

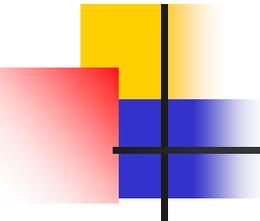
# State Business Tax Policy: A National Overview of Recent History and Current Issues

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Center on Budget and Policy Priorities

Presentation to the Maryland Business Tax Reform Commission

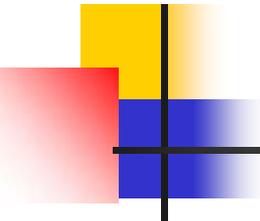
June 4, 2009



# Three major state and local taxes paid by businesses

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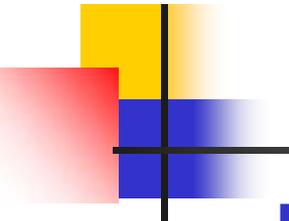
- Real and personal property taxes
- Sales taxes paid on business purchases
- Corporate income taxes and other general business taxes



## Real and personal property taxes: reliance

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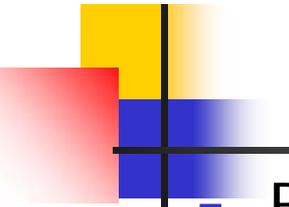
- State and local government reliance on property taxes has been essentially flat for almost 20 years
- State and local property taxes as a share of total state and local taxes:
  - FY89: 30.4%
  - FY99: 29.4%
  - FY06: 30.0% (most recent available from Census)



# Real and personal property taxes: Household vs. business shares

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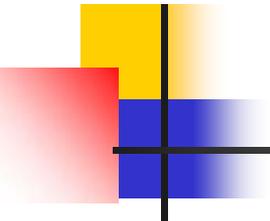
- Trend in household vs. business share and effective rates over this period is unclear
  - On the one hand, there has been significant targeted property tax relief focused on residential property
  - On the other hand, numerous business property tax incentives for economic development have been enacted: enterprise zones, tax increment financing districts (TIFs) and company-specific property tax abatements
  - Also, strong trend to eliminate or phase out business personal property taxes on equipment and inventories
  - No evidence of significant moves to increase effective rate of business property tax, e.g., through higher assess. ratios
  - COST/E & Y study estimates that business property tax payments increased 122% FY90-FY06, while Census says total property tax payments went up 131% over same period; implies that business share has fallen slightly



## Real and personal property taxes: Businesses' policy objectives

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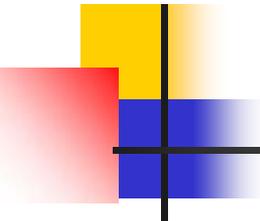
- Business community has focused on obtaining repeal of personal property taxes on equipment and inventories; achieved success in a number of states
- Telecommunications and other centrally-assessed businesses have campaigned for elimination of central assessment/"unit" valuation — without much success
- Business objects on principle to classified property tax systems that explicitly tax business property at higher effective rate but has not devoted much effort to changing this given low likelihood of success
- Business has supported general, across-the-board property tax caps in some states



## Sales tax: reliance

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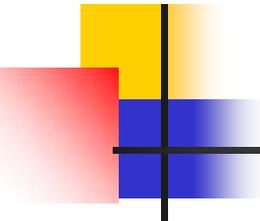
- State and local government reliance on sales taxes also has been essentially flat for almost 20 years
- State and local general sales taxes as a share of total s/l taxes:
  - FY89: 24.0%
  - FY99: 24.6%
  - FY06: 23.6% (most recent available from Census)



# Sales tax: Household vs. business share

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- Trend in household vs. business share of total sales tax liability over this period is also unclear
  - There has been some base narrowing over this period with respect to some household purchases (e.g., food), but there has been some modest base-broadening as well (services)
  - There has been some business base-broadening (services), but business has beaten-back most proposals that would have primarily targeted business-to-business services (MA, MI, MD computer services tax)
  - There has also been significant base narrowing (i.e., new exemptions for business purchases) both broad-based (R&D materials, equipment in enterprise zones) and industry-specific (sales tax exemptions for film/TV production, electricity used in manufacturing)
  - Overall trend has probably been slightly in the direction of somewhat less taxation of business purchases



## Sales tax on business purchases: Businesses' policy objectives

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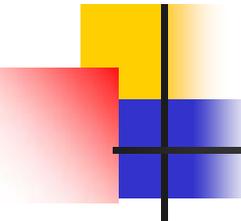
- Business community's top policy priority with respect to sales taxes on business purchases has been to block expansion of sales tax to significant business-to-business sales (e.g., data processing, accounting, advertising). Largely successful.
- Not a great deal of controversy regarding base expansion to minor business costs (e.g., janitorial services).
- When opportunity arises (e.g., 2005 COST study), business continues to argue that all sales taxation of business-to-business purchases is inappropriate. (Acute revenue needs of states makes much movement on this front unlikely unless business willing to trade off against more robust general business taxes.)

# General Business Taxes:

## Which states do and don't have CITs?

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- Corporate income taxes levied by all states except
  - Ohio (beginning next year)
  - Nevada
  - South Dakota
  - Texas
  - Washington
  - Wyoming
  
- Ohio and Washington have general gross receipts taxes as a substitute for CIT
  
- Texas has a modified gross-receipts tax that allows deduction for cost of goods sold or payroll; a hybrid between a gross receipts tax and a VAT



## State CIT: reliance and effective rates

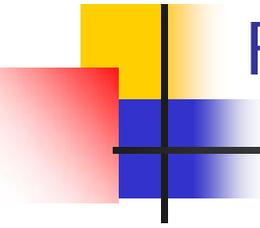
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- Share of total s/l taxes supplied by CIT:
  - FY89, 5.5%;
  - FY99 4.2%;
  - FY06 4.4%
- From FY89-FY05, federal corporate income taxes rose an average of 7.7% per year; state corporate income taxes only 5.4% per year – despite widespread state decoupling from some significant federal tax breaks
- Suggests effective rate of state corporate income taxation is falling

# General Business Taxes:

## Which states supplement their CITs?

- Four states with corporate income taxes have recently enacted a general business tax on an alternative base (i.e., other than business income) that functions like an alternative minimum tax
  - Kentucky
  - Michigan
  - New Hampshire
  - New Jersey (now applies only to out-of-state businesses)
- In Kentucky and New Jersey, the alternative base is gross receipts or gross receipts minus cost of goods sold (at taxpayer election).
- In Michigan and New Hampshire, the alternative base is value-added within the firm. (MI tax is a 2-part tax; companies pay both CIT and VAT.)



# State General Business Taxes: Focal Point of Business Tax Policy Debate

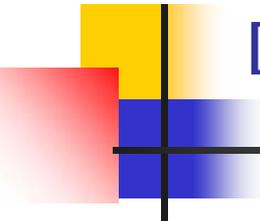
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- State general business taxes have been the focal point of intense business tax policy debate and ferment for past 15 years.

# State General Business Taxes:

## Delaware Holding Companies Spark the Debate

- If one had to pick a single event that sparked substantial state attention to state corporate tax avoidance/erosion and need for reform it would probably be 1993 South Carolina Supreme Ct. decision in Geoffrey (Toys R Us) vs SC case.
- Brought existence of Delaware intangible holding companies to attention of both revenue department staffs and state policymakers in many states
- Brought cascade of similar cases in many other states over subsequent 10 years (including SYL and Crown Cork and Seal in MD)



# State General Business Taxes:

## Delaware Holding Companies Spark the Debate

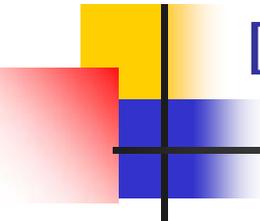
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- Large number of cases with many household-name companies eventually penetrated mass media, and state research and advocacy groups pressured elected officials for action
- SC case itself also raised the possibility of asserting taxing jurisdiction (“nexus”) over the DHC itself as a solution to the problem, which in turn generated broader discussion of “Why are corporations earning profits in my state not subject to corporate income tax in my state? What can we do about it?”

# State General Business Taxes:

## Delaware Holding Companies Spark the Debate

- Attention to DHC issue sparked broader investigation into vulnerabilities of state corporate income taxes to aggressive tax planning
  - Wisconsin's long campaign against banks' use of Nevada subsidiaries to hold income-earning assets drew attention to this alternative use of intangible holding companies
  - Uncovering of Auto Zone's use of "captive REIT" shelter by Louisiana in turn led North Carolina to look for it, and discovery of WalMart's use drew nationwide attention after front-page Wall Street Journal story
  - Texas discovered that its franchise tax was being severely eroded by reorganization of major TX corporations into limited partnerships owned 99% by DE IHCs

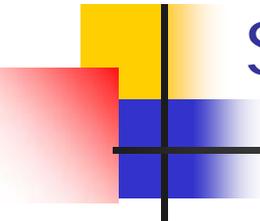


# State General Business Taxes:

## Delaware Holding Companies Spark the Debate

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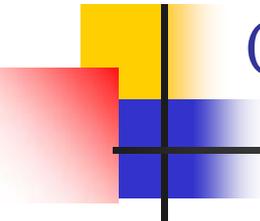
- Disparate streams of specific cases and investigations in particular states merged into a wide river of awareness that something was seriously amiss with state corporate income taxes
- Frustration of revenue department auditors and attorneys with ad hoc, case-by-case approach to addressing corporate tax avoidance led revenue department heads to push for legislative solutions as alternative to litigation



# Four State Responses to Growing Awareness of Significant Corporate Tax Base Erosion

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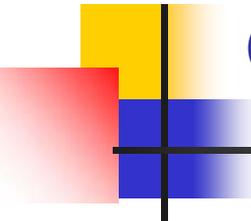
- Give up: TX and OH abandoned their corporate income taxes and substituted gross receipts (or gross receipts-like) taxes.
- KY and NJ enacted an add-on gross receipts-like tax as an alternative to meaningful structural reform. (NJ subsequently allowed add-on tax to sunset as applied to in-state companies; unclear as to extent of current compliance by out-of-state companies.)
- Targeted tinkering to address specific tax shelters. (MD and large number of other states enacting anti-DHC, anti-captive REIT, strengthened S. 482-type language, occasional throwback rule)



## Option 4: Significant Structural Reform of State Corporate Income Taxes — Combined Reporting

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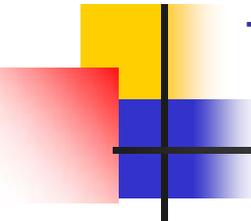
- Since 2004, 6 CIT states have chosen more comprehensive structural reform of combined reporting
  - VT (2004, effective 2006)
  - WV (2007, effective 2009)
  - NY (2007, effective 2007)
  - MI (2007, effective 2008)
  - MA (2008, effective 2008)
  - WI (2009, effective 2009)
- In addition, TX mandated CR for its modified gross receipts tax. (If deduction for cost-of-goods sold is allowed without mandating CR, then tax base is vulnerable to out-of-state subsidiaries selling goods for resale in TX at inflated transfer prices)



## Option 4: Significant Structural Reform of State Corporate Income Taxes — Combined Reporting

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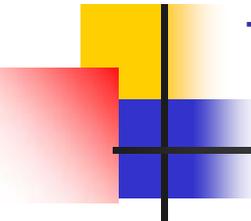
- Including TX, 23 of the 45 states for which it is a relevant policy choice – a majority – have now enacted combined reporting
- Number of CR states has increased from 16 to 23 in five years – rapid change given that no state had enacted CR in the previous 20 years.
- Noteworthy given that CR is a significant change in the structure of the CIT



# State Efforts to Expand Nexus: The Business Community's Response:

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- Where states have attempted to address corporate tax avoidance by expanding nexus, i.e., asserting tax jurisdiction over DHCs, financial institutions, etc., business has vigorously litigated (and continues to do so). States have won most cases in their own courts.
- Also has sought for 8 years (4 sessions of Congress) federal legislation raising the threshold for state CIT jurisdiction to a “substantial physical presence” in the taxing state. No real traction so far.
- No prospect for resolution of this issue; business and states both convinced they're right until US Supreme Ct. decrees otherwise (which seems unlikely)



# Targeted State Efforts to Attack Tax Avoidance: The Business Community's Response:

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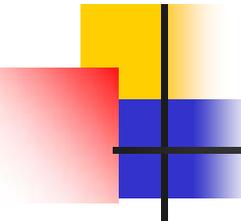
- Business community's initial response to targeted anti-DHC legislation was flat-out opposition; argued unnecessary because tax authorities already had discretionary authority to increase income of in-state businesses if needed to stop tax avoidance (modeled on Section 482 of Internal Revenue Code)
- Approach became untenable once pervasiveness of DHC problem became clear. Switched to efforts to put lots of "trap doors" in the legislation. Succeeded in watering it down substantially in several states.
- No real opposition to anti-captive REIT bills. Vigorous, largely successful opposition to throwback rules.

# Combined Reporting:

## The Business Community's Response:

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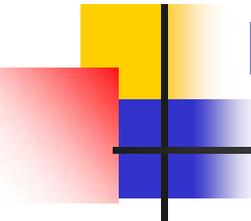
- Very little opposition of major multistate corporations to adoption in VT and WV, and surprisingly little in NY. But NY was a wake-up call, and there has been vigorous opposition since (e.g., MD, MA, and WI)
- COST switched its official position on CR from neutrality to opposition. Has testified or written in opposition to CR bills in virtually every state where a bill has been introduced since then. Commissioned Ernst & Young study in opposition.



## Policy choices confronting Maryland

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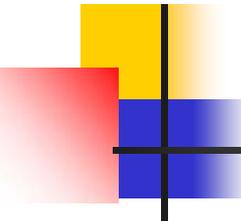
- There is “nothing new under the sun”; major policy issues and choices facing Maryland are those that all these other states have wrestled with:
  - Will the state continue to play catch-up with new techniques of corporate tax planning with targeted measures like its “royalty addback” and anti-REIT laws, or will it try to get ahead of the curve with the structural reform of combined reporting?
  - Should Maryland substitute a new form of general business tax for the corporate income tax, as OH and TX have done?



## Policy choices confronting Maryland

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- Should Maryland enact an add-on business tax calculated on a base not so vulnerable to tax planning -- like value-added or gross receipts – to function as an alternative minimum tax (as KY, MI, NH, NJ have done)?
- Should Maryland alter any of the tax provisions that have been enacted as economic development incentives? For example, are there some corporate tax credits that have not been effective? Have the beneficiaries of the single sales factor formula actually increased or maintained employment in the state?



## Policy choices confronting Maryland

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- Are there features of the Maryland corporate income tax that have lagged behind changes in the economy? For example, should Maryland adopt more of the Multistate Tax Commission's model apportionment rules for service industries that seek to ensure that profits are apportioned to states based on the location of customers just as profits from manufacturing and retailing always have been? Should MD emulate WV and MA in seeking to ensure that out-of-state financial institutions earning income from MD customers are subject to tax on that income here?
- As the Commission addresses these issues, I look forward to the opportunity to work with you and serve as a source of additional information at any time.