approach separate return states have taken to shore up the corporate income tax is to disallow some related-party expenses, including royalty and interest payments related to intangible property paid to affiliates. As shown in Figure 3, 21 states have statutory provisions requiring related-party intangible and interest expenses and costs to be added back in determining state taxable income.

Figure 2. Expansion of Combined Reporting

[Image Omitted]

Ohio -- if taxpayer doesn't elect to file a consolidated CAT return, a combined report is required.

Kentucky -- as part of its 2005 tax reform, Kentucky mandated nexus consolidated.

New York -- 2007 legislation requires a combined report in presence of substantial intercompany transactions.

A third approach has been a ramping up of enforcement measures to preserve the tax base. New York has aggressively increased its efforts to collect personal income taxes on nonresident income, even though it principally redistributes tax collections to New York from other states. Ohio is asking firms to report names of out-of-state vendors that could be possible Ohio taxpayers under the CAT. Massachusetts and Tennessee legislation shifted the burden of proof for some allowable expense deductions from the state to taxpayers. States are increasing scrutiny of transfer prices and have increased tax administrator discretion in adjusting taxable income and apportionment formulas to expand state tax bases.

State tax administrators have also increased cooperation by entering into information sharing agreements with the IRS and with other states. The Multistate Tax Commission announced its joint audit program with a requirement to report tax return information from all states. The Federation of Tax Administrators continued its efforts to foster increased cooperation among the states and with the federal government. Several states have adopted tax shelter disclosure requirements, while Massachusetts requires the disclosure of inconsistent filing positions.

A fourth approach that has often been combined with several of the other approaches is trying to make the state tax system more business-friendly for companies with significant payroll and property located in the state by moving to a more heavily weighted sales factor corporate income tax apportionment formula and providing targeted tax incentives for in-state investment and jobs.

Figure 3. Related-Party Intangible Interest/Expense Addbacks in Separate Filing States

[Image Omitted]

As shown in Table 3, 18 states use (or are scheduled to implement) a 100 percent sales factor apportionment formula (on all or selected broad industries), including the Ohio CAT that, in effect, is based on destination sales. There are now only 11 states that use an equally weighted, three-factor apportionment formula, the Uniform Division of Income for Tax Purposes Act standard. The remaining states use double-weighted or higher sales factor apportionment formulas. The shift to a single-sales-factor apportionment formula lowers state corporate income tax on companies with significant in-state payroll and property selling out-of-the-state while increasing income tax collections from companies selling into the state with little in-state payroll and property.

IV. The Importance of Business Tax Design for Current and Future Reforms

Recent state business tax reforms have included changes in multiple business taxes, particularly corporate income and property taxes. States that have modified the corporate income tax have made several adjustments, including expense addbacks and combined reporting, designed to increase the tax base. This section discusses some policy issues related to those changes.

Alternative Business Tax Bases

Table 4 provides a taxonomy of traditional business tax bases and the new tax bases adopted in Ohio, Texas, and Michigan. They range from a general gross receipts tax (GRT) to a value added tax to a general business tax to a corporate income tax. The table also provides estimates of the tax rates necessary to raise $ 50 billion nationally, approximately the total of all state corporate income taxes.

Several of the recent major tax reforms are hybrid systems that fall between a general GRT and a VAT in tax base size. The new Michigan modified GRT allows a deduction for tangible personal property purchased from other firms. Under a VAT, all purchases from other firms are deductible, including tangible personal property and services. The Texas gross margin tax (GMT) has an option for a deduction for cost of goods sold, which includes a portion of purchases from other businesses and employee compensation. A second Texas GMT option is gross receipts minus labor costs; a third is 70 percent of gross receipts. The modified gross receipts taxes have tax bases of similar size and all result in pyramiding of the tax on some business-to-business purchases.

Table 3. 100 Percent Sales Factor Apportionment Formulas, Current and Scheduled

State	Comments
Arizona	
Connecticut	
Georgia	Beginning January 2008
Iowa	
Illinois	
Indiana	Beginning in 2011
Kentucky	
Maine	
Michigan	Beginning January 2008
Minnesota	Beginning January 2014
Mississippi	
Nebraska	
New York	Beginning January 2008
Ohio	Applies to CAT
Oregon	
South Carolina	
Texas	
Wisconsin	Beginning January 2008

The last column of Table 4 also shows the relative size of the tax base using the overall U.S. economy to show the tax rates necessary to raise the same amount of revenue, $ 50 billion. A general GRT requires a 0.28 percent tax rate compared with a 1.1 percent tax rate for a "pure" VAT. In other words, the gross receipts tax base is roughly four times larger than the VAT tax base, a measure of the current level of private-sector economic activity in a state.

The Ohio CAT base is closest to a general GRT and is similar to Washington's business and occupation (B&O) tax. The GRT has a very low tax rate because the base includes both final sales and business-to-business sales. The GRT's tax pyramiding, or multiple taxation of the same sales, results in economic distortions and nonuniformity of effective tax rates that must be weighed against the low rate and administratively simple base.

Many economists believe that a VAT base is a desirable business tax base because it taxes equally all factors of production while avoiding tax pyramiding. With the elimination of the Michigan SBT after 2007, the New Hampshire business enterprise tax -- a minimum tax on all forms of doing business -- is now the closest state tax to a VAT.

A pure VAT has a significantly lower rate than a business *income tax (3.26* percent) that applies to all forms of doing business. The corporate income tax rate needed to raise $ 50 billion is 5.8 percent because it applies only to C corporations.

Winners and Losers

Moving from a corporate income tax to any new business tax base will result in significant winners and losers. Table 5 provides examples of the large redistributions of liabilities that are expected to occur under the new Michigan business tax package (business income tax and a modified GRT) compared with the SBT. Table 5 shows the effect of the Michigan tax reform on hypothetical multistate manufacturing and service firms. The combination of the substitution of income and modified GRTs for the SBT, expanded credits, and new property tax relief substantially reduces taxes for the manufacturing company example, while increasing taxes on the service company example. Compared with SBT liabilities, the tax changes will increase taxes on the service company by almost 30 percent and reduce taxes on the manufacturing company by 26 percent.

The important policy implication is that a revenue-neutral change in overall business taxes under a major reform package will create potentially significant redistributions in taxes among industries and types of taxpayers. The redistributions will depend on the legislators' perception of nonuniformities under the current tax system, the relationship between the new and old tax bases, whether taxpayers have a choice of tax bases, and the importance of tax credits for in-state activities. Business taxpayer involvement early and continually in the tax policy process will provide legislators with important information about the size of the tax redistributions under the alternative tax bases being considered.

Table 4. Taxonomy of New Business Taxes

Tax

Rates

to

Raise

$ 50

billion

Description

in

All

Tax Base	Examples	of Tax Base

	States		
General gross receipts tax	Ohio CAT, Washington B&O, Texas tax base option	Gross receipts (GR) with few, if any, deductions	0.28%
Modified GRT	Texas tax base option	GR minus labor costs	0.37%
	Texas tax base option	70 percent of GR	0.40%
	New Michigan base	GR minus purchases of tangible property	0.54%
Gross margin tax	Texas tax base option; Kentucky and New Jersey AMTs	GR minus cost of goods sold	0.70%
Value added tax	Pure VAT	GR minus purchases from other firms	1.10%
	Michigan single business tax	VAT with significant modifications	1.47%

Business income	New Michigan income tax base, applies to most businesses	GR minus labor costs, depreciation, interest, purchases from other firms	3.26%
Corporate income tax	Traditional business entity tax, applies to C corps only	Same as business income tax	5.80%

Rationale for Combined Reporting

The adoption of combined reporting under the new tax systems is raising significant tax policy issues. While Vermont, New York, and West Virginia have recently adopted or expanded combined reporting requirements for the corporate income tax, the three states undertaking broader business tax reform -- Ohio, Texas, and Michigan -- have also adopted mandatory combined reporting as part of their new business taxes.

The rationale for adopting combined reporting under the new business tax systems, however, differs significantly from the rationale for adopting combined reporting for corporate income tax purposes. States argue that the rationale for corporate income tax combined reporting is that profits cannot be accurately attributable to a single affiliated entity, because the interaction and interdependencies among all the unitary affiliates create the group's profits. Therefore, income of the group has to be combined to be accurately measured. To determine a single state's share of the combined income, the group's income is apportioned using payroll, property, and sales factors that indirectly measure where income is generated.

That rationale does not justify the adoption of combined reporting for the new, modified GRTs, although the rationale does apply to the income component of the Michigan business tax. For the modified GRTs, measurable destination sales (similar to the sales factor in the corporate income tax apportionment formula) determine the tax base and can be attributed to a specific company. The rationale for combined reporting for the new taxes is based more on the objective of identifying additional out-of-state firms subject to state taxation, not an adjustment needed because the base cannot be attributable to different affiliated taxpayers./9/ In other words, combined reporting is used to expand the tax base to more out-of-state companies selling into a state, a feature also seen in the efforts of states to maintain or expand the corporate income tax base.

Because the rationale for combined reporting under the modified GRTs is to increase the number of firms that are taxable in the state, it is potentially a more controversial issue between taxpayers and tax administrators. Taxpayers may view combined reporting under the modified GRTs as a method to maximize revenue, not to more accurately measure the tax base attributable to a state.

Also, the Ohio CAT actually introduced the concept of a "voluntary" consolidated return filing category that includes nonnexus taxpayers on the return in exchange for the group's ability to subtract intercompany revenues from the GRT base. Again, that is designed to increase the number of taxpayers identified as selling into the state by providing tax relief from pyramiding of the CAT base. Linking a reduction in the degree of pyramiding with the objective of increasing the number of out-of-state taxpayers is likely to raise additional legal challenges going forward.

Table 5. Michigan 2007 Tax Reform Effects:
Hypothetical Manufacturing and Service Firms

	Manufacturing	Services
Tax Liability		
Elimination of single business tax	$ (25,100)	$ (13,900)
Adoption of new business tax (before property tax relief)	$ 22,000	$ 18,600
Tax on net income	$ 17,400	$ 9,700
Tax on modified gross receipts	$ 13,900	$ 13,200
Credits (ITC, compensation, R&D, other nonrefundable)	$ (9,300)	$ (4,300)
Net Change in Business Entity Taxes	$ (3,100)	$ 4,700
Property Tax Relief	$ (5,700)	$ (300)
Total Change in Business Entity and Personal Property Tax	$ (8,800)	$ 4,400
Percentage Change	(26.0)%	29.5%

Note: Under the MBT, the taxable share of Michigan gross receipts is substantially smaller for manufacturers than services (modified gross receipts are 43 percent of total gross receipts in manufacturing, and 94 percent of total gross receipts in services).

V. Lessons Learned From Recent States' Business Tax Changes

There are several lessons from the recent efforts of states to fundamentally change their business tax systems or maintain the viability of existing corporate income taxes. Those lessons have important implications for business taxpayers.

Focus on System of Business Taxes

When policymakers are considering tax reform measures, rather than focusing on a single tax, such as the corporate income tax, they should consider the overall system of state and local business taxes. Legislatures and affected taxpayers must determine whether the proposed system will, as a whole, be an improvement over the existing system.

All states rely on several different business taxes, principally property taxes, sales tax on business inputs, gross receipt and excise taxes, and income/franchise taxes. It is important to analyze the effect of the entire state and local business tax system on a taxpayer's liability and a state's business tax competitiveness. The same economic effect on competitiveness could occur from many different combinations of property, sales tax on business inputs, and corporate income taxes, because they all affect a company's cost of capital and willingness to invest in a state.

The E&Y 50-State Business Tax Study has broadened the focus of state tax analysis beyond corporate income taxes and has directed more attention to the combined effects of total business taxes. Figure 4 shows the state-by-state variation in total state and local business tax rates, one measure of the size of business tax burdens. The total business tax rate (TTR) is measured as the ratio of total business taxes to state private-sector gross state product, the total value of a state's annual production of goods and services (value added). TTRs vary from 10.8 percent in Wyoming to 3.7 percent in the District of Columbia; the average TTR for all states is 5.1 percent.

Increased Business Competitiveness Concerns

The combination of the national recession in 2001 and 2002 and increasing national and international competition has generated increasing concern among state policymakers over business competitiveness. As a result, stimulating economic growth is an important consideration in business tax design. Origin-based taxes, such as property taxes and sales taxes on business inputs, are more likely to discourage in-state investment than destination-based taxes, such as a corporate income tax with a 100 percent sales-factor apportionment formula or a destination-based GRT that exempts exports and taxes imports.

Figure 4. State and Local Business Taxes as a Percent of Gross State Product, Fiscal 2006

[Image Omitted]

Given that increased interest in economic development and jobs, states continue to adopt new and expanded tax credits and subsidies targeted at new investments, employment, and other activity within the state. Whether states are making incremental changes in the corporate income tax or replacing the corporate income tax with new business tax bases, targeted incentives will continue to play a significant role in state economic development strategies. Although mobile capital investments will be most responsive to incentives in the short run, all businesses are mobile over time and look for a sustainable, specific tax structure.

Many states offer business tax incentives to encourage investment within the state. Some common examples include investment tax credits, property tax abatements, and employment tax credits. The incentives are often targeted to mobile firms and may be used to offset high tax rates that are the result of narrow bases. It also appears that an increasing number of states are considering or adopting transferable credits that increase the present value of credits for taxpayers with limited or no taxable income. Because those incentives are highly visible and offer observable results, they are a popular choice among lawmakers. However, opponents of incentives question their cost-effectiveness in retaining or expanding in-state investment and jobs./10/

Mobility of businesses, in both jobs and capital investments, must be given consideration in the discussions surrounding any proposed state tax reform. E&Y's annual study of mobile capital investments, the U.S. Investment Monitor, examines projects that are not tied to a specific geographic location by market or other issues, but are driven by more competitive features like tax, incentives, and input costs that influence economic growth. The annual study provides a good benchmark for state economic development agencies and policymakers to measure how well their economic development policies are working. The study shows considerable mobility across states by different industries./11/

Business Tax Uniformity

Although fairness is a difficult concept to define, businesses are concerned about fairness or uniformity in business taxation. The concept is that businesses in similar circumstances should pay comparable taxes. For example, proponents of uniform business taxation argue that a firm organized as a corporation should not face higher effective tax rates than a business organized as a passthrough entity. As another example, a business classified as being in a particular industry for regulatory or tax purposes should not face higher tax rates than a competitor classified in another industry. Proponents also assert that taxes should be more uniform across different types of economic activity, including the production of tangible personal property and services.

Although more uniform tax rates reduce economic distortions, state legislators continue to adopt targeted tax incentives that reduce effective tax rates for selected taxpayers and industries to support economic development objectives. In general, both state tax administrators and businesses benefit from more uniform state tax rules that simplify taxes and reduce tax compliance costs. The business tax reforms in Ohio, Texas, and Michigan apply broad tax bases to almost all forms of doing business and to almost all industries, changes that should result in more uniform business tax rates.

Another dimension of tax uniformity is the relationship between federal and state business taxes. Potential federal reform may have important implications for state business tax revenues and tax policies. For example, a recent U.S. Treasury Department study and a congressional tax reform proposal included a reduction in the U.S. corporate income tax rate with a revenue-neutral expansion of the corporate income tax base./12/ One of the benefits attributed to broadening of the federal corporate income tax base is a reduction in the variation in effective tax rates across industries.

Sustaining Business Tax Reform

In evaluating the major business tax reform efforts, the question arises whether the new broad-based, low-rate taxes can be sustained or whether their bases will be reduced in size and increased in complexity over time. The Michigan experience is instructive. The SBT was adopted in 1975 as a modified VAT that allowed immediate expensing of capital equipment. Over time the tax was modified continually until it became a complex, hard-to-understand combination of an income tax, a GRT, and a VAT. Business increasingly opposed the tax because of its complexity and because it was not based on ability to pay and was so different from the standard state business tax structure.

Some of the exclusions from the new, modified GRT bases, such as purchases of tangible personal property in Michigan and some intracompany transactions in Ohio, are more consistent with a VAT base and reduce GRT pyramiding. State adjustments to further address the pyramiding issue may include allowing further subtractions for purchases from other firms or adopting multiple tax rates that vary by industry depending on the perceived degree of pyramiding (the Washington state B&O tax approach, for example). Changes in rates and exclusions over time will likely add to the complexity of those new modified gross receipts taxes.

From the taxpayer's perspective, predictability and stability in state and local business taxes are important tax policy goals. Businesses make investment decisions based on extended time horizons. Frequent changes in business tax laws in response to short-run revenue needs or changes in interpretation of existing law increase tax compliance and administrative costs. Also, those changes may discourage capital investment and job creation because of the increased uncertainty of after-tax rates of return on investments in a state.

Business Input in Tax Reform Debates

The recent efforts of states to either reform their business tax structure or defend their corporate income tax base have focused attention on the importance of business input in tax policy debates. In fact, in Ohio, Texas, and Michigan, the business community was an active participant in the tax reform process. While the particular tax issues and tax reform options discussed will differ by state, there are significant areas in which business input is important in the tax policy process:

o Identification of negative effects of current taxes or proposed changes. The business community can take a leading role in identifying the components of a state's existing business tax system that put taxpayers at a competitive disadvantage. Examples include the strong case made by manufacturers in Ohio and Michigan for reduced property taxes on business tangible personal property.

For tax changes designed to expand the corporate income tax base, including combined reporting and the disallowance of expense deductions, businesses must explain the expected changes in tax liabilities and the possible negative effects on tax competitiveness. Although legislators may decide that the benefits of raising additional revenue from business exceed the potential negative economic effects, they need to be aware of those effects.

o Public support of tax changes. For tax changes that improve a state's competitiveness, business can provide public support for changes. Given the complexity and uncertainty of the effects of proposed business tax changes, legislators may find it easier to support changes that have strong backing from the business community.

In terms of economic development, legislators are also looking for confirmation that specific tax changes or reforms will provide incentives for expanding economic activity in a state. In some cases, that may involve a discussion of adding new jobs and investments or a discussion of minimizing reductions in the level of economic activity.

o Information on unintended consequences. Because of the complexity of business taxes and the limitations of detailed tax return information for estimating tax effects of significant changes in business taxes, proposed changes may have significant unintended consequences. Business should work with legislators and tax agencies to identify and resolve those issues before changes are adopted.

o Discussion of overall tax levels. The tax reform debate provides an opportunity to discuss both the structure and level of state and local business taxes, as seen in the Ohio example. The business community can play an important role in this discussion. If business tax reform is not constrained by the requirement that combined business tax changes be revenue neutral, it is easier to mitigate the negative effects of reform on the distribution of taxes and economic development.

o Rising expenditure needs. As discussed earlier, state fiscal needs are pushing some states to raise additional revenue from existing corporate income taxes to fund needed services. That pressure is leading states in the direction of extending their tax bases to cover more income, some of which taxpayers may consider to be unrelated to their economic activities in a state. That is increasing the tension between taxpayers and tax administrators.

Another expenditure pressure point is the growing state burden of funding healthcare access and services. As seen by recent legislative proposals in Illinois and California, states are considering significant payroll or GRT increases dedicated to funding healthcare. Those very large increases could result in substantial overall business tax burden increases. The business community will be significant participants in both the state healthcare spending and financing debates.

VI. Conclusions

Increased national and international competition, rising expenditure needs, and concerns over the longer-run viability of corporate income taxes are causing some states to reevaluate their business tax systems. Business tax changes over the next few years are likely to be a blend of states attempting to preserve or expand the existing corporate income tax base and a few states adopting fundamentally new business tax systems.

Although no single factor can predict whether a state will undertake business tax reform, the presence of some elements may indicate a high probability of significant changes in state business tax systems. Those elements include: the presence of current or recent state tax reform commissions (for example, in Georgia, Maryland, Massachusetts, North Carolina, and Pennsylvania); continued reductions in manufacturing employment; efforts to increase taxes on services; large projected budget deficits combined with inadequate budget reserves; the perception of significant tax planning opportunities; and the level and rate of increase of property taxes.

Although the timeline for future business tax changes is unclear, continued economic and budget pressures could accelerate state tax reform efforts over the next few years. States facing significant property tax problems (that is, relatively high business property taxes and rapidly increasing property taxes on homes) are good candidates for tax reform. Florida, Georgia, Indiana, and Illinois are examples of states that are considering alternative revenue sources to pay for substantial property tax reductions for homeowners. Unlike the business property tax reductions in the tax reform packages in Ohio, Texas, and Michigan, "reform" in those states may result in business taxpayers paying higher state and local business taxes to pay for property tax relief for homes.

In addition to their local property tax problems, states are beginning to forecast both short-run and long-run budget deficits. For example, Maryland just completed a special session to close a $ 1.7 billion structural deficit for fiscal 2009 and Florida is forecasting a shortfall in tax collections of $ 2.5 billion over the next two fiscal years. As another example, California is predicting that slowing revenue growth and rising expenditures will produce a $ 10 billion deficit by fiscal 2009. While the deterioration of state budget balances presents the substantial risk of higher state business taxes, it may also present the opportunity to reevaluate and reform business tax systems to increase tax competitiveness and long-run economic growth.

A third state budget challenge that could focus more attention on business tax reform is the search for an effective way to tax the consumption of services. Options states are considering include extending sales and use taxes to more services, adopting separate excise taxes on services, and adopting alternative tax bases, such as gross receipts, that would indirectly tax services./13/ Regardless of the option considered, attempts to tax services purchased by business raises the issue of tax pyramiding. In Ohio and Michigan, tax reform started with proposals for extending the sales tax to services and expanded into considerations of broader tax reforms. Regardless of the option considered, attempts to tax services purchased by business raises the issue of tax pyramiding.

In light of those challenges, it is imperative that business closely monitor state tax policy developments and actively participate in the development and promotion of proposals for business tax reform. The business perspective is critical in the process of developing better tax systems that meet state revenue needs while simultaneously encouraging long-run economic growth through increased investment and employment. Business can assist legislators in understanding the overall effect of state and local taxes on the state's competitiveness and in quantifying the long-run benefits to the state's residents, in terms of jobs and higher incomes, of a more competitive business tax structure. Business input is also important to avoid unintended consequences of complex tax changes.

FOOTNOTES

/1/ Ernst & Young LLP, "Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2006," done in conjunction with the Council On State Taxation (February 2007). Business taxes are defined as taxes that are the legal liability of businesses. They exclude sales taxes collected by business on household purchases.

/2/ Joel Slemrod and Varsha Venkatesh, "The Income Tax Compliance Costs of Large and Mid-Sized Businesses," report to the Internal Revenue Service Large and Midsize Business Division (September 2002).

/3/ Richard H. Mattoon and William A. Testa, "How Closely Do Business Taxes Conform to the Benefits Principle?" presentation at the Future State Business Tax Reforms: Perspectives From the Business, Government and Academic Communities conference, Federal Reserve Bank of Chicago (Sept. 17, 2007). The authors distributed state and local government expenditures between businesses and households. Services benefiting business include shares of expenditures for transportation, water and sewer infrastructure, police and fire protection, general government "overhead" (for example, legislative, administrative, and judicial services), interest, and regulatory activities. That study estimates that for all states, roughly 13 percent of state and local expenditures are attributable to business. The method used is described in detail in William H. Oakland and William A. Testa, "State-Local Business Taxation and the Benefits Principle," Economic Perspectives (January/February 1996).

/4/ The ratio is sensitive to the amount of state and local educational expenditures assumed to benefit business. Their 3-1 estimate assumes that education expenditures benefit households in the form of higher wages, rather than directly benefiting businesses. If the benefits of education are split evenly between business and households, the U.S. average ratio falls from 3.7 to 1.25.

/5/ The New Jersey and Kentucky minimum taxes are based on gross receipts or gross margins. The New Jersey minimum tax sunsetted in 2006, except for firms protected by P.L. 86-272. Those firms can avoid the AMA if they elect to pay the corporate income tax.

/6/ The Michigan tax changes do not include the budget-balancing, temporary personal income tax rate increase passed October 1, 2007, and the temporary business tax surcharge, 21.99 percent of precredit MBT liabilities for general taxpayers, passed on December 1, 2007. The surcharge was adopted to replace revenue from an extension of the use tax to selected services that was scheduled to take effect December 1, 2007.

/7/ For an example of estimates of the dynamic economic and fiscal impacts of Ohio's tax reform package, see testimony presented by Robert Cline of E&Y at the Ohio House Ways and Means Committee hearing on HB 1, Feb. 3, 2005.

/8/ During the 2007 special session, Maryland's General Assembly considered, but did not include, combined reporting in the recently passed tax bill (SB 2) that raises $ 1.1 billion in new taxes. However, the bill did establish a commission to study and evaluate the state's business tax structure. The commission is tasked with making recommendations on combined reporting, as well as the possible adoption of alternative business taxes, including gross receipts, value added, and minimum taxes.

/9/ The states adopting modified GRTs are asserting that P.L. 86-272, the federal law restricting income tax nexus, does not apply to the new taxes. Michigan held that position on the SBT and is expected to do so regarding the Michigan business tax. That position is also consistent with the legislative intent for the new Ohio and Texas business entity taxes. Also, states are increasingly asserting economic nexus (that is, economic rather than physical presence necessary to establish sufficient tax nexus). As a result of those two developments, the states are expecting an increase in the number of out-of-state businesses that are state taxpayers.

/10/ For a more detailed discussion of the trends and issues related to business incentives, see Jeffrey N. Saviano, Robert J. Cline, Kenneth T. Zemsky, and Rebecca D. Truelove, "A Roundtable Discussion on State and Local Tax Issues in the Northeast," Journal of Multistate Taxation (September 2007).

/11/ Ernst & Young LLP, United States Investment Monitor, October 2007.

/12/ U.S. Department of the Treasury, "Background Paper for Treasury Conference on Business Taxation and Global Competitiveness," July 26, 2007. The congressional proposal introduced by House Ways and Means Committee Chair Charles B. Rangel, D-N.Y., is analyzed in Tom Neubig and Estelle Dauchy, "Rangel's Business Tax Reforms: Industry Effects by Sector," Tax Notes, Nov. 26, 2007, p. 873, Doc 2007-25326, or *2007 TNT 228-26*.

/13/ For a detailed discussion of the issues related to extending the sales tax to services purchased by business, see Robert Cline, John Mikesell, Tom Neubig, and Andrew Phillips, "Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services" (Jan. 28, 2005). The study was prepared for the Council On State Taxation. State Tax Notes, Feb. 14, 2005, p. 457, Doc 2005-1861, or *2005 STT 29-1*.

END OF FOOTNOTES

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