

**EMERGING STATE BUSINESS TAX POLICY: MORE OF THE SAME OF
FUNDAMENTAL CHANGE?**

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INTRODUCTION

Much of the state tax policy discussion during the past decade has centered on the performance of corporate income taxes and ways to restructure them. It is interesting that corporate taxes receive so much attention in state capitols, industry location decisions and the media given the relatively small contribution that they make to total tax receipts. State corporate income taxes comprised only 6.0 percent of total state tax revenues in 2005, and even combined with corporate license taxes, which include the value-based franchise taxes among others, represented only about 7.1 percent of taxes.¹ Indeed, corporate income taxes provide no more than 10 percent of total state and local business taxes.² There are several possible explanations, including the visibility of corporate facilities, perceptions of corporate tax abuse and the difficulty of generating revenues from other sources. Though the issue of why the corporate income tax draws such attention may be a fascinating study, we will simply accept that states have considered and made many changes in corporate income tax even if they may have found other areas with more revenue potential.

This paper focuses on state responses to the weak corporate tax collections during the 2000 to 2003 time period as well as to the revenue performance during the years immediately preceding and following the recession. The paper is not an attempt to argue that the corporate income tax is an important component of good state tax policy. Instead,

¹ See <http://www.census.gov/govs/statetax/0500usstax.html>

² See Cline et al (2005).

our focus is on identifying state tactics to maintain or change the tax, determining whether these strategies are good tax policy, and evaluating whether they are working to achieve the basic goals of the states.

The paper is composed of three sections. Section 1 reviews the revenue performance of corporate taxes over the past 15 years to provide insight into why states may have sought new strategies. Section 2 presents a brief summary of state corporate tax policy changes and reforms during recent years. Finally, section 3 analyzes the policy changes in terms of their long-term effectiveness, across a broad set of criteria including their capacity to help or hinder states through economic cycles like 2001 to 2003.

PERFORMANCE OF CORPORATE TAX REVENUE

This section provides a brief overview of corporate income tax performance, particularly between the years 2000 and 2003, in order to set the stage for why states have adopted new corporate tax strategies. Corporate income taxes declined dramatically during the 2000 to 2003 window, both as a share of total tax revenues and in nominal terms. State corporate income taxes fell by \$7.4 billion between fiscal year 2000 and fiscal year 2002 before growing about \$3.3 billion in 2003. As a result, corporate income taxes declined from 6.9 percent of total state taxes in 1997 to only 4.7 percent in 2002, and then came back to 5.2 percent of taxes in 2003. As noted above, corporate taxes had risen to 6.0 percent of total taxes by 2005 and continued to grow as a percent of revenues in 2006.³

Corporate income taxes were affected much more by the 2000 to 2003 slowdown than were the other larger taxes. For example, corporate taxes declined 12.7 percent (even

³ Data for 2006 are only available through the U.S. Census' quarterly state tax revenues. These data generally record revenues on a cash basis and prior to some other revisions. See <http://www.census.gov/govs/www/qtax.html>

after the \$3.3 billion revenue growth in 2003) while individual income taxes fell only 6.5 percent and sales taxes rose 5.8 percent during the three years. Corporate taxes performed more weakly during the down cycle despite the slower growth in corporate income taxes relative to individual income and sales taxes that occurred from 1992 to 2000, the window leading up to the slowdown. Thus, corporate taxes were not simply more volatile, they have been very slow growing relative to the other large taxes.

The fall in corporate income taxes can be explained by two very different underlying causes: the cyclical downturn that took place during 1990-91 and again from 2000 through 2003 and the trend decline that has been going on since 1989. Fox and Luna (2002) describe three causes of the trend decline in corporate income tax revenues: reductions in the federal corporate tax base (arising from such factors as depreciation policies and the production exemption), state policy decisions that lowered corporate tax burdens (such as enacting LLC legislation), and more aggressive corporate tax planning. Presumably these three factors account for much of the decline in effective corporate tax rates. Corporate income taxes were 4.7 percent of total corporate profits (presumably a reasonable proxy for the overall tax base) in 1992 but fell slowly during the 1990s, suggesting at least slow trend erosion in corporate taxes.⁴

The big decline in the effective tax rate started in 2002, when taxes fell to 3.3 percent of profits. However, if the latter was merely due to cyclical rather than trend influences, taxes should have rebounded dramatically with the astounding growth in profits since 2001.⁵ But, this has not been the story. Corporate profits taxes fell to 2.5 percent of 2005 national corporate profits, even though they did rise as a share of total tax

⁴ Nominal corporate profits rose at a compound annual 7.3 percent from 1990 to 1999.

⁵ Before corporate income tax profits without inventory adjustment increased 155 percent from 2001 to 2006, rising from \$707.9 billion in 2001 to \$1,802.0 billion.

receipts.⁶ Thus, the corporate tax story appears to be much broader and deeper than is explained by a cyclical response between 2000 and 2003. We make no further effort here to examine the underlying causes of the trend decline in effective tax burdens, but they are key issues to the extent that state strategies must be intended to offset these factors.

One possible explanation is that loss carry forwards arising from corporate losses during the beginning of the 2000s are allowing aggregate corporate profits tax growth to lag corporate profits growth. This could explain a short-term fall in corporate taxes as a share of profits, but it seems an unlikely explanation for the entire decline and is certainly not an explanation for a trend decline in effective tax burdens. Combined corporate profits taxes would have been \$51.2 billion higher between 2002 and 2005, representing 41.8 percent of actual corporate profits tax receipts, if taxes had remained a constant 4.0 percent of corporate profits. This would have allowed the average state to collect more than \$1 billion in additional corporate tax revenues during these four years. But of course, huge loss carry forwards would have been required to reduce taxes by this much, suggesting that the factors explaining trend declines in the effective tax rate are the more likely explanation for the pattern of the last several years.

It is not possible to calculate state specific effective tax rates since corporate profits data are not available for states. The Table does highlight differences between states in reliance on the corporate income tax and how corporate tax revenues have grown in recent years. Alaska and West Virginia, states which tax natural resources heavily, and New Hampshire, which has neither a general income or sales tax, rely very heavily on corporate income taxes. No other state collected even 10 percent of its tax revenues from the corporate income tax. Performance of the tax has varied radically across the years.

⁶ A similar result was found for national corporate profits taxes. See Sullivan (2007).

Nationwide, corporate tax revenues grew a compound annual 4.5 percent since 1992 and a much faster 15.5 percent during the last three years. But, Connecticut, Iowa and Missouri have seen corporate income tax revenue fall over the last 13 years while Maryland and New Hampshire have seen a compound annual increase of over 10 percent. Even wider diversity has occurred during the past three years.

Two implications can be immediately drawn from the data. First, the cyclical downturn was not the only cause of the decline in corporate taxes, and was probably not the biggest source of the decline in effective tax rates. As a result, policy responses need to be aimed at longer-term solutions, not cyclical responses, insofar as states want to protect this revenue source. Second, the state policies adopted during the past decade have not offset the falling tax revenues, at least across the aggregate of states. Thus, state policy responses require very careful consideration to determine if they offer the prospect of helping states improve collections during recessions as well as over the longer-term. Of course, some states may be pursuing other goals, and are thus less concerned about the declines in the effective corporate income tax rate.

STATE RESPONSES

States have responded to reduced state and local corporate income tax revenues in a variety of ways. Broad measures include expanding the nexus threshold, taxing a base other than profits, extending the corporate income tax to non-corporate taxpayers, and requiring combined reporting. States have also selectively targeted the most “abusive” tax reduction strategies such as passive investment companies (PICs) and the IRS listed and reportable transactions. On a case by case basis, states also frequently challenge the classification of income as business or non-business to increase the state’s share of

apportioned or allocated income, and 23 states have imposed throwback rules in an attempt to capture “nowhere income.” The following section describes these responses, which are essentially efforts to capture or recapture the corporate tax base.

Broadening of nexus standard

The first hurdle to levying a tax is establishing that a business’s activity in a state is sufficient to create a taxable presence, or nexus. When nexus exists is a legal issue that has not been fully resolved by the courts.⁷ Since the *Quill* case, states have been divided as to an appropriate standard, ranging from a physical presence standard to a doing business standard employed by Kentucky. In most cases the courts have ruled that the *Quill* physical presence test only applies to sales and use taxes and not to income taxes,⁸ but careful planning made possible by the physical presence rules and P.L. 86-272 allows businesses to exploit nexus requirements to locate income in low tax jurisdictions or in ideal cases, create “nowhere” income that is not taxed in any state.

In response to these planning opportunities, states have recently become more aggressive in asserting nexus for income tax purposes, particularly when transactions involve affiliated corporations. As alternatives, states have asserted three types of nexus arguments that do not require physical presence: (1) affiliate/agency nexus, (2) economic nexus, and (3) flash nexus. Affiliate/agency nexus potentially arises when an in-state

⁷ Attempts have been made in Congress to create a bright line standard for nexus that would require physical presence for all business activity taxes and extend the protection of P.L. 86-272 to companies that solicit sales of services. See H.R. 1956 and S. 2721.

⁸ Courts in New Jersey, New Mexico, North Carolina, Ohio and others limit the physical presence requirement to sales and use taxes, consistent with a literal reading of the *Quill* decision. On the other hand, courts in Michigan, Tennessee and Texas have extended the physical presence standard to other taxes, including income taxes. The U.S. Supreme Court has been asked to decide whether states can assert nexus on a basis other than physical presence. In separate petitions, taxpayers seek review of decisions by the Supreme Courts of New Jersey (*Lanco*) and West Virginia (*MBNA*).

corporation performs services or acts as an agent for a member in the affiliated group. While there is limited case law on affiliated/agency income tax nexus,⁹ Virginia ruled that the use of truly independent contractors would not create nexus for the out-of-state purchaser of the services (Ruling of Commission, P.D. 06-114, 10/11/06). Using an affiliated entity that does not qualify as an independent contractor would create nexus for those entities to which it provides services. (P.D. 99-278, 10/14/99).

Economic nexus is asserted in cases where a company has a non-physical but “significant” presence in a state. For example, states have had some success arguing economic nexus involving licensed intangibles (e.g. trademarks) to affiliated companies for use in the state. Many businesses have created PICs to hold intangible assets such as trademarks which they license to related operating companies. The payments are often deducted by the operating entities, but can be non-taxable to the PIC in cases where the state in which the PIC is headquartered does not tax such income from intangibles (e.g. Delaware). Similarly, the PIC often can be headquartered in a combined reporting state in which other members of the group already have nexus without a significant increase in tax liability. Several state courts have held that the licensing taxpayer (PIC) with no taxable presence in the state other than the intangible asset did have substantial income-tax nexus.¹⁰

In addition to challenging nexus determinations in the courts, states have made some attempts to assert economic nexus in their statutes. For example, Kentucky

⁹ Idaho (HB 67) has proposed legislation that would impose attribution nexus on remote sellers if the remote seller and an in-state are related parties and the related party and in-state business use an identical or substantially similar trademark or the in-state business provides services that benefit the out-of-state business.

¹⁰ See for example, *Geoffrey, Inc. v. Oklahoma Tax Commission*, Okla. Ct. App. (12/23/05), *Kmart Corp. v. N.M. Taxation and Revenue Dept.*, N.M. S. Ct. (12/29/05), *Tax Commissioner v. MBNA America Bank, N.A.*, W.V. S. Ct. of App. 2006 W. Va. Lexis 132 (11/21/06).

changed from a physical presence standard to a “doing business” standard, where “doing business” includes receiving income from intangible property if the intangible property has a Kentucky business situs (regulation 16:240).¹¹ New Hampshire’s (HB 351) proposed legislation would redefine “business activity” to include when a business has a substantial economic presence in the state. Also, Texas’ new Margin Tax is imposed on taxable entities that do business in Texas and will likely be interpreted as a broad reaching nexus standard.

Flash nexus, a relatively new nexus arena, arises when a taxpayer brings a good into another state via common carrier and then sells the product to a related party or to a third party. The arguments are very similar to those involving drop shipments. In *Wascana Energy Marketing (U.S.), Inc., N.Y. Div. of Tax Appeals* (8/8/02), the court held that flash title transfer is insufficient to create nexus. However, Indiana (Revenue Ruling No. 2005-02URT 10/05) ruled that flash title was enough to create a utility receipts tax filing requirement for a gross receipts tax.

Membership in a pass-through entity, such as a partnership or LLC, is generally considered a nexus-creating activity. However, collecting the tax from the partner, shareholder or member, or conducting the necessary audits to identify and locate these taxpayers entities, is difficult and time-consuming. As a result, some states mandate that pass-through entities withhold the tax (at the highest rate) on behalf of its owners, allowing the entity to file a composite return and pay the appropriate tax for its nonresidents, or imposing an entity-level tax. When appropriate, out-of-state owners can file a claim for refund on taxes improperly withheld or paid on their behalf.

¹¹ See Tax Alert, Vol 24., No. 3, KY Dept. of Rev. (2005).

Combined Reporting

Common state income tax planning strategies involve forming multiple entities and structuring the activities within each entity, and transactions between related entities, to move profits into low or no tax states. There is a widespread belief by tax authorities that many planning efforts are abusive and artificially distort the reported profits actually earned in each state. Combined reporting reduces the advantages of many potentially abusive planning strategies because the profits and losses of all entities in a unitary group are combined for apportionment purposes, making the existence of multiple corporations and the transfer pricing between them irrelevant. Many separate filing states target clearly abusive situations and will adjust taxable income and effectively force a combined return if they do not believe the statutory method clearly reflects income, but these powers only address the most egregious situations.

In practice, combined reporting has limited effectiveness in combating aggressive tax planning. State laws differ regarding which related companies belong in the unitary group and are required to file a combined return (Fox, Luna and Murray, 2005). In addition, several states still allow (through voluntary combined reporting) or require each entity to file a separate return and effectively allow a corporation to choose the lowest tax reporting mechanism. The continued ability to file separate returns in some states allows multi-state businesses to plan around the combined reporting provisions. Furthermore, states adopting a domestic or waters-edge combination method will have the same effect as separate reporting when the affiliated group includes foreign affiliates.

Approximately half of the states require combined reporting. Vermont began requiring combined reporting for unitary business for taxable years beginning after 2005,

and Texas will require combined reporting beginning January 1, 2008. New York and North Carolina do not have required combined reporting; however, both states have been very aggressive in requiring unitary businesses to file a combined report if filing on a separate basis distorts the activities, business, income, or capital in the respective states. While a number of states have proposed combined reporting legislation (New Mexico, Missouri, Arkansas, and Pennsylvania),¹² it often fails due to strong lobbying by the business community.¹³

Disallowing deductions / requiring addbacks.

Broad nexus definitions and required combined reporting are big-picture challenges to income shifting strategies. Some states take a narrower approach with an “addback provision” and selectively target certain expenses that arise in transactions with related parties. The addback statutes, however, are written in a variety of ways and have different impacts on tax planning. For example some states, such as Kentucky, prohibit a deduction for interest expense connected to intangible property. On the other hand, Tennessee only requires *reporting* of firm-related transactions, and South Carolina only requires that the deducted expenses be paid (instead of accrued). Furthermore, most addback statutes provide safe harbors that allow taxpayers to claim the related party deduction in some circumstances. For example, Alabama and Massachusetts provide an exception if the addback would result in double taxation or if the transaction has economic substance and a valid business purpose other than tax avoidance. To date, 18

¹² States with current legislation include Iowa (HF 326), Maryland (SB 393 and HB 553), Missouri (SB 642), New Mexico (HB 535), North Carolina SB 244 and HB 462) and West Virginia (SB 749).

¹³For example, the Council On State Taxation (COST) generally opposes mandatory combined reporting because it imposes additional compliance costs on businesses. See Doug Lindholm’s Testimony before the Senate and House Revenue and Taxation Committees on Mandatory Unitary Combined Reporting, March 8, 2005.

states and the District of Columbia have addback statutes on the books with very little consistency among them.¹⁴

As an alternative to addbacks, some states have been successful in challenging abusive tax planning strategies by asserting the transaction has no business purpose. For example, several states have challenged the PIC strategies in the courts with mixed success. In several early successes, state authorities challenged the PIC and alleged the transactions had no purpose other than tax avoidance because the PIC lacked economic substance.¹⁵ In other cases, with perhaps more favorable fact patterns for the taxpayer, courts have held for the taxpayer that the transfer of intellectual property from the parent to its subsidiary, a PIC, and subsequent royalty payments had business purpose and the royalty payments were reasonable, deductible business expenses.¹⁶

It should come as no surprise that as the states attempt to combat the PIC and transfer pricing tax planning schemes, tax planners have found ways around the rules. This is a primary flaw in a piecemeal strategy to close loopholes. For example, the modern-day PIC prices the inter-company transactions by using a service model that accounts for non-routine contributions.¹⁷ Essentially, the related entities perform non-routine services and share specific profits. The non-routine services involve a unique process (e.g., creation of proprietary software or use of intangible property) that improves

¹⁴Alabama, Arkansas, Connecticut, District of Columbia, Georgia, Illinois, Indiana, Kentucky, Maryland, Massachusetts, Mississippi, New Jersey, New York, North Carolina, Ohio, Oregon, South Carolina, Tennessee, and Virginia all have addback provisions.

¹⁵ See, for example, *Syms Corp. v. Mass. Commissioner of Revenue*, 436 Mass. 505, 765 N.E. 2d 758 (2002) and *Comptroller of the Treasury v. SYL, Inc.* 375 Md. 78,825 A.2d 399 (2003), cert. den. U.S. S. Ct. Docket No. 03-335, 11/3/03.

¹⁶ See, for example, *Sherwin-Williams Co. v. Commission of Revenue* (Massachusetts), Doc 2002-24629, and *Cambridge Brands, Inc v. Commissioner of Revenue*, Doc 2003-17023.

¹⁷ See Brett House, Teri Ziacik, and Irving Plotkin. "Coping With Changing State Transfer Pricing Legislation: An Alternative to the Intangible Holding Company Structure," *State Tax Notes*, December 18, 2006, 839-843.

the efficiency of the operating entities and allows them to create an additional, or residual, profit. The licensing company in these circumstances can be compensated based on the non-routine profits of the licensor.

While other states' addback statutes are being challenged, Alabama's courts were the first to rule on its addback provisions. An Alabama Circuit Court held that a deduction for royalties paid to related parties was properly deducted in computing Alabama taxable income (*VFJ Venutres, Inc. f/k/a VF Jeanswear, Inc. v. Surtees*, CV-03-3172 (Ala. Cir. Ct., Montgomery Cnty, Jan. 24, 2007)). The taxpayer, VFJ, paid over \$100 million in royalties to two related intangibles management companies to use various trademarks. Alabama provides an exception for its addback provision if the corporation establishes that the addback is unreasonable. The court found in favor of VFJ and held that the addback would be unreasonable. The court determined that VFJ had a business purpose for making the royalty payments as it needed to use the trademarks in manufacturing jeans with the Lee and Wrangler name and the royalty payments represented real and necessary costs of doing business in Alabama. The court recognized that the transactions may have been motivated by tax considerations, but pointed to the several factors that indicated a bona fide business purpose for the arrangement (e.g., significant office space and number of employees, licensed trademarks to unrelated parties, and increased efficiency by concentrating the management of the trademarks). The ruling could provide a blueprint for similar corporate arrangements in Alabama and elsewhere (e.g. Connecticut and Georgia) where bona fide business purpose is sufficient to defeat addback provisions.

Amnesties

Many states have legislated amnesty programs, which cover a wide range of taxes, including the corporate income tax. Amnesties encourage taxpayers to file or remit past tax liabilities in exchange for forgiveness of penalties and sometimes part of the interest. These programs are intended to provide a “quick fix” to the states’ revenue shortfalls as well as add taxpayers to the rolls. The Federation of Tax Administrators reports 84 instances of state tax amnesties, beginning with Arizona’s in 1982. Most states have granted an amnesty and more than half have allowed more than one. In fact, 36 of the 84 total state amnesties offered since 1982 occurred during the 2000s, with 11 amnesties in 2002 and 9 amnesties in 2003.

Target Listed/Reportable Transactions

The stock market boom years of the late 1990s and early 2000s encouraged a number of questionable tax planning schemes. In response to the widespread abuse, the federal government, as part of the American Jobs Creation Act (AJCA) of 2004, required taxpayers to disclose participation in “reportable transactions” which are specifically defined by the IRS. The legislation provided the IRS with significant enforcement measures to combat abusive tax shelters as it imposed significant penalties on taxpayers for failing to comply. For example, corporate taxpayers that fail to disclose a reportable transaction will incur a \$200,000 penalty when the non-disclosed transaction is a “listed transaction.” Since most states use federal taxable income as a starting point or as an integral component on their own income tax returns, these tax shelters also have very direct implications for state income tax revenues.

Since AJCA, seven states have followed the federal government's lead and enacted new tax shelter disclosure penalties.¹⁸ In almost all cases, the states provided for a limited "amnesty" period when taxpayers were permitted to come forward, voluntarily disclose participation in the abusive transactions, pay the additional tax owed, and receive waiver of penalties. The hope was that taxpayers would voluntarily come forward and self-report abusive transactions to avoid the additional penalties that would apply if the abusive transactions were discovered during audit. Additionally, the states and IRS have initiated unprecedented cooperation regarding tax shelter participants. Names and promoters of tax shelters uncovered by the IRS or the states are systematically shared among all interested parties, increasing the odds of identifying participants in abusive transactions.

While the general structure of each of these programs is similar, there are differences with regard to the penalties and required disclosures. For example, the penalty for undisclosed listed transactions for corporate taxpayers ranges from \$30,000 in Illinois to \$200,000 in Minnesota. Furthermore, the penalty exposure for a multi-state taxpayer can be significant and even exceed the federal amount because there is no relief mechanism in place to prevent penalties from multiple states from applying for a single failure to disclose.

Decoupling from the federal base

Following the recession that began in 2001, the federal government enacted a number of corporate tax breaks. Since states typically begin their own corporate income tax calculation with federal taxable income followed by specified exceptions from that base, the federal action had a negative impact on state corporate tax collections. As a

¹⁸ Arizona, California, Connecticut, Illinois, Minnesota, New York, and West Virginia

result, states have frequently elected to decouple from specific federal provisions because of the potential loss of tax revenue. Three specific examples of significant decoupling by the states are the provisions for bonus depreciation, Section 179 immediate expensing election, and the Section 199 domestic production deduction.¹⁹ In addition, some states have adopted different definitions of what qualifies as “manufacturing,” creating additional recordkeeping for taxpayers.

Legislate Alternative Tax Bases

The strategies discussed to this point all attempt to work within the current income tax framework system and try to “fix” the most egregious abuses or unintended policy changes. In some cases, states have taken a different course and abandoned the income tax based on federal taxable income as unworkable for their revenue and/or competitiveness goals. These few states assess business tax based on a (1) gross receipts basis, (2) book income basis, or (3) alternative minimum tax basis. Recent comprehensive reforms have occurred in Ohio, Texas, and Kentucky. Other states, including Michigan, West Virginia, Illinois and North Carolina, are involved in current tax reform debate.

The Ohio Commercial Activity Tax (CAT) replaces franchise and personal property taxes with a lower-rate on gross receipts (.26 percent). The CAT is levied on persons with “taxable gross receipts” in Ohio. Therefore, the tax is designed to tax all businesses that have an economic presence in the state, which reaches beyond the traditional nexus standards for businesses that simply solicit sales in Ohio.

¹⁹ Thirty-three states have chosen to fully or partially decouple from bonus depreciation, 18 state have decoupled from the 199 provisions, and 17 states have decoupled from the 179 provisions.

The Texas margin tax, effective beginning in 2008, is expected to double the number of business that pay franchise tax and raise approximately \$4 billion in new revenue.²⁰ The tax is assessed on Texas-sourced “taxable margin,” and unlike the Ohio CAT, it allows deductions for cost of goods sold or compensations. Retailers and wholesalers pay a tax rate of 0.5 percent and all other business are taxed at a rate of 1.0 percent.

Other tax methods include minimum taxes and value added taxes. Michigan and New Hampshire both impose a VAT, which taxes profits, compensation, interest and rents. Michigan’s VAT, the Michigan Single Business Tax (SBT) is scheduled to sunset December 31, 2007. Three proposals are currently being debated, all of which suggest a broader base and a low tax rate. New Jersey’s Alternative Minimum Assessment was adopted in 2002 as an alternative to the corporate income tax, though the gross receipts base has been repealed. Kentucky also enacted legislation that imposes an alternative minimum tax if gross receipts or gross profits exceed \$3 million. And California is considering taxing corporations on the basis of book income. A goal in all these cases is to recapture corporate income tax revenue by broadening or redefining the base in a way that is less susceptible to tax planning schemes.

POLICY EVALUATION

The policy changes considered above represent a mix of more of the same as well as fundamental change. States have considered adoption of combined reporting mechanisms for decades, nexus has been an ongoing issue, policies to combat avoidance are likely as old as the corporate income tax itself, and throwback rules have been used for a considerable period of time. Since these policy changes are not new, the

consequences are not new either. Each policy change has consequences for administration and compliance costs, though there are no estimates of what these costs might be. Adoption of each entails transitional costs, and some create additional uncertainties. A prime example is more aggressive nexus standards, which will likely be challenged in the courts. There will be consequences for state tax revenues and tax neutrality as well, issues that are discussed more fully below.

The implementation of gross receipts taxes, like the CAT in Ohio and the margins tax in Texas, represent a more fundamental shift in state business tax structure through their replacement of other business taxes. These are certainly not *new* taxes; turnover taxes have long existed, and states like Washington have used broad-based gross receipts taxes in the modern era.²¹ The adoption of gross receipts taxes has been motivated by dissatisfaction with the complexities, planning opportunities and reduced revenue performance of state corporate income taxes as well as a desire to create greater perceptions of fairness in business taxation. But gross receipts taxes have been roundly criticized by noted tax policy experts (see, for example, McLure (2005)). The criticism is rooted primarily in the fact that the tax is flawed at inception by the tax on purchased inputs. While this criticism is valid, the evaluation of gross receipts taxes should be in the context of the tax that is being replaced. It is not obvious that a gross receipts tax is any worse than the state corporate income tax. Indeed, a single factor sales apportioned corporate income tax is implicitly a gross receipts tax. But, a gross receipts tax operating through the corporate income tax is inferior since the rate varies across taxpayers according to their relative profitability, and, as discussed more below, the single factor

²¹ Chamberlain and Fleenor (2007) discuss the history and current scope of gross receipts taxation across the states.

sales apportioned corporate income tax may have narrower coverage than a true gross receipts tax because of PL 86-272.

Like the incremental policy changes noted above, implementation of a gross receipts tax will introduce administration and compliance costs, though how these compare to costs of the current state corporate income tax depends on the specific structure. The Texas margins tax looks a lot like a corporate income tax, inclusive of apportionment, combined reporting requirements and a crude measure of profits (i.e. the margin), so there may be little change in the administration and compliance costs.

The Ohio CAT should be simpler than the existing corporate income tax since the tax is effectively on the numerator in the sales factor component of the apportionment formula and does not require calculation of profits or other apportionment factors. But gross receipts taxes draw new firms into the tax net adding to their aggregate compliance burden. Also, gross receipts taxes raise compliance burdens if they are used as minimum taxes, since both the profits and gross receipts taxes must be calculated.

There will also be transitional costs of implementation (e.g. using NOL and income tax credit carryforwards) and policy uncertainties (e.g. nexus). Businesses are left to rely on constitutional protections for determining the scope of the CAT, and ultimately, the courts will have to decide. The Ohio Department of Taxation has taken the position that the CAT is a business privilege tax, and therefore, income tax provisions, including P.L. 86-272 do not apply to the CAT.²²

The new taxes will also have financial reporting consequences. Gross receipts taxes and privilege taxes are recorded as ordinary expenses and will reduce so-called EBITDA or “earnings from operations.” On the other hand, the corporate income tax is

²² R.C. 5751.02(A).

subtracted after EBITDA. This could distort the financial markets' perspectives of companies operating in gross receipts' taxing states, to the extent that the markets focus on EBITDA. Complying with FAS 109 and the associated deferred tax assets and liabilities poses a reporting challenge during the transition period that will compound if/when other states adopt non-income based business taxes.

The remainder of this section examines recent state business tax policies in the context of two underlying goals that have driven the changes: revenue effects and tax neutrality/fairness.

Revenue Effects

Erosion of the relative revenues generated by corporate income taxes, both as a share of profits and of state tax revenues, was a very important factor in the search for policy options during the 2000 to 2003 state revenue slowdown, and remains an important consideration today. Most of the more modest policy changes considered here increase state revenue yield, especially in the short run, though reliable, detailed national estimates are difficult to develop. Of course, state specific-estimates are prepared as the policies are considered. Decoupling from federal bonus depreciation is an exception; it is estimated to have increased state tax revenues by \$14 billion during the 2002-04 window (Johnson 2002). Also, academic research can be used to estimate some expected effects.²³

Nonetheless, the direction that revenues are affected can be seen. Pushing the nexus envelope will pull more firms into the tax net; disallowing PICs and implementing throwback rules directly expands the taxable base; entity-level taxes improve tax reporting and thus compliance; and amnesties provide an immediate influx of revenue.

²³ For example, see Fox and Luna (2005) and Bruce, Deskins, and Fox (2007).

Combined reporting likely has a positive, though potentially not large, net effect on state tax revenue, with effects that vary by firm.

States will also see some increased elasticity from closing these gaps in the current corporate income tax, though the dynamic impacts may be more muted. Highly aggressive state policies may hurt the business climate and dampen economic growth, in turn reducing the tax base, though these effects would likely be modest. More significantly, the tax planning game will continue and new mechanisms will be identified that firms can exploit to their advantage. Also, legislatures may choose to temper any additional revenue growth by other policy decisions that narrow the base, including the granting tax of incentives. And legal challenges may undo some of the policy changes that help generate new tax revenue in the near term. The differences among state policies create opportunities for planning, but states would be more effective at maintaining the corporate income tax base if they were to broadly adopt these policies. Piecemeal adoption means only a partial remedy to the corporate income tax's declining role in state government finances.

Amnesties warrant special attention in part because of their extensive adoption in the post recession period. Amnesties provide a short-run boost to revenues at little direct cost to the states, and they avoid the administrative and auditing costs that would otherwise be associated with combating noncompliance. However, most amnesties include accounts receivable and forgive penalties and interest charges. In the recent California amnesty, \$390 million of the \$500 million in amnesty collections were known to be outstanding liabilities owed to the state (CCH Inc., 2005).

Amnesties are intended to raise short-term revenues and promote registration of taxpayers. They are often used in tandem with changes in the tax policy enforcement regime so as to improve compliance over time. But their repetitive use by the states may prove to be self defeating as taxpayers may now cheat with the reasonable expectation of being afforded an amnesty for their actions sometime in the future. Recent empirical work indicates that while a state's first amnesty may boost revenue yield, subsequent adoptions have no effect or a negative effect on collections (Fox, Munkin and Murray, 2007).

The newly-implemented gross receipts taxes have the capacity for substantial revenue yield because of the broad base and pyramiding across the production chain. In addition, if they survive legal challenges and are deemed gross income taxes, they overcome the nexus limitations imposed by P.L. 86-272 broadening the tax net further. The Ohio and Texas taxes were designed as replacement taxes and the tax rates have been chosen accordingly.

As replacement taxes, the issues of revenue stability and elasticity hinge on the performance of transactions (including business-to-business transactions) versus apportioned income. Kenyon (1997) compares the New Hampshire business enterprise tax—a variant of a VAT—to various measures of profit and generally concludes that value added offers a more stable base. Kenyon also argues that the growing service sector will enhance the elasticity of value added relative to profits. But value added is much narrower than gross receipts, which will generally exceed the value of state gross domestic product. The actual degree of stability and elasticity of a gross receipts tax will depend on the rate and base structure.

Frequent legislative tinkering with corporate income tax structures suggests that buoyancy may be a more relevant concept than elasticity. The corporate income tax has been eroded over time by legislative actions that have narrowed the base (like tax concessions) and the failure of the states to go as far as they can in shoring up the base and limiting tax planning (through, for example, the imposition of combined reporting requirements). There is ample reason to believe that a gross receipts tax will be subject to the same political pressures and policy manipulations. Over time, some sectors may be afforded preferential treatment to better enable firms to compete across state borders; rates may be increased if there are perceptions of tax exporting opportunities; and relief may be provided in the pursuit of state equity objectives. The initial simplicity of the Ohio CAT is appealing, but only time will tell whether or not this simplicity can be sustained in the face of competitive, revenue and political pressures. Still, the likely outcome is that legislators will slowly erode the base or create additional tax rates and cause revenues to grow more slowly than the underlying transactions tax elasticity would suggest.

Tax Neutrality/Fairness

Legislators have been concerned about the uneven application of the corporate income tax to a broad set of taxpayers and particularly to large firms with no tax liability and to out-of-state firms exploiting the state's market without sharing in the tax burden. This creates two concerns from the policymakers' perspective -- a lack of fairness and a lack of neutrality in the tax. The policy changes considered here are intended to limit

many of the distortions and enhance the coverage of taxation. Of course, since not all states have adopted the policy changes, many distortions will remain. As a result, it is not obvious that overall efficiency is enhanced in this clearly second-best world.

Tax Fairness

Tax fairness has never been a well-defined notion in the context of business taxes. But both horizontal and vertical equity issues have surfaced in the debate over gross receipts taxes. Horizontal equity—in particular making sure all firms pay the same tax instrument—has been influential in the movement to gross receipts taxation. But while all firms may pay the tax, the effective tax rates they pay will differ based on any rate differentials and pyramiding. Vertical equity has arisen in the context of firms that may not see any profit (and thus appear to have no ability to pay) but are nonetheless required to pay tax. Also, there is often concern because firms with low profit margins but high gross receipts (e.g., grocery stores) pay a relatively high CAT liability. Many economists do not see these as a problem since the base is not intended to be profits and the tax is likely shifted forward to consumers, but the issues are often raised by legislators.

The justifications for taxing business are many, but the benefit tax argument usually tops the list. Under a gross receipts tax, sales—or gross income—serves as the base. The value of transactions must then be viewed as a proxy for the benefits derived by the taxing jurisdiction. But gross receipts seem unlikely to be the best benefit surrogate. The corporate income tax base is also a poor proxy, since it presumes that only profitable corporations benefit from public services. A number of economists have argued that a state VAT is a much better option for taxing benefits (see Oakland and Testa, 1991).

More aggressive nexus standards probably move states in the direction of the benefit theory of taxation and the penetration of state product markets, at least in the sense that they broaden coverage of the tax. Economic nexus, coupled with combined reporting, limit tax avoidance opportunities across jurisdictions and enhance the ability to tax firms evenly. Avoidance statutes and disallowance of PIC deductions constrain paper-planning mechanisms. Entity level taxes enhance compliance and help level the playing field across business structural forms. On the other hand, throwback rules mean higher rates of taxation in production states and thus the incentive to locate production activities in other states.

Concerns have also been raised about transparency of gross receipts taxes. While the point is valid, it can be applied to any business taxes that are not levied in proportion to benefits, so this criticism is not unique to gross receipts taxes.

Tax Neutrality

A variety of neutrality concerns should be considered. Decoupling from federal policies such as bonus depreciation is likely driven mostly from revenue concerns, but it also has at least two neutrality dimensions. The first dimension is the extent to which decoupling created a lack of uniformity in the interstate corporate tax structure, exacerbating existing tax rate differentials and reallocating investment across state borders. The second is the extent to which bonus depreciation itself is desirable from a national perspective. Policy should generally be structured so that paper depreciation matches economic depreciation. But bonus depreciation was intended as a short-run tool to stimulate growth in the post-recession environment, so efficiency considerations are clouded by the macroeconomic stabilization objective. It has been argued that the short-

run stimulus would have been greater had the program been implemented for a single year rather than three years (Johnson, 2002).

The neutrality effects of alternative taxes come down to whether a low rate gross receipts tax is more distorting than a higher effective rate corporate income tax.²⁴ Gross receipts taxes introduce both interstate and intrastate distortions analogous to a sales tax. The distortions may be more pronounced because of the greater extent of pyramiding, but less pronounced because of significantly lower tax rates.²⁵ Interstate distortions arise if the gross receipts tax becomes embedded in the price of goods and services that must compete with those produced outside the state and not subject to the tax. Two concerns are that firms may be induced to change their location or to purchase out of state inputs to avoid gross receipts taxes. But the Ohio CAT is situated on a destination basis and does not burden out of state sales²⁶ except that the CAT becomes imbedded in business costs when business-to-business sales occur inside of Ohio. Thus, the CAT eliminates taxation on goods produced for sale outside of Ohio except to the extent taxes are embedded in the costs of inputs when one Ohio business buys from another. The CAT is also imposed on sales by Ohio businesses to Ohio consumers. This means the CAT could reduce the locational impacts of business taxation in Ohio, except for firms buying significant Ohio produced inputs.

Of course the corporate income tax levied in other states likely becomes imbedded in the cost of goods produced out of state and may have similar consequences depending on the extent of source-based taxation, including that resulting from

²⁴ The corporate income tax also introduces distortions because the income is taxed twice – first at the corporate level and again at the shareholder level.

²⁵ The Ohio CAT is levied at a 0.23 percent rate and the Washington B&O tax is levied at rates of 0.484 percent or less except on services (many of which are not taxable under the sales tax) and gambling.

²⁶ The tax operates much like a sales tax without a corresponding use tax.

throwback rules. Recent research suggests that the locational effects of corporate income taxes are growing (see Bruce, Deskins and Fox, 2007).

The effective tax rate is relatively higher on in-state production processes with more links in the supply chain giving rise to distortions across sectors and the incentive to vertically integrate. Estimates for New Mexico indicate that 32 percent of gross receipts tax revenue comes from pyramiding, despite provisions in the tax code to provide relief on selected purchased inputs (New Mexico Tax Research Institute, 2005). Of course, the New Mexico gross receipts tax effectively operates as a sales tax, and this evidences the common tendency to tax business-to-business transactions under sales taxes. A study of the Washington Business and Occupations Tax—a gross receipts tax rather than a sales tax—indicates an average pyramiding rate of 2.5 (Chamberlain and Fleenor, 2007). Both studies also show substantial effective rate differentials across sectors. Of course, the state corporate income tax also produces differences in effective rates across sectors and firms, though no empirical evidence is available to make a direct comparison to a gross receipts tax. Pyramiding can be avoided by moving towards state VATs or pure retail sales taxes, which provide broader exemptions on input purchases, though this would entail higher costs of administration and compliance. It is unlikely that a simple gross receipts tax with rates well under 1.0 percent would be sufficient to induce significant vertical integration or reallocation of capital to different sectors.

CONCLUSION

State corporate income taxes suffered greatly in the aftermath of the 2000 recession, displaying a much weaker performance than other broad-based state tax instruments. By 2005 corporate tax revenues had rebounded as a share of tax receipts,

but the effective tax rate on corporate profits had slipped further. Both short-term factors like loss carryforwards and long-term factors such as tax planning have contributed to the decline.

The states have responded in a variety of ways to the weak performance of the corporate income tax. But by in large the responses in the current post-recession environment are analogous to policies that have been considered and adopted in earlier years. The policies have been intended to shore up the tax base itself and improve revenues, as well as reduce distortions and perceptions of unfairness in business taxation. The revenue objective will likely be met, at least in the short run. Over the long term, however, revenue erosion will likely continue as state legislatures choose to narrow the base as they have done in the past and as businesses learn new ways to engage in effective tax planning. While the number of distortions may be reduced as states broaden the tax net, cross state variation in the corporate tax structure will sustain the tax's non-neutrality.

Movement to gross receipts taxation in lieu of corporate income tax taxation is perhaps the most significant change in business tax policy in recent years. Gross receipts taxes are appealing because of their low rate that helps dampen distortions, their application to all businesses that promotes perceptions of fairness, and at least in the case of Ohio, their relative simplicity that reins in costs of administration and compliance. Pyramiding is the primary criticism. But it is not clear that the distortions caused by pyramiding are any worse than those created by the current state corporate income tax.

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State Corporate Income Tax Performance

	Compound Growth Rate 1992 - 2005	Compound Growth Rate 2002 - 2005	As Percent of Total Taxes 2005
United States	4.49	15.48	5.97
Alabama	7.00	7.19	5.09
Alaska	8.66	29.79	31.68
Arizona	9.69	26.55	6.38
Arkansas	6.29	16.17	4.23
California	5.14	17.58	8.81
Colorado	7.49	15.46	4.13
Connecticut	-0.25	56.69	4.96
Delaware	5.20	-0.37	9.13
Florida	7.53	13.57	5.27
Georgia	5.05	7.83	4.54
Hawaii	4.77	33.10	2.80
Idaho	5.73	22.34	4.79
Illinois	6.43	16.41	8.27
Indiana	1.59	5.15	6.42
Iowa	-0.26	28.29	3.24
Kansas	1.71	26.72	4.43
Kentucky	4.47	16.56	5.26
Louisiana	3.26	10.02	4.08
Maine	5.24	20.65	4.42
Maryland	10.63	30.95	5.98
Massachusetts	4.45	17.95	7.40
Michigan	0.75	-2.62	8.11
Minnesota	6.29	20.49	5.88
Mississippi	5.21	13.09	5.21
Missouri	-0.39	-10.11	2.29
Montana	4.18	12.94	5.24
Nebraska	5.12	22.61	5.23
Nevada	-	-	-
New Hampshire	13.15	8.09	23.56
New Jersey	7.72	26.41	9.70
New Mexico	9.14	24.94	5.42
New York	0.78	7.24	5.55
North Carolina	5.38	23.94	6.82
North Dakota	5.33	14.90	5.40
Ohio	5.75	20.38	5.53

Oklahoma	0.96	-0.93	2.46
Oregon	6.97	23.02	5.60
Pennsylvania	0.37	12.43	6.25
Rhode Island	6.75	58.85	4.31
South Carolina	4.35	15.60	3.37
South Dakota	2.59	6.62	4.43
Tennessee	8.03	17.00	8.05
Texas	-	-	-
Utah	7.21	19.38	4.03
Vermont	6.36	22.73	3.07
Virginia	6.32	25.23	3.81
Washington	-	-	-
West Virginia	7.45	28.14	10.77
Wisconsin	4.57	20.71	5.82
Wyoming	-	-	-

Source: U.S. Bureau of the Census