

***What Will Happen to State Corporation
Taxes After Federal Tax Reform?***

David Brunori and Martin A. Sullivan
Contributing Editors
Tax Analysts, Inc.
Arlington, VA
www.taxanalysts.com

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DRAFT

What Will Happen to State Corporation Taxes After Federal Tax Reform?

By David Brunori and Martin A. Sullivan*

I. Introduction and Overview

State corporate taxes are messy things—in theory and in practice. Corporate income taxes in general are arbitrary penalties on some income generated by certain corporations. State corporate taxes deserve special criticism. On top of the federal tax, state corporate taxes place an additional layer of complexity and inefficiency. And because they are more prone to artificial avoidance techniques than even the federal corporate tax, they are neither sufficient nor efficient sources of revenue for state governments.

Commentators like Charles McLure¹ have argued that there is no justification for such taxes beyond the desirability of letting corporations pay for services they receive from state governments. But the benefits corporations receive are not different from those received by noncorporate businesses and businesses without profits. And even among profitable corporations, the amount of benefits is unlikely to be even loosely related to a prespecified percentage of corporate income that determines the amount of corporate tax. So the corporation tax cannot be justified by the benefit principal. McLure also points out that corporate income taxes are equivalent to taxes on the factors used to apportion multistate corporate income. With the increased proclivity of states toward weighting apportionment factors heavily to sales, state corporation taxes are increasingly turning out to be the equivalent of wildly uneven² sales taxes. McClure advocates the replacement of corporation income taxes with explicit (and hopefully reformed) state sales taxes.

Other commentators have stressed the practical problems with state corporate income taxes.³ Corporations are increasingly able to find loopholes in corporate tax laws and to shift income out of states with corporation income taxes to no-tax or low-tax states. The result is high compliance costs for taxpayers, with relatively small revenue yields for state governments. Contrary to what the public may believe, the state corporate tax is not a major source of revenue, accounting on average for only 5 percent of total state revenue excluding fees, intergovernmental aid, and other non-tax income.

* Contributing Editors, Tax Analysts, Arlington, Virginia (www.taxanalysts.com).

¹ Charles E. McLure, “How—and How Not—to Tax Business,” *State Tax Notes*, April 4, 2005, p. 29.

² The rate of the sales tax equivalent for each business depends on the ratio of sales to taxable income. The rate of tax on ultimate sales to consumers will further vary with the degree taxes cascade through the intermediate stages of production.

³ David Brunori, “Stop Taxing Corporate Income,” *State Tax Notes*, July 1, 2002.

The chart below shows the decline in state corporation income taxes. From a peak in 1995 when state corporate tax revenues amounted to 0.40 percent of gross domestic product, they have dropped by more than one-third to the level of 0.24 percent of GDP in 2002 and 0.26 percent in 2003.⁴

There are steps that states could take to shore up their leaky corporation taxes, but in the face of stiff political opposition from business lobbies, they rarely have the will to make those changes. So no matter how popular state corporate taxes might be in some quarters, the lack of enforceability and the limited prospects for improvement mean the tax is unlikely to become cost-effective. And so, as a practical matter, serious consideration should be given to the complete repeal of state corporate income taxes.

As dark as this picture may be, the future of state corporate income taxes becomes even dimmer in light of many proposed fundamental tax reform proposals that have received a lot of attention during the last decade. If the federal corporate income tax is torn out by its roots, the states that rely heavily on federal rules and enforcement to administer their own taxes would be able to enforce their already shrinking corporate taxes only with an unlikely massive increase in the budgets of state tax collectors.

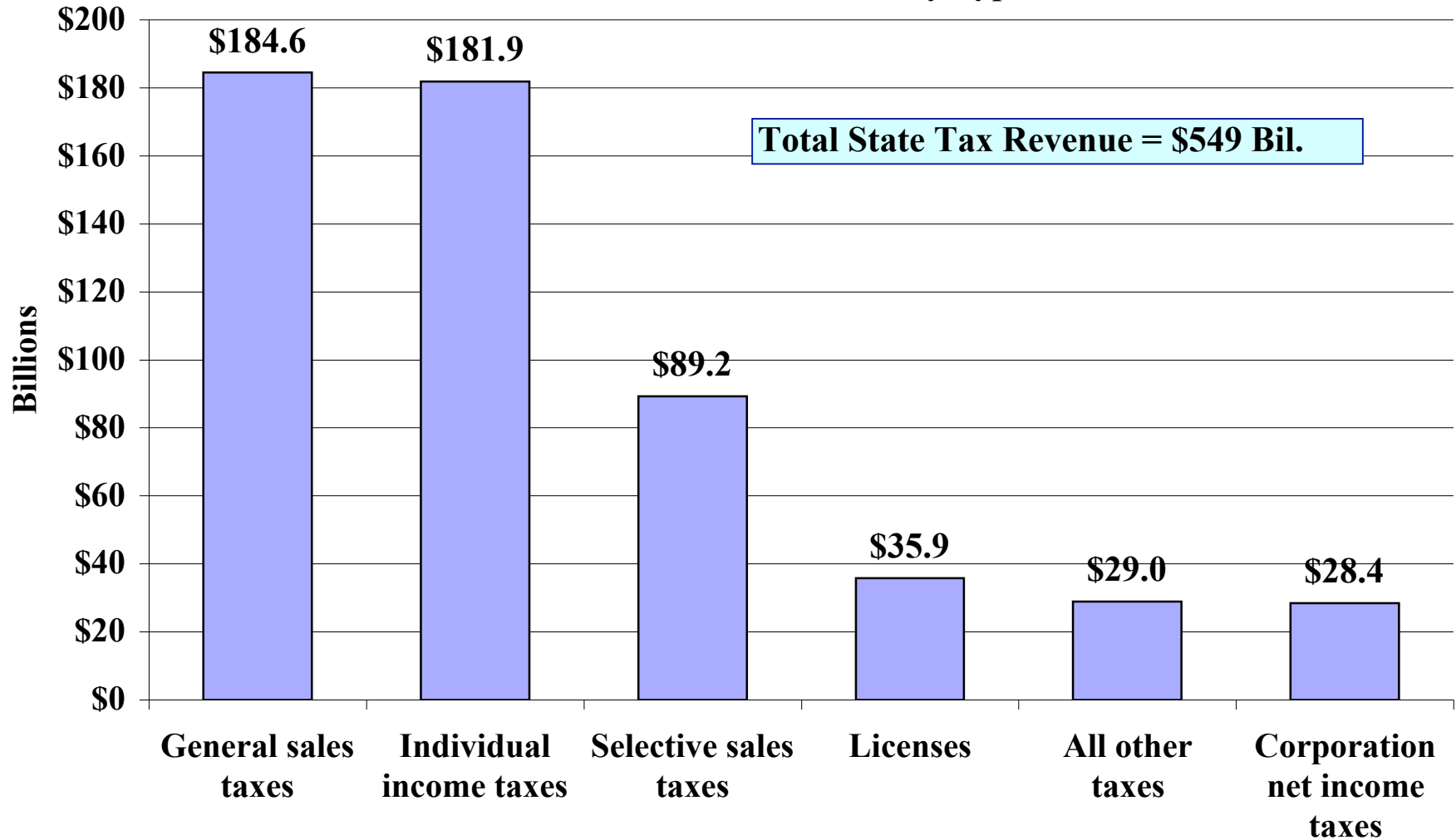
President Bush has not formally foreclosed on any tax reform options, and even if he did, Congress would not be required to follow any specific suggestions. There are, however, many indications that the plan Bush will ultimately propose to Congress for tax reform will not be as radical as many Republicans were envisioning in the mid-1990s.⁵ If that is the case, the president's proposal will either (A) leave a modified federal corporation income tax in place or (B) instate a new federal business level tax that most likely would be related to some form of a flat tax or a subtraction method value added tax.

There are a remarkable variety of tax reforms now under consideration. Unlike in the mid-1980s, when proposals for income tax reform predominated, and the mid-1990s, when proposals for consumption taxes held center stage, both income and consumption taxes are now getting serious attention. Also, various hybrid (part income and part consumption) tax systems as well as dual (separate income and consumption taxes in operation simultaneously) systems are on the table. Some proposals would entail a sweeping overhaul of federal taxation of business, while others would involve only incremental changes or no change at all to business taxation.

⁴ Similarly, a study funded by the Council on State Taxation (COST) points out that although the corporate income tax in recent years has been the focus of intense legislative debate which asks: "Are businesses paying their fair share of taxes?" the corporation income tax accounted for only about 10 percent of state and local business taxes in 2003. See, Robert Cline, William Fox, Tom Neubig, and Andrew Phillips, "Total State and Local Business Taxes: Fiscal 2003 Update," *State Tax Notes*, October 20, 2003, p. 205.

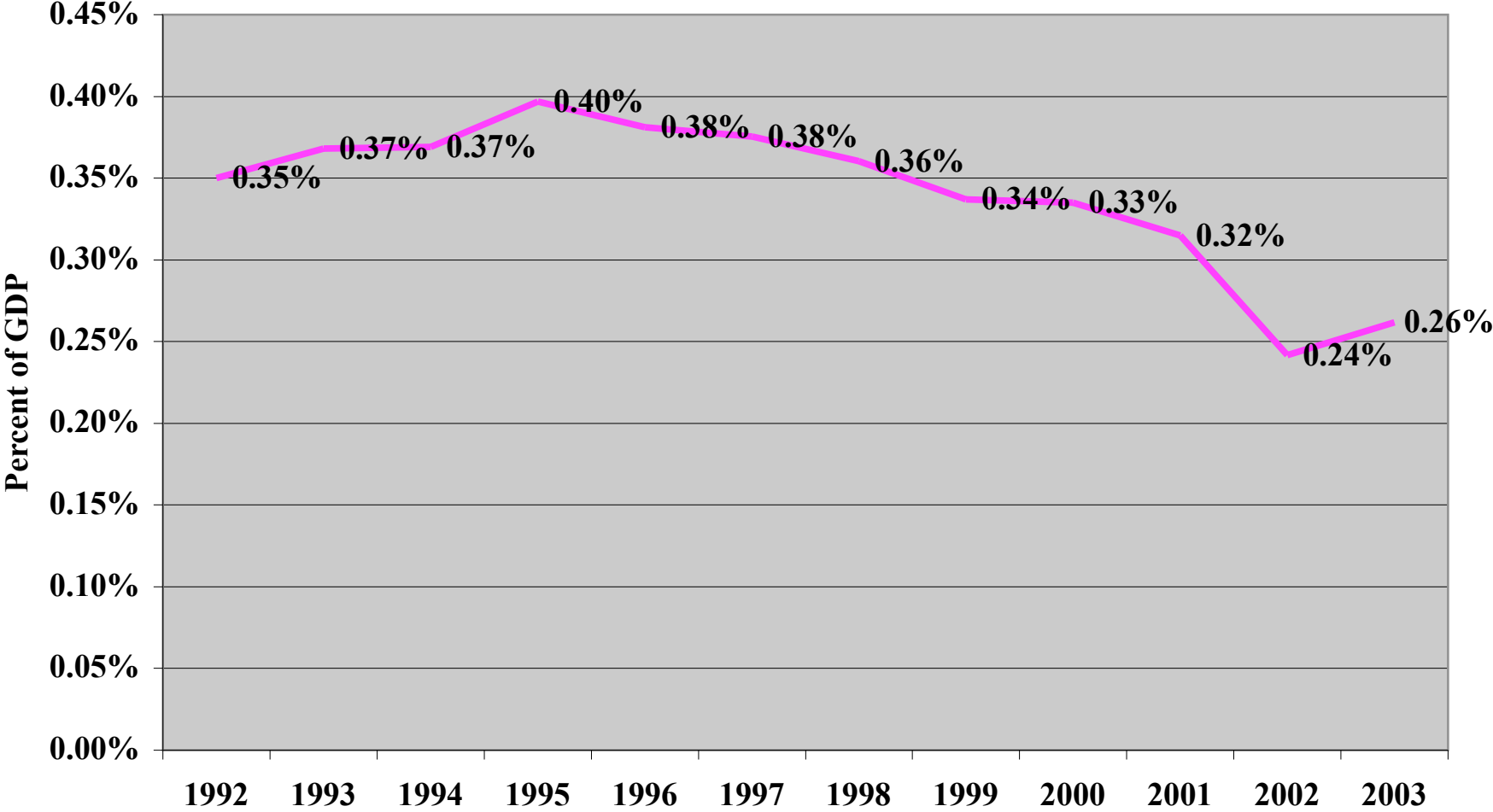
⁵ Martin A. Sullivan, "Treasury's Five Options for Tax Reform," *Tax Notes*, March 14, 2005, p. 1276.

Chart 1. State Tax Collections in 2003, By Type of Tax



Source: "State Government Tax Collections: 2003," U.S. Census Bureau (www.census.org).

Chart 2: State Corporation Taxes as a % of GDP, 1992-2003



Source: "State Government Tax Collections" U.S. Census Bureau (www.census.org).

The first part of this paper provides an organizational framework for these various tax reform plans. Our classification of proposals is fourfold: (1) replacement consumption taxes; (2) income tax reforms; (3) add-on consumption taxes; and (4) incremental transformations of the income tax to a consumption tax.

After introducing the fundamental aspects of the proposals, we reorganize them into categories according to their effect on federal (and, therefore, also state) business taxation. Those three categories are: (1) reforms that repeal the federal corporation tax, with no new federal business tax; (2) reforms that replace the current corporation tax with a new type of business tax; and (3) reforms that keep the current general structure of the federal corporation tax in place.

The implications of tax reform for state corporate taxation depend generally on which of the three categories reform ultimately may be classified. The first and third cases are the easiest. In the first case—if the federal corporate income tax is repealed—states almost certainly must follow the lead of the federal government and repeal their corporation taxes. In the third case—if the federal corporate income tax is retained and, depending on the proposal, the base is either broadened or narrowed—the states, as during prior changes in federal law, can be expected to mimic most of those tax changes.

The second case—which covers a variety of options, including replacing the current corporation tax with various subtraction method value added taxes or flat taxes—leaves states with two fundamental choices. The states could retain their corporation income taxes and try to blend their current corporation taxes on to federal reporting, compliance, and administrative efforts devoted to the new federal business tax. Or the states could shadow the federal government by repealing their corporation taxes and replacing them with whatever new federal business tax is installed. In general, states would benefit from that change. The new federal business taxes would have broader bases and lower rates than current corporate taxes, making them less susceptible to avoidance. The whole issue of what factors are appropriate for apportionment would remain, but the issue would be muted by lower rates.

II. Four Types of Federal Tax Reform

Type A. Proposals for Replacement Consumption Taxes

The most sweeping types of tax reform proposals would eliminate the current income tax (and sometimes all other current federal taxes) and institute new systems of consumption taxation. Some of those new taxes—like a national retail sales tax or a value added tax—would not require individuals to file tax returns but would shift the burden of tax collection to businesses. Others, like the flat tax and the Nunn-Domenici USA plan, would impose sweeping changes but would retain most of the institutional framework of the current system whereby individuals and businesses file annual returns.

1. Retail Sales Tax Proposals

The first legislation designed to replace the current tax system with a retail sales tax was introduced by Republican lawmakers Billy Tauzin of Louisiana, Dan Schaefer of Colorado, and Dick Chrysler of Michigan (H.R.3039, 104th) on March 6, 1996. The plan would have repealed the individual and corporate income taxes, estate and gift taxes, and most excise taxes and replaced them with a 15 percent flat rate tax on retail sales of goods and services.

Under the latest version of that bill, the Individual Tax Freedom Act of 2004, the rate is still 15 percent. To lessen the burden on low-income families, a rebate would be paid equal to the product of the sales tax rate times the lesser of the poverty level (adjusted for family size) or the wage income of the family. Any business required to collect the sales tax would keep 0.5 percent of tax receipts to offset compliance costs. Under the proposal, a state could choose to administer the tax within its borders. To qualify as an administering state, a state would have to conform its sales tax base to the federal base. In return, the state would receive an administration fee equal to 1 percent of the tax receipts

A retail sales proposal similar to the Tauzin plan, the Fair Tax Act of 2003 (H.R.25), was introduced on January 7, 2003, by Rep. John Linder, R-Ga. Among the 54 cosponsors of the legislation is House Majority Leader Tom DeLay, R-Texas. The major difference between the Linder plan and the Tauzin plan is that the former would repeal payroll taxes and impose a higher rate of 23 percent.

2. Subtraction Method VAT Proposal

Before his retirement in 1996 after 34 years in Congress, Rep. Sam Gibbons, D-Fla., then ranking minority member on the House Ways and Means Committee, introduced legislation to replace the individual and corporation income taxes as well as payroll taxes with a single-rate subtraction method value added tax. The rate of tax under H.R.4050 (104th Congress) would be 20 percent. To maintain distributional neutrality to current law, there would be a burden adjustment for taxpayers with incomes below \$30,000 and above \$75,000. Low-income taxpayers would receive a rebate, phased out proportionally for incomes increasing from zero to \$30,000. Taxpayers with incomes of more than \$75,000 would pay a 17 percent rate on the amount their adjusted gross incomes exceed \$75,000.⁶

3. Two-Tiered VAT (Flat Tax) Proposals

⁶ Although every attempt is made by Gibbons to simplify the burden adjustment, it is in effect a full-fledged income tax. The side-by-side operation of a VAT and an income tax means the Gibbons plan has much in common with the Graetz plan (described below).

The idea for a flat tax originated in the early 1980s and was proposed by two Hoover Institution scholars, Robert Hall and Alvin Rabushka.⁷ The flat tax is essentially a subtraction method value added tax split into two parts. Instead of disallowing deductions for wages, as under a subtraction method VAT, businesses would be able to deduct wage costs under the flat tax. Wages, however, would be taxed at the individual level where large personal exemptions would exempt many individuals from tax and make the tax more progressive at the low end. Both the individual and business tax would have the same single rate, and all deductions and credits allowed under current law would be repealed. The subtraction method VAT and the flat tax are compared in Table 1.

Table 1			
Comparison of the Flat Tax and a Subtraction Method VAT			
Subtraction Method VAT		The Flat Tax	
<i>A. Business Tax</i>		<i>A. Business Tax</i>	
Gross Receipts	100	Gross Receipts	100
<i>Less</i>		<i>Less</i>	
Materials Cost	20	Materials Cost	20
Capital Expenditure	10	Capital Expenditure	10
		Employee Compensation	40
Total Costs	30	Total Costs	70
<i>Equals</i>		<i>Equals</i>	
Tax Base	70	Tax Base	30
17 Percent Tax	11.90	17 Percent Tax	5.10
<i>B. Individual Tax</i>		<i>B. Individual Tax</i>	
--None--		Employee Compensation	40
		<i>Less</i>	
		Standard Deductions	15
		<i>Equals</i>	
		Tax Base	25
17 Percent Tax	0.00	17 Percent Tax	4.25
TOTAL TAX	11.90	TOTAL TAX	9.35
		Note:	
		Total Tax Without Standard Deductions	11.90

⁷ The most recent version of the Hall-Rabushka plan, *The Flat Tax*, can be found in a 56-page special supplement to the August 4, 1995, edition of *Tax Notes*.

Rep. Dick Armev introduced H.R. 4585, the Freedom and Fairness Restoration Act of 1994, in June 1994. That flat tax proposal gained widespread attention in 1995 when Armev became House majority leader and publisher Steve Forbes made the flat tax a mainstay of his campaign for the Republican presidential nomination. From then until his retirement from Congress in 2000, Armev was the most visible proponent of the flat tax. During that period, Sen. Richard Shelby, R-Ala., introduced companion legislation in the Senate.

The most current version of the flat tax is H.R. 3060 (108th), introduced by former Rep. Nick Smith, and S. 1040 (108th) introduced by Shelby. Their legislation, the Tax Simplification Act of 2003, would levy a business and individual tax similar to that proposed by Hall and Rabushka as a replacement for individual and corporate income taxes and estate and gift taxes (but not payroll taxes).

Under the plan, the tax would be levied initially at a 19 percent rate, which would gradually be reduced to 17 percent. The individual tax would be levied on all compensation, including pension and unemployment benefits. Employees of governments and nonprofit organizations would include the imputed value of fringe benefits in their taxable wages. Social Security benefits would not be taxed. There would be no deductions, except for business expenses, and no credits. The standard deduction would be \$12,790, and double that amount for married couples. An additional deduction of \$5,510 would be available for each dependent.⁸

The business tax base would be the difference between gross revenues less the sum of purchases from other firms, wages, and pension contributions. There would be no deduction for fringe benefits. State and local taxes and payroll taxes would not be deductible.

Sen. Arlen Specter, R-Pa., has also been an advocate of a flat tax since his bid for the Republican presidential nomination in 1996. His most recently introduced flat tax legislation was S. 907 (108th). For the most it is similar to previous proposals, but there are some important differences between the Specter plan and the Smith-Shelby plan. First, the Specter plan has a higher rate and a lower standard deduction. The standard deduction would be \$10,000 for single individuals and \$17,500 for married couples. An additional deduction of \$5,000 would be available for each dependent.⁹ The tax rate would be 20 percent.

Second, the plans would allow some itemized deductions. Individuals would be allowed to deduct up to \$2,500 annually for charitable contributions. Mortgage interest deductions would also be allowed, but only on acquisition indebtedness not exceeding \$100,000.

4. Combined VAT/Personal Consumption Tax Proposals

⁸ These amounts are for 2003. According to the legislation, amounts for subsequent years would be adjusted upward with the rate of inflation as measured by the consumer price index.

⁹ These amounts are for 2004. According to the legislation, amounts for subsequent years would be adjusted upward with the rate of inflation as measured by the consumer price index.

After years of preparation, Sens. Sam Nunn of Georgia and Pete Domenici, R-N.M., in 1995 introduced the 293-page USA Tax Act of 1995 (S.722, 104th). The Nunn-Domenici plan would eliminate corporation and individual income taxes, but would retain estate and gift taxes and payroll taxes. Income taxes would be replaced by two new consumption taxes. The individual tax is a form of the personal consumption tax described in the prior section. The business tax is a subtraction method value added tax. In general the plan is far more complicated but less sweeping in its elimination of tax preferences than any of the other flat tax proposals.

As under the current individual income tax, individuals under the USA tax would compute adjusted gross income and subtract itemized deductions and personal allowances to arrive at taxable income. The important difference between the current individual income tax and the Nunn-Domenici individual tax is the deduction for additional saving. In fact, the USA in the proposal's title refers to unlimited savings allowance. Personal exemption and the standard deduction would not be much different than under current law, but individuals could simultaneously claim itemized deductions in addition to the standard deduction. The rate structure would be progressive—from 9 percent to 40 percent.

Under the plan, mortgage and charitable deductions would be allowed as under current law, as would a deduction for education expenses. Deductions would not be allowed for state and local taxes. A refundable earned income credit would be available.

At the core of the Nunn-Domenici proposal is its treatment of personal savings. That complicated provision has four major components: (1) net additions to savings are deductible; (2) net new borrowing is included in income (but most mortgage, automobile, and credit card indebtedness is exempt from this rule); (3) withdrawals from accounts and proceeds from sales are included in income; and (4) to provide transition relief for existing saving, basis may be deducted for existing assets when asset balances are declining.

The Nunn-Domenici business tax is an 11 percent subtraction method VAT. There are some differences from a standard VAT, however. First, state and local taxes are deductible. Second, there is a credit against the business tax for the employer portion of payroll taxes. Third, although all new capital expenditures are expensed, existing capital would be depreciated under a more accelerated schedule than allowed under current law.

The current version of the Nunn-Domenici proposal is the simplified USA tax (H.R.269, 109th), introduced by Ways and Means Committee member Phil English, R-Pa. It has several differences. The individual tax rate structure is less progressive, spanning a range from 15 percent to 30 percent. Businesses no longer pay the flat rate but a tax of 8 percent on their first \$150,000 of value added and 12 percent on amounts above that.

In an attempt to respond to widespread criticism that the savings deduction of the original USA tax was too complicated, the English proposal replaces it with a USA Roth IRA that, like current law Roth IRAs, allows no deduction for contributions but allows all withdrawals to be tax free. Many current law restrictions, however, are eliminated. Although called an IRA, the

accounts could be used for any purpose, not just retirement. Also, there are no restrictions based on age or income and no limitation on contribution amounts. All persons are eligible to contribute all or any portion of their current year's taxable income.

Type B. Income Tax Reform

Instead of being replaced with a consumption tax, the current system could be revised so that it would operate more like a pure income tax. Although most discussion of tax reform in the United States over the past decade has centered on consumption taxes of one form or another, income tax reform cannot be ruled out as an option. Several influential tax specialists inside and outside government have seriously discussed the idea. And after all, it was the basis of the most significant tax reform actually enacted to date—the Tax Reform Act of 1986.

The major shortcoming of even the best income tax reform is that the tax penalty on saving, and the associated impediments to economic growth, would remain. There are, however, other benefits that result from both income and consumption reform.

1. The 1986 Act and Other Visions of Income Tax Reform

Although it ultimately passed by wide margins in the House (292 to 136) and in the Senate (74 to 23), the landmark Tax Reform Act of 1986 had a difficult two-year journey through the legislative process. Signed by President Reagan on October 22, 1986, the act used revenue generated from eliminating or reducing numerous tax credits, exclusions, and deductions to fund a reduction of rate of tax on the highest incomes from 50 percent to 28 percent and the top corporate rate from 46 percent to 34 percent. The major revenue-raising reforms of the 1986 Act were:

- (1) Elimination of the investment tax credit;
- (2) Elimination of the capital gains exclusion;
- (3) Less accelerated depreciation allowances;
- (4) Strengthening of the corporate and individual alternative minimum taxes;
- (5) Restricting individuals' ability to deduct passive investment losses, miscellaneous itemized deductions, business meals and entertainment expenses, and medical expenses;
- (6) Restrictions on the availability of individual retirement accounts;
- (7) Restrictions on the ability of state and local governments to issue bonds to finance private-sector investments;
- (8) Tightening antiferral and source rules concerning foreign-source income.

Many of those revenue-raising reforms have since been repealed or the underlying tax preferences have been reconstituted or reinstated in a limited form. They include the tax treatment of capital gains, business meals, IRAs, losses on real estate investment, accelerated depreciation, and foreign-source income. Also, the corporate and individual alternative minimum taxes are extremely unpopular, and their elimination is a priority of almost all tax reform proposals.

2. A replacement income tax

It should be noted that the Treasury Department has given serious consideration to a broad-based flat income tax,¹⁰ although it has received no interest in political or even academic circles. As noted above, the flat tax is roughly equivalent to a subtraction method value added tax. The major difference between the two is that a pure value added tax is collected solely from business. Under a flat tax, businesses would be able to deduct wages as they could not under a subtraction method VAT. Under a flat tax system, wages would instead be taxed at the individual level.

Both a subtraction method VAT and a flat tax could be converted from a consumption tax to an income tax by requiring businesses to deduct depreciation expenses over the economic life on an asset rather than in the year it was purchased. The Treasury Department has both the income VAT and the income flat tax as options for tax reform.

Type C. Add-On Consumption Taxes

The third general type of tax reform would involve the United States operating an income tax and a broad-based consumption tax simultaneously. That is the general fiscal structure of many other industrialized countries. As shown in Table 5.2, the United States is the only major economy without a value added tax.

Rank by Size of Economy	Country	Value Added Tax?	Standard Value Added Tax Rate
1	United States	No	-
2	Japan	Yes	5.0
3	Germany	Yes	16.0
4	United Kingdom	Yes	17.5
5	France	Yes	19.6
6	Italy	Yes	20.0
7	Canada	Yes	7.0
8	Spain	Yes	16.0
9	Korea	Yes	10.0
10	Mexico	Yes	15.0
11	Australia	Yes	10.0
12	Netherlands	Yes	19.0
13	Switzerland	Yes	7.6

¹⁰ Memorandum from Pamela F. Olson for Treasury Secretary Paul O'Neill, "Tax Reform Materials," November 7, 2002, available online at www.thepriceofloyalty.com.

14	Belgium	Yes	21.0
15	Sweden	Yes	25.0
16	Austria	Yes	20.0
17	Norway	Yes	24.0
18	Denmark	Yes	25.0
19	Turkey	Yes	18.0
20	Poland	Yes	22.0
Source: Organization for Economic Cooperation and Development (www.oecd.org).			

An add-on consumption tax for the United States with a major reduction in scope of the income tax was first outlined late in the first Bush administration by then Treasury Secretary Nicholas Brady.¹¹ The proposal has since received much attention, because it was again proposed with more detail by Yale Law School Prof. Michael Graetz.¹² The main attraction of the plan is that it would approximately attain revenue- and distributional neutrality with current law while eliminating the need for over 100 million taxpayers to file individual tax returns.¹³

According to Graetz's calculations, by allowing a standard deduction of \$100,000 per family (\$50,000 for unmarried taxpayers), more than 90 percent of all income tax filers would be removed from the tax rolls. That would restore the individual income tax to its pre-World War II status as a tax that applied to a relatively small group of high-income taxpayers.

Under the plan, a single rate of 25 percent would apply to all income. Itemized deductions for charitable contributions, home mortgage interest, and medical expenses would be retained. Graetz says his plan may be alternatively characterized as a repeal of the regular income tax, leaving only the alternative minimum tax modified with a lower tax rate and a larger exemption amount.

To pay for the revenue lost from a reformed income tax, the plan includes an entirely new credit-invoice value added tax. To keep the tax simple and efficient, there would be a single rate of tax, and exemptions would be kept to a minimum. The rate of tax would be approximately 14 percent or 15 percent. There would be no exemption for food or clothing, but there would be no tax on medical, religious, or education expenses. And to ease administrative burdens, very small businesses would be exempt. Graetz emphasizes that the use of the credit-invoice method is his

¹¹ Nicholas F. Brady, "Remarks Before the Columbia University School of Business," *Tax Notes Today*, December 11, 1992 (92 TNT 247-33).

¹² Michael J. Graetz, "100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System," *Yale Law Journal*, Vol. 112, No. 2., Nov. 2000, pp. 263-312. Graetz served as deputy assistant secretary of Treasury for tax policy under Brady from 1990 to 1992.

¹³ Graetz's calculations are based on 1999 IRS data when approximately 125 million individual tax returns were filed. The IRS projects that approximately 133 million individual tax returns will be filed in 2005. See "Selected Returns and Forms Filed or to Be Filed by Type During Specified Calendar Years, 1980-2005," *SOI Bulletin*, January 2005, available online at www.irs.gov.

recommendation but not essential to the proposal. The key is that there be a simple and fair tax collected only from business.

To maintain progressivity at the low end of the income scale in the absence of the earned income tax credit, the plan would include a reduction in payroll taxes for low-wage earners (with no reduction in Social Security benefits). Unlike the benefits of the earned income tax credit, which are usually received in a lump sum when returns are filed, take-home pay would be increased through reduced withholding or even negative withholding.

The corporation income tax would be simplified by requiring greater conformity between tax and financial accounting. The rate of tax would be equal to the 25 percent rate paid by individuals. The corporate alternative minimum tax would be repealed.

Type D. Incremental Transformation to a Consumption Tax

A fourth path to tax reform would move the United States closer to a consumption tax that could be instituted within the current system. A necessary intermediate step in any transition from an income tax to a consumption tax is the elimination of the double taxation of corporate profits. Once the double taxation of corporate profits is eliminated, the next steps in moving toward pure consumption taxation would be eliminating or effectively eliminating tax on all capital income. The two methods most often discussed for achieving that is the exemption of capital income generated in specified saving accounts from income taxes and the expensing of the entire cost of capital expenditures in the year of purchase.

1. Eliminating the Double Taxation of Corporate Profits

There is no economic justification for a separate tax on corporations, but for many—especially in prior decades—the ideal tax system was the “classical system” whereby profits of corporations were subject to entity-level tax and then subject to tax again when paid as dividends to shareholders. The notion of a classical system is now widely rejected, but hardly absent. It was the implicit guiding principle for the Tax Reform Act of 1986, which broadened the bases for both the individual and corporate income taxes.

Eliminating the double tax on corporate profits is referred to as the integration of the individual and corporate income taxes. Any discussion of tax reform must include integration, because it is the logical first step in any move from an income tax to a consumption tax. After all, if the objective of consumption taxation is to eliminate all taxation on capital, it makes sense that priority should be given to the capital that is taxed most highly.

The double taxation of corporate profit can be reduced by either providing tax relief at the corporate level on dividends paid (for example, a deduction) or on the individual level for dividends received (for example, a credit or an exclusion). As a result of legislation enacted in 2003 (the Jobs and Growth Tax Relief Reconciliation Act of 2003), the United States now

imposes a maximum tax rate on individuals of 15 percent for dividend income received. That provision expires at the end of 2008.

It is worth noting that early in 2003 the Treasury Department proposed that the tax exemption on dividends be tied on a company-by-company, year-by-year basis to the amount of taxes paid at the corporate level. The simple idea behind those complex calculations was that only to the extent that profits were subject to tax at the corporate level would there be relief at the individual level. Corporations would have to keep track of the relationship between taxable profits and dividends paid and report it to shareholders annually so that they could determine the tax status of their dividends. That approach was rejected for the simplicity of the across-the-board 15 percent rate for most dividends.

2. Eliminating Taxes on Saving

The most important difference between an income tax and a consumption tax is that a consumption tax eliminates the tax burden on income from saving. Many features of the current U.S. tax system reduce or eliminate the tax burden on saving. State and municipal bonds, investments through life insurance contracts, and investments through pension plans are tax free. Investment income of universities, charities, and other nonprofit organizations is not subject to income tax. And, in general, income generated in the form of capital gains and dividends is subject to a top rate of 15 percent. Also, if investors meet some conditions and do not exceed specified limitations, several savings vehicles—including traditional IRAs, Roth IRAs, section 529 education plans, and medical and savings accounts—provide tax-free (or the equivalent of tax-free) investment income. Finally, the tax burden on income generated by businesses (whether or not subject to corporation income tax) can be significantly reduced through tax credits (such as the research credit) and deductions for depreciation and amortization that are more rapid than the actual decline in the value of business assets.

Because of the availability and the quantitative importance of these and other forms of tax relief for capital income, the U.S. income tax is best characterized as a hybrid income-consumption tax than as a less-than-perfect income tax. Recognizing that may be key to understanding the next episode of tax reform in the United States. Influential politicians frequently cite the need for the United States to move toward consumption taxation. While that could entail a radical restructuring of the U.S. tax system, it could also simply mean expanding tax breaks for savings (such as reducing restrictions on pensions and IRAs) or providing businesses with more tax credits or more accelerated depreciation.

In each of his three budgets released since 2003, Bush has proposed a dramatic change in the tax treatment of personal savings. The president's proposal would create three new types of tax-favored accounts: retirement savings accounts (RSAs), lifetime savings accounts (LSAs), and employee retirement savings accounts (ERSAs). Those accounts would substantially simplify rules for tax-favored savings accounts and expand opportunities for tax-free saving by disregarding or liberalizing most age and contribution limitations under current law. Enactment

of the plan would constitute a major movement for the United States along the spectrum from income taxation to consumption taxation.

RSAs would replace traditional (deductible, front-loaded) individual retirement accounts and Roth IRAs. Unlike IRAs, they would have no income limits, age limits for contributions, or minimum distribution requirements. Annual contributions would be limited initially to \$5,000 and would be indexed to inflation after the initial year. As with Roth IRAs, contributions would not be deductible, but distributions after age 58 would be tax free. For a married couple, contributions up to the dollar limit could be for each spouse as long as the combined compensation of both spouses is at least equal to the contribution limit.¹⁴ Taxpayers would not be required to convert traditional IRAs to RSAs, but contributions to IRAs would no longer be allowed. There would be no limit on the amount taxpayers could convert from traditional IRAs to RSAs, but conversion proceeds would be taxable income in the year of conversion or, if conversions are made in the calendar year the proposal initially becomes law, taxpayers would have the option of paying the tax over four years.

LSAs would provide another \$5,000 (indexed) of tax-advantaged savings. They would be similar to RSAs except that the funds could be used anytime before or after retirement. This unlimited ability to distribute funds—that is, the lack of both a minimum holding period and minimum age requirements—is the greatest departure from current law.

ERSAs are modeled after 401(k) plans and would function as a replacement for most defined contribution plans, including 401(k)s, simplified employee pension plans, and SIMPLE IRAs. The proposal would simplify many complex rules that attempt to encourage executives and business owners to provide pension benefits to rank-and-file employees.

III. Implications of Federal Tax Reforms for State Corporation Taxes

A. State Corporate Tax Implications: Big, Small, and Everything in Between

Table 3 takes the four categories of tax reform plans (Types A through D discussed above) and reclassifies them according to their general effect on the state corporate income taxes. Under the more radical versions of tax reform, the federal corporation income tax is eliminated and there is no new business tax. A second, intermediate category of reform would involve the elimination of the federal corporation income tax, but it would be replaced by a substantial new business-level tax. The third, most moderate type of reform involves retention of the federal corporation income tax, but the reform might still include some amount of base broadening or narrowing.

Because they are the easier cases, the first (repeal with no replacement) and third possibilities (no repeal but some modification) are discussed in the sections immediately

¹⁴ For example, a couple could contribute \$5,000 to each spouse's account even though one spouse had no income.

Table 3.

Type of Consumption Proposals	Federal Business Tax Under Reform	Implications for State Business Taxes
A. REPLACEMENT CONSUMPTION TAXES		
<ol style="list-style-type: none"> 1. <i>Retail Sales Tax Proposals</i> <ol style="list-style-type: none"> a. <i>Tauzin Proposal</i> b. <i>Linder Proposal</i> 	<p><i>Eliminate Corporation Income Tax with No New Business Taxes</i></p>	<p><i>State are on the their own—Eliminate State Corporate Income Taxes</i></p>
<ol style="list-style-type: none"> 2. <i>Subtraction Method VAT Proposal</i> 3. <i>Two-Tiered VAT (“Flat Tax”) Proposals</i> <ol style="list-style-type: none"> a. <i>Early Proposals</i> b. <i>Shelby-Smith Proposal</i> c. <i>Specter Proposal</i> 4. <i>Combined VAT/Personal Consumption Tax Proposals</i> <ol style="list-style-type: none"> a. <i>Nunn-Domenici Proposal</i> b. <i>English Proposal</i> 	<p><i>Eliminate Corporation Income Tax and Replace with a New Business Tax</i></p>	<p><i>States with difficulty probably can maintain thei own corporate taxes. Better policy is to adopt new Federal business rax.</i></p>
B. INCOME TAX REFORM		
<ol style="list-style-type: none"> 1. <i>A replacement income tax</i> 2. <i>The 1986 Act and Other Visions of Income Tax Reform</i> 		
C. ADD-ON CONSUMPTION TAXES		
<ol style="list-style-type: none"> 1. <i>Dual Income-Consumption Tax Regimes in Other Major Industrialized Countries</i> 2. <i>The Greatz Plan for a Broad-based VAT with an Income Tax Only on High Income Taxpayers</i> 	<p><i>Maintain Current Corporation Tax with Incremental Cnahges or No Changes at All</i></p>	<p><i>State Corporation Taxes Should Adjust to New Federal Tax Base</i></p>
D. INCREMENTAL TRANSFORMATION TO A CONSUMPTION TAX		
<ol style="list-style-type: none"> 1. <i>Eliminating the Double Taxtion of Corporate Profits</i> 2. <i>Eliminating Taxes on Saving: The President’s Plan to Reduce Taxes on Savings: LSAs, RSAs, and ERSAs</i> 		

following. The more complex issues regarding the effect of a new federal business-level tax on the states is considered last.

B. Eliminate Corporation Income Tax With No New Federal Business Tax

Although for many it is a foregone conclusion that state corporation income taxes would be unsustainable if the federal corporation income tax or some similar tax was not simultaneously in force, it will be useful to take a moment and imagine the states trying to enforce state income taxes without a comparable federal tax.

First, states that explicitly cross-reference federal income tax law would have to revise those laws. Second, the states would lose all the benefits of federal enforcement efforts. States would have to increase their enforcement budgets or stiffen tax penalties to try to reduce evasion. Third, dissatisfaction with state tax would likely rise dramatically because compliance costs incurred by businesses would probably not decline significantly from what they were when both federal and state corporation tax was being collected.

There is a bright side, however. Because federal corporate tax rates drop to zero, the incentive for corporations to engage in costly avoidance techniques is greatly reduced. That could result in a significant expansion of the state corporation income tax base. Also, for a few states—Alabama, Iowa, Louisiana, Missouri, and North Dakota—there will be a direct revenue benefit because they allow deductions for federal corporate income taxes paid.

C. Maintain Current Corporation Tax With Incremental Changes or No Changes

There is good reason to believe that if tax reform legislation is enacted soon, it will not involve significant restructuring of the current system.¹⁵ It is interesting to note, however, that it is unclear right now which direction reform will take regarding federal corporate tax reform. Under some proposals, the corporate tax base would be narrowed. Under others, it would be broadened.

Although these types of changes have serious revenue implications for many states, they do not necessitate a sea change in the ways states think about taxing business. And because the federal government expanded and contracted the federal corporate tax base on numerous occasions in the past, the states have a wealth of historical experience for dealing with changes of this type.

¹⁵ In addition to the indications of a lack of interest in fundamental restructuring by the president (see, for example, Martin A. Sullivan, “Tax Reform Panel Explores Options,” *Tax Notes*, Feb. 21, 2005, p. 893), Senate Finance Committee Chair Chuck Grassley, R-Iowa, has said he is studying tax reform options that would involve modifications to the current tax system (Dustin Stamper, “Grassley Admits Jobs Act’s Dual Rate Structure Not Good Policy,” *Tax Notes*, April 11, 2005, p. 162).

1. Base broadening

The landmark Tax Reform Act of 1986 had a profound effect on state public finance. For the most part, reform provided substantial revenue gains for the states. After passage of the act, the U.S. Advisory Commission on Intergovernmental Relations¹⁶ estimated that the federal reform act would result (assuming conformity to the base broadening provisions) in:

- Large gains of personal income tax revenue (7 percent to 28 percent) in 23 states;
- Moderate gains of revenue (1 percent to 6 percent) in 10 states;
- Negative revenue in 10 states (4 states based personal income tax liability as a percentage of federal liability); and
- No effect in 7 states (without income taxes)

On the business side, conformity with federal tax reform was estimated by the U.S. Treasury to increase state corporate tax revenue by \$2.9 billion (a 14.9 percent increase) in 1987.¹⁷ That figure assumed that states would continue to offer investment tax credits and that states would not establish a corporate minimum tax. Under the Senate Finance Committee proposal, the total loss over the course of the fiscal crisis would rise to \$8 billion. (Note that the Congressional Research Service, using a different method, found that the dividend proposal would cost \$4.3 billion when fully in effect, so the cost to states could be even greater than \$8 billion.)

2. Integration Proposals

In 2003 Treasury first proposed, and Congress ultimately enacted, a proposal to reduce the double taxation of corporate income in the form of a reduced rate for individuals on dividend income. The Center on Budget and Policy Priorities estimated that that preferential treatment of dividends would lose \$1.3 billion because of this conformity in tax year 2003, \$2.7 billion in 2004, and \$4 billion in 2005.¹⁸ Although the proposal had no direct effect on state corporate tax revenue, it should be noted that equivalent relief could have been provided in the form of a new deduction at the corporate level for dividends paid.¹⁹ The reduced tax rate on dividends is

¹⁶ Carolyn Lynch, “A Preliminary Report: Preliminary Estimates of the Effect of the 1986 Federal Tax Reform Act on State Personal Income Tax Liabilities,” (Washington, DC: ACIR, 1986).

¹⁷ Robert Aten, “The Magnitude of the Additional Revenues Available From Corporate Income Taxes as a Result of Federal Tax Reform,” *Tax Notes*, August 4, 1987.

¹⁸ Center for Budget and Policy Priorities, “States Could Lose up to \$8 Billion During Current Fiscal Crisis,” May 6, 2003, online at www.cbpp.org.

¹⁹ States would be in jeopardy of losing \$8 billion to \$11 billion in revenue, with the amount of loss depending on which states conformed to the federal treatment. Thirty-seven states and the District of Columbia use federal definitions of income in their own tax systems. Those states, with a few exceptions such as California, would automatically exclude dividends from state taxable income if they were excluded from federal taxable income. A few states — Alabama, Arkansas, Mississippi, New Jersey, Pennsylvania, and Tennessee — ask taxpayers to report

scheduled to expire at the end of 2008. Bush and many members of Congress support permanent extension.

3. Investment Incentives

Federal tax reform—in an attempt to reduce the taxation of capital income and thereby move the federal tax system more toward a tax on consumption—could include investment incentives that would narrow the corporate tax base. The large reduction in corporate taxes initiated by the Reagan administration in 1981 had a large negative impact on state corporate tax receipts. The expansion of the investment tax credit and the acceleration of tax depreciation allowances enacted in 1981 were estimated to cost the states \$27.5 billion over six years in lost corporate taxes. By 1986, the annual cost was estimated to be \$10.2 billion. The centerpiece of the incentives, the accelerated cost recovery system, was automatically adopted by 25 states, and 13 additional states conformed by enacting legislation.

Although perhaps the largest package of federal tax incentives, the 1981 Economic Growth and Recovery Tax Act was not the only federal legislation in recent years to reduce the corporate tax base. As part of its economic stimulus package, Congress enacted the Job Creation and Worker Assistance Act of 2002. A cornerstone of the legislation was a special, first-year 30 percent bonus depreciation for some investments made through 2004. Traditionally, states have linked their depreciation rules to federal rules, but in the case of bonus depreciation 30 states have decoupled. The other states continued to suffer a revenue loss of \$4 billion through September 2004.²⁰

That left the states with a difficult choice. They could do nothing and provide the same tax relief as the federal government, or they could decouple from the federal depreciation rules. As of the end of 2004, 28 states have opted to follow the federal government and continue to conform to the national depreciation rules. At the same time, 18 states have chosen to decouple from the federal system regarding how they treat depreciation²¹.

directly the amount of dividends they receive rather than deriving dividend income from the federal tax return. Those states would not automatically lose revenue, but would undoubtedly face pressure to conform to the federal treatment. California, which has a tradition of allowing its tax structure to deviate from federal law, might decouple, but most other states likely would not. Although 30 states did decouple from the federal bonus depreciation provision enacted in 2002, only 17 states have decoupled from the phaseout of the estate tax credit that eliminates state estate taxes. The same pressures that are being brought to bear for a dividend exclusion at the federal level also exist in state capitols. For those reasons, when the dividend proposal was first released in January, Standard & Poor's said about the dim prospects for decoupling, "State legislative changes to tax structure, even given the obvious necessity and benefit, will likely prove difficult, at best."

²⁰ Iris J. Lav, "Many Federal 'Stimulus' Tax Cuts Under Consideration Would Be Costly for States," January 6, 2003, Center for Budget and Policy Priorities, online at www.cbpp.org.

²¹ Four states (Nevada, Washington, South Dakota, and Wyoming) were not affected by the federal depreciation changes.

In 2002 Congress enacted a tax relief measure under section 179 of the Internal Revenue Code that allows an immediate deduction for small and midsize companies that make equipment purchases. Traditionally, taxpayers had to depreciate those assets over time. Because every state except California follows the federal rules for expensing of business purchases, the states lost approximately \$1.1 billion in 2003 income tax revenue as a result. And the expected loss in state income tax revenue through 2013 was estimated by the Joint Committee on Taxation to be \$5.2 billion.

For the fourth year in a row, the federal government in 2004 enacted a major tax law that affects state tax collections. Provisions of P.L. 108-357, the American Jobs Creation Act of 2004, could cost states substantial revenue. Although the bill has dozens of separate, complex provisions, including many narrow tax breaks for specific industries, one provision stands out for its breadth and its potential to cost states revenue: the tax deduction for qualified production activities income, or QPAI.

When it is fully phased in, the QPAI deduction will represent the largest single tax break for corporate America in years. The Joint Committee on Taxation estimates that the deduction will cost the federal government \$10.7 billion annually when fully phased in, equivalent to a 3 percent to 4 percent reduction in federal tax revenue from the profits of incorporated and unincorporated businesses. (The actual impact will depend largely on how the Treasury Department and the federal courts interpret the law.) There is every reason to think that many states will face a comparable percentage decline in state tax revenue should they conform to the provision. Had the full deduction been in effect in 2004 and had all states fully conformed to it, the total revenue loss for states could have equaled \$1.3 billion or more.

Most states will want to conform to some portions of it, since it includes two provisions that could have a positive effect on state taxes. Those are the phaseout of a provision that protects extraterritorial income from foreign exports that the World Trade Organization has said is illegal under international law, and the elimination of some costly and inappropriate tax shelters.

Nevertheless, if states conform to the legislation as a whole, it is likely to result in a net loss of revenue. Nor is there any reason for a state to conform to the whole.²² The QPAI deduction is not a “swap” for the loss of the extraterritorial income exclusion because the latter benefits only exporters while the QPAI deduction is for any domestic producer. And closing tax shelters used by a limited number of taxpayers to avoid taxes is good policy in its own right.

²² Nicholas Johnson and Elizabeth McNichol, “States Can Decouple From the ‘Qualified Production Activities Income’ Deduction.” Center for Budget and Policy Priorities, February 8, 2005, available online at www.cbpp.org.

D. Eliminate Corporation Income Tax and Replace With a New Business Tax

As shown in Table 3, if the federal corporation income tax is repealed and a new federal business tax is instated, four general approaches can be taken. Table 4 focuses on those changes and compares the general approaches to each other and a corporation income tax. Although politicians love to give these taxes new and different names, they have more in common than might be obvious to the average citizen.

Table 4					
Four Types of New Business Taxes Under Federal Tax Reform					
	Current Law	Subtraction Method VAT (English, H.R. 269)	IVAT (Treasury 2002)	Business Component of Flat Tax (Shelby)	CBIT (Treasury 1992; Treasury 2002)
In General	Corporate Income Tax	Subtraction Method Value Added Tax		Business Component of Flat Tax	
Tax Base	Corporate Profits	Value Added (profits+interest+wages)		Business Capital Income (profits+interest)	
Taxpayers	C corporations	All Businesses	All Businesses	All Businesses	All Businesses
Capital Recovery	Depreciation	Expensing	Depreciation	Expensing	Depreciation
Interest Deductible?	Yes	No	No	No	No
Wages Deductible?	Yes	No	No	Yes	Yes

The table shows that four general types of proposals are of two types: a subtraction method VAT and the business component of a flat tax. The relationship between a subtraction method VAT and a flat tax was illustrated with an example in Table 5. Each of these types of business-level taxes can be further divided into the subcategories of income and consumption versions. The difference between the two is that under a consumption tax, the cost of capital expenditures is expensed while under an income tax they are depreciated over their economic lifetime.²³

²³ To the extent that tax depreciation schedules are more accelerated than economic depreciation, the tax moves away from a pure income tax and more closely resembles a pure consumption tax.

Table 5		
Comparison of Corporate Income Tax and a Subtraction Method VAT		
	Income Tax	VAT
Business Receipts—Domestic	90	90
Business Receipts—Exports	10	-
Interest Income	5	-
Total Gross Receipts	105	90
Business Purchases (Other than capital)	35	35
Wages	45	-
Interest Expense	10	-
Depreciation	10	-
Capital Spending	-	15
Total Deductions	100	50
Tax Base	5	40

E. How States Piggyback on Federal Corporation Tax

Forty-six states and the District of Columbia levy a corporate income tax. Only Nevada, South Dakota, Washington, and Wyoming do not.²⁴ Most states impose a flat rate corporate income tax. In 2003 states raised \$28.3 billion from those taxes.

In most states, the starting point for computing corporation income tax is income as reported on the federal corporate income tax return. Twenty-five states begin with federal taxable income before special deductions (line 28 of Form 1120). Twenty states begin with federal taxable income (line 30 of the 1120).²⁵ Only a small fraction of nationwide state corporate tax revenue is raised in jurisdictions with no reference to federal taxable income: Arkansas, Kentucky, and the District of Columbia do not start with any reference to federal taxable income. For filing purposes, every state except Texas and Tennessee requires some portion of the federal Form 1120 to be attached to the state return.

²⁴ Franchise taxes are excise taxes imposed on the privilege of doing business within a state. Twenty-seven states impose a capital stock tax. (measured by a corporation's net worth—outstanding stock or equity). Eleven states impose a corporate license fee. But six states impose a franchise tax based on income (Florida, Idaho, Nebraska, New York, Ohio, Utah).

²⁵ There is some overlap because some states offer incentives, special industry breaks, and so forth.

Then additions and subtractions are made to arrive at each state's corporate tax base. Typical additions to federal income are state and local bond interest, deductions for state and local taxes paid, federal special deductions like dividends received, and deductions for cost recovery if assets are not depreciable for state purposes. Typical subtractions are interest on federal bonds, refunds of state and local taxes paid, and dividends received from out-of-state corporations.²⁶

Nonbusiness income is also subtracted from any income that must be apportioned. The net amount of adjusted federal taxable income must then be apportioned to the state according to the state's apportionment formula—usually some weighted average of in-state sales to total sales, in-state employee compensation to total compensation, and in-state property to total property. Taxable income apportioned to the state is then adjusted again for gains and losses allocable to the state.

In addition to those general conformity requirements, specific state rules piggyback on federal rules. For example, all states except New Mexico, New York, Hawaii, and New Jersey follow section 338 of the Internal Revenue Code, which permits a corporation acquiring at least 80 percent of a target to receive a stepped-up basis in the acquired corporation's assets. Also, all states follow federal tax rules²⁷ for like-kind exchanges. Finally, all states allow taxpayers to change accounting methods if permission is received from the IRS.

F. Could States Piggyback Their Corporate Taxes on the New Federal Business Tax?

As will be discussed in more detail in the following section, two states—Michigan and New Hampshire—currently collect broad-based business taxes generally resembling value added taxes. That shows it is possible—politically and administratively—to collect and enforce a VAT at the state level at the same time the federal government collects corporate tax. Is the opposite true? Is it possible and sensible to collect and enforce a state corporation income tax while the federal government collects a value added tax (or a flat tax)?

The answer appears to be no or only with great difficulty. The reason is that because subtraction method value added and flat taxes are less complicated than corporation income taxes, the requirements for businesses to comply and government to enforce those new taxes are a subset of the requirements for compliance with and enforcement of a corporation income tax. In other words, a broad-based VAT or VAT-like tax can piggyback on a corporate tax, but the opposite is far more difficult.

The new business taxes generally compute the tax base on a cash-flow basis. Corporate taxes for the most part are calculated using accrual accounting. The new business taxes have no rules for determining interest expense or interest costs. There is no concept of basis. They do not include foreign source income in the tax base. They deduct inventory cost when purchased.

²⁶ These are examples. There are many more additions and subtractions.

²⁷ Internal Revenue Code sections 1031 and 1033.

In general, they deduct capital when purchased rather than expensing. And, at least as proposed, they usually do not include incentive tax credits, such as the credit for research and development. The states that kept their income taxes would no longer have the benefit of federal law and federal enforcement to help administer these aspects of their taxes.

IV. Should States Repeal Corporate Taxes and Adopt a New ‘Reformed’ Federal Business Tax?

A. States With Alternative Business Taxes

Originally enacted in 1975, Michigan’s single business tax (SBT) is an addition method, consumption-base value added tax. The tax base is computed by starting with federal taxable income, adding interest and wages paid, and making adjustments so that costs of capital purchases are effectively expensed rather than depreciated. The rate of tax is 1.9 percent. Michigan Gov. Jennifer Granholm (D) is pressing for a restructuring of the tax, which would include a reduction in the rate from 1.9 percent to 1.2 percent, a 35 percent credit for personal property taxes paid by manufacturers, and an increase in the profit component of the tax base by a factor of three.²⁸

In 1993 New Hampshire became the second state to adopt a value added tax. Like Michigan’s SBT, New Hampshire’s business enterprise tax (BET) is an addition method VAT. Its tax base is wages, interest paid, and dividends.²⁹ New Hampshire’s Form BET does not reference federal taxable income. The rate of tax is 0.75 percent.³⁰

B. Past and Current Proposals for Alternative Business Taxes

Ohio Gov. Bob Taft (R) has proposed repealing the state corporate income tax and replacing it with a new commercial activity tax—not a value-added tax but a tax on gross receipts of all (not just retail) businesses. The proposed rate is 0.21 percent.³¹ (We wholeheartedly agree with the Charles McLure’s recent assessment of this tax: “The inherent defects of turnover [i.e. gross receipts] taxes have long been recognized. . . . One can only wonder whether—and why—Ohio would want to repeat the sad history of turnover taxes.”³²)

In Minnesota, a think-tank named Growth and Justice has proposed a tax reform for the state that includes replacement of the state corporation tax with an addition method value added tax.

In Texas, David A. Hartman of the Lone Star Foundation has proposed that the state adopt a business activity tax (a flat BAT) as a replacement for local school ad valorem taxes and

²⁸ Robert Kleine, “Michigan Governor Calls for Business Tax Restructuring,” *State Tax Notes*, Feb. 7, 2005, p. 342.

²⁹ So, unlike the SBT, the BET does not include retained earnings as part of the tax base.

³⁰ Stan Arnold and William F.J. Ardinger, “Top Ten Reasons Why New Hampshire’s BET May Provide an Answer to State Tax Reform,” *State Tax Notes*, November 29, 2004, p. 583.

³¹ J.M. Ortega, “Legislative Leaders: Governor’s Tax Plan Likely to Pass,” *State Tax Notes*, Mar. 28, 2005, p. 922.

³² Charles E. McLure, “Why Ohio Should Not Introduce a Gross Receipts Tax,” *State Tax Notes*, April 18, 2005, p. 213.

a variety of state business taxes, including the corporate franchise tax. The tax would be a subtraction method VAT with a rate no higher than 3 percent.³³

In 1998 the D.C. Tax Reform Commission proposed the creation of a broad-based value added tax, called the business activity tax, as a replacement for the corporation income tax and other business taxes.³⁴ The proposed tax would use the addition method to compute the VAT base and would have a rate of 1.5 percent. The proposal was not adopted by the district.

C. The Benefits of State Conformity to New Business Taxes

If a new federal VAT or Flat Tax were imposed on businesses, it is hard to see any reason why states should not follow suit and repeal their corporation taxes and impose state VATs or Flat taxes as replacement sources of revenue. A 1995 article by Christopher Zimmerman appears to concur with this view: “On the business side, [a flat tax] could have some benefits to states because they could easily couple the proposed VAT, which is similar to Michigan’s single business tax, easing administrative problems and perhaps providing a broader base than current corporate taxes.”³⁵

The never-ending problem of choosing an apportionment formula remains, but it does not appear that apportionment issues are made any more difficult.³⁶ For both the Flat Tax and the

33 David Hartman, “Texas Public School and Business Tax Reform Via the Flat BAT,” Lone Star Foundation, December 3, 2003.

34 Jacquelyn V. Helm, “Businesses Protest Activity Tax Proposal,” *State Tax Notes*, August 3, 1998, p. 256.

³⁵ Christopher Zimmerman, “Flat Tax, Sales Tax, Or VAT?,” *State Tax Notes*, November 13, 1995, p. 1407.

³⁶ Steven M. Sheffrin is not as sanguine on this issue. Expecting that under a Flat Tax, businesses would have much more revenue at stake, he speculates: “the increased level of potential revenue to the states would put immense political stress on their respective systems for apportioning income. As tax experts know, methods of apportioning income among states are fraught with difficulty and subject to much litigation. It is not clear whether the current system could handle the additional burden that a Hall-Rabushka tax reform would impose without undergoing a major restructuring, and only then after protracted legislative wrangling.” Steven M. Sheffrin, “Should the Federal Income Tax Be Replaced with a National Sales Tax or Value Added Tax?” *State Tax Notes*, October 21, 1996, p. 1147. Comments by Eric Toder in 1996 indicate that he shares this view: “My guess is states would shift to a sales-weighted system.” Otherwise, he explained, the combined federal-state-local tax on business would become very large. Economically competitive states likely would then attempt to retain and attract business by allowing part of the state tax burden to be passed through to consumers.’ [CITE TO BE PROVIDED]

Nunn-Domenici USA tax, Bucks has pointed out: “State could simply transport their apportionment formulas from the corporate income tax arena to the new operational VAT.”³⁷

Federal-state conformity is good in and of itself. By eliminating duplicative administrative costs for governments and compliance costs for taxpayers, conformity of a state business tax with a federal business tax is a major cost saving. The benefits can be large because conformity to federal taxes by all states means states would conform to each other as well. The benefits of conformity can outweigh other negative aspects of an inferior tax system. For example, even if the federal government has an economically inefficient business tax, it may still be better for states to conform to that tax than adopt better taxes of their own.

Of course states, as a rule, do not like conformity. In this case, as noted by Dan Bucks, “the issue will be framed as a trade-off between national simplicity and state tax autonomy.” Bucks is gloomy about the prospect of federal state conformity: “consolidation of the two levels of taxation would mean that Congress would control state taxes.”³⁸ This is no doubt that the issue of autonomy vs. conformity has a political dimension that cannot be ignored. And, as a practical matter, conformity may be an impossible dream. However, speaking not as analysts but as private citizens, the prospect of federal-state conformity is not unappealing to us, that is, the real economic benefits of simplicity greatly outweigh the nebulous political benefits (if any) to citizens of autonomy. If readers share our view, tax reform may be viewed as an *opportunity* to further the cause of conformity rather than a unwelcome disruption to the status quo.

A business VAT is economically superior to a corporation tax. If the federal government chose to tax businesses under a VAT, it would be a vast improvement over the largely unjustifiable corporate tax. The corporation tax, besides being complex, reduces capital formation, favors noncorporate business over corporate business, encourages increased indebtedness, and discourages the payment of dividends. In sharp contrast, the VAT, as a consumption tax, largely avoids all of those problems and as a broad-based consumption tax is generally considered most economically beneficial. If states were to adopt a new federal business tax, they would doubly promote efficiency through conformity (discussed in the prior paragraph) and economic neutrality.

Lower rates means less tax avoidance. Probably the most attractive feature of a reformed business tax system is the lower tax rates that would ensue. The base of these taxes is considerably broader. For the business component of the flat tax, the base is profits plus interest. That approximately doubles the tax base, which allows a tax rate one half that of an equal-revenue corporate tax. For a value added tax, the base is profits plus interest plus wages. For the economy as a whole, wages are typically two-thirds to three-quarters of national income. That means that for most businesses, the value added tax base will be at least five times greater than

³⁷ Dan R. Bucks, “Federal Tax Restructuring: Perils and Possibilities for the States,” State Tax Notes, August 7, 1995, p. 417.

³⁸ Dan R. Bucks, “Federal Tax Restructuring: Perils and Possibilities for the States,” State Tax Notes, August 7, 1995, p. 415.

the corporate tax base, and so the VAT rate may be a small fraction of the rate of corporate tax it replaces.

Besides resulting in fewer impediments to the economy, a lower tax rate reduces the incentive for business to engage in tax avoidance. For example, the benefit of shifting income from intangibles from a state with a 1.5 percent VAT to a no-tax state are one-fifth of what they would be if the taxing state instead had a 7.5 percent corporate tax.

VATs are far less volatile sources of revenue than corporation taxes. Business profits are highly cyclical. Corporation taxes increase disproportionately when the economy is strong and decrease disproportionately during recessions. Under a corporate income tax, low profits and loss firms not only can escape the tax, but may also collect refunds. Tax collections from new state business VATs would still move with the business cycle, but they would be far less volatile.

V. Conclusion

In the unlikely case of radical tax reform, states will be left to their own devices to enforce their state corporation taxes. In the highly likely case that federal tax reform leaves the corporate income tax largely in place, states will have to monitor changes in the federal corporate tax base and decide how and if they will respond—as they have done during previous adjustments to the federal corporate tax base.

There is some possibility that tax reform may involve repeal of the federal corporation income tax and its replacement with a subtraction method VAT or a flat tax. The case for federal-state tax conformity is always a strong one. The case for repealing state corporation taxes is already a good one. If the federal government replaces its corporation tax with a new, broad-based VAT-like tax, states should jump at the opportunity to reform their systems rather than “prolonging the inevitable demise of these traditional systems.”³⁹

This paper has not discussed the economically and politically complex issue of tax fairness and the distribution of the tax burden. To politicians, average citizens, and businesses themselves, any switch from a corporate tax to a new business tax may seem like a straightforward switch of one business tax for another. Economists and other public finance specialists, however, realize that these new business taxes are economically equivalent to broad-based sales taxes. Although an examination of existing research shows that there is much uncertainty about the incidence of corporation and sales taxes, the burden of sales taxes is generally considered far less progressive than that of the corporation tax. It is likely that any replacement of a VAT for a corporation tax at the federal or state level must be countered with some tax reduction for low-income households if distributional neutrality is one of the objectives of reform.

³⁹ Stan Arnold and William F.J. Ardinger, “Top Ten Reasons Why New Hampshire’s BET May Provide an Answer to State Tax Reform,” *State Tax Notes*, November 29, 2004, p. 583.

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