Where is the State Corporate Income Tax Headed?

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Why Tax Businesses?

- Revenue
- Tax handles
- Tax exporting
- Tax portfolio balance
- Benefit tax
Composition of Total State and Local Business Taxes, FY2013

PERCENTAGE DISTRIBUTION OF STATE TAX COLLECTIONS, 2013

- Individual Income: 36.6%
- Corporate Income: 5.3%
- Selective Sales: 16.3%
- General Sales: 30.1%
- Other: 10.1%
- Property: 1.6%

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Corporate Tax Revenues as a Share of Total Taxes

- U.S. = 6.7%
- Less than 5.0%
- 5.0% to 6.7%
- Greater than 6.7%
STATE CORPORATE INCOME TAX RATES
as of Jan. 1, 2014

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Corporation Net Income Tax and Corporation License Tax as a Share of Corporate Profits

Percent of Corporate Profits

- Corporation License as % of Corp Profits
- Corporation Net Income as % of Corp Profits

Years: 92, 93, 94, 95, 96, 97, 98, 99, 00, 01, 02, 03, 04, 05, 06, 07, 08, 09, 10, 11, 12, 13

Percentages: 0%, 1%, 2%, 3%, 4%, 5%, 6%
Some reasons for decline in the effective rate

- Tax planning
  - Business structures – LLCs, LLPs, General partnerships
  - Planning around the sales factor
- Federal tax policy changes
- State policy changes
  - Single sales factor apportionment
  - No strong downward trend in nominal tax rates
State Corporate Income Tax Revenue Since the Start of the Recession

Four-Quarter Moving Average, Adjusted for Inflation

Cumulative Percent Change Since Start of Recovery

Quarters Since Start of Recession

2007 Q3 U.S.
1997 Q1 U.S.
2013 Q4 U.S.

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Why is Forecasting Difficult?

- Unpredictability of corporate profits
- Differences between book earnings and tax earnings
- Impact of small number of firms
- Timing of tax payments and revenue recognition
- Tax incentives
- Loss carry-forwards
- Refunds associated with prior year activity
Tennessee Franchise and Excise Collections, September
What’s driving current state and local tax changes/reform?

- Rebound in taxes, budget surpluses (e.g., CA) “tax fairness” debates, change in party/one-party control of state houses
- Responding to political base
  - Republicans pushing reduction of rates/elimination of entire taxes with emphasis on economic development
  - Democrats pushing fairness, increased progressivity, base expansion, restoration of spending cuts due to recession
- Why the move away from income-based taxes?
  - Continued decoupling from federal bases
  - State tax competition – everyone wants to be like Texas
  - Improved state tax rankings
- More general tax policy objective of shift to consumption taxes
  - Sales tax has its limitations
  - Alternative forms of business entity taxes?
Two trends, that focus on two entirely different policy goals

Destination based structures
  ◦ Single sales apportionment
  ◦ Destination situsing of services
  ◦ Economic nexus
State Apportionment of Corporate Income

- N/A ---6---
- Equal Weighted ---11---
- Greater Sales Weight ---15---
- Sales Only ---18---
Single factor sales apportionment

- Intended to eliminate excises on payroll and property to stimulate job creation. Effectively convert the CIT to a transactions tax.
- Taxable profits\(_i\) = 
  \[(\text{sales}_i/\text{national sales}) \times \text{national profits}\]
- Potentially benefits some but not all businesses
- Statistical analysis suggests small economic stimulus from greater sales factor and less perverse effects of high marginal tax rates
- Sales only states rely more on CIT, suggesting the destination tax intended to mitigate the effects
Two cases where single factor sales harms the economy

- Becomes a heavier tax at the origin on services unless have changed the situsing – benefits manufacturing more than services
- Tax is on all sales, not just final sales. So, can increase the tax implicit in the value of some items. E.g., tax implicit in purchases can be very large relative to value added for wholesalers who resell out of state. The important tax is on their purchases (which is increased) and not their sales (which are sitused out of state)
States That Have Adopted Market Sourcing of Services
Attempts to deal with tax planning. Planning has certainly been an important aspect of diminishing CIT revenues

- Combined reporting
- Addbacks
- New structures – CAT, Margins Tax
Mandatory Combined Reporting
What policies will states pursue?

- Depends on the goals, which may differ by state
  - Generating revenues
  - Stimulating the economy relative to existing structures
- Political/competitive pressures will continue to push towards destination taxation
- Taxation of other business structures? CAT
- Consider potential unintended consequences
State Corporation License and Corporation Net Income as a Percent of GDP

Corporation Net Income as Percent of GDP

Corporation License as Percent of GDP

Year

Corporation Net Income (Left Axis)
Corporation License (Right Axis)
Average Share of Corporate Income/Total

- Equal Weighted = 5.14%
- Greater Sales Weighted = 5.87%
- Sales Only = 6.28%

- Correlation of Tax Rate to Corporate Income Share of Total = 0.29