MEETING OF THE STATE BUSINESS TAXATION SUB-GROUP

Wednesday, September 10, 2008
8:00 a.m. - 9:30 a.m. – **Executive Dining Room/Ground Floor**
Department of Administration/Powers Building
One Capitol Hill, Providence, RI 02908

MEETING AGENDA

I. Presentation on Issues in State Taxation
   Douglas L. Lindholm, President & Executive Director
   Council On State Taxation *

II. Review of Potential Policy Options

III. Next Steps

* The **Council On State Taxation (COST)** is the premier state tax organization representing taxpayers. COST is a nonprofit trade association consisting of over 600 multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Contact: Christine O'Connor 574-8999

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Wednesday, September 10, 2008
8:00 a.m. - 9:30 a.m. – **Conference Room B**
Department of Administration/Powers Building
One Capitol Hill, Providence, RI 02908

MEETING MINUTES

I. Presentation on Issues in State Taxation
Douglas L. Lindholm, President & Executive Director
Council On State Taxation

The **Council On State Taxation (COST)** is the premier state tax organization representing taxpayers. COST is a nonprofit trade association consisting of over 600 multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Mr. Lindholm presented four reports issued by cost (reports attached).

II. Next Meeting September 25 – Entire Group Meeting

Contact: Christine O'Connor 574-8999

The Best and Worst of State Tax Administration

Scorecard on Tax Appeals & Procedural Requirements

Douglas L. Lindholm
Stephen P. Kranz

April 2007

Executive Summary

The Council On State Taxation (COST) has long monitored and commented on state tax administrative practices. Part of that effort has resulted in the regular publication of a Scorecard ranking the states on their treatment of significant issues which impact the perceived fairness of the rules and requirements for administration and appeal of state tax matters. These administrative and appeal issues are important because of their relationship to the effectiveness of our voluntary system of tax compliance. Taxpayers are more willing to comply with a tax system they perceive to be balanced, fair, and effective. Taxpayers operating in an oppressive, unfair, or otherwise biased system are less likely to voluntarily comply. The clear message to state tax administrators and state legislatures is that they should be sensitive to the compliance implications and competitiveness concerns created by poor tax administrative rules and ineffective tax appeal systems.

Douglas L. Lindholm is President and Executive Director of the Council On State Taxation (COST). Stephen P. Kranz is COST Tax Counsel. The authors would like to express their gratitude to Dr. Sandra Bland, Professor of Accounting at Bemidji State University and recipient of the 2006 Faculty Fellowship at COST, for her untiring efforts in the development and completion of the 2006 Survey used to develop this report.

COST has evaluated the states based on their treatment of selected procedural elements and the presence of an independent appeals process. The procedural elements consider whether the state has:

- even-handed statutes of limitations,
- equalized interest rates,
- adequate time to file a protest,
- a due date for corporate income tax returns at least 30 days beyond the federal due date, and
- an automatic extension of the state return due date based on the federal extension.

COST has evaluated state tax appeals processes using two separate questions to better articulate the elements of a high quality appeals system. The first question addresses the need for an independent non-judicial forum, and the second inquiry addresses the need for access to an independent tribunal without a prepayment requirement. It is COST's view that these elements, at a minimum, should be a part of any state's tax administration that seeks to achieve fairness, efficiency and a customer-focused environment.

The 2007 Scorecard ranks each of the states on their adherence to the above procedural and appeals system elements. By focusing on strictly objective criteria, the Scorecard gives states the opportunity to enact corrective legislation as a means of improving business climates. Indeed, several states have taken significant legislative steps over the years that have significantly improved their ranking on the Scorecard. Maryland and Tennessee are examples of states that have moved upwards on the Scorecard as a result of favorable legislation regarding appeals systems or procedural issues. Texas and North Carolina are both likely to consider legislation that would improve their grade. It is our hope that by publishing this Scorecard we will spur policymakers to improve the rules for tax administration and appeal of tax matters in all of the states.

Top-Ranked States

State	Grade
Alaska	A
Arizona	A
Hawaii	A
Idaho	A
Iowa	A
Montana	A
South Carolina	A
Virginia	A

Bottom-Ranked States

State	Grade
North Carolina	D-
Connecticut	D
Louisiana	D
Rhode Island	D
Alabama	C-
California	C-
Texas	C-

Introduction

This Scorecard is COST's third published effort to objectively analyze state treatment of significant procedural issues that reflect whether states provide fair, efficient, and customer-focused tax administration. The Scorecard expands on and updates the 2001 and 2004 versions[1] and sets the stage for important policy discussions in states where certain procedural practices either create inefficiencies for business and government, or focus on preservation of the fisc rather than providing good customer service. As with prior versions, this Scorecard provides an objective counterpart to the subjective surveys CFO Magazine presented in 1996, 2000, 2004 and 2007.[2] While the COST study evaluates each state's statutory scheme against objective criteria, the CFO Magazine surveys asked corporate tax executives and state tax practitioners questions on their subjective views of both state tax administrative practices and substantive tax positions.

To properly gauge taxpayer responses to specific state administrative systems, the approach taken by COST (assessing objective criteria) and the approach taken by *CFO Magazine* (compiling subjective taxpayer responses), should be viewed in conjunction. Taken separately, each approach may be fairly criticized. Analyzing a set of objective criteria creates a useful benchmark for comparison of administrative practices from state to state, but fails to recognize incompetent administration and aggressive personnel operating within a sound statutory framework. Conversely, an evaluation of taxpayer responses to subjective questions might mask a deficient statutory framework by recognizing only the goodwill engendered by fair and competent administrative officials.

A prime example of the difference between the two approaches is reflected in the different rankings each study gives to the independence of state administrative appeals processes. *CFO Magazine* ranks the administrative appeals process in Illinois, Pennsylvania, California, New Jersey and North Carolina the least independent, respectively, from their audit departments. These five states are ranked as the worst even though, according to the COST Scorecard, New Jersey offers a Tax Court that is completely independent from the state's audit process and California provides for appeal of income and franchise tax matters to the State Board of Equalization (although the SBE also serves a dual role as a tax agency). This difference reflects the fact that the COST Scorecard looks at the statutory provisions while *CFO Magazine* captures the subjective views of corporate tax representatives. Viewing the two analyses in conjunction, one can conclude that California and New Jersey, while offering independent review, each suffer from a perception that their appeals process is reluctant to overturn revenue department decisions. The fix may be more than statutory.

The *CFO Magazine* and COST approaches produce consistent analysis where the statutory lack of independence is the cause of negative taxpayer opinion. As set forth above, North Carolina, Pennsylvania and Illinois were among the five worst states in the *CFO Magazine* ranking of independent administrative appeals. These three states lack statutory independence in their appeals process and were thus also ranked among the worst on this issue in the COST Scorecard. Taxpayer attitude regarding the environment in these two jurisdictions will only be improved once true statutory reform is accomplished.

The COST Survey

The 2007 Scorecard takes a different approach to ranking the states than has been COST's practice in the past. This year rather than numerically ranking the states against each other we have assigned a grade based on an accumulated point total. The point total was determined by assessing states 1 to 3 points for each category where the state deviates from COST's recommendations for achieving a balanced, fair and effective tax system. Specific scores are based on COST's determination of the relative importance of specific issues to business taxpayers, and the presence or absence of mitigating and/or aggravating circumstances. The final grades are based on the following scale:

- A = 0 to 4 points;
- B = 5 to 8 points;
- C = 9 to 12 points;
- D = 13 to 15 points; and
- F = over 15 points.

As in past editions of the Scorecard, COST has evaluated the states based on their treatment of selected procedural elements and the presence of an independent appeals process. The procedural elements consider whether the state has:

- even-handed statutes of limitations,
- equalized interest rates,
- adequate time to file a protest,
- a due date for corporate income tax returns at least 30 days beyond the federal due date, and
- an automatic extension of the state return due date based on the federal extension.

In past versions of the Scorecard COST reviewed whether states had a policy of opening the entire state return to audit in response to federal audit changes. Because many states have moved away from this practice we no longer include this factor as a separate question in the Scorecard. Instead we have included this factor in the new “key additional issues” column discussed under “Barometers of State Tax Administration” (p. 9).

Consistent with the 2004 Scorecard we have continued to evaluate state tax appeals processes using two separate questions to better articulate the elements of a high quality appeals system. The first question addresses the need for an independent non-judicial forum, and the second inquiry addresses the need for access to an independent tribunal without a prepayment requirement. It is COST’s view that these elements, at a minimum, should be a part of any state’s tax administration that seeks to achieve fairness, efficiency and a customer-focused environment.

The table on page 5 ranks each state’s procedural practice in the areas described above. Although much progress has been made over the last 20 years, numerous states are significantly behind the curve in providing fair and efficient tax administration. Detailed survey data for each state is provided beginning on page 10.

	Even-handed statutes	Interest rates	Protest period	State return due date	Automatic extension	Independent dispute forum	Pay to Play	Other key issues	Total Points	Grade
AL	0	0	2	3	0	2	1	4	12	**C-**
AK	0	0	0	0	0	0	0	3	3	**A**
AZ	0	0	0	0	0	0	0	3	3	**A**
AR	0	0	2	3	0	3	3	0	11	**C**
CA	0	2	0	3	0	2	2	3	12	**C-**
CO	0	0	2	0	0	3	3	2	10	**C**
CT	0	2	0	2	3	3	0	4	14	**D**
DE	0	0	0	2	0	0	0	2	4	**A-**
DC	0	3	2	3	3	0	0	0	11	**C**
FL	0	0	0	2	1	3	1	4	11	**C**
GA	0	0	2	3	0	3	0	1	9	**C+**
HI	0	0	2	0	0	0	0	0	2	**A**
ID	0	0	0	0	0	0	1	1	2	**A**
IL	0	0	0	3	0	3	0	3	9	**C+**
IN	0	2	0	0	0	0	0	5	8	**B**
IA	0	0	0	0	0	3	0	0	3	**A**
KS	0	0	0	0	0	0	0	5	5	**B+**
KY	2	0	1	0	0	0	0	2	5	**B+**
LA	0	2	2	0	0	1	1	7	13	**D**
ME	0	0	2	0	0	3	0	3	8	**B-**
MD	0	0	2	3	2	0	0	0	7	**B**
MA	0	2	0	3	3	0	0	1	9	**C+**
MI	2	1	2	0	0	0	0	3	8	**B-**
MN	0	0	0	3	0	0	0	5	8	**B-**
MS	0	0	2	3	0	3	3	0	11	**C**
MO	0	0	1	0	0	0	0	6	7	**B**
MT	0	0	2	0	0	0	0	0	2	**A**
NE	0	0	1	3	0	3	0	0	7	**B**
NV	0	2	1	0	0	3	3	0	9	**C+**
NH	2	3	0	3	0	0	0	1	9	**C+**
NJ	0	2	0	0	1	0	1	0	4	**A-**
NM	0	1	2	3	0	3	0	1	10	**C**
NY	0	3	0	3	3	0	0	0	9	**C+**
NC	0	1	2	2	1	3	2	4	15	**D-**
ND	2	1	2	0	0	3	0	0	8	**B-**
OH	0	0	0	3	0	0	0	1	4	**A-**
OK	0	0	0	3	2	1	1	4	11	**C**
OR	0	0	2	0	0	0	0	3	5	**B+**
PA	3	2	1	0	1	3	0	0	10	**C**
RI	0	0	2	3	3	3	3	0	14	**D**
SC	0	0	0	3	0	0	0	0	3	**A**
SD	0	0	2	0	0	3	3	0	8	**B-**
TN	0	0	0	0	0	3	2	1	6	**B**
TX	0	1	2	0	3	0	3	3	12	**C-**
UT	0	0	2	0	0	3	3	0	8	**B-**
VT	0	0	0	3	1	3	0	0	7	**B**
VA	0	0	0	0	0	2	0	0	2	**A**
WA	0	0	2	0	0	1	3	1	7	**B**
WV	0	0	0	3	0	0	0	3	6	**B**
WI	0	2	0	3	0	0	0	3	8	**B-**
WY	0	2	2	0	0	0	0	0	4	**A-**

Barometers of State Tax Administration

Fair, Efficient, Independent Appeals

Foremost in good tax administration is a fair and efficient tax appeals system. A state's ability to recognize the potential for error or bias in its tax department determinations and to provide taxpayers access to an independent appeals tribunal is the most important indicator of the state's treatment of its tax customers.

Today, almost half of the states provide an independent non-judicial appeals process specifically dedicated to hearing tax cases. Although the structure and rules may differ from state to state, taxpayers in these states are able to establish a record for appeal in an independent adjudicative body, before judges well-versed in tax matters. The ability to reach an independent tribunal, non-judicial or judicial, without prepayment is another key factor of a fair and efficient appeals process. Currently, almost two-thirds of states offer this opportunity with a non-judicial forum at a minimum, often with both judicial and non-judicial review. In addition, many tax dispute systems are designed to allow taxpayers and the state adequate opportunity to meet and discuss settlement opportunities before incurring the hazards and costs of litigation.

States without an independent tax tribunal or similar appeals system limit a taxpayer's real ability to challenge a state tax assessment. States that do not offer an independent tribunal are less attractive to businesses and are more likely to see taxpayers avoiding potential problems with the state by engaging in structural tax planning to minimize potential liabilities in the state.

States with fair and efficient tax appeal systems share three essential elements:

- The tax tribunal is independent;
- The tribunal's judges are specifically trained in tax law; and
- Taxpayers are not required to prepay a disputed tax or post a bond in order to receive an independent, impartial hearing.

Independent Tribunals: First, the tax court or tribunal must be truly independent. It must not be located within or report, directly or indirectly, to the department of revenue or to any subordinate executive agency. Without independence, the *appearance* of objectivity is simply not present. That perception, regardless of its accuracy, necessarily detracts from even exemplary personnel and work product of the adjudicative body. Independent tribunals are less likely to be perceived as driven by concerns over revenue collection, upholding departmental policies, or offending departmental decision-makers.

On January 3, 2007, Texas Comptroller Susan Combs transferred responsibility for administrative tax hearings in Texas from the Comptroller's Office to the State Office of Administrative Hearings. In announcing the transfer, Combs said. "It is imperative to move tax hearings out of the Comptroller's office, to remove any appearance of bias and ensure that the integrity of the hearing process is beyond question." It is hoped that the twenty-seven states that lack independent tribunals will follow Texas' lead.

Trained Judges: Second, the tax tribunal's judges must be specifically trained as tax attorneys, and the tribunal should be dedicated solely to deciding tax issues. The tribunal should be structured to accommodate a range of disputes from less complex tax issues, such as those arising from personal income tax matters, to highly complex corporate tax disputes. The tremendous growth and complexity in the body of tax law and the nature of our multi-jurisdictional economy makes this consideration paramount. Judges not trained in tax law are less able to decide complex corporate tax cases on their merit and a perception exists (rightly or wrongly) that the *revenue impact* of these complex cases too often helps guide decision-makers through the fog of complicated tax statutes, regulations, and precedent. That perception reflects poorly on a state's business climate and reputation as a fair and competitive place to do business.

No Prepayment Required: Finally, taxpayers should not be required to post bond or pay a disputed tax before an initial hearing. More than 60% of the states grant taxpayers at least a *de novo* hearing on the validity of the assessment, in front of an independent arbiter, before payment of the tax is required. As a matter of fundamental fairness and due process, taxpayers should have this right in every state. It is unfathomable that taxpayers would be denied a fair hearing before being deprived of property (*i.e.*, disputed taxes). It is inherently inequitable to force a corporate taxpayer to pay a tax assessment, often based on the untested assertions of a single auditor or audit team, without the benefit of a hearing before an independent trier of fact. Free access to an independent hearing without having one's property confiscated by the law is especially important during difficult state economic climates; once tax money is paid into the system, it is often difficult or impossible to wrest a refund from the state, even after disputes are resolved in the taxpayer's favor. There are three degrees of state prepayment requirements.

- **Full "Pay to Play":** Since Massachusetts eliminated its "pay-to-play" requirement several years ago, we are unaware of any state that requires taxpayers to pay an assessed tax upon receipt of a notice of assessment, without an opportunity to contest that assessment before an independent tax tribunal, the tax commissioner, or—at the very least—an administrative hearing officer. Such systems were the scourge of fair tax administration; their elimination represents a significant step forward in fairness.
- **Partial "Pay to Play":** While no state currently requires payment of a disputed tax during the administrative appeals process, some states still require payment of the tax or posting of a bond to obtain access to the circuit court level. In those states, taxpayers are at least granted a hearing before a non-judicial tax tribunal, an administrative hearing officer, or the state tax commissioner before such payment is extracted. The perception of unfairness is more acute in partial pay-to-play states where the initial hearing is before an adjudicatory body that is not independent of the state's department of revenue.
- **No "Pay to Play":** In almost two-thirds of the states, taxpayers may appeal a disputed tax to an independent tribunal for final determination of the issue before having to pay the tax. Some states require payment or a bond for an appeal to the circuit court level in the case of an adverse decision by an independent non-judicial body, or if the taxpayer elects to bypass the non-judicial forum and proceed directly to the circuit court level. These systems are perceived to be the most fair – in large part because taxpayers are not held hostage by the jurisdiction in possession of the taxpayer's funds.

Jeopardy Situations Justify Prepayment: We do not question the necessity of state jeopardy assessment and collection authority. If a state department of revenue feels that a particular tax assessment is in jeopardy based on the facts and circumstances before it, it should certainly issue a jeopardy assessment on that amount. In those circumstances states need the flexibility to move quickly and should do so as long as minimum due process protections are afforded. Such assessments are a legitimate means of protecting the state fisc. However, the jeopardy assessments should *only* be used in extreme circumstances and the burden of proving that the assessment is in jeopardy should fall upon the state. It would be an extremely unusual circumstance for a state to find it necessary to impose a jeopardy assessment on a publicly traded company.

Basic Procedural Provisions Reflecting Good Tax Administration

In addition to an independent tax tribunal accessible without prepayment and a non-judicial forum, states tax administration should include a number of fundamental components necessary to a fair, efficient, and customer-focused state tax system. The following are basic procedural elements that should be included in every state's law:

Even-Handed Statute of Limitations: Statutes of limitation should apply even-handedly to assessments and refund claims. Requiring taxpayers to meet one statute while the tax administrator is granted additional time is unfair and should not be tolerated in a voluntary tax system. A three-year statute of limitations for assessments should be accompanied by a three-year statute of limitation for refund claims. Extension of the statute of limitations for federal adjustments should apply equally for assessments and refunds. Claims for refund based on constitutional challenges should not be singled out for discriminatory treatment by shortening the statute of limitations.

With a single exception—Pennsylvania—COST is pleased to report that all states offer even-handed statutes of limitations for assessments and refunds. Only four states, Kentucky, Michigan, New Hampshire and North Dakota, have adopted provisions which shorten the statute of limitations when the challenge is Constitutional in nature. Each of these states has been assessed two additional points for attempting to curtail taxpayers' rights to challenge unconstitutional deprivations.

Equalized Interest Rates: Interest Rates should apply equally to both assessments and refund claims. Failure to equalize interest rates diminishes the value of the taxpayer's remedy of recovering tax monies to which it is legally entitled. While states are entitled to penalize taxpayers who underreport tax liabilities, the punishment should be imposed through the penalty structure. Interest rates are meant to compensate for the lost time-value of money and should apply equally to both parties. Refunds and liabilities should offset in calculating the amount of interest and penalty due.

The current data shows that two-thirds of the states offer even-handed interest rates. Since COST began doing its Scorecard, states have moved to narrow the difference between interest rates or close the gap altogether; Oklahoma has moved from an extremely large spread to even-handed treatment; the District of Columbia passed legislation narrowing the spread between over and under payments; South Carolina allowed its temporary rate discrimination to lapse.

Protest Periods: The first step in the administrative process in most states is the issuance of an assessment with notification of a right to protest. That protest period should be at least 60 days and preferably 90 days. Shorter protest periods are unreasonable and could jeopardize a taxpayer's ability to fully respond to a proposed assessment. A notice period of 60 days or longer is of increasing importance in a global economy where taxpayers are working to comply with the laws of numerous jurisdictions.

Many states have increased the number of days to submit a protest as compared to prior studies. Even so, twenty five states still offer less than 60 days to file protests. While all of the states now offer at least 30 days to protest, COST hopes to see all states grant at least 60 days.

Extended Due Dates: The state's corporate income tax return due date should be at least 30 days after the federal tax return due date. Further, the state's corporate income tax return due date should be automatically extended by obtaining a federal extension. By extending state due dates to this point, state tax administrators allow taxpayers to file correct returns based on complete federal return information. Although corporate taxpayers often file a single consolidated federal return, the adjustments necessary to generate the multitude of state tax returns required are complex and time-consuming. A minimum of 30 days beyond the extended federal due date is needed to complete these adjustments; 60 or more days is preferred. To ease administrative burdens, an automatic state extension should only require attaching a copy of the federally extended return with the state return to qualify.

Twenty-five states do not give taxpayers the recommended 30 additional days to complete their state returns after the federal due date. All but 13 states automatically grant an extension of the state due date upon obtaining a federal extension.

Other Significant Procedural Issues

New to the 2007 Scorecard is an opportunity for each state to earn extra demerits – the "key additional issues" column. In preparing the Scorecard we surveyed tax practitioners asking them to identify key additional issues that impact fair and efficient tax administration in the state. In past editions of the Scorecard we discussed many of these issues but did not affirmatively adjust state scores on the basis of these practices. This Scorecard attempts to assign points to the states identified as having negative practices; the adjustments are identified in the state by state point chart at the end of the Scorecard. Some of the noteworthy adjustments were made based on the following practices: independent local revenue departments which create disconformity and complexity; use of outside paid counsel to litigate tax matters (sometimes fees for these counsel are billed through to taxpayers); federal RAR adjustments open the entire state return to audit; imposition of retroactive penalty and interest provisions. States should guard against utilizing these unfair and burdensome practices.

Detailed Survey Data

The table beginning on page x provides detailed survey data for each state. At least one practitioner from each state and the Department of Revenue of each state were asked to review and offer corrections to the data. Where received, responses were integrated into the chart as appropriate to reflect the current status of the law in each state. COST extends its gratitude to those practitioners and DOR employees who assisted in compiling the data necessary for this study. Note that certain exceptions to the general rules stated do exist, but were not included. Further, we were not always able to reconcile the responses by in-state practitioners with the responses by the DOR; this demonstrates the lack of clarity surrounding some of the issues. Accordingly, this document is not intended to be used as a comprehensive listing of legal authority for the issues identified, and taxpayers are cautioned to research individual state laws.

Survey Questions for Practitioners and Administrators

1. Does the state provide even-handed statutes of limitation on over and underpayments of income and sales/use tax?
2. Does the state provide equal interest on refunds and assessments of income tax?
3. Within what time period must taxpayers file a protest after receiving a notice of assessment from the department of revenue?
4. Is the state's corporate income tax return due date at least 30 days after the Federal corporation income tax due date?
5. Does the six-month Federal extension for corporate income tax returns automatically extend the State due date for six months?
6. Does the state provide a non-judicial tax dispute forum (where the record for appeal is set) that is independent of the state DOR?
7. Are taxpayers required to prepay assessed amounts prior to an independent hearing in your state?
8. List any key additional issues that impact fair and efficient tax administration in your state.

COST Survey of Administrative Practices & Appeal Requirements

	Even-handed statutes of limitations (refunds and assessments)	**Interest rates on assessments and refunds**	**Number of days to protest an assessment**	**State return due at least 30 days after Federal return?**	**Federal extension automatically extends state due date**	**State provides independent, non-judicial tax dispute forum**	**Payment or bond required before independent hearing**	**Key additional issues impacting fair and efficient tax administration**
AL	3 years both *Assessment* Ala. Code §40-2A-7(b)(2). *Refund* Ala. Code §40-2A-7(c)(2).	Federal underpayment rate, equally applied. *Underpayment* Ala. Code § 40-1-44(a) *Overpayment* Ala. Code § 40-1-44(b).	30 days. §40-2A-7(b)(4).	No. Ala. Code §40-18-39.	Yes. Administrative Rule 810-3-39-.02 Tax Form 20-E Instructions.	No, Admin. Law Judge only. Ala. Code §40-2A-7, 9.	Yes, unless TP can show net worth ≤ $20,000. Ala. Code §40-2A-7	1) Independent local revenue departments create disconformity and complex interpretive and compliance burdens for taxpayers. 2) Department is using outside counsel to challenge pending refund claims after losing *South Central Bell* at US Supreme Court.
AK	3 years both *Assessment* AK. Stat. §43.05.260(a). *Refund* AK. Stat. §43.05.275(a)(1)(A).	Greater of Fed. Reserve Rate plus 5%, or 11%, equally applied. *Underpayment* Alaska Stat. § 43.05.225(1) *Overpayment* Alaska Stat. §43.05.280(a), §43.05.225(1).	60 Days §43.05.240 (a).	Yes. TP permitted to file return within 30 days after federal return due. §43.20.030(a) tax is due and payable at the same time payable to the fed gov't. 43.20.030(d)	If tax is due, no. Tax return, yes. See Instructions 04-611.	Yes. The Office of Admin. Hearings. Ak. Stat. 43.05.405 et seq (as amended and effective July 1, 2005	No. Tax is not required to be paid to appeal to the Office of Admin. Hearings. It must be paid, or a bond posted, to appeal to court. Ak. Stat 43.05.480	Federal RAR opens entire state return to audit. §43.20.030(d).
AZ	4 years both *Assessment* A.R.S. §42-1104(A). *Refund* A.R.S. §§42.1106(A). and 42-1104(A).	Fed. Short Term Rate Plus 3%, Equally Applied. A.R.S. §42-1123(A).	Yes. 90 days from date of mailing for income tax protests; 45 days from receipt of notice to	Yes. Ariz. Rev. Stat. Ann. §43-325.	Yes. A.R.S. § 42-1107.B if the 90% payment requirement is met.	Yes. A.R.S. §42-1252, 1253.[3]	No.[4]	1) Taxpayers that receive sales tax refunds do not have to return them to their customers. Ariz. *Dep't of Rev. v. Canyoneers*, 200 Ariz. 139, 23 P.3d 684 (Ct. App. 2001). Refunds may

	Even-handed statutes of limitations (refunds and assessments)	Interest rates on assessments and refunds	Number of days to protest an assessment	State return due at least 30 days after Federal return?	Federal extension automatically extends state due date	State provides independent, non-judicial tax dispute forum	Payment or bond required before independent hearing	Key additional issues impacting fair and efficient tax administration
			taxpayer for all other tax protests. §42-1108(B)					be issued as credits or vouchers. A.R.S. § 42-1118.A. 2) Judges of the Arizona Tax Court are regular Superior Court judges with no tax background, and are regularly rotated out of the Court and replaced every three to four years. The Arizona courts rarely see sophisticated income tax cases.
AR	3 years both *Assessment* A.C.A. §26-18-306(a). *Refund* A.C.A. § 26-18-306(i).	10%, equally applied *Underpayment* A.C.A. § 26-18-508(1) *Overpayment* A.C.A. § 26-18-508 (3).	30 days. §26-18-404(c).	No. ACA 26-51-806 (a)(3); See Form AR1100 CT instructions	Yes. ACA §26-51-807(a).	No. A.C.A. §26-18-405.	Yes.[5]	
CA	4 years both *Assessment* Cal. Rev. & Tax Code §19057(a), 19067(a), 19065. *Refund* Cal. Rev. & Tax Code §19306(a0, 19308.	*Underpayment* Federal underpayment from I.R.C. § 6621(a)(2) applies. Cal. Rev. & Tax Code §§ 19101(a) & 19521(a). *Overpayment* rate is modified to lesser of 5% or bond equivalent rate of	60 days for income tax. § 19041. 30 days for sales/ use. § 6561.	No. See Form 100 instructions.	7 months. See Form 100 instructions.	CA does provide a non-judicial tax dispute forum for corporation franchise and income taxes (i.e. the State Board of Equalization) that is independent of the Franchise Tax Board.[6] Cal. Rev. & Tax. Code §	Not before SBE hearing. However, Taxpayer must pay tax & file refund claim prior to de novo review at Superior Court.	CA imposed retroactive penalties and interest under their recent Voluntary Compliance Initiative with limited rights of appeal.

	Even-handed statutes of limitations (refunds and assessments)	Interest rates on assessments and refunds	Number of days to protest an assessment	State return due at least 30 days after Federal return?	Federal extension automatically extends state due date	State provides independent, non-judicial tax dispute forum	Payment or bond required before independent hearing	Key additional issues impacting fair and efficient tax administration
		13-week treasury bills. §19521(a)(1) (A), (B), (C).				19045, et seq. Sales/use tax issues are administered and appealed before the SBE.		
CO	4 years both *Assessment* Corporate 4 years C.R.S. §39.21-107(2). All other taxes 3 years C.R.S. §39-21-107(1). *Refund* Corporate 4 years C.R.S. §39-21-108(1). All other taxes 3 years C.R.S. §39-21-108(1).	Prime Rate plus 3%, equally applied *Underpayment* C.R.S. § 39-21-109 / § 39-21-110.5 *Overpayment* C.R.S. § 39-21-110 / § 39-21-110.5 C.R.S. 39-21-110.5(2).	30 days. §39-21-105(1).	Yes. See Form 112 instructions	Yes. See Form 112 instructions.	No. Colo. Rev. Stat.§ 39-21-103 to 39-21-105.	Yes. Colo. Rev. Stat. § 39-21-105 (4)	Local jurisdictions use private attorneys to prosecute tax cases.
CT	3 years both Conn. Gen. Stat. §§12-225, 12-226 and 12-233 for business tax. Conn. Gen. Stat. §§12-415 and 12-425 for sales/use tax.	*Underpayment* 1% per month § 12-235 *Overpayment* .66% per month C.G.S.A. § 12-227 Interest on underpayment runs from due date of return. Interest on overpayment only runs from claim for refund filed.	60 days. §12-418	No. First day of the month next succeeding the due date of the Federal return. Conn. Gen. Stat § 12-222(b)	No. Conn. Gen. Stat. §12-222; See Form CT-1120 instructions.	No.	No. Taxpayer "may make" payment. Conn. Gen. Stat 12-39m	1) Federal RAR opens entire state return to audit. §12-727. 2) There is no time limit set for CT to act on a refund request.

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DE	3 years both *Assessment* 30 Del. Code §531. *Refund* 30 Del. Code §539.	1% per month, equally applied *Underpayment* § 533(a) *Overpayment* § 540(a).	60 days. §1904	No. First day of fourth month. See Delaware Form 1100 instructions. See 30 Del. C. § 1904(b)	Yes. See Delaware Form 1100 instructions.	Yes. The Delaware Tax Appeal Board. 30 Del. Code § 544, see also 30 Del. S. § 321 *et seq.*	No. 30 Del. C. § 544	DOR has used private attorneys to prosecute tax cases.
DC	3 years both *Assessment* DC Code §47-4301(a). *Refund* §47-4304(a).	*Underpayment* 13% per year, simple interest (after 1/1/03, 10% per year com-pounded daily). § 47-4201 *Overpayment* 6% per year, simple interest § 47-4202.	30 days. §47-3303.	No. See Form D-20 instructions	No. See Form D-20 instructions.	Yes. New Office of Admin. Hearings (hears both tax and non-tax cases). DC Code 2-183, et seq.	No, if appeal is to Office of Admin. Hearings. Yes, if taxpayer chooses to appeal to DC Superior Court.	
FL	3 years both *Assessment* Fla. Stat. §220.705/§95.091 (3). *Refund* Fla. Stat. §220.727/§215.26 (2).	Prime Rate + 4% not to exceed 12% equally applied *Underpayment* §§ 220.809 & 220.807 *Overpayment* F.S.A. §§ 220.723 & 220.807 213.255.	60 days. §72.011.	No. First day of 4^{th} month. Fla. Stat. 220.222(1)	Yes. Fla. Stat. § 220.222(2) Taxpayer must file form F-7004 to obtain the extension.	No. F.S.A. §§ 213.015, 213.21 & 213.731	No.[7] § 72.011.	1) Taxpayers seeking direct appeal from informal determination must do so within 30 days and are limited to the record appealed from. 2) The ALJ in formal administrative litigation may "fast-track" the final hearing on 14 days' notice.
GA	3 years both *Assessment* Ga. Code Ann. §48-2-49(b). *Refund* Ga. Code. Ann. §48-2-35(b)(1).	1% per month, equally applied *Underpayment* §§ 48-2-48 & 48-2-40 *Overpayment* § 48-2-35(a).	30 days. §48-2-45.	No. See form IT 611 instructions and O.C.G.A. §48-7-56	Yes. GA Code Ann. § 48-7-57 (d); Revenue Rule 560-7-8-.08.	No. Ga. Code Ann. §§ 48-2-46 to 48-2-50, & 48-2-59.[8]	No.[9]	Taxpayers may not directly appeal to Court of Appeals; must first file application for discretionary appeal seeking permission to file.

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HI	3 years both *Assessment* H.R.S. §235-111(a). *Refund* §235-111(b)	2/3 of 1% per month, equally applied *Overpayment* § 231-39(b)(4)(A) *Underpayment* § 231-23(d)(1).	30 days. §235-114.	Yes. Form N-30 instructions.	Yes. Form N-30 instructions.	Yes. H.R.S. §§ 232-8 through § 232-13. Proviso: Appeal from BOR to tax appeal court is de novo.	No. H.R.S. § 235-114 [eff 7-1-06]	
ID	3 years both *Assessment* Idaho Code §63-3068(a); Sales Tax 63-3633(a). *Refund* Idaho Code §63-3072(b); Sales Tax §63-3626(b).	Same as federal Mid-Term Rate plus 2%, equally applied *Underpayment* § 63-3045(6)(c) *Overpayment* § 63-3073 / § 63-3045(6)(c).	63 days. §63-3045(1).	Yes. Idaho Code §63-3032 and 63-3085	Yes. Idaho Code §63-3033. Idaho allows an automatic 6-month extension.	Yes. Idaho Code §§ 63-3801 through 63-3820.	Yes. 20% of the amount asserted. Idaho Code §63-3049 [eff. 7-01-05]	If Idaho taxable income or credits are adjusted as a result of a final federal determination, and the limitations period is less than one year, the limitations period is extended to one year from the date the IRS delivered the final notice to the taxpayer. Idaho Code 63-3072.
IL	3 years both *Assessment* 35 Ill. Comp. Stat. §5/905(1). *Refund* 35 Ill. Comp. Stat. §5/911(1).	Fed. Underpayment Rate, adjusted semiannually, equally applied *Underpayment* 35 ILCS §§ 5/1003(a) & 735/3-2. *Overpayment* 35 ILCS §§ 5/909(c) & 735/3-2.	60 days. 35 ILCS 5/ 908.	No. ILCS § 5/505(1) 35 ILCS §5/505(a)(i)	Yes. The extension is 6 mos. Plus 1 additional month 35 ILCS 5/505 (L).	No. 35 Ill. Comp. Stat. §§ 5/908 through 5/918, & § 5/1201	No. ILCS § 5/3-103	Cumbersome Administrative Hearing process. Taxpayers are subject to discovery although rules of evidence do not apply. Appeal to Circuit Court is not de novo, but on the record made at the Administrative Hearing.
IN	3 years both *Assessment* Ind. Code §6-8.1-5-2(a). *Refund* Ind. Code §6-8.1-9-	*Underpayment* Average investment yield on state money plus 2%. IC 6-8.1-10-1(c)	60 days. §6-8.1-5-1.	Yes. Compare IC 6-3-4-3 (15th day of fourth month following the close of the	Yes. IC 6-8.1-6-1(c).	Appeals from adverse findings from the DOR's informal conference may be	No.	1) Federal RAR opens entire state return to audit. § 6-3-4-6. 2) Administrative

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	1(a)(1).	*Overpayment* Average investment yield on state money. IC 6-8.1-9-2(c); IC 6-8.1-10-1(c).		tax year); I.R.C. §06072(b) (15th day of the third month.)		brought before the Indiana Tax Court de novo. See Ind. Code §6-8.1-5-1(g) and (h) and Ind. Code §6-8.1-9-1(c) and (d).		hearings for refund denials are at DOR discretion. Additionally, certain appellate rights are different in refund cases. See IC 6-8.1-9-1. 3) Special time limitations are imposed on taxpayers who wish to either petition to commence filing combined (unitary) returns or to stop filing combined (unitary) returns. See Ind. Code §6-3-2-2(q), as amended by the Indiana General Assembly in 2006 (House Enrolled Act 1001). Similar time periods are not imposed upon the Department of Revenue.
IA	3 years both *Assessment* Iowa Code §422.39, 422.25, 423.37. *Refund* Iowa Code §423.37 and 423.47.	Average Prime Rate (previous 12-month period) plus 2%, equally applied *Underpayment* §§ 422.39, 422.24, & 421.7 and 423.40(1) *Overpayment* 421.7/ 422.28/422.41/422.39/422.25(3) and 421.60(2)(e).	60 days. §§422.28, 422.41 and Iowa Regs. §701-55.5.	Yes. Iowa Code 422.21	Yes. Form IA 1120 instructions; Taxpayer must pay 90% of correct tax by due date.	An ALJ of the Admin. Hearings Division of the Department of Inspections and Appeals conducts evidentiary hearings, unless the Director of Revenue retains jurisdiction. Dept. rule 701-7.50(1)	No. Iowa Code § 17A.19 and § 421.1; 422.28; 423.47	
KS	3 years both *Assessment*	Fed. Underpayment Rate plus 1%,	60 days. §79-3226.	Yes. Form K-120 instructions.	Yes. Form K-120 instructions.	Yes. Kan. Stat. Ann. 79-3233g.	Board of Tax Appeals -- no.	1) Concerns have been expressed about the lack

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	K.S.A. §79-3230(a). *Refund* K.S.A. §79-3230(c).	equally applied *Underpayment* K.S.A. §§ 79-3228(a) & 79-2968 *Overpayment* K.S.A. §§ 79-32,105(e) & 79-2968.					K.S.A. §74-2433; K.S.A. §74-2426 (d)	of specific state tax experience required for arbiters serving on the Kansas Board of Tax Appeals. 2) DOR doesn't pay interest on refunds paid within 60 days; Also, interest is calculated from the date the amended return is filed, and not the date of overpayment.
KY	4 years both *Assessment* K.R.S. §141.210(2). *Refund* K.R.S. §134.580(4). Statute is shorter if challenge is Constitutional KRS 134.590	Adjusted Prime Rate, equally applied. *Underpayment* K.R.S.§ 131.183(1) *Overpayment* K.R.S. § 131.183(2)	45 days. §131.110(1) & 131.081(11); 103 KAR 1:010.	Yes. KRS 141.160 and 141.220	Yes. Form 720 SL instructions.	Yes. Ky. Rev. Stat. Ann. §§ 131.310 thru 131.370.	No. Ky Admin Reg 1:010 Section 4	DOR is using private attorneys to prosecute tax cases.
LA	3 years both *Assessment* La. Cont. Art. 7, §16; La. R.S. 47:1579 and 1581 based on LA Cont. Art. VII § 16. *Refund* La. R.S. 47:1623.	*Underpayment* 1 1/4 % per month La. R.S. 47:1601(A) *Overpayment* Discount Rate plus 3 1/4% per year La. R.S. 47:1624(A) La. C.C. Art. 2924(B)(1) La. R.S. 13:4202(B) R.S. 47:1601(2)(a).	15 calendar days from notice if no return filed; 30 days from notice if incorrect form filed. §47:1563.	Yes. La. R.S. 47:287.614 and 47:609	Yes. La. R. S. 47:614(D) and 47:612.	Yes. La. R.S. 47:1401 to 1486; however, the La. DOR has some control over whether a taxpayer can appeal to the BTA. See La. R.S. 47:1431 (formal assessment required).	Yes.[10] §§47:1401 to 1486.	1) Numerous separate local taxing authorities (Parishes), create disconformity and complex interpretive and compliance burdens for taxpayers. 2) Local jurisdictions use outside counsel to prosecute tax cases

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								3) Taxpayers are liable for outside counsel's attorney fees up to 10% of amount collected.
ME	3 years both *Assessment* 36 M.R.S.A. §141(1). *Refund* 36 M.R.S.A. §5278(1).	Prime plus 3 %, equally applied. *Underpayment* 36 M.R.S.A. §186. *Overpayments*36 M.R.S.A. §5279(1) & 186.	30 days. §151.	Yes. 36 M.R.S.A. §151.	Yes. Automatic, Fed + 30 36 M.R.S. § 5231.1-A.	No. 36 M.R.S.A. §§5301 and 151.	No.	Although appeal to Superior Court is de novo, the AG's office argues taxpayers are precluded from raising issues not heard at the informal conference level.
MD	3 years both *Assessment* Md. Code Ann. Tax – Gen. § 13-1101(a). *Refund* §§ 13-903 and 1103(a).	Greater of 13% or Average Prime Rate plus 3% per year, equally applied.	30 days. §13-508, §13-1104	No. Form 500 instructions	Yes. HB 1434, effective July 1, 2006, if the Comptroller finds that good cause exists and subject to §13-601, the Comptroller may extend the time to file a tax return up to 7 months for a corporation. Otherwise the Form 500E Instructions had set the extension at 6 months.	Yes. Md. Code Ann. Tax – Gen. §§ 3-101 to 3-113	No. Md. Code Ann. Tax – Gen. § 13-510	
MA	3 years both *Assessment* M.G.L.A. 62C §26(b). *Refund* M.G.L.A. 62C §37.	Underpayment federal ST rate plus 4%; overpayments: federal ST rate plus 2%. L.L. c. 62C, s.32, 40.	60 days. §§37& 39.	No. Form 355 instructions.	No. Form 355 instructions.	Yes. M.G.L.A. 58A §§1-14 Appellate Tax Board.	No. Mass. Gen L § 32 G.L.C. 62C § 32	S of L for refunds is 3 years from the un-extended due date of the return; for assessments, it is 3 years from the extended due date.
MI	4 years Both *Assessment* MCL	Prime plus 1% equally applied	35 days. §205.22.	Yes. MCL 208.73(4).[12]	Yes -- period of federal extension	Yes.[13] MCL 205.21, 205.22.	No.[14] MCL 205.22.	Refunds must be requested explicitly on the

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	§ 205.27a(2) *Refund* MCL § 205.30(2), §205.27a(2), 209.27a(2) Statute is shorter if challenge is Constitutional MCL 205.27a(6).	*Underpayment* MCL § 205.23(2) *Overpayment* MCL § 205.30(3) / § 205.23(2) MCL 205.23(2). But see special rules for refund claims[11]			plus 60 days -- MCL 208.73(4) "automatic" with filing of required forms by due date.			face of a return or in a separate request or correspondence in order to commence the refund payment process. Interest on a refund begins to run forty-five days after the refund is requested.
MN	3 1/2 Years Both *Assessment* Minn. Stat. § 289A.38 *Refund* Minn. Stat. § 289A.40	6% per annum, equally applied. *Underpayment* Minn. Stat. §§ 289A.55; § 270C.40 *Overpayment* Minn. Stat. §§ 289A.56, 270.76; § 270C.405.	60 days. §289A.65.	No. Form M4/Minn. Stat. §289A.18	Yes. Automatic 7 months extension whether Fed 7004 filed or not. Form M4 Taxpayers are not required to file a form for an extension but must pay 90% of the tax due by the original due date. Form M4/Minn.Stat. §289A.19.	Yes. Minn. Stat. Ann. 271.01 to 271.21	No.	1) Refund interest differential on purchaser refund claims compared to vendor refund claims (sales tax). 2) Refunds payable in installments where aggregate refunds exceed $50 million. Minn. Stat. §270C.43 3) Penalty abatement procedure resides in the Collections Division rather than the Appeals Division; no independent appeal review. 4) RAR opens entire return to audit unless return has already been subject to field audit.
MS	3 Years Both *Assessment*	1% per month, equally applied	30 days. §27-77-5	No. Form 83-100 instructions.	Yes. Instructions say "commissioner	No.	Yes. 2005 Miss. Laws Ch. 499	

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	Income Miss. Code Ann. § 27-7-49(1) *Refund* Income Miss. Code Ann. § 27-7-313 Sales 27-65-42	*Underpayment* Miss. Code Ann. § 27-7-51(2) *Overpayment* Miss. Code Ann. § 27-7-51(2) / § 27-7-315.	§27-7-71(1)		may recognize time authorized by IRS for filing of annual income tax returns" Form 83-100 instructions.		(S.B. 2742)	
MO	3 Years Both *Assessment* R.S.Mo. § 143.711(1) *Refund* R.S.Mo. § 143.801(1).	Adjusted Prime Rate equally applied *Underpayment* R.S.Mo. § 143.731(1) / § 32.065 *Overpayment* R.S.Mo. § 143.811(1) / § 32.065	60 days. §143.631. Upon appeal to the Admin. Hearing Cmsn, only 30 days to appeal. §621.052.	Yes. Mo Rev. Stat § 143.511	Yes. Form MO-1120 instructions.	Yes. Mo. Rev. Stat. 621.015 to 621.205 The Admin. Hearing Commission is under a different state department. Comm'rs are appointed by Governor for terms of 6 years.	No. Mo. Rev. Stat. § 621.050	1) DOR argues that sales & use taxes are different taxes and if offset during audit, tolls the statute of limitations for the offset tax. 2) New issues to support claims for refunds may not be raised at the AHC. 3) The state does not allow the payment of refunds attributable to the carryback of income tax credits filed on amended returns. See L. 2002, S1248, effective 6-19-2002.
MT	3 Years Both Corporate: *Assessments* Montana Code Ann. §15-31-509(1); M.C.A. § 15-30-146. *Refunds* M.C.A. §§15-31-509(2);	1% per month, equally applied *Underpayment* Mont. Code Ann. § 15-31-503 / § 15-1-216 *Overpayment* Mont. Code Ann. § 15-31-531 /	30 days. §15-1-211.	Yes. Form CLT-4 Instructions	Automatic whether Federal 7004 filed or not; 11/15 is furthest extension Mont. Code Ann. § 15-31-111(3).	Yes. Mont. Code Ann. 15-2-101 to 15-2-307	No. Mont. Code Ann. § 2-4-702	

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	15-30-149.	§ 15-31-503 / § 15-1-216.						
NE	3 Years Both *Assessment* Income Tax Neb. Rev. Stat. § 77-2786 Sales Tax Section 77-2709 *Refund* Income Tax Neb. Rev. Stat. § 77-2793 Sales Tax-Section 77-2708	Fed. ST Rate plus 3%, equally applied *Underpayment* Neb. Rev. Stat. §§ 77-2788(1) & 77-2709(3) & 45-104.02(2) *Overpayment* Neb. Rev. Stat. §§ 77-2794(1) & 45-104.02(2).	90 days for income tax, 30 days for sales/use and withholding tax. §77-2777.	No. Form 1120 instructions and Section 77-2768. 15th day of the 3rd month following the close of the tax year.	Yes. Form 1120 instructions and Section 77-2770.	No. Neb. Rev. Stat. §§ 77-27,127	No. Neb. Rev. Stat § 77-2798	
NV	3 Years Both *Assessment* Nev. Rev. Stat. Ann. § 360.355 *Refund* Nev. Rev. Stat. Ann. § 372.635 See also NRS 374.640 for refunds.	*Underpayment* 12% per annum *Overpayment* 6% per annum Nev. Rev. Stat. Ann. § 372.660 See also NRS 374.665 with regard to overpayments.	45 days. §360.360	N/A	N/A	No. Nev. Admin. Code 360.185	Yes. Taxpayers must prepay or enter a payment agreement. See NRS 360.395	
NH	3 Years Both *Assessment* N.H. Rev. Stat. § 21-J:29(I)(a) *Refund* N.H. Rev. Stat. § 21-J:29(I)(b). Statute is shorter if challenge is Constitutional. RSA 21-J:29-I(d).	*Underpayment* Fed. Underpayment Rate plus 2% N.H. Rev. Stat. § 21-J:28(II) *Overpayment* Fed. Underpayment Rate less 3% N.H. Rev. Stat. § 21-J:28(III)	60 days. §21-J:28-b.	No. General instructions for filing business tax return. RSA 77-A:6(I)	Yes. Automatic 7 months whether Federal 7004 filed or not. See NH General Instructions for filing Business Tax -- but must have paid 100% of tax due.	Yes. N.H. Admin. Rules, Tax 102.01; N.H.R.S. § 71-B:1 through B:22; RSA 21:J(3)-XVII Rev 204. Taxpayer option to appeal administrative decisions to Board of Tax and Land Appeals (non-Judicial) or	Generally no. May be required to post bond if department makes a request based on risk of non-payment RSA § 21-J:28-b, V but is unusual.	DOR is asserting that "failure to pay" penalties apply on amounts assessed based on interpretive differences as well as on amounts paid on the original return.

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						Superior Court.		
NJ	4 Years Both *Assessment* N.J. Stat. Ann. § 54:49-6(b). *Refund* N.J. Stat. Ann. § 54:49-14(a).	*Underpayment* Prime Rate plus 3% N.J.S.A. § 54:49-3 *Overpayment* N.J.S.A. § 54:49-15.1 [prime rate]	90 days. §54:49-18(2).	Form CBT-100 instructions. Yes. N.J.S.A. 54:10A-15.	No. N.J.S.A. 54:10A-19, N.J.A.C. 18:7-11.12 Must use Form CBT-200T.	New Jersey tax Court provides independent tax dispute forum.	No, but taxpayer may be required to post bond for contested amount	
NM	3 Years Both *Assessment* N.M.S.A. § 7-1-18(A) *Refund* N.M.S.A. § 7-1-26(D)(1).	15% per year, equally applied *Underpayment* N.M.S.A. § 7-1-67(B) *Overpayment* N.M.S.A. § 7-1-68(B). Interest runs from date of claim for refund, not date of overpayment.	30 days. §7-1-24.	No. NMSA 1978, §7-2A-9; Form CIT-1 instructions	Yes. Form CIT-1 instructions. NMSA 1978, § 7-1-13.	No. NMSA 7-1-1 to 7-1-82 There is no prepayment remedy in a non-judicial forum independent of the department.	No. Taxpayer can challenge assessment without paying tax or pay and claim refund. NMSA 1978, §7-1-23 but see 7-1-26(d)	The dept will not offset an overpayment in an open period for assessment against an underpayment for a different open period on the theory that the SOL for claiming a refund on overpayments is closed.
NY	3 Years Both *Assessment* Corporate Franchise Tax §1083(a) Sales/Use Tax § 1147(b) *Refund* Corporate Franchise Tax § 1087(a) Sales/Use Tax § 1139(a),(c).	*Underpayment* Fed. ST Rate plus 5% N.Y. Tax Law §§ 1084 (a) and 1096(e)(2)(B). *Overpayment* Fed. ST Rate plus 2% N.Y. Tax Law §§1088(a) and 1096(e)(2)(A).	90 days §1138(a)(1).	No. Form CT-4 instructions	No. A separate extension form must be filed for New York. (Forms may be obtained on the Department of Taxation and Finance's website.) N.Y. Tax Law §§ 193,0211,1462 and 1515.	Yes. The New York State Division of Tax Appeals and the Tax Appeals Tribunal. N.Y. Tax Law §§ 2000-2026.	No. N.Y. Tax Law 2006	
NC	3 Years Both *Assessment* N.C. Gen. Stat. § 105-241.1(e) *Refund*	The interest rate, set by the Secretary twice a year (min.5%/max. 16% per year), is applied	30 days. §105-241.1(c).	No. N.C. Gen. Stat §105-130.17	No, a taxpayer must submit a request for an extension to the DOR by the due	No. The record on appeal is not set at the Tax Review Board, which hears appeals of	Yes. GS 105-267. DS. 105-241.3 allows filing of a bond in lieu of	Federal RAR opens entire state return to audit. §105-130.20. Lengthy and cumbersome

	Even-handed statutes of limitations (refunds and assessments)	Interest rates on assessments and refunds	Number of days to protest an assessment	State return due at least 30 days after Federal return?	Federal extension automatically extends state due date	State provides independent, non-judicial tax dispute forum	Payment or bond required before independent hearing	Key additional issues impacting fair and efficient tax administration
	N.C. Gen. Stat. § 105-266(c)(1).	equally.[15] *Underpayment* N.C. Gen. Stat § 105-241.1(i) *Overpayment* N.C. Gen. Stat § 105-266(b).			date of the return. Extension is automatic if timely requested and gives the taxpayer seven add'l months to timely file the return. N.C. Gen. Stat § 105-130.17 (d); N.C. Gen. Stat § 105-263.	the Secretary's decisions based on the record established at a Department of Revenue hearing.	payment of tax in order to obtain judicial review of the Tax Review Board's administrative review of the Secretary's decision.	administrative refund claim process. GS 105-266.1
ND	3 Years Both *Assessment* N.D. Cent. Code § 57-38-38 *Refund* N.D. Cent. Code § 57-38-40 Statute is shorter if challenge is Constitutional. N.D.C.C. § 57-01-19.	Income Taxes: 1% per month, equally applied *Underpayment* N.D. Cent. Code § 57-38-45(1)(d) *Overpayment* N.D. Cent. Code § 57-38-35.2(1) Sale/Use Taxes: *Assessments*: 12% per annum; N.D.C.C. § 57-39.2-15 *Refunds:* 10% per annum on refunds. N.D.C.C. § 57-39.2-24	30 days. N.D. Cent Code §57-38-39.	Yes. Form 40 instructions	Yes. Form 40 instructions.	No. The Office of Administra-tive Hearings is an independent tribunal that conducts the hearings in tax disputes. The ALJ issues Proposed Findings of Fact and Conclusions of Law, which may or may not be adopted by the Tax Commissioner, N.D.C.C. ch. 28-32, and 57-38-39 to 57-38-40.	No.	
OH	4 Years Both *Assessment* O.R.C. § 5747.13(A *Refund*	Fed. ST Rate plus 3%, equally applied *Underpayment* ORC. §§ 5747.13(C)	Franchise tax: 60 days. R.C. 5733.11 Sales tax:	No. Form 1120 instructions.	Yes. Form FT 1120-E instructions.	Yes. Ohio Rev. Code Ann. 5717.01 to 5717.06.	No. Ohio Rev. Code Ann. §5717.02	Taxpayer may not raise new issues in an appeal from a final determination of the Tax Commissioner R.C. 5717.02

	Even-handed statutes of limitations (refunds and assessments)	Interest rates on assessments and refunds	Number of days to protest an assessment	State return due at least 30 days after Federal return?	Federal extension automatically extends state due date	State provides independent, non-judicial tax dispute forum	Payment or bond required before independent hearing	Key additional issues impacting fair and efficient tax administration
	O.R.C. § 5747.11(B).	& 5703.47 *Overpayment* ORC. §§ 5747.11(C) & 5703.47	60 Days R.C. 5703-9-45					
OK	3 Years Both *Assessment* 68 Okl. St. § 223(A) *Refund* 68 Okl. St. § 2373.	*Underpayment* 1 1/4% per month 68 Okl. St. § 217(A) *Overpayment* 1-1/4% per month 68 Okl. St. § 217(H).	60 days. §221.	No. Form 512 instructions	Yes. Form 512 instructions. (Must file Oklahoma form)	No. Okla. Stat. Ann. tit. 68, §§ 101-102, 201-203, 207, 225-228 But the Tax Commission does offer a non-judicial dispute forum statutorily and functionally separate from the audit functions of the Commission.	As of July 1, 2002, prepayment no longer required, but Tax Commission may "request" Okla. Stat. 68 §225(D)	1) Federal RAR opens entire state return to audit. §2375(H). 2) The section of the Uniform Tax Procedure Code authorizing filing of a claim for refund and payment of a refund of tax provides that it does not apply to refunds of income tax erroneously paid. 68 O.S. 2001, § 227(f)(1).
OR	3 Years Both *Assessment* ORS § 314.410(1) *Refund* 3 years after return filed or 2 years after tax or portion of tax paid, whichever is later ORS § 314.415(2)(a).	Equally applied Rates are different for different tax periods. As of 1-1-06 rate is 7% simple per year. *Underpayment* ORS § 305.220(1) *Overpayment* ORS § 305.220(2).	30 days for informal conference at DOR; 90 days to Magistrate Division. §305.265(5).	Yes. Form 20 instructions.	Yes. Form 20 instructions. ORS §314.385(1)(c)	Yes. The record is not created in the State DOR, it is first created in the regular division of the court. ORS 305.425.	No. Tax is not due in the magistrate division. ORS § 305.419(1). Another exception to the prepayment requirement exists for hardship 305.419(3).	Federal RAR opens entire state return to audit. ORS §314.140, 314.380.
PA	*Inc./Franchise Assessment* Req. within 18 mos: resettlement within 3 yrs 72 P.S. § 7407; Sales	No. *Underpayment* the Federal Underpayment rate is used. *Overpayment* the Federal	90 days from date of settlement notice for corporate (§1102) and	Yes. Form CT-1 instructions	Yes, provided the taxpayer files a request with PA to get 30 days after the Federal extended due date.	No. Both the Governor and the Business Tax Reform Commission have recommended the	No, however security is required to stay collection action. Pa. R.A.P. 1731, 1782.	

	Even-handed statutes of limitations (refunds and assessments)	Interest rates on assessments and refunds	Number of days to protest an assessment	State return due at least 30 days after Federal return?	Federal extension automatically extends state due date	State provides independent, non-judicial tax dispute forum	Payment or bond required before independent hearing	Key additional issues impacting fair and efficient tax administration
	Tax 3 yrs plus current yr. *Inc/Franchise Refund* Req. within 6 mos of pymt on account of audit assessment or settlement; otherwise within 3 Yrs from payment 72 P.S. § 10003.1(a); Sales Tax 3 yrs plus current year	Underpayment rate minus 2% is used. 72 P.S. §806.	individual (§§1103 and 7340). 30 days for sales/use tax (§7232).		72 P.S. § 7405.	establishment of a non-judicial tax dispute forum.	(Appellants allegedly do not have to incur the cost of a bond.)	
RI	3 Years Both *Assessment* Corporate Tax: R.I. Gen. Laws § 44-11-7.1(a); Sales Tax: 44-19-13 *Refund* Corporate Tax: R.I. Gen. Laws § 44-11-20(a); Sales Tax: 44-19-26.	Prime Rate plus 2%, equally applied *Underpayment* R.I. Gen. Laws §44-11-7/§44-1-7 *Overpayment* R.I. Gen. Laws §44-1-7.1/§44-1-7.	30 days. R.I. Gen. laws §44-30-89; §8-8-25.	No. Form RI 1120C instructions. The due date is set forth in 44-11-3 and it is not specitically tied to the federal due date.	No. Have to file RI 7004. Form RI 1120C instructions. Under 44-11-3 the discretion to grant an extension is vested in the tax administrator	No. Appeals of decisions of the tax administrator go to the district court (8-8-25); administrative appeals are decided by the tax administrator (44-11-6, 44-11-20, 44-30-89, 44-19-17, 44-19-25.	Yes. Taxpayer may file a motion for exemption. R.I. Gen. Laws §8-8-26. This exemption is only available in hardship cases where TP can show a reasonable probability of success on the merits.	
SC	3 Years Both *Assessment* S.C. Code Ann. § 12-54-85(A). *Refund* S.C. Code Ann. §	Interest on assessments and refunds is at the federal underpayment rate. See S.C. Code § 12-	90 days. §12-60-450.	No. Form SC1120 instructions. S.C. Code § 12-6-4970 (B)	Yes.	Yes. S.C. Code Ann. 1-23-500-660 and Chapter 60 of Title 12.[16]	No. Tax Appeal Procedures for State Tax Assessments and License Revocations	

	Even-handed statutes of limitations (refunds and assessments)	Interest rates on assessments and refunds	Number of days to protest an assessment	State return due at least 30 days after Federal return?	Federal extension automatically extends state due date	State provides independent, non-judicial tax dispute forum	Payment or bond required before independent hearing	Key additional issues impacting fair and efficient tax administration
	12-54-85(F)(1).	54-25 (d) and IRC §§ 6621 (a)(2) and 6622.					(Other than property tax) Chapter 60 of Title 12	
SD	3 Years Both *Assessment* S.D. Codified Laws § 10-59-16(3) *Refund* S.D. Codified Laws § 10-59-19.	1 1/4 % per month, equally applied *Underpayment* S.D. Codified Laws § 10-59-6 *Overpayment* S.D. Codified Laws §§ 10-59-24 and 10-59-6.	30 days. §10-59-9.	N/A	N/A	No. SDCL 10-59.	Yes. But Bond may be posted in lieu of payment. S/D/ Codified Laws §10-59-9	
TN	3 Years Both *Assessment* Tenn. Code Ann. § 67-1-1501(b) *Refund* Tenn. Code Ann. § 67-1-1802(a).	Formula Rate of Interest published in Tenn. Admin. Register, equally applied. *Underpayment* Tenn. Code Ann. § 67-1-801(a) *Overpayment* Tenn. Code Ann. § 67-1-801(b).	90 days. §67-1-1801.	Yes. Tenn Code Ann § 67-4-2015	Yes. Tenn Code Ann § 67-4-2015.	No. Tenn. Code Ann. 67-1-1801 to 67-1-1807.	No. But bond, letter of credit, or affidavit is required in the amount of 150% of assessment. Tenn Code Ann §67-1-1801	"Double-Secret Assessment" – An assessment for additional tax is deemed made by recording the liability in the office of the department. The assessment is valid regardless of whether notice is provided to the taxpayer.
TX	4 Years Both *Assessment* Tex. Tax Code §§ 111.201, 111.205 *Refund* Tex. Tax Code §§111.107, 111.206, 111.201.	*Underpayment* interest rate is Prime Rate plus 1%. Tex. Tax Code § 111.060(b). *Overpayment* interest rate is the lesser of the annual rate of interest earned on deposits in the state treasury	30 days. §§1.5, §111.009(b)§111.105(a).	Yes. Tex. Tax Code Ann. § 171.202	No. Tex. Tax Code Ann. § 171.202.	Yes. All cases were transferred to the State Office of Administrative Hearings by Comptroller Combs effective January 3, 2007.	Yes, unless the taxpayer files an oath of inability to prepay the tax and the court grants relief from the requirement to prepay the tax. Tex. Tax Code § 112.051 and	Federal RAR opens entire state return to audit. §§111.206 and 171.212.

	Even-handed statutes of limitations (refunds and assessments)	Interest rates on assessments and refunds	Number of days to protest an assessment	State return due at least 30 days after Federal return?	Federal extension automatically extends state due date	State provides independent, non-judicial tax dispute forum	Payment or bond required before independent hearing	Key additional issues impacting fair and efficient tax administration
		during December of the previous calendar year or the Prime Rate plus 1% Tex. Tax Code § 111.064(a).					§112.108	
UT	3 Years Both *Assessment* Utah Code § 59-7-519(1) *Refund* Utah Code § 59-7-522(2)(a) Utah Code Ann. 59-12-110 gives time for refund (2)(b) and assessment (6)(a).	Fed. ST Rate plus 2%, equally applied *Underpayment* Utah Code §§ 59-7-510 & 59-1-402(3)(b) *Overpayment* Utah Code §§ 59-7-533 & 59-1-402(3)(a).	30 days for the petition with supplemental information allowed later. §59-7-517(3)(f).	Yes. Utah corporate/franchise tax returns are due 15th day of fourth month following close of taxable year. Utah Code Ann. § 59-7-505(2); Form TC-20 Instructions	Yes, whether Federal 7004 filed or not. Form TC-20 instructions; Utah Code Ann. §59-7-505(3).	No. Utah Code §§ 59-1-501 to 59-1-505	Effective May 1, 2006, taxpayers seeking judicial review shall provide security to cover the deficiency in full or in part, but may be granted a waiver by the commission under certain circumstances. Utah Code Ann. § 59-1-611	
VT	3 Years Both *Assessment* 32 V.S.A. § 5882(a) *Refund* 32 V.S.A. § 5884(a).	Average Prime Rate (previous 12-month period), equally applied *Underpayment* 32 V.S.A. § 3108 *Overpayment* 32 V.S.A. §§ 5884(b) & 3108.	60 days §5868.	No. Form CO-411 instructions	No., but copy of federal form may be used for Vermont. Form CO-411 instructions.	No. 32 V.S.A. §§ 5883 to 5888	Corporate -- No. Vt. Stat. Ann. §5886 Sales & Use -- Yes. Vt. Stat. Ann. §9817	
VA	3 Years Both *Assessment* Va. Code Ann. § 58.1-104 *Refund* Va. Code Ann. §	*Underpayment* Fed. Underpayment Rate plus 2% Va. Code Ann. §§ 58.1-308 and 58.1-	90 days §58.1-1821.	Yes. Form 500 instructions	Yes. Whether Federal 7004 filed or not. Va. Code Ann. §58.1-453	No. Va. Code Ann. 58.1-1820 to 58.1-1825, 58.1-1845. But taxpayer does enjoy a right to an internal conf.	Payment is not required prior to proceeding with an appeal in circuit court. The Tax	

	Even-handed statutes of limitations (refunds and assessments)	Interest rates on assessments and refunds	Number of days to protest an assessment	State return due at least 30 days after Federal return?	Federal extension automatically extends state due date	State provides independent, non-judicial tax dispute forum	Payment or bond required before independent hearing	Key additional issues impacting fair and efficient tax administration
	58.1-1823.	15 *Overpayment* Fed. Overpayment (non-corp) Rate plus 2% Va. Code Ann. § 58.1-15.				before a determination is issued for an administrative appeal filed pursuant to Va. Code Ann. § 58.1-1821. The conference does not establish the record for appeal. Any proceeding with the circuit court is de novo.	Commissioner may petition the court to compel payment prior to proceeding with the appeal under certain statutorily prescribed conditions designed to protect against frivolous litigation.	
WA	4 Years Both *Assessment* Rev. Code Wash. § 82.32.050(3) & 82.32.100(3) *Refund* Rev. Code Wash. § 82.32.060(1).	Fed. ST Rate plus 2%, equally applied *Underpayment* Rev. Code Wash. § 82.32.050(2) *Overpayment* Rev. Code Wash. § 82.32.060(1), (5)(b) / § 82.32.050(2).	30 days for excise tax (no income tax for WA). §82.32.160.	N/A	N/A	Yes. Rev. Code Wash §§ 82.03.010 to 82.02.200. Taxpayers are allowed an appeal before the Board of Tax Appeal (an agency independent of the DOR). See RCW 82.03.010 et seq.[17]	Yes. Wash. Rev. Code & 82.32.180.[18]	Subject to certain exceptions, the DOR's administrative rule governing refunds provides that a purchaser "should" request a refund of overpaid sales tax directly from the vendor before requesting a refund from the DOR. See WAC 458-20-229(3)(b)(ii).However, there is no statutory provision that supports the DOR's authority to impose such a requirement.
WV	3 Years Both *Assessment* W. Va. Code § 11-10-15(a) *Refund*	Greater of Adj. Prime Rate or 8%, equally applied *Underpayment*	60 days. §11-10-8.	No. 2005 Combined Corporate Net Income/Bs Franchise Tax	Yes. 2005 Combined Corporate Net Income/Bs Franchise Tax	Yes. Procedural Rule WV Office of Tax Appeals § 121-1-88 thru 101	Bond required or certification of assets. W. Va. Code § 11-10A-19(e)	Federal RAR opens entire state return to audit. 11-24-6a, 11-24-6

	Even-handed statutes of limitations (refunds and assessments)	Interest rates on assessments and refunds	Number of days to protest an assessment	State return due at least 30 days after Federal return?	Federal extension automatically extends state due date	State provides independent, non-judicial tax dispute forum	Payment or bond required before independent hearing	Key additional issues impacting fair and efficient tax administration
	W. Va. Code § 11-10-14(l).	W. Va. Code §§ 11-10-17(a) and 11-10-17a *Overpayment* W. Va. Code §§ 11-10-17(d) and 11-10-17a.		Booklet. § 11-23-9; §11-24-13	Booklet. § 11-23-10; §11-24-18.	W. Va. Code § 11-10A-8.		
WI	4 Years Both *Assessment* Wis. Stat. § 71.77(2) *Refund* Wis. Stat. § 71.75(5).	*Underpayment* 12% per year Wis. Stat. § 71.82(1)(a) *Overpayment* 9% per year Wis. Stat. § 71.82(1)(b).	60 days. §71.88(1)	No. Wis. Stat § 71.44 (1)(a) Wis. Stat. §§ 71.24 (7)	Yes. Wis. Stat § 71.44 (3).	Yes. Wis. Stat. §§ 71.87 to 71.90, & 73.01.	No. Wis. Stat. Ann. § 73.01 (5)(a)	Federal RAR opens entire state return to audit. §§ 71.76 & 71.77.
WY	3 Years Both *Assessment* Wyo. Stat. § 39-15-110(b) *Refund* Wyo. Stat. § 39-15-110(a).	*Underpayment* Average Prime Rate (by formula) plus 4% Wyo. Stat. § 39-15-108(b) *Overpayment* Interest is provided on any protested payments of tax at average prime 39-11-109(f)	30 days. §39-15-110.	N/A	N/A	Yes. Wyo. Stat. §§ 39-11-102.1, 39-11-109.	No. Wyoming Rules Bd. of Eq. Gen. 5 Commencement of Case	

Endnotes

[1] *Best and Worst of State Tax Administration: COST Scorecard on Appeals, Procedural Requirements*, 8 Multistate Tax Report 231 4/27/01; *Best and Worst of State Tax Administration: COST Scorecard on Appeals, Procedural Requirements,* 11 Multistate Tax Report 137 3/26/04.

[2] *See* Tim Reason, *Stingers: Cash-Strapped States Put the Bite on Business,* CFO Magazine, January 2004 at 32; George Donnelly, *States of Confusion: The 2000 Tax Survey*, CFO Magazine, September 2000 at 54; Ian Springsteel, *State Taxes: A Guide for the Besieged*, CFO Magazine, August 1996 at 26; Kate O'Sullivan, *Give & Take: As state economic-development teams offer tax breaks to attract companies, revenue departments seek to get that money back,* CFO Magazine, January 2007.

[3] A.R.S. §§ 42-1251 and 1253 and other authority provide that appeals of tax assessments and refund denials must first go through the Arizona Department of Revenue and a hearing officer.

[4] Under A.R.S. § 42-1251.A, no amount under protest must be paid prior to filing an appeal. Only those amounts <u>not</u> protested have to be paid. This remains the same throughout all possible appeals, including in the court system. (A.R.S. §§ 42-1251.B says that if you fail to timely appeal an assessment, you can pay all of it and then file for a refund. To the extent it requires paying, it's an additional remedy after the normal appeal route is gone.)

[5] Taxpayer has only 2 options: 1) Pay all or a portion of assessment. Tax agency may pursue collection activities on unpaid amounts A.C.A. 26-18-406 (a)(1)(A), or 2) File Bond to secure payment of tax A.C.A. 26-18-406 (a)(1)[2](A).

[6] However, the court proceeding following an adverse decision by State Board of Equalization is de novo and thus "no record for appeal is set" at the Board of Equalization level.

[7] If the taxpayer elects to file an action with the Division of Administrative hearings pursuant to Fla. Stat. § 72.011 (1)(a) and Fla. Chapter 120. Yes - (Fla. Stat. § 72.011(3)) requires the taxpayer to pay the contested portion of the assessment if the taxpayer elects to file an action with the circuit court pursuant to Fla. Stat. § 72.011 (1)(a). The Department may waive the requirement to pay or provide bond. Fla. Stat. § 72.011 (3)(b)1. The circuit court may determine the amount, if any, of alternative security. Fla. Stat. § 72.011(3)(b)2.

[8] Georgia provides alternate appeal routes -- either to the superior court pursuant to O.C.G.A. §48-2-59 as noted <u>or</u> to the Office of State Administrative Hearings where the matter is heard by an administrative law judge who is independent of the DOR. O.C.G.A. § 50-13-12. That decision can then be appealed to superior court.

[9] There are several alternatives to contesting the matter without paying the tax. First, payment can be avoided in the appeal directly to superior court under O.C.G.A. §48-2-59 if taxpayer owns real estate within the state equal to the tax or posts a bond. Second, tax is not required to be paid if the taxpayer selects the appeal route through the Office of State Administrative hearings as noted in footnote 6. Third, the taxpayer can provide an "affidavit of illegality" to a levying officer of the DOR who is then required to file the matter in the superior court and the matter will be adjudicated without payment of the tax.

[10] The taxpayer has the right to a hearing in order to dispute an assessment of taxes, interest, and penalties by timely filing an appeal with the BTA in accordance with R.S. 47:1414, 1431, and 1481. A taxpayer shall not be required to pay the disputed tax, interest, and penalties in order to exercise this right. The taxpayer has the right to a formal hearing in order to contest the assessment of taxes, interest, and penalties by timely filing suit with the appropriate state district court. The assessment must be paid in full under protest in order to exercise this right in accordance with R.S. 47:1576. By refusing to issue a formal assessment, the La. DOR could effectively "force" a taxpayer to pay the disputed taxes under protest (La. R.S. 47:1576) and sue for a refund.

[11] In contrast, interest on refunds does not accrue until 45 days after a refund claim is filed. MCL 209.30(3). Although the statute governing tax refunds provides that the declaration of an overpayment on a return constitutes a

claim for refund MCL 209.30(2), the Dept ignores the statute and requires a separate refund claim in order to commence the running of interest.

[12] If a TP is granted an extension of time within which to file the federal income tax return for any taxable year, the filing of a copy of the (federal) request for extension together with a tentative (state) return and payment of an estimated tax by the due date (the last day of the 4th mo after the end of the TP's tax year) will automatically extend the due date for filing of the final return for an equivalent period plus 60 days.

[13] MI provides an opportunity for Informal Conference before the Hearings Division within the Department of Treasury under MCL 205.21(2)(c) There is no record made. MCL 205.21(2)(d). An appeal from a determination made following an Informal Conference is subject to de novo review in either the MI Tax Tribunal or the MI Court of Claims where a record is made. MCL 205.22(1).

[14] Independent hearings are available in MI through a proceeding in the MI Tax Tribunal or the MI Court of Claims MCL 205.22(1). The TP is not required to prepay the contested amount of a final assessment prior to a Tax Tribunal appeal, but is required to prepay the amount of an assessment prior to an appeal through the MI Court of Claims. Amounts must be paid under protest prior to proceeding in the Court of Claims. MCL 205.22(2). Uncontested amount must be paid.

[15] Interest on an underpayment accrues from the date the tax was due. Interest on an overpayment of income tax accrues from a date 45 days after the latest of the following: (1) The date the return was filed. (2) The date the return was due to be filed. (3) The date of the overpayment. Interest on an overpayment of franchise tax begins to accrue after 90 days instead of 45 days.

[16] The ALJs are independent as they are elected by the General Assembly; strictly speaking they are non-Judicial; even though they are referred to as Administrative Law Judges, all are lawyers, and they are part of the Administrative Law Court, from a constitutional law perspective they are part of the Executive Branch, not the Judicial branch.

[17] Judicial review of matters decided through formal BTA hearings are based on the record considered by the BTA and are reviewed under the state's administrative procedures act; judicial appeals of informal BTA hearings are reviewed de novo. RCW 82.03.180. Although the BTA is technically "independent" of the DOR, it is generally perceived as unsatisfactory for litigating excise tax disputes. In practice, the vast majority of the cases heard by the BTA are property tax valuation disputes. The three board members (appointed by the Governor) often have little or no prior experience with excise tax matters.

[18] While prepayment is not a jurisdictional prerequisite to filing a notice of appeal with the BTA, filing such an appeal does not stay collection, effectively requiring the taxpayer to pay the amount due unless arrangements for a stay can be negotiated with the DOR. See WAC 458-20-100(8) ("A taxpayer filing an appeal with the board of tax appeals must pay the tax by the due date, unless arrangements are made with the department for a stay of collection under RCW 82.32.200.") Prepayment is a jurisdictional prerequisite to filing a refund suit in Superior Court. See RCW 82.32.180.

Total state and local business taxes

50-state estimates for fiscal year 2007

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The authors

Andrew Phillips is a Senior Manager in the Quantitative Economics and Statistics group of Ernst & Young LLP. He has extensive experience working on state and local tax issues for both public and private sector clients. He has a B.A. from Emory University.

Robert Cline is the National Director of State and Local Tax Policy Economics of Ernst & Young LLP. He is the former director of tax research for the states of Michigan and Minnesota. He has a Ph.D. in Economics from the University of Michigan.

Thomas Neubig is the National Director of Quantitative Economics and Statistics of Ernst & Young LLP. He is the former Director and Chief Economist of the U.S. Treasury Department's Office of Tax Analysis. Tom is a former President of the National Tax Association. He has a Ph.D. in Economics from the University of Michigan.

This study was prepared by the Quantitative Economics and Statistics Practice (QUEST) of Ernst & Young LLP in conjunction with the Council On State Taxation (COST).

QUEST is a group of economists, statisticians, and tax policy researchers within Ernst & Young's LLP National Tax Practice, located in Washington, DC. QUEST provides quantitative advisory services and products to private and public sector clients that enhance business processes, support regulatory compliance, analyze proposed policy issues and provide litigation support.

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of more than 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities.

Executive summary

This is the sixth annual report prepared by Ernst & Young LLP in conjunction with COST that provides detailed state-by-state estimates of state and local taxes paid by business. This edition of the study updates information included in prior studies with new estimates for fiscal year 2007.[1] The study also examines the level of state and local business taxes relative to the value of public services and infrastructure used by business, suggesting that tax competitiveness involves evaluating business taxes and the level of government services.

Businesses paid $577 billion of state and local taxes in fiscal year 2007, which accounted for 44.1% of total state and local taxes. This and other business tax estimates presented in this study will help inform tax policy questions currently being debated by state legislatures: "How much tax do businesses pay?" and "Is our current state and local business tax structure adversely affecting our state's economic competitiveness?"

To provide a starting point for these policy discussions, this study estimates the level of total taxes paid by businesses to state and local governments. These include business property taxes, sales and excise taxes paid by businesses on their input purchases, gross receipts taxes, corporate income and franchise taxes, business and corporate license taxes, unemployment insurance taxes, individual income taxes paid by owners of non-corporate (pass-through) businesses and other state and local taxes that are the statutory liability of business taxpayers.

The state-by-state estimates reveal significant variation in the share of state and local taxes paid by business across the states. The business share is determined by a state's overall tax structure, the composition of its economy and the types of business taxes levied. The study also examines the level of state and local business taxes as a share of private-sector economic activity in each state.

Key findings of the study include:

- State and local business taxes increased by 5.7% in FY2007 compared to 10.2% in FY2006. In FY2007, business taxes accounted for 44.1% of total state and local taxes.
- Over the last five years, state and local taxes on business have risen faster than total state and local taxes. As a result, businesses paid 46% of the additional state and local taxes collected from FY2002 to FY2007.
- Property taxes on business property totaled $203 billion in FY2007, equal to 35% of total state and local business taxes. Sales tax on business inputs and capital equipment totaled $132 billion, nearly 23% of business taxes. The property tax and a significant portion of sales taxes paid by business are taxes on capital invested within a state.
- Although the corporate income tax has been the focus of significant debate in a number of state legislatures during recent years, it represents 17% of total state business taxes and only 10% of total state and local business taxes.
- The composition of total state and local business taxes paid varies by industry, with manufacturing and transportation continuing to face significant property taxes and sales taxes on business purchases. Traditionally regulated businesses are subject to significant industry-specific excise and gross receipts taxes.
- State and local business taxes exceed the estimated value of state and local public services benefiting businesses by 78%.

Total state and local business taxes in FY2007

Businesses paid $577 billion in total state and local taxes in FY2007, as presented in Table 1.[2] The following taxes are included in the business tax estimates to the extent each tax is determined to be the statutory liability of businesses and their owners:

- Property taxes on real, personal, and utility property owned by business account for the largest share of total state and local business taxes, 35% or $202.5 billion. Taxes on real property and utilities account for $181 billion (90%) of the total business property tax. Business personal property, which is exempt from tax in some states, generates the remaining $21 billion of business property tax revenue. Property taxes increased 6.8% from FY2006 to FY2007, slowing from 12.9% growth during the prior year.
- Sales and use taxes paid by businesses on purchases of inputs, including capital equipment, totaled $132 billion. The business sales tax represents 23% of all state and local business taxes and 44% of total state and local sales and use taxes. Sales and use taxes collected on sales to final consumers are not included; only the taxes paid on businesses' operating inputs and capital equipment purchases are included in the total business tax estimates.[3]

Table 1. State and local business taxes, FY2007 ($Billions)

Business taxes	FY2007	% total taxes	One-year growth
Property taxes on business property	$202.5	35.1%	6.8%
General sales taxes on business inputs	132.3	22.9	4.2
Corporate income tax	58.7	10.2	11.9
Unemployment insurance	35.8	6.2	(1.7)
Business and corporate license	33.3	5.8	4.9
Excise taxes	27.6	4.8	10.6
Individual income tax on business income	25.8	4.5	8.9
Public utility taxes	23.7	4.1	1.1
Insurance premiums taxes	15.4	2.7	(0.5)
Other business taxes	22.4	3.9	2.2
Total business taxes	**$577.4**	**100.0%**	5.7%

Source: EY calculations. Figures may not appear to sum due to rounding.

- Corporate income taxes were $59 billion in FY2007, accounting for 10% of total state and local business taxes. Due to growth in corporate profits, corporate income taxes increased 12% over the past fiscal year.
- Employer contributions for unemployment insurance were nearly $36 billion in FY2007.
- Excise taxes imposed on business purchases accounted for $28 billion of FY2007 revenue. Although businesses are generally responsible for collecting and remitting all excise taxes, the estimates only include taxes paid on purchases by businesses. Excise taxes attributed to business include a portion of motor fuel taxes and other selected excise taxes, such as hotels and rental car taxes. Taxes on tobacco, alcoholic beverages, amusements and pari-mutuels are allocated to households.

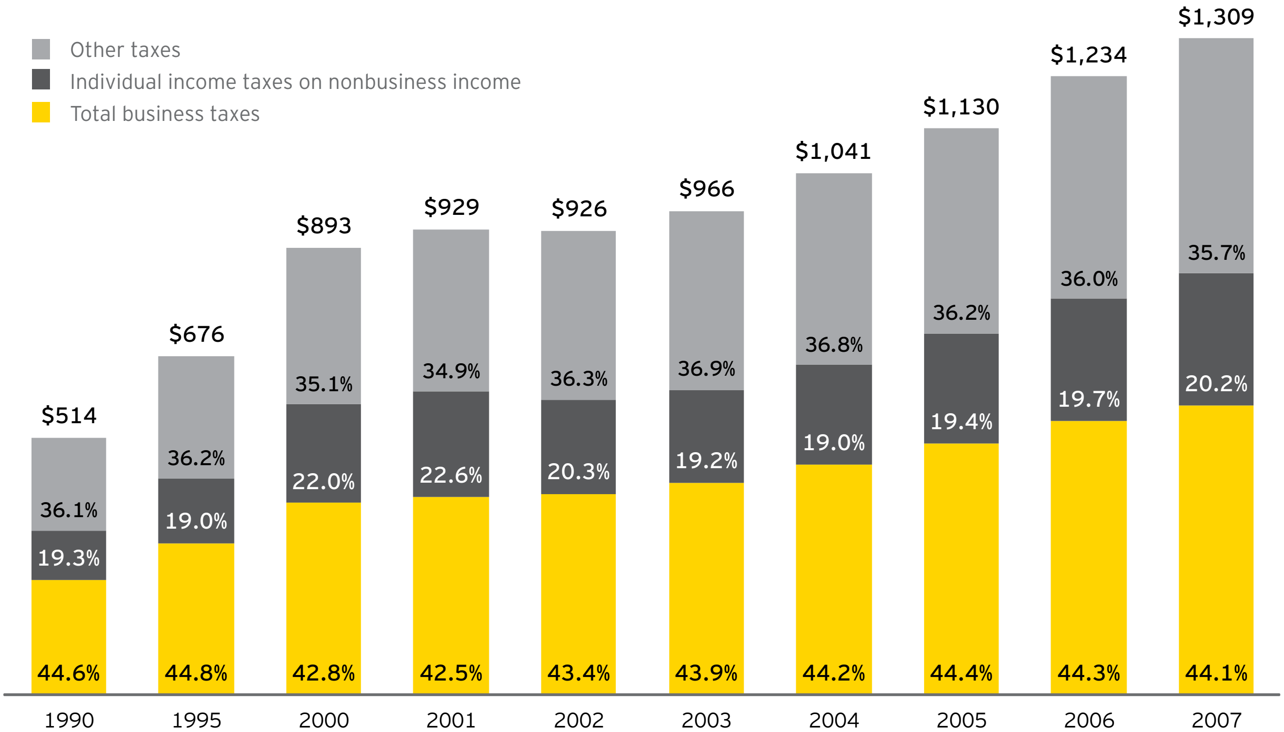
- Taxes on insurance premiums and public utility gross receipts totaled $39.1 billion in FY2007. These taxes are generally based on business gross receipts, and because they are often levied in lieu of property or corporate income taxes, they are allocated solely to business.
- License taxes and other business taxes totaled $56 billion in FY2007. Of this total, $17.9 billion were general business and occupation taxes, and $6.4 billion were motor vehicle license fees and taxes.
- Individual income taxes paid by owners of pass-through entities (e.g., partnerships, sole proprietorships, S-corporations, etc.) are estimated to total $26 billon in FY2007. Individual income taxes on pass-through business income were 44% as large as corporate income taxes and represent almost 5% of total state and local business taxes.

Business share of state and local taxes, 1990-2007

Total state and local business taxes grew from $229 billion in FY1990 to $381 billion in FY2000 and to $577 billion in FY2007. Figure 1 shows the composition of total state and local taxes, split between business taxes and nonbusiness taxes. Businesses paid 44.1% of total state and local taxes in FY2007.

Appendix Table A-1 presents the level and composition of state and local business and nonbusiness taxes from 1990 through 2007. Appendix Table A-2 shows business taxes by tax type for the same period.

Figure 1. Composition of state and local taxes, FY1990 to FY2007 **($Billions)**



Source: EY calculations. Figures may not appear to sum due to rounding.

Recent trends in state and local taxes

Recent trends in business tax growth

Total state and local business taxes increased by 44%, or almost $176 billion, between FY2002 and FY2007. This compares with 39% growth in nonbusiness taxes. Table 2 shows that business tax growth over this period was fuelled by rapidly growing corporate income (+106%) and business license taxes (+97%) and by the sustained growth of business sales taxes (+35%) and business property taxes (+32%), the two largest components of the state and local business tax base. This section examines the growth of major state and local business taxes since FY2002 and the significance of growth rates over the past fiscal year.

Business property taxes

The property tax is the largest component of the state and local business tax system, representing 35% of total state and local business taxes in FY2007 and accounting for 28.2% of total business tax growth between FY2002 and FY2007. While the property tax has been a source of significant revenue growth over the past five years due to rapidly increasing real property values, the rate of growth is projected to decline due to real estate market conditions and property tax reforms in many states.

Business property taxes increased 6.8% from FY2006 to FY2007, rising faster than local business income, license taxes, and other local business taxes, which increased 4.5% overall. Growth in residential property taxes is not expected to continue at its current rate due to declining real property values and increased homestead exemptions, credits, and other relief provided to residential property taxpayers. In fact, taxpayer "revolts" have driven property tax reforms in states where residential market values have fallen below assessed values, such as Indiana and Florida. This dynamic is relevant to business taxpayers because the property tax on residential and business property accounts for 73% of total local government tax revenues and is the only major tax source available to many local governments. To generate sufficient revenue as the residential property tax base shrinks, local governments may shift additional tax burden to business taxpayers. Classified property assessment and rate structures used in many states are designed to tax business property at higher effective rates than residential property. Other tax features, such as limitations on the annual increase in the assessed value of residential properties, can also result in higher effective business tax rates while using the same tax rates and property classification systems for residential and business property.

Evidence from past economic cycles shows that a decline in the property tax base during recessionary periods results in a higher effective tax rates on business property following the recession while residential property rates remain relatively stable. The effective

Table 2. Change in state and local business taxes, FY2002–FY2007 ($Billions)

Business taxes	FY2002	FY2007	% growth FY02–FY07	% of total tax increase
Property taxes on business property	$152.9	$202.5	32.4%	28.2%
General sales taxes on business inputs	97.9	132.3	35.0	19.5
Corporate income tax	28.5	58.7	106.1	17.2
Unemployment insurance	21.0	35.8	70.9	8.5
Business and corporate licenses	17.0	33.3	96.5	9.3
Excise taxes	20.3	23.7	17.0	2.0
Individual income tax on business income	14.8	25.8	74.0	6.2
Public utility taxes	20.8	27.6	32.4	3.8
Insurance premiums	11.2	15.4	37.2	2.4
Other business taxes	17.4	22.4	28.4	2.8
Total business taxes	**$401.8**	**$577.4**	**43.7%**	**100.0%**
Total state and local taxes	**$926.1**	**$1,309.4**	**41.4%**	

Source: EY calculations. Figures may not appear to sum due to rounding.

property tax rate is defined as taxes divided by the market value of property. As shown in Figure 2, effective property tax rates on business property increased significantly shortly after the recessions in 1991 and 2001.[4] As property values recovered in the following years, the amount of revenue raised from residential property was limited by increases in homestead exemptions, assessed value or rate increase limitations, long residential property assessment cycles, and other residential property tax relief mechanisms. The current decline in property values in many parts of the country may result in another shift of property taxes to business taxpayers.

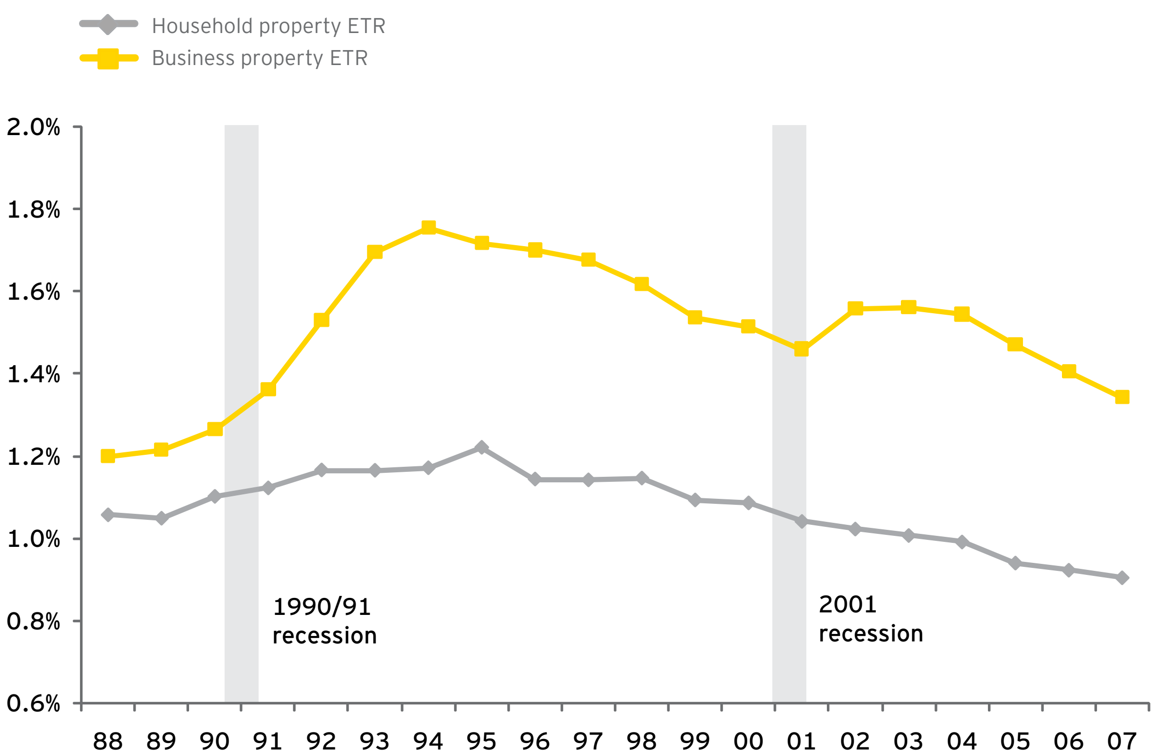
Business sales taxes

Businesses pay nearly 44% of state and local sales taxes, which include taxes on operating inputs and capital expenditures. Sales taxes paid by business grew 35% since FY2002 and accounted for nearly 20% of the total growth in state and local business taxes during that period.

Recent business state sales tax growth has not been as strong: as shown in Table 3-A, state sales taxes grew 4.4% from FY2006 to FY2007 compared to 6.5% the prior fiscal year. The rate of sales tax growth varied significantly from state to state, ranging from a 3.4% decrease in New York to a 21.8% increase in New Jersey. New Jersey, Idaho, and

Figure 2. Effective property tax rates on residential and business property, 1988-2007

(Household and business property tax divided by value of household and business property.)



Source: EY calculations; see endnote 4

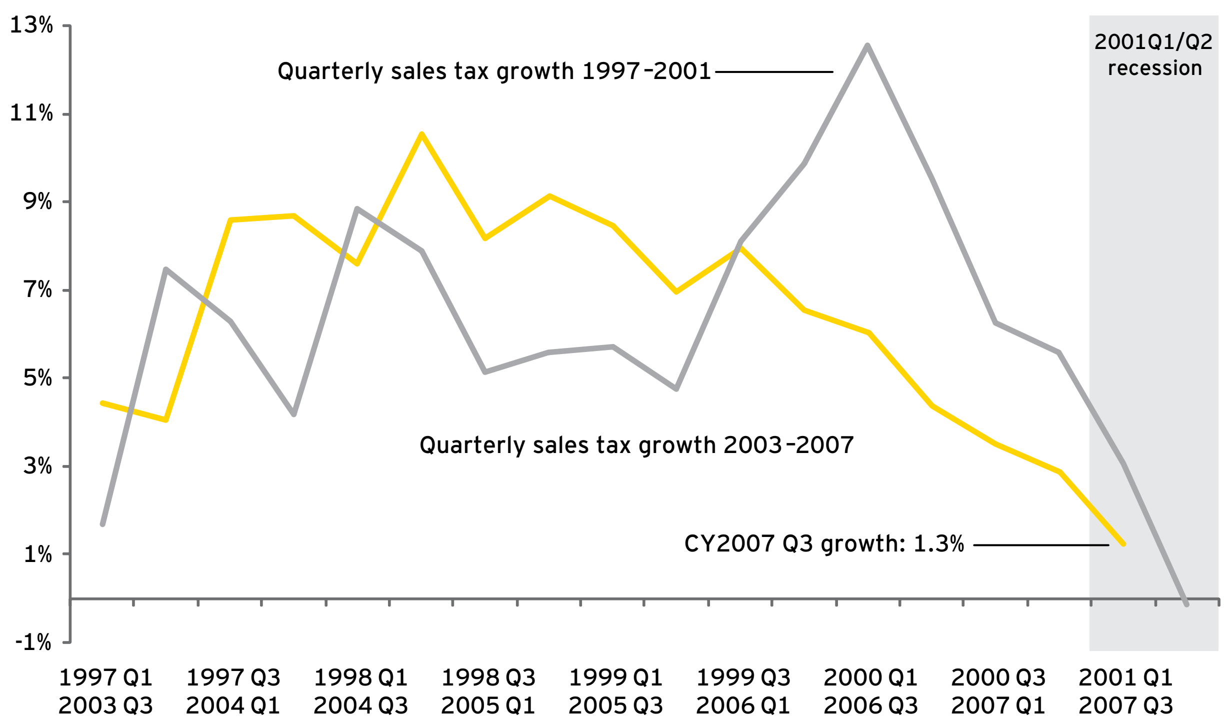
South Carolina each enacted 1% rate increases for FY2007. Adjusting for rate changes that occurred during the fiscal year, state sales taxes grew by only 4.2%.[5] One factor contributing to the slowing growth of business sales tax in FY2007 was business capital investment, which accounts for 26% of total business sales taxes and grew at a rate less than one-third of the growth rate the prior fiscal year.

The sales tax revenue growth rate declined each of the seven quarters since the first quarter of CY2006. In the third quarter of CY2007, year-over-year sales tax collections grew only 1.3% — the lowest level since 2002. The recent slowdown in sales tax collections is noteworthy because sales tax collections also slowed significantly in the quarters immediately preceding the 1990–1991 and 2001 recessions. Shown in Figure 3, the growth in sales tax collections declined for the five quarters proceeding the 2001 recession, eventually becoming slightly negative. A similar pattern has emerged recently, with seven consecutive quarters of declining sales tax growth as of the third quarter of CY2007.

Corporate income taxes

While the corporate income tax continues to represent a relatively small share of total state and local business taxes, rising corporate profits over the FY2002–FY2007 period have created significant growth in corporate income tax revenue — more than doubling over

Figure 3. Sales taxes growth: comparing pre-2001 recession growth to recent trends
(Year-over-year quarterly change in tax collections. Shaded region indicates 2001 recession.)



Source: EY calculations

the five-year period. The rapid increase in corporate profits underlying the recent surge in corporate income tax collections illustrates the instability of the income tax base and why it remains an unstable source of revenue for funding government. The relative volatility of the corporate income tax has been particularly high since the beginning of the 2001 recession. From June 2001 to June 2002, corporate income taxes fell almost five times faster than total state taxes, and then from June 2002 through the June 2007, corporate income taxes increased almost three times faster than all state taxes. In the third quarter of CY2007, year-over-year corporate income tax collections declined 3%, the first time corporate income tax growth has been negative since the year following the last recession in 2001.

Gross receipts taxes

Alternatives to the corporate income tax have been considered by many states undertaking significant tax reforms. Three states — Michigan, Ohio and Texas — recently replaced existing business tax systems with modified gross receipts taxes. Hawaii and Washington have existing general business gross receipts taxes, which are classified as sales taxes in our analysis. The substitution of these new taxes for current business income and franchise taxes will reduce traditional corporate income and license taxes by approximately 7% once they are fully phased-in.[6]

Local business taxes increased faster than state business taxes during FY2007

Local business taxes grew faster than state-level business taxes during FY2007. Tables 3-A and 3-B provide the dollar amounts, percentage distributions and growth rates in FY2007 for total business taxes at the state and local levels of government. As shown in Table 3-B, total local taxes increased by 6.3%, while state business taxes grew by 5.1% (Table 3-A). Recent growth in state and local business taxes provides insight into the potential fiscal stress states will face through FY2009 due to projected declines in corporate profits and taxable business purchases in combination with lower projected nonbusiness taxes. Although states are still projecting tax revenues for FY2009, 22 states and the District of Columbia have already identified significant budget shortfalls totaling $39 billion.[7]

At the state level, business tax growth from rising corporate income, excise and individual income taxes on business income, which increased more than 10% since FY2006, was partially offset by modest declines in unemployment insurance, insurance premiums and utility gross receipts taxes. Table 3-A shows that while state level corporate income and excise taxes grew more than 10%, other state taxes had a combined growth rate of 3.0%.

At the local level, the moderately high growth rate of the local business property tax (6.9%) combined with its importance in the local business tax mix is primarily responsible for the higher overall growth rate of local business taxes compared to state-level business taxes.[8]

Table 3-A. State business taxes, FY2007 ($Billions)

Business taxes	State amount	% total state taxes	One-year growth
General sales and use tax on inputs	$102.1	32.4%	4.4%
Corporation net income	53.6	17.0	12.6
Unemployment compensation	35.8	11.3	(1.7)
Business license tax	29.6	9.4	4.0
Individual income tax	25.8	8.2	8.9
Excise taxes	22.8	7.2	11.7
Insurance premiums tax	15.4	4.9	(0.5)
Public utility taxes	11.1	3.5	(3.5)
Property tax on business property	7.6	2.4	5.6
Other business taxes	11.8	3.7	1.1
Total business taxes	**$315.5**	**100.0%**	**5.1%**

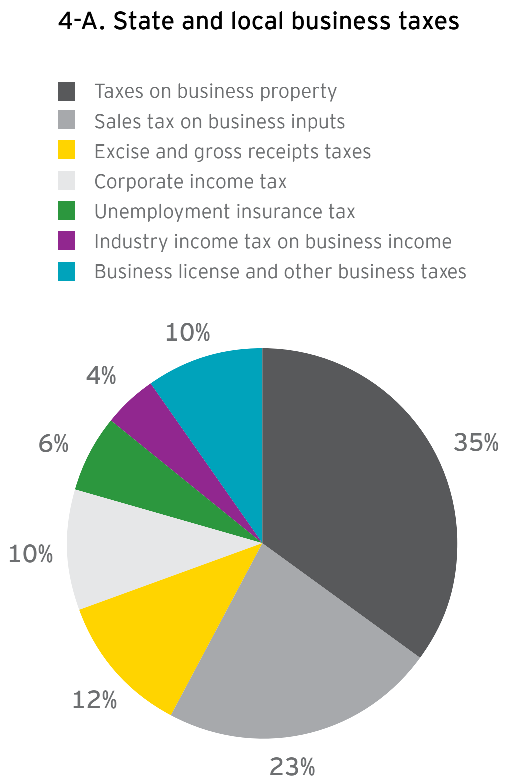
Source: EY calculations. Figures may not appear to sum due to rounding.

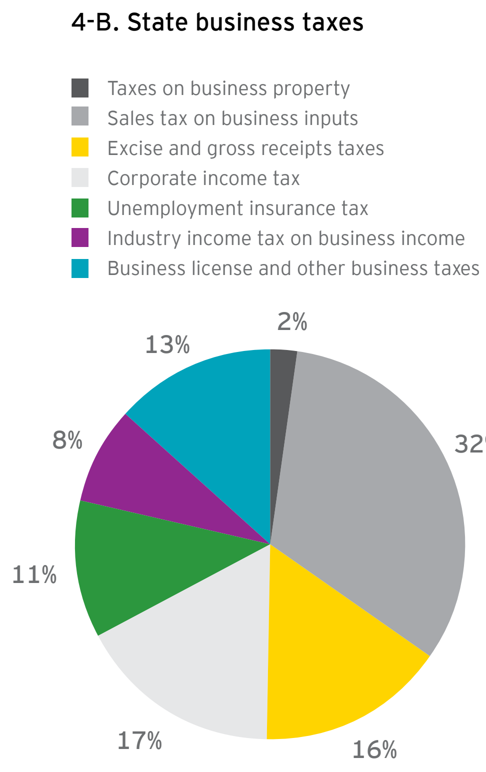
Table 3-B. Local business taxes, FY2007 ($Billions)

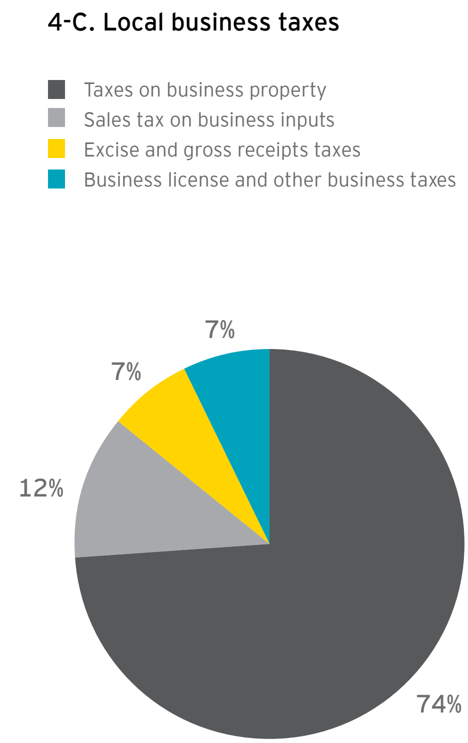
Business license	Local amount	% total local taxes	One-year growth
Property taxes on business property	$194.9	74.3%	6.9%
General sales taxes on business inputs	30.2	11.5	3.3
Public utility taxes	12.6	4.8	5.6
Excise taxes	4.8	1.8	5.6
Other business taxes*	19.9	7.6	5.5
Total business taxes	**$262.4**	**100.0%**	**6.3%**

**Includes local corporate income and business license taxes. Source: EY calculations.*

Figure 4 illustrates the significant difference in the composition of state and local business taxes. Figure 4-A shows the percentage distribution of total state and local taxes by tax type. The property tax — the least volatile state and local business tax — represents 35% of total taxes. Figures 4-B and 4-C show that the business property tax accounts for only 2% of state business taxes but represents 74% of local taxes.[9]







Source: EY calculations. Figures may not appear to sum due to rounding.

State-by-state business tax estimates

This section presents state and local business taxes by type of tax for each of the 50 states plus the District of Columbia. Table 4 presents the different business taxes by state. Appendix Table A-3 presents the percent composition by type for each of the 50 states. Origin-based taxes, such as the property tax and sales tax on business input purchases, which are more important in businesses' location decisions than destination-based taxes, vary significantly as a share of total business tax. Arizona, Iowa, Maine, Nebraska and South Dakota generate more than 70% of business taxes from the sales and property taxes, resulting in significant taxes on business capital located in the state.

Table 5 presents business taxes as percentage of total, state and local taxes by state. The business share of total state and local taxes will depend on many factors, including a state's reliance on individual income taxes and general sales taxes, and the level and type of business activity in the state. The business share of total taxes averages 44% nationally, but ranges from 32% in Maryland to 81% in Alaska.

The business share of total taxes indicates how heavily state and local tax systems rely on taxes that are liabilities of businesses instead of households. However, this measure provides limited information about the competitiveness of a state's business tax system compared to other states. A state's competitiveness depends upon many factors, including the level of business taxes compared to the level of economic activity that is being taxed and the final incidence of business taxes, after they have been shifted to consumers or owners of factors of production, including workers. Because state business tax bases include a diverse mixture of receipts, net income, input purchases, payroll, property and other tax bases, a broad measure of a state's overall economic activity should be used to determine the measure of aggregate business tax burden that can be compared across states.

The last column in Table 5 presents a state-by-state measure of the total effective tax rate (TETR) imposed on business activity by state and local governments. The TETR is measured as the ratio of state and local business taxes to private-sector gross state product (GSP), the total value of a state's annual production of goods and services by the private sector. The average TETR across all states is 5.0%; TETRs range from 3.5% in Delaware to 11.6% in Alaska.

While the business TETRs provides a starting point for comparing burdens across states, they do not provide sufficient information to fully evaluate a state's competitiveness. For example, Indiana has the 10th lowest TETR, but derives nearly 70% of its business tax revenue from sales and property taxes, which are origin-based taxes on business capital that may negatively impact competitiveness. More generally, a state with an average overall TETR may impose relatively high taxes on capital-intensive manufacturers, while imposing relatively low taxes on labor-intensive service industries. As a result, this state's tax structure and composition may create disincentives for locating new plant and equipment in the state and hinder economic growth. State legislators and policymakers need to look closely at the structure and composition of business taxes and the composition of economic activities when evaluating their state's business tax competitiveness.

Table 6 shows the state-by-state increase in total state and local business taxes between FY2002 and FY2007 and the business share of total state and local tax increases during that period. Nationwide, businesses paid 46% of the increase in all state and local taxes over this five-year period. Although not shown in the table, the picture is the same for the aggregate ETR: the ratio of business taxes to private-sector economic activity increased from 4.4% to 5.0% over the same period.

Table 4. State and local business taxes, by type, FY2007* ($Billions)

State	Property taxes	Sales taxes	Excise and gross receipts	Corporate income tax	Unemployment insurance tax	Individual income tax (on pass-thru business income)	License and other	Total business taxes
Alabama	$1.4	$1.4	$1.4	$0.5	$0.3	$0.3	$0.9	$6.2
Alaska	0.6	0.0	0.1	0.8	0.2	-	2.3	3.9
Arizona	3.6	3.8	0.9	1.0	0.3	0.2	0.5	10.4
Arkansas	0.9	1.3	0.5	0.4	0.3	0.2	0.2	3.7
California	16.4	19.1	7.5	11.2	5.3	5.5	8.0	72.9
Colorado	3.2	2.6	0.6	0.5	0.5	0.6	0.5	8.6
Connecticut	2.9	1.5	0.7	0.8	0.6	0.6	0.3	7.4
Delaware	0.3	-	0.2	0.3	0.1	0.1	1.0	1.9
Florida	11.5	7.9	5.7	2.4	1.2	-	2.0	30.8
Georgia	5.2	4.3	1.2	1.0	0.7	0.8	0.7	13.9
Hawaii	0.6	0.8	0.5	0.1	0.1	0.1	0.1	2.4
Idaho	0.8	0.4	0.2	0.2	0.1	0.2	0.2	2.0
Illinois	10.4	3.9	4.9	2.9	2.6	0.8	1.6	27.3
Indiana	4.4	1.7	0.6	1.0	0.6	0.4	0.2	8.9
Iowa	2.9	0.9	0.3	0.3	0.3	0.2	0.3	5.3
Kansas	2.5	1.3	0.5	0.5	0.3	0.3	0.3	5.8
Kentucky	1.5	1.3	1.1	1.0	0.4	0.3	0.7	6.2
Louisiana	2.5	5.0	0.9	0.8	0.2	0.3	1.5	11.2
Maine	1.9	0.4	0.2	0.2	0.1	0.1	0.2	3.1
Maryland	2.4	1.4	1.6	0.8	0.5	0.7	1.6	9.0
Massachusetts	6.2	1.6	0.9	2.1	1.7	0.9	0.5	13.8
Michigan	8.7	2.6	1.1	1.8	1.6	0.6	0.9	17.3
Minnesota	3.5	2.0	1.3	1.2	0.9	0.5	0.7	10.0
Mississippi	1.8	1.2	0.4	0.4	0.1	0.1	0.4	4.4
Missouri	2.8	2.6	1.1	0.4	0.6	0.4	0.7	8.6
Montana	0.8	-	0.2	0.2	0.1	0.1	0.4	1.8
Nebraska	1.6	0.9	0.2	0.2	0.2	0.2	0.2	3.5
Nevada	1.6	1.4	0.8	-	0.3	-	1.1	5.2
New Hampshire	1.6	-	0.4	0.6	0.1	0.0	0.2	2.8
New Jersey	8.3	3.3	1.8	2.9	1.6	1.0	1.4	20.2
New Mexico	0.5	1.5	0.3	0.4	0.1	0.1	1.0	4.0
New York	22.2	12.0	5.8	10.1	2.6	4.2	1.7	58.6
North Carolina	3.7	2.9	1.8	1.6	1.0	0.8	0.9	12.6
North Dakota	0.5	0.2	0.2	0.1	0.1	-	0.5	1.7
Ohio	7.9	4.0	1.3	1.7	1.1	1.0	1.8	18.7
Oklahoma	1.2	2.0	0.5	0.6	0.3	0.5	1.5	6.6
Oregon	2.0	-	0.5	0.4	0.7	0.5	0.9	5.0
Pennsylvania	7.8	3.5	2.9	2.3	2.4	1.2	3.3	23.4
Rhode Island	1.3	0.4	0.2	0.2	0.2	0.1	0.1	2.4
South Carolina	3.0	1.1	0.7	0.3	0.3	0.2	0.6	6.2
South Dakota	0.7	0.5	0.1	0.1	0.0	-	0.1	1.6
Tennessee	3.1	3.0	0.9	1.1	0.4	-	1.2	9.8
Texas	18.4	13.6	6.6	-	1.7	-	7.6	48.0
Utah	1.2	0.9	0.5	0.4	0.2	0.2	0.3	3.6
Vermont	0.8	0.1	0.2	0.1	0.1	0.0	0.1	1.4
Virginia	4.5	1.7	2.1	1.3	0.5	0.7	1.4	12.3
Washington	3.2	7.3	2.0	0.0	1.5	-	0.9	14.9
West Virginia	1.0	0.3	0.6	0.5	0.1	0.1	0.6	3.3
Wisconsin	4.7	1.8	0.9	0.9	0.7	0.4	0.7	10.1
Wyoming	0.9	0.5	0.1	-	0.0	-	0.9	2.4
Dist. Of Columbia	1.0	0.3	0.2	0.2	0.1	0.1	0.2	2.2
United States	**$202.5**	**$132.3**	**$66.7**	**$58.7**	**$35.8**	**$25.8**	**$55.7**	**$577.4**

**Note: $0.0 indicates a value less than $50 million. Source: EY calculations. Figures may not appear to sum due to rounding.*

Table 5. Business taxes as a share of state, local and total taxes and private sector GSP, FY2007* ($Billions)

	State			Local			State and local			
State	Business	Total	Business share	Business	Total	Business share	Business	Total	Business share	% of GSP
Alabama	$3.8	$9.1	41.5%	$2.4	$4.7	52.3%	$6.2	$13.8	45.2%	4.6%
Alaska	3.4	3.6	93.4	0.6	1.2	44.5	3.9	4.8	80.8	11.6
Arizona	5.5	12.7	43.0	4.9	8.6	57.2	10.4	21.3	48.7	5.1
Arkansas	2.8	7.7	36.2	0.9	1.8	49.3	3.7	9.5	38.7	4.6
California	47.2	120.0	39.3	25.7	55.9	46.0	72.9	175.9	41.4	4.7
Colorado	3.4	9.7	34.7	5.2	9.5	54.6	8.6	19.2	44.6	4.2
Connecticut	4.4	13.4	32.6	3.0	8.4	36.1	7.4	21.8	34.0	4.0
Delaware	1.6	3.0	55.2	0.3	0.8	37.7	1.9	3.8	51.6	3.5
Florida	15.1	36.9	41.0	15.7	29.8	52.7	30.8	66.7	46.2	4.9
Georgia	6.4	19.3	33.0	7.5	14.1	53.4	13.9	33.4	41.6	4.2
Hawaii	1.6	5.2	31.1	0.8	1.2	64.8	2.4	6.5	37.6	5.4
Idaho	1.2	3.7	31.5	0.9	1.4	60.9	2.0	5.1	39.7	4.6
Illinois	14.3	32.1	44.6	12.9	26.1	49.6	27.3	58.2	46.8	5.1
Indiana	4.4	14.7	30.0	4.5	7.5	60.1	8.9	22.2	40.2	4.0
Iowa	2.1	6.7	31.1	3.2	4.8	66.4	5.3	11.5	45.8	4.8
Kansas	2.8	7.2	38.1	3.0	4.6	64.8	5.8	11.9	48.5	6.1
Kentucky	4.5	10.3	44.2	1.7	3.6	47.0	6.2	13.9	44.9	5.0
Louisiana	5.7	11.1	51.2	5.6	7.4	75.0	11.2	18.5	60.8	6.5
Maine	1.2	3.7	32.3	1.9	2.6	71.3	3.1	6.3	48.5	7.6
Maryland	5.3	15.6	34.1	3.7	12.3	29.7	9.0	27.9	32.2	4.2
Massachusetts	7.5	22.4	33.4	6.4	13.0	49.1	13.8	35.4	39.2	4.5
Michigan	9.6	25.4	37.6	7.7	14.2	54.6	17.3	39.6	43.7	5.1
Minnesota	6.7	18.7	35.7	3.4	6.1	54.8	10.0	24.8	40.4	4.6
Mississippi	2.5	6.5	38.8	1.9	2.5	74.8	4.4	9.0	48.8	6.3
Missouri	3.9	11.3	34.3	4.7	9.5	49.6	8.6	20.8	41.3	4.3
Montana	1.1	2.4	45.5	0.7	1.0	66.5	1.8	3.4	51.8	6.5
Nebraska	1.6	4.2	37.0	2.0	3.3	59.3	3.5	7.6	46.8	5.4
Nevada	2.9	6.6	43.9	2.3	4.0	57.8	5.2	10.7	49.1	4.9
New Hampshire	1.4	2.2	60.5	1.4	2.8	51.0	2.8	5.0	55.2	5.4
New Jersey	11.6	30.7	37.8	8.6	23.8	36.0	20.2	54.5	37.0	4.9
New Mexico	2.9	5.3	54.4	1.1	2.0	54.5	4.0	7.3	54.4	6.3
New York	23.3	65.8	35.4	35.3	72.5	48.7	58.6	138.3	42.4	6.4
North Carolina	7.9	23.6	33.4	4.8	10.6	44.9	12.6	34.2	36.9	3.9
North Dakota	1.1	1.8	57.0	0.6	0.9	68.8	1.7	2.7	60.9	7.4
Ohio	9.4	25.9	36.4	9.3	19.6	47.3	18.7	45.5	41.1	4.5
Oklahoma	4.3	9.2	46.4	2.3	4.1	57.4	6.6	13.3	49.8	5.8
Oregon	2.3	8.5	27.3	2.7	5.5	49.2	5.0	14.0	35.9	3.8
Pennsylvania	14.4	33.3	43.2	9.1	22.5	40.3	23.4	55.8	42.0	5.1
Rhode Island	1.1	3.0	38.7	1.3	2.3	56.5	2.4	5.2	46.4	6.1
South Carolina	2.7	9.0	30.4	3.5	5.4	65.1	6.2	14.4	43.4	5.0
South Dakota	0.7	1.3	54.9	0.8	1.2	69.2	1.6	2.5	61.9	5.5
Tennessee	5.7	11.7	48.4	4.1	7.3	55.7	9.8	19.1	51.2	4.6
Texas	25.0	42.0	59.4	23.0	37.5	61.4	48.0	79.5	60.3	5.0
Utah	2.0	6.1	32.6	1.7	3.2	51.7	3.6	9.3	39.1	4.3
Vermont	1.2	2.6	44.9	0.2	0.4	62.1	1.4	3.0	47.2	6.8
Virginia	5.4	19.5	27.4	7.0	14.1	49.3	12.3	33.7	36.6	4.0
Washington	10.2	19.1	53.4	4.6	10.0	46.3	14.9	29.1	51.0	5.8
West Virginia	2.1	4.8	43.9	1.2	1.5	82.9	3.3	6.3	53.1	7.2
Wisconsin	5.1	15.2	33.8	5.0	10.0	49.7	10.1	25.2	40.1	5.0
Wyoming	1.5	2.1	74.1	0.9	1.2	72.5	2.4	3.3	73.5	9.3
Dist. of Columbia	2.2	4.9	45.1	0.0	0.0	0.0	2.2	4.9	45.1	3.8
United States	**$315.5**	**$790.9**	**39.9%**	**$261.9**	**$518.5**	**50.5%**	**$577.4**	**$1,309.4**	**44.1%**	**5.0%**

**Percent of 2006 private sector GSP equivalent to an effective tax rate on economic activity occurring within the state. Source: EY calculations. Figures may not appear to sum due to rounding.*

Table 6. Change in state and local business taxes, FY2002 to FY2007 ($Billions)

State	Total state and local business taxes FY2002	FY2007	$change	%change	Total state and local taxes $change	%change	Business share of tax growth
Alabama	$4.5	$6.2	$1.8	39.2%	$3.9	39.4%	45.1%
Alaska	1.6	3.9	2.4	151.2	2.7	121.6	88.6
Arizona	7.0	10.4	3.4	48.0	6.7	46.1	50.1
Arkansas	2.5	3.7	1.2	46.9	2.9	44.5	40.1
California	51.3	72.9	21.6	42.1	52.7	42.8	41.0
Colorado	6.0	8.6	2.6	43.6	5.2	36.8	50.3
Connecticut	5.4	7.4	2.0	36.3	6.3	40.4	31.4
Delaware	1.5	1.9	0.4	29.7	1.0	37.3	43.4
Florida	21.7	30.8	9.1	42.0	21.2	46.7	42.9
Georgia	9.7	13.9	4.2	43.9	9.2	38.0	46.1
Hawaii	1.6	2.4	0.8	48.0	2.1	49.0	37.0
Idaho	1.4	2.0	0.6	46.6	1.7	51.0	37.4
Illinois	19.1	27.3	8.2	42.7	15.5	36.2	52.8
Indiana	7.7	8.9	1.3	16.5	5.0	28.9	25.4
Iowa	3.8	5.3	1.5	38.2	3.0	35.0	48.8
Kansas	3.7	5.8	2.0	54.3	3.7	45.4	54.7
Kentucky	4.6	6.2	1.7	36.8	2.8	25.7	59.0
Louisiana	7.3	11.2	3.9	53.8	6.1	49.8	64.0
Maine	2.2	3.1	0.9	39.5	1.6	34.7	53.2
Maryland	6.4	9.0	2.6	40.7	7.8	38.6	33.4
Massachusetts	9.0	13.8	4.9	54.7	10.6	42.9	46.1
Michigan	12.9	17.3	4.4	34.3	7.9	25.0	55.7
Minnesota	7.3	10.0	2.7	37.3	6.0	31.9	45.4
Mississippi	3.1	4.4	1.3	42.6	2.4	35.9	55.1
Missouri	6.1	8.6	2.5	41.7	5.4	35.0	46.9
Montana	1.1	1.8	0.7	62.7	1.2	55.9	55.6
Nebraska	2.5	3.5	1.0	41.3	2.2	40.1	47.8
Nevada	3.3	5.2	2.0	59.8	4.0	60.0	49.1
New Hampshire	2.0	2.8	0.8	37.7	1.4	38.5	54.3
New Jersey	13.5	20.2	6.7	49.2	18.6	51.9	35.7
New Mexico	2.5	4.0	1.5	61.5	2.4	47.8	64.1
New York	37.5	58.6	21.0	56.0	47.2	51.8	44.5
North Carolina	8.2	12.6	4.4	54.2	11.3	49.1	39.4
North Dakota	1.0	1.7	0.6	63.8	1.0	53.7	67.9
Ohio	15.2	18.7	3.5	23.0	8.6	23.5	40.4
Oklahoma	4.1	6.6	2.5	62.8	4.4	49.7	57.8
Oregon	3.4	5.0	1.6	48.6	4.5	47.3	36.5
Pennsylvania	15.5	23.4	7.9	51.1	16.7	42.7	47.5
Rhode Island	1.6	2.4	0.8	49.0	1.5	39.2	54.2
South Carolina	4.3	6.2	2.0	46.5	4.4	44.6	44.7
South Dakota	1.2	1.6	0.4	33.2	0.6	34.9	59.6
Tennessee	6.7	9.8	3.0	45.3	5.8	43.3	52.8
Texas	36.9	48.0	11.1	30.0	19.3	32.1	57.3
Utah	2.1	3.6	1.5	70.5	3.2	52.9	46.8
Vermont	0.9	1.4	0.5	58.7	1.0	50.1	52.3
Virginia	8.0	12.3	4.3	54.2	11.4	51.0	38.1
Washington	10.9	14.9	3.9	36.2	8.6	42.0	45.8
West Virginia	2.4	3.3	0.9	37.1	1.5	31.3	60.3
Wisconsin	7.1	10.1	3.0	42.6	6.1	32.2	49.2
Wyoming	1.3	2.4	1.1	88.8	1.4	76.8	79.6
Dist. of Columbia	1.5	2.2	0.7	48.0	1.6	48.1	45.1
United States	**$401.8**	**$577.4**	**$175.6**	**43.7%**	**$383.4**	**41.4%**	**45.8%**

Source: EY calculations. Figures may not appear to sum due to rounding.

An alternative measure of business tax burdens

This study provides estimates of the taxes paid by businesses in each state, an important first step in any evaluation of business taxes or tax reform. To enable comparisons across states, the study also expresses business taxes as a share of total state and local taxes and as an effective tax rate on private sector economic activity.

These measures were developed to answer questions from legislators asking, "Are businesses paying their fair share of taxes?" Increasing economic competition among states and around the globe has transformed the initial question into a more fundamental query: "What is the basis or rationale for business taxation at the state or local level?" The basic rationale for business taxes, recognizing that business taxes are ultimately borne by consumers or owners of factors of production (including workers), is to pay for government services that directly benefit businesses. This section provides a comparison of business taxes to these benefits in each state.

If state and local business taxes were equal to the value of the benefits business received from state and local public services, they could be considered a payment for services, and taxes would not influence business location decisions or impact competitiveness. However, if state and local business taxes exceed the value of the benefits received from government services, the difference represents an excess cost to business that will reduce profitability in the absence of shifting the tax through higher prices or lower payments to labor. When such excess costs exist, they can affect a company's choice of locations. Estimates of these excess costs, developed by economists at the Federal Reserve Bank of Chicago, have been calculated as the ratio of state and local business taxes to the cost of government services most likely to benefit businesses.[10]

The ratio of business taxes to government expenditures for services benefiting businesses is very sensitive to assumptions about who benefits from public spending for education, one of the largest state and local expenditure categories. Prior analyses have incorporated a range of estimates, assuming that businesses receive between 0% and 50% of the benefit from expenditures for education. The estimates presented in this study assume that 25% of the education expenditures directly benefit business.[11]

Figures 5-A to 5-C compare the three measures of business tax burden: the tax to benefit ratio described above, the business share of total taxes and the total effective tax rate on GSP. Figure 5-A illustrates the range of tax to benefit ratios, from 1.38 in Oregon to 3.73 in Wyoming. The average U.S. ratio is 1.78. (See Table A-4 for detailed results.) As can be seen comparing the three figures, each measure of business tax burden provides a different perspective on the level of business taxes in each state. For example, Georgia ranks among the lowest states in terms of the effective tax rate on private sector economic activity (Figure 5-B) but among the highest in terms of business taxes relative to benefits received. This indicates that while Georgia's business taxes are low relative to its overall economic activity, businesses in Georgia receive fewer government services in return. Maryland and Oregon, however, have low business taxes as a share of total taxes, relative to economic activity, and compared to the value of public services benefiting businesses. Because of their significant severance taxes, Alaska and Wyoming rank among the five highest tax states for each metric. While most states rank relatively closely under each measure, these differences serve to illustrate the danger of using a single metric to evaluate complex business tax systems.

Figure 5-A. Ratio of business taxes relative to benefits received, FY2005

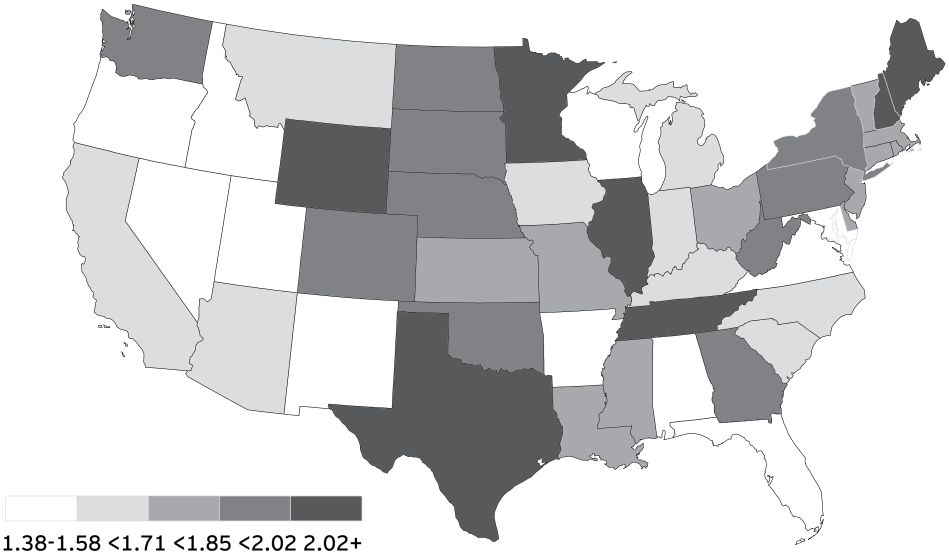


Figure 5-B. Total effective business tax rate on gross state product, FY2007

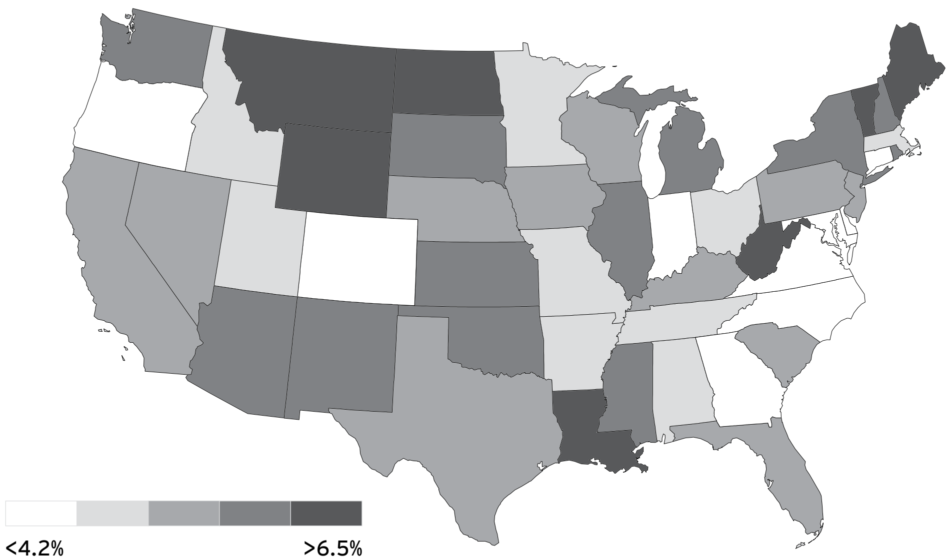
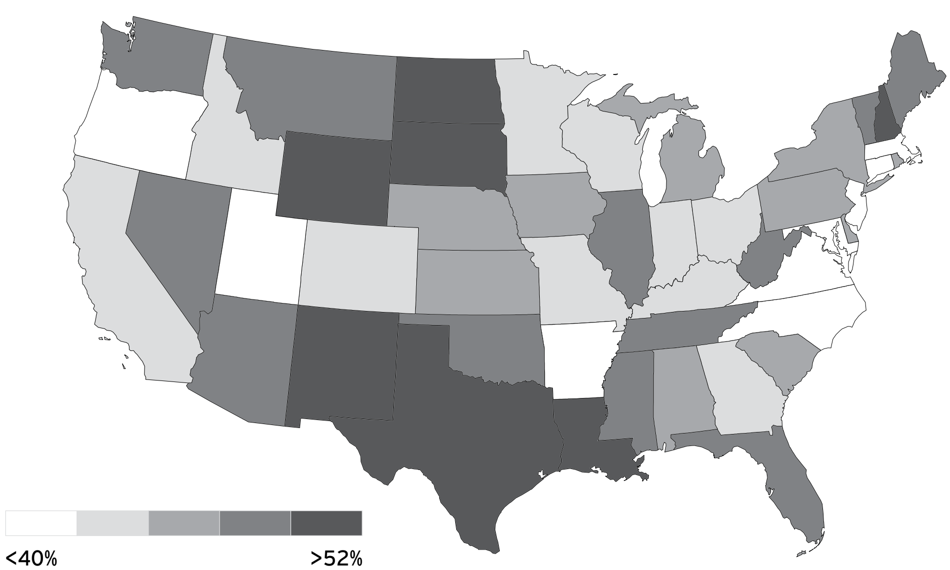


Figure 5-C. Business share of state and local taxes, FY2007



Business taxes by industry

The results of this study highlight the importance of evaluating the overall level of state and local business taxes in the tax policy debate. Table 7 adds another dimension to the total business tax results, presenting estimates of total state and local taxes paid by major industries in FY2007. The results indicate that the composition of total state and local business taxes varies significantly among industries.

Table 8 presents a comparison of the composition of total state and local business taxes by major industry group. The figures show, for example, that corporate income taxes account for the largest share of the taxes paid by firms in the "management of companies" industry. The industry known as "management of companies" is comprised of three primary types of companies and activities: bank holding companies, non-financial holding companies, and corporate, subsidiary and regional managing offices. These activities, which include the profits of holding company entities that have few employees, generate significant corporate income and corporation license tax liability relative to other state and local business taxes. This finding confirms that a state's corporate income tax system will be a primary tax consideration when deciding where to locate corporate headquarters or regional management offices.

The results also indicate that property taxes account for more than 40% of state and local taxes for utilities, transportation and real estate. Regulated industries, including the utility, telecommunications and insurance industries, pay taxes based on gross receipts or premiums in many states, often in lieu of corporate income taxes and other taxes. Table 8 shows that these gross receipts taxes represent a substantial portion of the total taxes paid by those industries. In formulating tax policy, the composition of business taxes should also be examined, considering the impact of taxes on business capital and the effect those taxes may have on the ability to retain and attract jobs and new investments.

Table 7. State and local business taxes by industry, FY2007* ($Billions)

Industry	Property taxes	General sales taxes	Excise and gross receipts	Corporate income tax	Business license and other taxes	Payroll taxes	Individual income tax (on pass-thru business income)	Total business tax
Electric and gas	$19.4	$3.5	$16.6	$1.6	$2.2	$0.3	$0.0	$43.6
Manufacturing	30.8	22.9	0.2	18.7	5.3	9.4	0.8	88.1
Non-durable goods	14.7	10.1	0.2	6.8	3.3	3.1	0.0	38.1
Durable goods	16.1	12.9	0.0	11.9	2.0	6.3	0.8	50.0
Wholesale trade	9.6	11.4	15.8	4.1	3.7	2.0	0.6	47.2
Retail trade**	12.4	18.2	6.3	5.8	3.7	6.2	0.7	53.3
Transportation	9.6	7.2	1.1	1.4	1.5	1.3	0.7	22.8
Communications	6.1	6.1	6.1	4.4	1.0	0.5	0.3	24.5
Finance and insurance	16.6	12.7	15.4	5.6	6.5	1.6	5.2	63.7
Real estate	54.8	1.5	0.0	0.9	2.2	0.5	3.1	63.1
Services	21.0	24.8	5.1	12.3	12.9	11.2	4.1	91.3
Mgmt of companies	0.7	0.5	0.0	8.7	6.2	0.1	0.3	16.5
Business services	5.5	13.7	0.0	1.6	1.0	3.1	1.9	26.8
Other services	14.9	10.5	5.1	2.0	5.6	8.0	1.9	48.0
Other	22.0	23.8	0.0	4.0	16.6	2.9	10.3	79.6
Total business taxes	**$202.5**	**$132.3**	**$66.7**	**$58.7**	**$55.5**	**$35.8**	**$25.8**	**$577.4**

**Note: $0.0 indicates a value less than $50 million. **Includes food services industries. Source: EY calculations. Figures may not appear to sum due to rounding.*

Table 8. Composition of total state and local business tax by industry, FY2007* (% of total business taxes paid by industry)

Industry	Property taxes	General sales taxes	Excise and gross receipts	Corporate income tax	Business license and other taxes	Payroll taxes	Individual income tax (on pass-thru business income)	Total business tax
Utilities	44.5%	8.1%	38.1%	3.7%	4.9%	0.6%	0.1%	100%
Manufacturing	35.0	26.0	0.2	21.2	6.0	10.6	0.9	100
Non-durable goods	38.6	26.4	0.5	17.8	8.6	8.1	0.0	100
Durable goods	32.2	25.7	0.0	23.8	4.0	12.6	1.7	100
Wholesale trade	20.3	24.2	33.5	8.8	7.8	4.2	1.2	100
Retail trade**	23.3	34.2	11.8	10.8	7.0	11.6	1.2	100
Transportation	42.1	31.8	5.0	6.0	6.4	5.7	3.0	100
Communications	24.9	24.7	25.0	18.0	4.3	1.9	1.2	100
Finance and insurance	26.1	20.0	24.1	8.8	10.3	2.6	8.1	100
Real estate	86.9	2.4	0.0	1.4	3.5	0.8	5.0	100
Services	23.1	27.2	5.6	13.4	14.1	12.3	4.4	100
Mgmt of companies	4.1	3.3	0.0	52.5	37.7	0.4	1.9	100
Business services	20.6	51.2	0.0	6.1	3.8	11.5	6.9	100
Other services	31.0	21.9	10.6	4.1	11.7	16.7	3.9	100
Other	27.7	29.9	0.0	5.0	20.8	3.6	13.0	100
Total business taxes	**35.1%**	**22.9%**	**11.6%**	**10.2%**	**9.6%**	**6.2%**	**4.5%**	**100%**

**Note: 0.0% indicates a value less than 0.05%. **Includes food services industries. Source: EY calculations. Figures may not appear to sum due to rounding.*

Conclusions

State and local taxes paid by businesses in FY2007 totaled $577 billion, increasing almost 6% since FY2006 and 44% from FY2002, the trough of the prior economic slowdown. Total business taxes represented 44.1% of all state and local taxes collected in FY2007, up slightly from 43.5% in FY2002. Annual increases in property taxes and sales tax on business inputs — the two largest state and local business taxes — accounted for nearly half of the total increase.

The composition of total state and local business taxes paid can vary dramatically by industry. As indicated by this study, legacy taxes on traditionally regulated businesses can represent nearly half of the entire state and local tax burden paid by companies in these industries. Other industries, including manufacturing and transportation, continue to face significant property and sales tax liabilities.

This study provides several complimentary measures which policymakers can use to evaluate business tax systems across states. These include 1) the total effective business tax rate (business taxes as a percentage of private sector economic activity), 2) the business share of total state and local taxes, and 3) the ratio of business taxes relative to the value of public services benefiting businesses. Although each of these measures provides insight into the taxes paid by businesses currently operating in a state, they do not measure marginal taxes on new capital investment and business activity and do not reflect taxes paid by individual industries, all of which are determinants of a state's business tax competitiveness.

Mounting evidence that the growth of state and local taxes will slow over the next fiscal year has prompted many states to predict significant budget shortfalls for FY2009. When faced with significant shortfalls in the past, many states saw business tax reforms only in the context of their short-term objectives to raise revenue. In an economic environment affected significantly by increased global competition, continued deregulation, the growing importance of intangible assets – and increasingly mobile labor and capital, it is important for policymakers to understand the level and composition of their state's total state and local business taxes and government services and the potential long-term impacts of business tax reforms designed to meet short-term objectives.[12]

Appendix: description of methodology

The Ernst & Young 50-state business tax methodology uses detailed information from public sources to estimate the business share of each of 26 taxes at the state and local levels of government. Generally, business taxes include all taxes that are the legal liabilities of business, including taxes paid with respect to corporations, non-corporate businesses, including partnerships and sole-proprietorships, non-profit entities and with respect to rental property owned by individuals. Sales and excise taxes paid by households are not considered business taxes, even though the taxes may be the legal liability of retailers and wholesalers. The individual income taxes paid by owners of pass-through business entities are included.

Property taxes

Real and tangible property taxes

Tax data describing tax levies or taxable assessed value by class of property were obtained from state and local government agencies. Although each state differed in the data that were available, most states provided separate totals for residential and commercial taxable property values or tax levies, by real and personal property. In cases where statewide estimates were not available, we relied upon data for the largest counties or previous estimates of the business share.

Taxes on residential rental property are treated as business taxes, similar to the treatment by the US Commerce Department in measuring national income. Many states included residential rental properties in the residential property tax base. These states' household property tax shares were adjusted to remove the rental residential housing from the household share and allocate it to the business share. Educational, farm and not-for-profit entity property was allocated to business to the extent that it was taxed. Individual federal income tax deductions claimed by residents of each state for real estate and personal property taxes were compared to the estimates of household property taxes to validate the estimated levels of business and household property taxes.

State intangible property taxes

State-level property taxes on intangible property held by corporations and partnerships are allocated entirely to business.

Sales, gross receipts and excise taxes

General sales tax

Sales tax paid by businesses on purchases of goods and services used in operations and production and on business purchases of capital equipment was estimated using the Ernst & Young 50-state sales tax model. The model estimates the total taxable business input purchases, business investment purchases and personal consumption purchases that occur annually in each state to calculate the business share of total sales tax collections.

The sales tax model constructs state-specific industry-by-industry matrices of business input transactions, business investment transactions and personal consumption transactions using economic and related data from government agencies. Business input transactions were estimated using national input-output relationships and data describing value-added, total sales and employment by industry for each state. Business investments were estimated using national ratios of investment to output by industry and state specific estimates of output by industry. Based on the current level of economic activity in a state, investment due to expansion and the replacement of depreciating equipment and structures was estimated. Personal consumption expenditures were calculated based on census data describing the sales to household consumers by each industry. National trade data was used to estimate retail sales to consumers, while state-specific estimates were used for the services sectors. Additional data on utility and telecommunications sales were used to supplement the industry aggregate calculations and reflect the special tax treatment of these services.

To reflect accurately the sales tax due on business and household transactions, state and local tax laws were researched for each type of business and household purchase. Each transaction type reflects a sales tax feature that can be generally applied across industries and commodities. For example, a computer manufacturer's purchase of electronic components may be exempt as manufacturing inputs that were directly used in the manufacturing process. The same purchase of electronic components by a business services firm, however, would be considered taxable or treated under a different exemption. These transaction categories reflect the state-specific sales tax treatment, by purchaser, for business investments, business purchases of operating and production inputs and personal consumption expenditures.

A few states impose additional gross receipts taxes on businesses, such as Washington state's business and occupation tax, which are reflected in the census general sales tax data. Because these taxes are the legal liability of business, they were considered business taxes in this analysis.

The sum of sales taxes on business inputs, investment expenditures, and business gross receipts was divided by total estimated state and local sales taxes to derive the business share. The business share was then used to calculate the actual dollar amount of business sales taxes paid, based on aggregate sales taxes reported by the Census Bureau. Additional information is available from the COST report, "Sales Taxation of Business Inputs."[13]

Gross receipts taxes on insurance premiums and utility receipts

Gross receipts taxes levied on insurance and utility companies were allocated to business because these taxes are often levied in lieu of generally applicable business taxes. Sales tax due on consumer purchases of these services, however, was not included in this category. Additional taxes based on gross receipts, such as local gross occupation taxes, are included in "other taxes."

Motor fuel excise taxes

Motor fuel taxes were allocated to the purchaser of the fuel, although many states require the wholesale distributor to remit such taxes. The percent of fuel consumed by business consumers was estimated using national input-output data describing the total value of petroleum refinery products used in commercial transportation activities and by household users. Purchases by other users of petroleum refinery products were excluded from the calculations under the assumption that these users were purchasing non-motor-fuel petroleum products.

Other selective sales taxes

Excise taxes on alcohol, pari-mutuels and tobacco were considered household taxes and excluded from the business tax estimates. The remaining selective sales taxes were allocated 50% to business and 50% to households.

Income Taxes

Corporate net income taxes

Corporation net income taxes were allocated entirely to business. Individual income taxes were allocated entirely to households, other than the portion of these taxes due to income earned by owners of pass-through entities. Individual income taxes paid on corporate dividends were allocated entirely to households.

Individual income taxes on pass-through business income

The individual income taxes paid on income earned by owners of pass-through entities (partnerships, sole proprietorships and Subchapter S corporations) were estimated based on net income after losses, as reported by the IRS Statistics of Income. Pass-through entity income was allocated across states based on U.S. Bureau of Economic Analysis proprietorship income data for each state, which includes partnership and Subchapter S income. The SOI total pass-through entity net business income after losses was extrapolated to FY2007 based on the growth in national proprietorship income in the BEA personal income accounts. Individual income tax on pass-through business net income after losses was assumed to be at the state's average tax rate on estimated adjusted gross income, which has the effect of applying a portion of credits, deductions and exemptions to business income as well as to nonbusiness income.

Asset transfer taxes

Documentary and stock transfer taxes

These taxes on the transfer of ownership of an asset were allocated 94% to households and 6% to business. Only the 6% of these taxes that were estimated to arise from business acquisition of assets were considered paid by business.

Estate and gift taxes

All taxes on transfers of assets by gift or bequeath were assumed to be paid by individuals and were excluded from the business tax estimates.

License taxes

Business license taxes

These taxes were allocated entirely to business. License taxes paid by businesses selling entirely to consumers were allocated to business because these taxes are the statutory liability of business.

Motor vehicle license taxes

Taxes on motor vehicle licenses and registrations were allocated to business based on US Department of Transportation data describing the revenue for each type of vehicle by state. Automobile taxes and a portion of truck taxes were allocated to households, while all fees by weight, motor carrier fees and other truck fees were allocated to business.

Driver's license, hunting and fishing license taxes

These fees and taxes were allocated to households because they were generally the liability of individuals, even if directly related to the operation of a business or profession.

Economic activity, for purposes of calculating an effective tax rate measure applied to the disparate state and local business taxes, was measured using private sector economic activity for 2006. Private sector economic activity is equivalent to GDP by state, less public sector value added.

Appendix: Supplemental tables

Appendix Table A-1. Total state and local business taxes, FY1990–FY2007 ($Billions)

State and local taxes	1990	1995	2000	2001	2002	2003	2004	2005	2006	2007
Total business taxes*	$229.4	$303.2	$382.4	$395.3	$401.8	$424.2	$459.9	$502.0	$546.5	$577.4
Individual income taxes on nonbusiness income	99.1	128.3	196.5	209.7	188.0	185.5	197.7	219.4	243.0	264.2
Other taxes	185.5	244.9	313.7	324.3	336.2	356.5	383.6	408.5	444.2	467.9
Total state and local taxes	**$514.0**	**$676.4**	**$892.6**	**$929.4**	**$926.1**	**$966.2**	**$1,041.2**	**$1,130.0**	**$1,233.7**	**$1,309.4**
Composition of state and local taxes	**1990**	**1995**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total business taxes*	44.6%	44.8%	42.8%	42.5%	43.4%	43.9%	44.2%	44.4%	44.3%	44.1%
Individual income taxes on nonbusiness income	19.3	19.0	22.0	22.6	20.3	19.2	19.0	19.4	19.7	20.2
Other taxes	36.1	36.2	35.1	34.9	36.3	36.9	36.8	36.2	36.0	35.7
Total state and local taxes	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

**Includes individual income taxes on pass-through business income. Source: EY calculations. Figures may not appear to sum due to rounding.*

Appendix Table A-2. Composition of state and local business taxes, FY1990–FY2007 ($Billions)

Business taxes	1990	1995	2000	2001	2002	2003	2004	2005	2006	2007
Property taxes on business property	$84.7	$110.7	$136.8	$142.6	$152.9	$160.9	$169.7	$176.6	$189.5	$202.5
General sales and use taxes on inputs	53.4	70.2	94.4	97.6	97.9	100.9	107.3	115.2	127.0	132.3
Corporation net income	23.7	31.7	36.4	35.8	28.5	31.9	34.1	43.5	52.5	58.7
Business license tax	10.5	15.6	19.8	20.1	22.1	22.1	24.6	35.5	38.0	39.7
Unemployment compensation	12.4	15.8	20.9	20.8	21.0	23.9	31.9	35.5	36.4	35.8
Excise taxes	10.6	16.0	20.1	20.2	20.8	21.9	23.4	23.9	24.9	27.6
Individual income tax	6.6	9.4	15.1	16.3	14.8	14.8	17.5	21.5	23.7	25.8
Public utility taxes	11.4	15.0	17.7	17.9	20.3	21.2	21.3	22.6	23.5	23.7
Insurance premiums taxes	7.4	8.6	9.8	10.3	11.2	12.6	14.0	14.9	15.4	15.4
Other business taxes	8.6	10.0	11.5	13.9	12.3	14.2	16.2	12.8	15.6	16.0
Total business taxes	**$229.4**	**$303.2**	**$382.4**	**$395.3**	**$401.8**	**$424.2**	**$459.9**	**$502.0**	**$546.5**	**$577.4**

Source: EY calculations. Figures may not appear to sum due to rounding.

Appendix Table A-3. Composition of state and local business taxes, by type, FY2007 ($Billions)

State	Property taxes	Sales taxes	Excise and gross receipts	Corporate income tax	Unemployment insurance tax	Individual income tax	License and other	Total business taxes
Alabama	22.8%	23.2%	23.1%	8.1%	4.4%	4.4%	14.0%	100%
Alaska	13.9	2.3	2.4	20.3	4.0	0.0	57.1	100
Arizona	34.9	36.4	9.0	9.5	2.9	2.4	4.9	100
Arkansas	23.7	34.5	13.0	9.9	7.5	5.3	6.2	100
California	22.5	26.2	10.3	15.3	7.2	7.6	10.9	100
Colorado	37.6	30.4	7.5	5.6	6.0	7.2	5.7	100
Connecticut	39.8	20.1	9.7	11.1	7.9	7.8	3.6	100
Delaware	13.3	0.0	12.7	15.5	4.2	4.5	49.8	100
Florida	37.4	25.6	18.6	7.9	3.9	0.0	6.5	100
Georgia	37.1	30.9	8.9	7.3	4.8	5.6	5.3	100
Hawaii	26.3	34.2	19.6	4.1	5.9	4.2	5.6	100
Idaho	39.8	17.7	9.5	9.3	7.0	7.6	9.1	100
Illinois	38.1	14.5	18.1	10.8	9.6	3.0	6.0	100
Indiana	49.3	19.6	6.4	11.1	6.8	4.6	2.3	100
Iowa	54.3	16.9	6.4	6.2	5.3	4.6	6.3	100
Kansas	44.2	22.8	7.9	9.2	5.9	4.7	5.3	100
Kentucky	24.6	20.9	17.6	15.8	5.9	4.7	10.5	100
Louisiana	22.4	45.0	7.9	6.7	1.7	2.9	13.4	100
Maine	61.1	12.8	7.8	6.0	3.4	3.7	5.2	100
Maryland	26.3	15.6	18.0	8.7	5.6	8.2	17.6	100
Massachusetts	44.7	11.6	6.4	15.2	12.2	6.6	3.4	100
Michigan	50.5	14.9	6.6	10.3	9.1	3.3	5.1	100
Minnesota	34.8	19.7	12.9	11.8	9.1	5.0	6.8	100
Mississippi	40.9	26.7	9.5	8.4	3.0	2.8	8.8	100
Missouri	32.8	29.8	12.5	4.8	6.8	5.0	8.2	100
Montana	44.9	0.0	11.2	10.1	4.4	5.1	24.4	100
Nebraska	45.9	25.9	6.7	6.0	4.3	4.6	6.6	100
Nevada	30.9	26.9	15.5	0.0	6.5	0.0	20.1	100
New Hampshire	57.4	0.0	12.6	21.4	2.4	0.3	5.7	100
New Jersey	41.3	16.1	8.9	14.3	7.8	4.8	6.8	100
New Mexico	13.6	37.2	8.7	10.7	2.4	2.3	25.1	100
New York	37.8	20.4	10.0	17.3	4.4	7.2	2.9	100
North Carolina	29.3	22.6	14.6	12.4	7.6	6.2	7.4	100
North Dakota	33.0	15.0	10.0	8.2	3.5	1.9	28.3	100
Ohio	42.0	21.3	7.0	9.2	5.7	5.3	9.5	100
Oklahoma	18.9	29.8	7.6	8.5	4.2	8.3	22.7	100
Oregon	40.7	0.0	9.3	8.1	14.6	9.7	17.5	100
Pennsylvania	33.2	14.9	12.5	9.8	10.3	5.2	14.2	100
Rhode Island	51.6	16.6	9.8	7.4	8.2	3.2	3.3	100
South Carolina	47.3	18.0	11.7	5.0	4.6	3.4	10.1	100
South Dakota	43.6	33.7	8.9	4.9	1.3	0.0	7.6	100
Tennessee	32.0	31.0	8.7	11.5	4.1	0.3	12.5	100
Texas	38.4	28.4	13.8	0.0	3.5	0.0	15.9	100
Utah	32.6	23.8	13.3	10.9	6.5	5.9	7.0	100
Vermont	56.2	9.5	16.6	5.9	3.8	3.3	4.7	100
Virginia	36.9	14.1	17.4	10.4	4.4	5.4	11.5	100
Washington	21.3	49.3	13.5	0.0	9.8	0.0	6.1	100
West Virginia	31.0	9.8	18.2	16.1	4.2	3.0	17.7	100
Wisconsin	46.8	17.6	8.8	9.1	7.2	3.9	6.5	100
Wyoming	37.5	21.2	3.0	0.0	1.9	0.0	36.4	100
Dist. of Columbia	44.5	14.5	9.1	10.9	5.0	5.3	10.7	100
United States	**35.1%**	**22.9%**	**11.5%**	**10.2%**	**6.2%**	**4.5%**	**9.6%**	**100%**

Source: EY calculations. Figures may not appear to sum due to rounding.

Table A-4: State and local tax to benefit ratios, FY2005 ($Billions)			
State	**2005 state and local business taxes**	**2005 business benefit from state and local services**	**Ratio of taxes to benefits**
Alabama	$5.5	$3.6	1.53
Alaska	2.3	1.1	2.12
Arizona	9.0	5.5	1.63
Arkansas	3.2	2.1	1.52
California	64.3	39.7	1.62
Colorado	7.3	3.9	1.88
Connecticut	6.9	3.8	1.82
Delaware	1.7	1.0	1.73
Florida	28.4	18.5	1.54
Georgia	11.8	6.4	1.86
Hawaii	2.2	1.3	1.65
Idaho	1.8	1.2	1.52
Illinois	24.3	11.6	2.11
Indiana	8.0	5.0	1.61
Iowa	4.5	2.8	1.63
Kansas	4.7	2.7	1.77
Kentucky	5.5	3.3	1.68
Louisiana	8.6	4.8	1.79
Maine	2.5	1.2	2.11
Maryland	8.3	5.5	1.52
Massachusetts	11.7	6.8	1.72
Michigan	15.7	9.8	1.60
Minnesota	8.9	4.3	2.06
Mississippi	3.7	2.1	1.71
Missouri	7.3	4.2	1.73
Montana	1.4	0.8	1.67
Nebraska	3.2	1.7	1.92
Nevada	4.5	3.2	1.42
New Hampshire	2.4	1.1	2.20
New Jersey	17.0	9.4	1.81
New Mexico	3.2	2.2	1.49
New York	48.1	24.1	1.99
North Carolina	11.0	6.9	1.59
North Dakota	1.3	0.7	1.88
Ohio	17.7	9.6	1.85
Oklahoma	5.2	2.6	2.01
Oregon	4.3	3.1	1.38
Pennsylvania	20.7	10.8	1.92
Rhode Island	2.1	1.2	1.74
South Carolina	5.3	3.2	1.67
South Dakota	1.3	0.7	1.95
Tennessee	8.4	4.0	2.09
Texas	43.4	20.3	2.14
Utah	2.9	2.1	1.38
Vermont	1.2	0.7	1.83
Virginia	10.4	7.1	1.45
Washington	12.8	6.3	2.02
West Virginia	3.0	1.5	1.98
Wisconsin	8.7	5.7	1.53
Wyoming	2.0	0.5	3.73
Dist. of Columbia	2.2	0.9	2.41
United States	**$502**	**$282.5**	1.78

Source: EY calculations.

Endnotes

[1] Cline, Neubig and Phillips, *Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2006*, February 2007.

[2] The general methodology used to estimate state and local business taxes is described in detail in the Appendix to the March 2006 report cited in endnote 1. Note that business tax estimates for prior years have been revised from those published in earlier editions of this study due to feedback from state tax agencies, the use of updated and more detailed information on local business taxes and refinements to the property tax estimation methodology to reflect the rapid rise in the value of residential property since 2002. The most significant change was to business property taxes, which we estimated to be $204.8 for FY2006 in the February 2007 study and have been revised in the current analysis to $189.5 for FY2006. All references to business taxes in prior fiscal years refer to the updated estimates rather than the previously published estimates.

[3] A more detailed analysis of state and local sales taxation of business inputs was done by Robert Cline, John Mikesell, Tom Neubig and Andrew Phillips in the COST study, *Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services*, 25 January 2005. (Also in *State Tax Notes*, 28 January 2005.)

[4] Effective property tax rate for business property equals the estimated business property tax divided by the sum of (1) nonresidential property owned by nonfarm non-financial corporate business at market value, (2) nonresidential property owned by nonfarm non-corporate businesses at market value, (3) residential property owned by non-financial corporate business at market value, (4) equipment owned by nonfarm non-financial corporate business (replacement cost) and (5) equipment owned by non-corporate business (replacement cost). Asset data was obtained from the Federal Reserve Flow of Funds balance sheet data for relevant sectors. The effective residential property tax rate equals the Ernst & Young estimated household property tax divided by the sum of the value of households and nonprofit organization real estate, excluding nonprofits, and household motor vehicles (net stock). Real property values were obtained from the Federal Reserve Flow of Funds balance sheet data for households and nonprofits; motor vehicle values were obtained from the Bureau of Economic Analysis detailed residential fixed-asset tables.

[5] Rate increases include an Idaho 1% rate increase effective 1 October 2006, a New Jersey 1% rate increase effective 15 July 2006 and a South Carolina 1% rate increase effective 1 June 2007. North Carolina decreased its rate by 0.25%, effective 1 December 2006.

[6] Recently enacted gross receipts taxes will replace existing taxes that raised approximately $4.2 billion of the $59.4 billion of corporate income and corporation license taxes in FY2006. This study follows the classification of business taxes established by the Census Bureau — as a general sales/gross receipts for Washington state's B&O tax, as a corporate income tax for Michigan's former SBT and replacement MBT as well as Ohio's CAT and as a corporation license tax for the Texas Franchise (margin) tax.

[7] Center for Budget and Policy Priorities, *22 States Face Total Budget Shortfall of at Least $39 Billion in 2009; 6 Others Expect Budget Problems*, March 2008.

[8] See Cline, Kim and Phillips, *Property Taxes on Business Captial: Large and Growing Share of State and Local Business Taxes*, presented at the National Tax Association Annual Conference, November 2005.

[9] In Figure 4 and Table 3, the excise and gross receipts taxes category includes excise, insurance premiums and public utility taxes. The business license and other taxes category includes corporate license, business license and other business taxes

[10] Richard H. Mattoon and William A. Testa, *How Closely Do Business Taxes Conform to the Benefits Principle?* presentation at the Future State Business Tax Reforms: Perspectives from the Business, Government and Academic Communities conference, Federal Reserve Bank of Chicago (17 September 2007). The authors distributed state and local government expenditures between businesses and households. Services benefiting business include shares of expenditures for transportation, water and sewer infrastructure, police and fire protection, general government "overhead" (e.g., legislative, administrative and judicial services), interest and regulatory activities. The methodology used is described in detail in William H. Oakland and William A. Testa, *State-Local Business Taxation and the Benefits Principle*. Economic Perspectives (January/February 1996). The authors also note that selective excise taxes, such as the severance tax, impact a small portion of businesses and could be removed from the business tax numerator to provide a measure of the tax to benefit ratio generally applicable to most firms.

[11] The estimated ratios of business taxes to services benefiting businesses presented in this study are based on the results presented by Testa and Mattoon (2007). The authors' original results were revised to incorporate updated estimates of business taxes in each state for FY2005 and 25% of state and local educational expenditures in the value of services benefiting businesses.

[12] For a discussion of mobile capital investments and interstate investment trends, see *The 2007 U.S. Investment Monitor*, Ernst & Young, August 2007 and *Future State Business Tax Reforms: States Defend or Replace the Tax Base*, Ernst & Young, December 2007.

[13] Cline, Mikesell, Neubig and Phillips, *Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services*, 25 January 2005. (Also in *State Tax Notes*, 28 January 2005.)

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COMBINED REPORTING

UNDERSTANDING THE REVENUE AND COMPETITIVE EFFECTS OF COMBINED REPORTING

MAY 2008

By Robert Cline, Ernst & Young LLP

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EXECUTIVE SUMMARY

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and corporate taxpayers is how a state should determine the corporate income tax base for multistate corporations with multiple businesses and entities. The debate is framed as a choice between two distinctly different corporate income tax systems used by states to answer this question: separate filing and combined reporting.

The first approach to determining the income of a multistate enterprise, separate filing, treats each corporation as a separate taxpayer. Under separate filing, each corporation includes only its income on the corporate tax return it files. The second approach, combined reporting, treats affiliated taxpayers (parents and subsidiaries) engaged in a unitary business as a single group for purposes of determining taxable income.[1] In the process of determining tax liabilities of the members of the combined group, the separate incomes of the members are added together or "combined." In effect, combined reporting treats the members of the unitary business as though they were a single company in determining their income. Under both systems, the income of the taxpayer or group is then distributed (apportioned) by a formula to a specific state. States vary widely both on the composition of the combined group and the apportionment formula.

Prior to Vermont's adoption of combined reporting beginning in 2006, no state had adopted combined reporting for two decades. West Virginia and Michigan followed Vermont in adopting combined reporting for their business income taxes, and New York recently expanded its combined filing requirements. Additional states are considering the switch from separate filing to combined reporting. Proponents

Robert Cline is the National Director of State and Local Tax Policy Economics at Ernst & Young LLP. He is the former tax research director for the states of Michigan and Minnesota. He has a Ph.D. in economics from the University of Michigan. He is part of E&Y's Quantitative Economics and Statistics practice that provides quantitative, regulatory and policy services to private and public sector clients.

maintain that the switch will increase state corporate tax collections and reduce tax base shifting attributable to tax planning by multistate firms. Opponents assert that combined reporting decreases a state's economic competitiveness and may result in a state taxing more or less income than is justified based on the taxpayer's actual in-state activities. This study provides additional information that should help legislators and policymakers better understand the complex issues involved in this debate.

Key study findings

- Combined reporting may increase, decrease or leave unchanged the taxable income reported on the combined return compared to the sum of the taxable incomes for the separate taxpayers, assuming that corporations in the combined group are already taxpayers in a state. The result depends upon the difference in profitability per dollar of U.S. payroll, property and/or sales ("factors") for the different corporations in the group.
- Combined reporting has uncertain effects on a state's revenues, making it very difficult to predict the revenue effect of adopting combined reporting. This is due to the fact that combined reporting assumes that all members of the group have the same profitability per dollar of factors. This assumption contradicts both economic theory and business experience. The assumption is invalid for almost all taxpayers, not just corporations using tax planning strategies.
- Combined reporting replaces one set of distortions with another set of distortions. Combined reporting may reduce distortions in reported taxable income among related companies due to tax planning. However, combined reporting will simultaneously create new distortions related to the averaging effect for a large number of taxpayers with different profitability across businesses, with no tax planning. This fact should not be ignored in the evaluation of the benefits and costs of adopting combined reporting.
- Combined reporting cannot differentiate between real economic differences among taxpayers and the tax planning situations many intend for it to address. For this reason, a switch to combined reporting may have significant and unintended impacts on taxpayers and tax liabilities unrelated to tax planning.
- The type of filing system a state uses does not provide an explanation for the presence of zero or minimum tax filers. Proponents of combined reporting have frequently argued that combined reporting is justified by the significant percentage of corporate income taxpayers that pay no tax or pay only a state's minimum tax unrelated to corporate profits. The study finds that a high percentage of companies in both separate and combined filing states paid no corporate income taxes in excess of the minimum tax for the years reported.
- Reliably estimating the state revenue impact of adopting combined reporting is a very challenging task. Considerable uncertainty surrounds combined reporting estimates due to: the lack of needed information on separate filing returns, inability to identify members of the unitary group, absence of information on carryover net operating losses and unused credits into the new system, insufficient data to estimate changes in apportionment formulas, and the interaction of combined reporting with addback statutes and other measures previously enacted to address income shifting in many separate filing states.
- A review of past state revenue estimates of combined reporting reveals a wide range of expected impacts reflecting the high degree of uncertainty in the estimation process. States that looked at current tax return information as a starting point in the estimating process found lower impacts. The short-run impact of adopting combined reporting may be a relatively small increase or even no change in corporate income tax revenue. The one state that actually reviewed the initial estimates after implementation, Minnesota, concluded that combined reporting did not increase revenues at all in the short- or intermediate-run.
- States that have already enacted addback provisions can expect significantly reduced additional revenue from combined reporting. Addback provisions achieve much of the same revenue effect as combined reporting.
- Economic theory, empirical studies and economic simulation modeling all suggest that switching from separate filing to combined reporting will have a negative impact on a state's economy. If combined reporting increases tax revenues, it will also increase effective corporate income tax rates, on average, for the states' taxpayers. In response, firms will reduce the level of investment and jobs in states adopting combined reporting.
- Simple comparisons of aggregate state job growth rates, when adjusted to reflect population changes, show that separate filing states are doing no worse or slightly better than combined reporting states. Data on recent large investment projects across the states reinforce this conclusion. Comparisons of separate filing and combined reporting states show that the ratio of project-related jobs to gross state product is substantially higher for separate filing states.
- The additional compliance, administrative and litigation costs associated with combined reporting should be in-

cluded in a balanced evaluation of the benefits and costs of adopting combined reporting.

The analysis in this paper suggests that combined reporting is not a panacea for addressing the problem of how to determine accurately multistate business income that is attributable to economic activity in a state. From a business taxpayer perspective there is a significant risk that combined reporting will arbitrarily attribute more income to a state than is justified by the level of a corporation's real economic activity in the state. This will occur simultaneously with any gains from reducing tax planning opportunities.

State legislators should carefully evaluate the revenue, economic development, and tax policy impacts before adopting combined reporting. The revenue and economic impacts are complex and, in some cases, uncertain. Given this uncertainty, legislators should consider the range of options available for achieving their corporate tax policy objectives at a lower cost, while minimizing the unintended and negative consequences from combined reporting.

I. INTRODUCTION

Overview

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and corporate taxpayers is how a state should determine the multistate corporate income tax base. This complex and controversial tax policy question has two separate, but closely related, issues that are central to this debate. The first is determining the total income attributable to the taxpayer and the second is determining the state's share of that total income.

Answering the first question is relatively straightforward in the case of a single, unaffiliated company doing business in a single state or in multiple states. The total income of the company is the tax base distributed across the states where the taxpayer is operating. It becomes more complex, however, when a parent company operates with a number of affiliates with economic activity in multiple states. In this case, states have historically taken two distinct approaches to determining income: separate filing and combined reporting.

In separate filing states, the parent company and affiliates are treated as separate companies in determining income. Each of the companies that a state is permitted to tax (companies with "nexus") files a tax return that includes only the income and factors of that company. In determining income, there is no merging of income or factors of the related companies.

In contrast, combined reporting states disregard separate legal business entities in determining income for corporate tax purposes.[2] The parent corporation and its affiliates that are engaged in a unitary business are treated as a single group in determining income.[3] In the process, the nationwide income and factors of the members of the unitary group are combined, as though they were operating as a single company.

The second key question, how should the total tax base be divided among these states, is answered using an apportionment formula that includes measurable, state-specific "factors" (payroll, property and sales) assumed to reflect where the firm's economic activity generating the income is located. For a single company, a weighted average of a state's shares of the taxpayer's factors (for example, instate payroll divided by U.S.-wide payroll) is applied to the taxpayer's business income to determine each state's share of the tax base. The apportionment formula approach is used for taxpayers with multistate business income in both separate and combined filing states.

Even with a single company as the taxpayer, there is some controversy and disagreement among the states over the measurement and weighting of the factors. For example, 18 states have adopted (or are phasing in) an apportionment formula that uses only the sales factor. In effect, these states take the view that only sales generate income. At the other extreme, 11 states have "traditional" apportionment formulas that apply a weight of one-third to the sales factor and two-thirds to the payroll and property factors combined. These states view payroll and property together as the most important determinants of where income is generated.

In the states with combined reporting, the apportionment formula is applied to the combined income of the unitary group to determine the distribution of nationwide income to a state. Compared to the separate filing method, the combined reporting apportionment formula includes the nationwide factors of the combined group in determining the state's share of factors. For example, with two affiliated corporations in a combined group, each company's share of payroll is calculated by dividing the company's instate payroll by the sum of the nationwide payroll for both members of the unitary group, rather than only the nationwide factors for one firm as calculated under separate filing. Each firm's weighted average of the apportionment factors is then multiplied by the group's combined income to determine each company's taxable income in a state. The sum of the taxable income amounts for the two firms equals the group's total income.

Issues related to combined reporting

The proponents of combined reporting focus on the combination of income dimension of mandatory combined reporting.[4] They argue that combined reporting is needed to offset erosion in the corporate income tax base attributed to tax planning strategies available to multistate corporations. Proponents argue that these strategies, such as the use of passive investment companies to manage intangible assets or the distortions in prices charged by one firm to other firms in the group (transfer prices), allow multistate corporations to lower their tax liabilities by shifting income to affiliates in low-tax or no corporate income tax states. By combining income of affiliated companies in a unitary group, the adoption of combined reporting is viewed as one method of negating these shifts and making the group's tax liability independent of business structure.

The proponents of combined reporting also argue that it provides increased uniformity in the effective tax rates paid by companies that operate as multiple divisions rather than multiple corporations. Proponents expect single-company corporations to have fewer tax planning opportunities that reduce tax liabilities. It is also argued that combined reporting will reduce the administrative and compliance costs associated with monitoring transfer prices under separate filing systems.

While the proponents focus on expanding the taxable income of an affiliated group of taxpayers, there is less discussion or even awareness of the impacts of combining factors in moving from separate filing to combined reporting. Issues related to factor combination (the second question of how to distribute income among the states) introduce additional controversy into the debate that goes beyond the issue of how to define the taxpayer group and how to combine income. As discussed in this paper, these two issues are integrally interrelated.

The interaction of the two issues creates significant challenges and uncertainty in estimating the revenue impacts of adopting combined reporting and magnifies the potential negative impact on a state's economy from adopting combined reporting. More fundamentally, the interaction creates an actual or perceived disconnect in the link between the location of measurable, state-specific factors and the attribution of income to a state. This distortion adds even more controversy to the debate; while combined reporting is advocated as a method of more reliably measuring the income of a unitary business, it may not attribute this income to the state in which the economic activities that actually generated the income occur.

While the proponents focus on expanding the taxable income of an affiliated group of taxpayers, there is less discussion or even awareness of the impacts of combining factors in moving from separate filing to combined reporting.

Examples of the possible effects of combined reporting on state tax liabilities

The example provided in Table 1 may help to clarify this point by illustrating how combined reporting works. Company 1 and Company 2 are commonly-owned multistate corporations engaged in a unitary business operating in State A, which apportions multistate income based on an equally weighted, three-factor formula using payroll, property and sales.[5] Also assume that for non-tax reasons the two companies are operated as separate legal entities. Both companies have $10 million of annual sales and $1 million of net income.

Under *separate filing*, both firms file separate tax returns in State A as follows:

- Company 1 has 5 percent of each factor (payroll, property, and sales) in state A. With an equally weighted apportionment formula, the apportionment factor is also 5 percent. After apportionment, Company 1 has 5% of its $1 million of U.S. income or $50,000 taxable in the state.

Table 1
Example of Combined Reporting Reducing State Taxes
(dollars in thousands)

A. Separate filers			
Company 1	**US-wide**	**In-state**	**In-state share**
Sales	$10,000	$500	5.0%
Payroll	5,000	250	5.0
Property	5,000	250	5.0
Apportionment factor			5.0%
Taxable income	$1,000	$50	
Company 2			
Sales	$10,000	$5,000	50.0%
Payroll	1,000	500	50.0
Property	1,000	500	50.0
Apportionment factor			50.0%
Taxable income	$1,000	$500	
Total taxable income: separate		**$550**	
B. Combined report			
Sales	$20,000	$5,500	27.5%
Payroll	6,000	750	12.5
Property	6,000	750	12.5
Apportionment factor			17.5%
Taxable income: combined	**$2,000**	**$350**	
Change in taxable income			
Company 1		$22	
Company 2		-$222	
Total change		**-$200**	

- Company 2 has 50% of each factor in State A; after apportionment, $500,000 (50 percent) of its U.S. income is taxable in State A.
- The sum of the incomes taxable in State A is $550,000 under separate filing.

Assume that State A adopts combined reporting and Company 1 and Company 2 are members of a unitary group. (To simplify the example, assume that they do not have intercompany sales.) The combined nationwide income of the unitary group is $2 million, the sum of the separate company incomes. To determine each company's taxable income in State A, the in-state payroll, property and sales for each firm is divided by the total of the U.S.-wide factors summed over both firms, $20 million of sales and $6 million each for payroll and property. After weighting each factor by one-third, the combined apportionment factor is 17.5%. Multiplying the combined income of $2 million by 17.5% results in total income subject to tax in State A of $350,000, a reduction of $200,000.

The 36% reduction in taxable income from $550,000 to $350,000 can be explained in terms of the mechanics of combined reporting. When the two companies are combined two things happen: 1) they must include the combined income for both firms on their tax returns ($2,000 in this example), and 2) their apportionment factor is lowered significantly as the U.S.-wide factors of both firms are included in the denominator of the apportionment factors.[6] In both cases the income they report increases by 100 percent because each has the same amount of U.S. income. If the apportionment factor for both companies were reduced by exactly 50 percent, there would be no change in income apportioned to State A.

However, in this example Company 1 is bigger than Company 2 as measured by U.S. factors. As a result, when the two firms are combined, the apportionment factor for Company 2 falls by 72 percent. Because it falls by more than 50 percent, it more than offsets the doubling of income to be apportioned and Company 2's taxable income in State A falls by 44 percent to $278,000. In contrast, Company 1, because it has larger U.S.-wide factors, only experiences a 28 percent decrease in the apportionment factor following combination. This is too small a decrease to offset the doubling of U.S.-wide income, so taxable income for Company 1 rises by 44 percent to $72,000.[7] In effect, combination significantly "dilutes" the apportionment percentage for both companies by increasing the denominators of the factors, but the Company 2 reduction is 2.6 times larger. Because Company 2 has 50 percent of its factors in State A, compared to only 5 percent for Company 1, the 44 percent decrease in taxable income for Company 2 results in a greater dollar reduction in taxable income than the increase for Company 1 and total taxable income goes down under combined reporting.

Another way to understand why combined taxable income fell is to note that Company 2 is approximately 66 percent more profitable, per dollar of total U.S. factors, than Company 1. Because of the averaging of income per dollar of factors under combined reporting, the combination of the two firms lowers the income per dollar of in-state factors for Company 2 by 25 percent, while increasing the income per dollar of in-state factors for Company 1 by 25 percent. Because Company 2 accounts for 86 percent of the in-state factors, combined reporting lowers total taxable income attributed to State A.

There are a number of reasons why profits per dollar of factors vary across firms and states. The most important source of variation is the difference in ratios of value added to sales across companies and states. Value added is the additional value that a company adds to the products and services that it purchases from other companies. It measures the contribution of the companies' labor and capital to production.[8] Firms with high value added, such as manufacturers using significant amounts of real, personal and intangible capital, tend to have high ratios of income to factors. In contrast, retailers will have low value added (and income) relative to sales and other factors. This is why retailers are often referred to as low-margin businesses. There are also competitive and economic factors that influence the ratio of income to factors in different regions of the country.

Table 2 provides an example where combined reporting would have no impact on state taxes compared to a separate filing system. In this situation, the ratios of income to U.S. factors included in the apportionment formula are the same for both companies. Under combined reporting, the income apportioned to the state on the combined return is the same as the combined income of the separate filers even though their in-state apportionment factors are different because there is no change in income per dollar of in-state factors. In this example, the combined income to be apportioned is doubled and the apportionment factor for both companies is reduced by 50 percent. As a result, there is no change in State A taxable income. Combined reporting will not change taxable income (and taxes) attributable to these two firms overall. It will increase the tax on Company 1 and reduce the tax on company 2.

Table 2
Example of Combined Reporting with no Change in State Taxes
(dollars in thousands)

A. Separate filers			
Company 1	**U.S.-wide**	**In-state**	**In-state share**
Sales	$10,000	$500	5.0%
Payroll	5,000	250	5.0
Property	5,000	250	5.0
Apportionment factor			5.0%
Taxable Income	$1,000	$50	
Company 2			
Sales	10,000	5,000	50.0%
Payroll	5,000	2,500	50.0
Property	5,000	2,500	50.0
Apportionment factor			50.0%
Taxable income	$1,000	$500	
Total taxable income: separate		**$550**	
B. Combined Report			
Sales	$20,000	$5,500	27.5%
Payroll	10,000	2,750	27.5
Property	10,000	2,750	27.5
Apportionment factor			27.5%
Taxable Income: combined	$2,000	**$550**	
Change in taxable income			
Company 1		$0	
Company 2		$0	
Total change		**$0**	

Table 3 provides an example of the situation where combined reporting would increase taxable income apportioned to State A. In this case, Company 1 has significantly higher profits per dollar of U.S. factors than Company 2. In moving to combined reporting, the income each company is apportioning doubles. Because Company 1 is smaller (in terms of U.S. payroll and property), combination reduces its apportionment factor by 72 percent more than offsetting the higher income and reducing State A taxable income. In contrast, Company 2's apportionment factor only falls by 28 percent, resulting in a significant increase in Company 2's taxable income apportioned to the state. Because Company 2 has significantly larger in-state factors, the taxable income on the combined report increases. In this example, combination increases corporate income attributable to State A by $200,000 or 36 percent.

The example in Table 3 is generally the one that proponents of combined reporting have in mind when they present the case for switching from separate filing to combined reporting. Proponents often describe the more extreme case where Company 1 has no physical presence (as compared to a relatively small presence shown in Table 3) in State A, and therefore, is not a taxpayer in the state. This firm is often described as a Delaware intangible holding company receiving royalties from Company 2 for the use of intangible property. Combined reporting then results in Company 1's income being included on the return for Company 2, and the sum of the U.S. factors for both companies being included in the denominators of Company 2's apportionment factors. In this situation, combined reporting doubles the income reported on Company 2's return but only reduces Company 2's apportionment factor by 28 percent.[9] The net result is a 44 percent increase in Company 2's income apportioned to State A.

The proponents of combined reporting might argue that even in the situation shown in Table 3 (both companies are taxpayers) the profits per dollar of factors for Company 2 might be artificially reduced due to improper transfer pricing adjustments or other tax planning techniques. Conversely, they might argue that the income per dollar of factors is artificially inflated for Company 2. By combining income, any income shift between affiliates due to tax planning might be negated.

Table 3
Example of Combined Reporting Increasing State Taxes
(dollars in thousands)

A. Separate filers			
Company 1	**US-wide**	**In-state**	**In-state share**
Sales	$10,000	$500	5.0%
Payroll	1,000	50	5.0%
Property	1,000	50	5.0%
Apportionment factor			5.0%
Taxable income	$1,000	$50	
Company 2			
Sales	$10,000	$5,000	50.0%
Payroll	5,000	2,500	50.0%
Property	5,000	2,500	50.0%
Apportionment factor			50.0%
Taxable income	$1,000	$500	
Total taxable income: separate		**$550**	
B. Combined report			
Sales	$20,000	$5,500	27.5%
Payroll	6,000	2,550	42.5%
Property	6,000	2,550	42.5%
Apportionment factor			37.5%
Taxable income: combined	**$2,000**	**$750**	
Change in taxable income			
Company 1		-$22	
Company 2		$222	
Total change		**$200**	

However, it is also possible that the income-factor differences actually reflect differences in relative profitability based on the economics of the two businesses with no tax planning involved. In the case where the differences are "real" (not created by tax planning opportunities), combined reporting will distort the distribution of taxable income and taxpayers could assert that by adopting combined reporting State A is arbitrarily attributing a portion of the income earned by factors and economic activity in other states to State A. This fundamental difference in perspective on the relationship between real economic activity, reported income and the mechanism for attributing multistate income to different states is one of the reasons why many taxpayers with diverse businesses strongly oppose the concept of combined reporting.

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It is also apparent that some state tax administrators and legislators do understand the different impacts on state corporate tax collections under combined reporting illustrated in the three examples. This understanding is evident in a bill introduced this legislative session in Alabama.[10] The bill would give the Commissioner of Revenue the authority to require a corporation to file a combined return if the ratio of the taxpayers profits (under separate filing) to profits of the combined unitary group is less than 50 percent of the taxpayers factors (payroll, property and sales) relative to the factors of the group. This arbitrary rule would have the effect of ensuring that the average income (profits) per dollar of in-state factor is increased with combination.

The exercise of this authority will increase Alabama tax collections, regardless of the presence of intercompany transactions, income shifting or economic differences in profitability among members of the unitary group. Because the bill does not allow taxpayers to elect combined reporting, it avoids any revenue losses from the example illustrated in Table 1 where the firm added to the group decreases both income per dollar of in-state factors and taxable income apportioned to the state. The bill is designed to raise revenue, not to create a fairer attribution of multistate taxable income to Alabama.

Insights provided by the three simple examples include:

- Independent of any intercompany transactions that could distort taxable income between the two companies, the examples show that under different circumstances mandatory combined reporting could result in reduced, unchanged, or increased income taxable in a state. The outcome is dependent on the level of each company's income, total U.S. apportionment factors, and state apportionment percentages under separate filing. Changes in the relative levels of these factors can result in seemingly arbitrary assignment of income to a particular state.
- The example that shows combined reporting reducing a state's taxable income (and taxes) may not be intuitively obvious, but it is a result of the fundamental assumption underlying combined reporting. The assumption is that both of the companies in the combined group are equally profitable for each dollar of their factors. In other words, each dollar of capital equipment (property), labor costs (payroll) or sales is assumed to generate the same level of profits in both companies.

  The proponents of combined reporting argue that this is a reasonable assumption because it is not possible to determine where corporate net income is generated for a group of unitary companies. However, economists would assert that income, a payment for the use of capital, varies depending upon the amount of equity capital used in each company. The combined reporting assumption that the profitability of the two firms is the same, when economic theory and fact conclude otherwise, illustrates the disconnect between economic reality and the operation of the state corporate income tax system.[11]

  In effect, combined reporting based on this averaging assumption creates distortions in the distribution of taxable income among firms and across states that are unrelated to business economics. This is a result similar to the situation where distortions in transfer prices may result in the distribution of income across states unrelated to real economics. While combined reporting may reduce distortions related to tax planning, it will have the effect of creating new distortions related to the averaging effect. This fact should not be ignored in the evaluation of the benefits and costs of adopting combined reporting.

  The key point is that combined reporting cannot differentiate between the examples reflecting real economic differences and the tax planning situations it intends to address. For this reason, a shift to combined reporting

The combined reporting assumption that the profitability of the two firms is the same, when economic theory and fact conclude otherwise, illustrates the disconnect between economic reality and the operation of the state corporate income tax system.

may have significant and unintended impacts on taxpayers and tax liabilities unrelated to tax planning. Legislators need to be aware of this problem and consider alternatives for dealing with the shifting of income through tax planning opportunities that do not have these unintended consequences caused by combined reporting.

- To estimate reliably the revenue impact of adopting combined reporting, estimators would have to know which companies would be combined and all details related to their apportionment factors and incomes. For example, in Tables 1-3, if Company 2 was not a taxpayer in State A under separate filing, the needed information would not be available from State A tax return information. This helps explain why estimating the revenue impact of combined reporting is so difficult. (This is discussed in detail in a later section.)

... a shift to combined reporting may have significant and unintended impacts on taxpayers and tax liabilities unrelated to tax planning.

No-tax or minimum-tax returns

Proponents of combined reporting have frequently argued that combined reporting is justified by the significant percentage of corporate income taxpayers that pay no tax or pay only a state's minimum fee or tax. To many legislators, these appear to be surprisingly large numbers of taxpayers. It is often suggested by proponents of combined filing that this results from tax planning opportunities in separate filing states. What has been overlooked is how many taxpayers in combined reporting states also pay no tax based on income or only minimum taxes unrelated to a taxpayer's income.

Table 4 provides a broader perspective on the issue of taxpayers that have no positive income tax liabilities beyond minimum taxes. Collection information on the components of corporate tax liabilities that address this issue is available from a number of state tax agencies. Table 4 presents information on the number of returns that have zero or only minimum tax liabilities in both separate filing and unitary combined filing states. Minimum taxes may be, for example, fixed dollar amounts, sliding scale taxes based on the level of factors (payroll, property and sales), or other non-income measures. The table also shows the tax year for the reported data.

In order to make interstate comparisons, the last column reports the percentage of total corporate income tax returns that report zero or only minimum tax liabilities. The interesting insight from the percentages shown in the last column of Table 4 is the similarity in the range of percentages for combined and separate return states. The combined reporting states have zero or only minimum tax percentages that range between 44.5 and 71.2 percent; the range for separate return states is 50.1 to 71.9 percent. The percentages in Table 4 show that at least 45 percent of the taxpayers in both separate and combined filing states paid no corporate income taxes in excess of the minimum fee for the years reported, including the years of significant corporate tax growth following the 2001 recession. Note that Utah, a unitary state, and Pennsylvania, a separate filing state, both have no-or-minimum tax percentages exceeding 71 percent.[12]

Table 4
State Corporate Income Tax Returns with State No Liability or Only Minimum Taxes

State	Year	Returns with minimum tax or no income tax: Number	% of total
I. Combined returns			
California	2005	163,712	49.0%
Kansas	2005	17,645	56.7
Minnesota	2001	23,321	44.5
Nebraska	2005	11,342	56.3
Utah	2005	14,981	71.2
II. Separate returns			
Massachusetts	2004	32,645	53.5%
North Carolina	2004	52,788	65.5
Ohio	2006	45,353	50.1
Pennsylvania	2002	100,448	71.9
Virginia	2005	46,998	63.3
Wisconsin	2004	33,883	65.1

While the simple average percentage of taxpayers paying no more than the minimum fee is slightly higher in the separate filing states, it still exceeds 55 percent in combined reporting states. Clearly, this commonly high level of taxpayers with only zero or minimum payments cannot be explained by tax planning opportunities in either type of reporting system.[13] Instead, they are explained by economic and other tax system features including the presence of significant carryforward losses, a large number of inactive corporations in all the states, regulatory registration requirements, and the share of businesses with income less than state exclusions and deductions and with before-credit tax liabilities less than credits. The exclusions, deductions and credits that reduce or eliminate regular tax liabilities have been adopted by legislators to achieve non-revenue objectives, including stimulating capital investment and new job creation in a state.

Clearly, this commonly high level of taxpayers with only zero or minimum payments cannot be explained by tax planning opportunities in either type of reporting system.

The important point for emphasis in the corporate income tax policy debate is that a majority of corporations in the states included in Table 4 (excluding Minnesota and California) do not have income tax liabilities in excess of minimum taxes. State tax agencies could do a better job of explaining to legislators the reason for these apparently high percentages that are independent of the type of state filing system.

State tax agencies could do a better job of explaining to legislators the reason for these apparently high percentages ...

II. REVENUE EFFECTS FROM ADOPTING COMBINED REPORTING

This section looks at the experience of state revenue estimators in tackling the very challenging task of estimating the revenue effects of switching from separate to combined reporting. The central problem is that corporate tax returns in separate filing states do not contain sufficient information to estimate reliably the revenue impacts of adopting mandatory combined reporting. In separate filing states, only the U.S.-wide net income and apportionment factors of the separate multistate taxpayers are available from state tax return information. In many cases even the data that is reported on corporate tax returns is not captured during the processing of corporate returns because of resource limitations in state tax agencies.

Given this lack of information from state tax returns, revenue estimators must supplement actual state-specific tax return information with data from other sources that may have limited applicability to the state considering combined reporting or may provide only partial state-specific information that is difficult to extrapolate to the population of state taxpayers. The alternative sources of information that have been used in different states include:

- Federal tax return information for consolidated federal returns that include state taxpayers in the consolidated group.
- Tax return information from unitary states that may partially match actual taxpayers filing separately in the state preparing the combined reporting revenue estimate.
- The experience of a state's auditors in challenging transactions or structures under the state's current separate income tax filing system.
- Revenue estimates prepared by other states that are applied to the estimating state using ratios of tax return information combined with comparisons of state economic variables.

The following discussion highlights the difficulties in producing reliable estimates under the various approaches. The discussion of the key issues challenging all revenue estimators is followed by a summary of specific state estimates of the expected impact of adopting combined reporting. The evaluation is not a critique of revenue estimators, but rather a reflection of the lack of information for reliably estimating the revenue impacts of adopting a different corporate income tax system.

A. Factors affecting revenue impacts

This section identifies several of the most important data limitations that increase uncertainty in the revenue estimates of the impact of combined reporting.

Identifying members of a unitary group

Mandatory combined reporting requires affiliated companies in a unitary group to file a combined return. Unfortunately, combined reporting laws do not provide specific details on what constitutes a unitary relationship among related companies. Consequently, it is left to revenue agency regulations and court decisions, only available after the adoption of combined reporting, to offer guidance on how to define a unitary business. Revenue estimates of the switch to combined reporting have to be made without this guidance. This is an important source of the uncertainty in the revenue estimating process.

Under the combined reporting concept, there are two independent tests that must be met before an entity can be included in a combined report. First, only firms that meet minimum ownership requirement thresholds are to be included in the group filing a combined return. Typically, the group includes firms with at least fifty percent common ownership. However, there is little, if any, information on state separate tax returns or attached state-required versions of federal corporate tax returns to identify firms that may be included in a unitary group if they meet the ownership test. Because federal consolidated returns use an 80 percent ownership test, members of the federal consolidated group do not, in many cases, match the potential members of a state combined group.

The second test for being included on a combined report is that the included firms must have a unitary relationship, which is a constitutional requirement. In other words, definite economic and managerial interactions must provide a link between the members of the group. States are constitutionally limited to including only the companies that have a unitary business connection among the firms in the state combined group. Even if members of the federal combined group are identical to a state's common ownership group, some members of the federal group may not meet the state's unitary requirement. As discussed in the section on compliance costs, there is significant uncertainty over the factors that determine a unitary relationship among members of a group meeting the ownership requirements. Determining the unitary group of taxpayers is a difficult first step in the estimation process.

Net operating losses

A key factor in determining the change in revenue from adopting combined reporting is the treatment of net operating losses (NOLs). Consistent with the underlying theory that is used to justify the combination of a unitary group's income, combined reporting should also allow any NOLs earned by separate members to be aggregated and used to offset the group's combined income going forward. However, this consistent treatment of NOLs can result in a significant reduction in the unitary group's taxable income in the transition from separate to combined reporting. This occurs because combination can convert unused NOLs (for separate filers) into current "used" deductions against the combined net income of the unitary group. In other words, a greater amount of NOLs can be used earlier to offset current positive taxable income. While this is a transition issue for carryovers from the separate filing system, it can have a significant impact on the estimated revenue impacts of adopting combined reporting.

For example, under separate filing each affiliated company is restricted to deducting only carryforward NOLs or current-year losses that they generate. In other words, the NOLs from a subsidiary cannot be used to offset the taxable income of the parent company under separate filing. Under combined reporting, the NOLs and current losses may be used to offset the combined income of the affiliated group. In effect, combined reporting is likely to increase the amount of NOLs that effectively offset net income and reduce corporate income tax collections. As discussed in the state case studies in the Appendix, one of the most significant challenges in estimating the net revenue impact of combined reporting is determining the negative impact of future and previously accumulated NOLs on the combined unitary income base. The revenue impacts of adopting combined reporting are heavily influenced by the treatment of NOLs under combined reporting. This is particularly important when the economy is experiencing a sharp economic slowdown or a recession.

... combined reporting should also allow any NOLs earned by separate members to be aggregated and used to offset the group's combined income going forward.

State corporate income taxpayers have accumulated large net operating losses over the last decade. For example, as reported in annual reports of the California Franchise Tax Board, annual losses reported on state corporate returns grew significantly faster than reported profits from 1997 to 2001; as a result, the ratio of losses to profits increased from 35 to 81 percent over the four-year period. Since the end of the recession in 2001, losses have continued to average over 50 percent of profits. To the extent that corporations taxable in states currently considering adopting combined reporting have experienced a similar surge in annual losses, the cumulative stock of NOLs may substantially reduce expected revenue or even result in an initial revenue loss from adopting combined reporting.

Assuming that taxpayers in a separate filing state are allowed to carry forward unused NOLs to future years, switching to combined reporting should provide the same carryforward treatment. However, because combined reporting treats the affiliated companies as a single corporation, any carryforward NOLs from separate returns should be allowed to offset the income of the combined group, not just the income of the entity generating the NOLs under separate filing. Any limit on the use of the carryforwards would be inconsistent with the rationale for requiring combined reporting.

The following example illustrates the possible negative impact of NOLs on state corporate income tax collections. Two subsidiaries and a parent company operate as part of a vertically integrated company. State A that is adopting combined reporting has a 100% sales factor apportionment formula. It is also assumed that the manufacturing and sales distribution companies have nexus in State A; the parent's headquarter company does not.

- The manufacturing subsidiary has net income of $50 and sells 50% of its output to a sales distribution subsidiary located in State A.
- The sales distribution subsidiary has net income of $50 and sells 50% of the company's final product in State A and 50% to final customers in other states.
- The parent company has operating losses of $60 based on economic activity unrelated to the subsidiaries and sales to final customers outside of State A.

Under separate filing, the two subsidiaries are taxpayers in State A. With 50 percent of their sales in the state, they both have 50 percent apportionment percentages in State A, and the sum of their taxable incomes attributable to State A is $50.

Any limit on the use of the carryforwards would be inconsistent with the rationale for requiring combined reporting.

If State A adopts combined reporting, the sales factor for the combined group excludes intercompany sales and is equal to sales to unrelated parties for the three companies ($700 in State A and $1,500 in the U.S.) by the sales and distribution subsidiary in State A.[14] However, the income of all three companies is combined for a total of $40 of income. The income loss of the parent company, which does not have nexus in State A, is included in the combined group U.S. income amount, resulting in $60 less of U.S. net income subject to apportionment to State A.[15] Despite the fact that the apportionment factor remains the same under separate and combined reporting, the inclusion of losses held in the parent company reduces income taxable in State A by 60%.[16]

Tax revenue estimators have limited information on the carryover stock of NOLs for existing taxpayers. Even if reported on tax returns, this information may not be captured when returns are processed. More importantly, the unitary group will normally include corporations that are not current taxpayers, since it includes non-nexus companies. Revenue estimators will have no information on the carryovers for these firms.

Table 5
How Net Operating Losses May Reduce Taxable Income Under Combined Reporting

Filing system	Sales factor US	Sales factor State A	Apport. factor	Taxable income US	Taxable income State A
Separate filing					
Manufacturing subsidiary	$1,000	$500	50%	$50	$25
Sales/distribution subsidiary	1,400	700	50	50	25
Headquarters	100	–	–	-60	–
Separate filing income					**$50**
Combined filing					
Manufacturing subsidiary	$1,000	$500		$50	
Sales/distribution subsidiary	1,400	700		50	
Headquarters	100	–		-60	
Eliminate intercomp. sales	-1,100	-500			
Total for combined group	$1,400	$700	50%	$40	**$20**
Change in taxable income					**-$30**

Apportionment factors

Even if the net income of a unitary group is measured accurately, it is difficult for estimators to measure the apportionment factors of members of the unitary group that are not currently state taxpayers. Mandatory combined reporting requires that the group's net income be apportioned to the combined filing state based on the state's share of the group's factors that include a weighted average of the state's share of payroll, property and sales or a single sales factor. Separate filing states are generally limited to knowing only the in-state share of factors for each separate filer without having information on intercompany sales between members of the combined group. In addition, if a unitary group includes companies that are not current state taxpayers, revenue estimators may have no information about the factors of the non-nexus members of the combined group. As shown in the examples included in this study, small errors in the estimates of the apportionment factor can have large impacts on revenue estimates.

Addback statutes

As illustrated in several of the case studies, there can be substantial differences in the expected additional revenues from combined reporting depending upon whether or not a separate-filing state has already adopted expense addback provisions for royalties and expenses related to payments to affiliates for the use of intangible property and, in some states, for interest payments to affiliates as well. States with addback provisions already collect a portion of the revenue normally

States with addback provisions already collect a portion of the revenue normally expected from adopting combined reporting.

expected from adopting combined reporting. The revenue estimates should not double count this revenue. There are now 22 states with various forms of addback statutes.

B. Case studies of combined reporting revenue impacts

This section summarizes the revenue estimating experience of states that either have adopted combined reporting or have recently considered the adoption. The Appendix provides more detailed information about the revenue estimates and lessons learned from the estimating process.

Table 6 presents the results of this state-by-state review. The table identifies both the estimated annual revenue impacts and the percentage change in corporate income taxes from adopting combined reporting. Where available, the estimates represent the first full-year impacts of the change in tax collections in switching from separate filing to combined reporting. The comments in the last column of the table identify issues that are specific to a state and that may, therefore, limit the application of the results to other states.

Table 6
State Revenue Estimates of the Impact of Combined Reporting

State revenue estimates	Annual impact (millions)*	Percent of corporate income taxes	Year estimate was prepared	Comments
Iowa	$75	16.7%	2007	Permits consolidated filing
Maryland	25	3.0	2007	Addback of expenses
Massachusetts	188	8.9	2007	Addback of expenses; methodology not described
Minnesota – initial est.	23	5.5	1981	Low end of estimated range
Minnesota – revised est.	–	–	1984	Short-run, post-implementation
New York	315	6.0	2007	Addback of expenses
New Mexico	90	20.0	2008	Permits comb./ consol. election; methodology not described
Pennsylvania	150	7.9	2004	With uncapped NOLs
West Virginia	24	10.0	2007	Methodology not described
Wisconsin	30	3.5	2007	Est. for non-bank taxpayers

*For the first full-year of tax impacts, where available.

The individual state studies provide important insights and lessons related to estimating the revenue impacts of adopting combined reporting. The following highlights summarize the detailed, state-by-state descriptions of revenue impact analyses presented in the Appendix.

High Degree of Uncertainty of Revenue Impacts

There is a very large range of estimates of the revenue impacts across the states as shown in the table. For analyses prepared at the time of the adoption of combined reporting, the percentage increases range from 3 percent of corporate tax revenue in Maryland to 20% percent in New Mexico. While states do differ in the structure of their corporate income taxes and the composition of their economies, this unusually wide range illustrates the inherent uncertainty in estimating these impacts.

It should be noted that bill analyses for three of the high-end estimates of the percentage increase in corporate taxes from adopting combined reporting (Massachusetts, New Mexico and West Virginia) do not provide a description of the methodology used to estimate the impacts. The estimates based on detailed analyses of corporate tax return data or information from state tax auditors (New York, Pennsylvania and Wisconsin, for example) report significantly lower impact estimates. Several of the bill analyses (Maryland and Minnesota) actually note that the impacts cannot be reliably estimated.

In addition, this wide range in the net impacts masks substantially larger potential errors in the tax increase and tax decrease components of the estimated net change. Small errors in estimating both increases and decreases can have large impacts on the net change revenue estimates. As explained in the discussion of Pennsylvania's estimates in the Appendix, if tax increases were overestimated by 10 percent and decreases underestimated by 10 percent, the Pennsylvania estimate of the combined reporting impact would drop by 60 percent. In this case, the additional revenue from combined reporting would drop from 7.9 percent as reported in Table 6 to a little over 3 percent.

... this wide range in the net impacts masks substantially larger potential errors ...

The important point is that the size of the potential errors should be made clearer in the estimation process, especially if legislators are relying on the adoption of combined reporting to close state tax revenue gaps due to the current economic slowdown. As an example, the Minnesota bill analysis pointed out to lawmakers that the estimated switch to combined reporting was expected to raise between $23 and $103 million, an unusually large range for a bill analysis. As explained below, the actual results in Minnesota were closer to a zero increase.

Shorter-run revenue increases could be very small

Only one state, Minnesota, conducted an analysis of the revenue impacts of adopting combined reporting after implementation of the law change. Using actual tax return data, Minnesota researchers compared initial taxes paid under combined reporting with estimates of the sum of taxes that would have been paid by members of the combined group if separate filing had continued. The comparison found that, for the first tax year under combined reporting, tax collections actually decreased. Instead of collecting 15% more in taxes as predicted in the bill analysis, state taxes fell 9% with the adoption of combined reporting.

After analyzing additional tax return data, the researchers concluded that the short-to-intermediate impact was no change in corporate tax revenue. A major reason for this unexpected result was the fact that combined reporting "unlocked" net operating losses (NOLs) that previously could not be claimed on separate returns. In the transition, the NOLs actually reduced the income tax base.

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As illustrated by Pennsylvania's experience, the revenue estimates are very sensitive to the treatment of NOLs under combined reporting. In the Pennsylvania estimates, full allowance of NOLs (both carried in from the separate filing system and earned under the combined reporting system) reduced the expected additional revenue from combined reporting by 64 percent; for manufacturing, the reduction was 80 percent. In addition, revenue estimators often are asked to estimate the impact of combined reporting proposals that do not clearly specify the NOL treatment. Combined with the lack of information about the accumulated stock of NOLs, this creates significant uncertainty in the estimation process.

As the U.S. economy continues to slow in early 2008, corporate profits are declining and net losses in selected industries may increase significantly. As a result, NOLs will becoming increasingly more important in determining the shorter-run revenue impacts of switching to combined reporting. This will add further to forecasting risk.

Even if the longer-run estimates of revenue impacts from adopting combined reporting are reliable, states lack sufficient information to determine the time profile of the revenue response as taxpayers adjust to combined reporting. As shown in the Minnesota case, little additional revenue may be collected in the short-run, an adjustment period that may cover several years. This creates an additional fiscal risk for legislators who view combined reporting as a short-run, budget-balancing component.

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Addback provisions substantially reduce revenue impacts

Approximately 20 states have adopted various add-back provisions that deny income tax deductions for selected expenses paid to affiliates for the use of intangible assets. Of this group, 16 are separate filing states. The addbacks have the effect of increasing the taxable income of separate filers in the state by the amount of the disallowed deductions without requiring combined reporting. These provisions, therefore, reduce the additional revenues expected from adopting combined reporting.

For separate filing states with add-back provisions, the percentage increase in corporate taxes shown in Table 6 averages 5.9 percent; for New York and Maryland, the average is 4.5 percent. The revenue impact estimates in Maryland, for example, suggest that the adoption of expense add-back provisions reduced the additional revenue from combined reporting by approximately by roughly 55 percent.

Based on this experience, it is reasonable to conclude that the large number of separate filing states with add-back provisions can expect additional intermediate- or long-run corporate income tax collection increases of no more than 5 percent in shifting from separate to combined filing.

Each state's experience is unique

In considering the use of revenue impact ratio estimates for combined reporting from other states, tax researchers must carefully consider the unique tax system features and tax compliance issues in each of the other states. For example, Wisconsin estimated that combined reporting would increase corporate tax collections by 10.5 percent. However, an estimated 75 percent of the total was from banks. Because many states tax banks under separate tax systems from general corporate taxpayers, the Wisconsin ratio is not applicable in these other states. Adjusted to remove banks, the Wisconsin ratio was 3.5 percent, the figure shown in Table 6.

A related point is that the members of a combined unitary group may vary across states and will differ from the corporations included on federal consolidated returns. States may use different ownership tests for affiliation, as well as different concepts for determining a unitary relationship among affiliated corporations. These differences greatly limit the applicability of federal or other state tax return information in the estimation process.

Revenue estimates do not consider negative impacts on the economy

All of the revenue estimates reviewed in this study are static revenue estimates. In other words, the estimates assume that there will be no change in the level of economic activity or corporate tax bases in response to the adoption of combined reporting. However, as discussed further in the next section, combined reporting will increase the taxes paid for many corporations operating in a state. In response to higher taxes, these corporations can be expected to reduce their level of investment in the state. This results in a negative feedback effect in the form of reduced state and local taxes from all sources, not just corporate income taxes. If this dynamic tax effect is included in the revenue estimates, the net impact of combined reporting on state tax collections may be substantially reduced from the static revenue impacts reported in Table 6.

In response to higher taxes, these corporations can be expected to reduce their level of investment in the state.

III. IMPACTS OF COMBINED REPORTING ON A STATE'S ECONOMIC COMPETITIVENESS

Some proponents of combined reporting suggest that the shift from separate to combined reporting would not have any negative impact on a state's economy. For example, after citing manufacturing job growth performance in selected combined states and anecdotes about corporation investment decisions, one proponent suggests "that the burden of proof ought to lie with combined reporting opponents to demonstrate that the policy has a negative impact on state economic growth."[17] In legislative testimony focusing on combined reporting in 2005, the Secretary of the Pennsylvania Department of Revenue stated: "There is no evidence that adoption of combined reporting has a negative effect on a state's ability to attract employers. In fact, by some measures combined reporting states have actually done better economically than separate company states."[18]

Measuring the impact of a single tax policy change, such as adopting combined reporting, on a state's economy is, in fact, difficult to do. The basic problem lies in the inability to account for "all other factors" that are changing simultaneously and affect a state's economy. These factors include changes in the U.S. economy, changes in the composition of economic activity within a state, and changes in tax policies in other states. This is why simple comparisons of groups of states on a single economic measure, such as manufacturing job growth, cannot "prove" that the policy change has had either a positive or a negative impact on an economy.

This section discusses several different approaches to identifying the economic impacts of combined reporting. These different approaches suggest that combined reporting may have a negative impact on a state's economy. The approaches include predictions derived from economic theory, the simulation of corporate tax changes using state economic models (which attempt to hold other factors constant), empirical studies of the response of economic activity to changes in business tax rates, and an expanded comparison of state job growth rates.

... simple comparisons of groups of states on a single economic measure, such as manufacturing job growth, cannot "prove" that the policy change has had either a positive or a negative impact on an economy.

A. How does combined reporting affect a state's competitiveness?

Proponents of combined reporting focus on the increase in the corporate income tax base that they anticipate from eliminating income-shifting opportunities under separate filing tax systems. The expectation is that combining income of affiliated corporations will negate any tax-related shifts in income among states due to transactions or restructuring that are unrelated to the on-going business operations in a state. However, this perspective assumes that combined reporting can achieve revenue-raising objectives without having a significant negative impact on the level of payroll, property and sales in a state. In other words, this perception assumes that any income-shifting activity has no real economic substance and negating these shifts will have no impact on a state's real economy. This is not correct. In fact, a shift to combined reporting can have substantial negative impacts on the real economy.

... a shift to combined reporting can have substantial negative impacts on the real economy.

As shown in the taxpayer example in Table 3, adopting combined reporting may actually increase effective corporate income tax rates even in cases where there is no tax planning that distorts income. This occurs when the income per dollar of factors used in the apportionment formula is higher for the additional firms added to the combined group compared to the ratio for the original separate filing company. In this case, combination increases income to be apportioned by a greater percentage than the decrease in the apportionment factor and state tax payments increase. Compared to the income earned by the separate filing company, this increases the effective tax rate on additional investment in the state adopting combined reporting. It is also possible that the move to combined reporting could decrease effective tax rates, but if state revenue estimators score the legislation as a tax increase, then effective tax rates on average must also be assumed to increase.

Enactment of combined reporting will increase effective tax rates on some new investment and may trigger redistributions of investments and jobs among states, independent of any reduction in tax planning opportunities. As pointed out in the discussion of the revenue estimates, even if combined reporting results in a relatively small increase in net corporate taxes, there will be significant firm-level increases and decreases in tax liabilities. Depending upon the industry distribution of winners and losers and the overall size of the net tax increase, adopting combined reporting may have a negative impact on a state's overall economy.[19]

If the increased tax liabilities are imposed on multistate firms sensitive to interstate effective tax rate differences, combined reporting may result in a reduction in the level of investment and jobs in a state. The companies most affected would be those that sell products or services in national or international markets and use significant amounts of mobile capital. These are firms that will have a limited ability to pass higher taxes on to customers in higher prices but do have the option of shifting capital and jobs to locations with lower state tax rates.

To the extent that combined reporting increases a state's taxes (relative to other states) and reduces the after-tax rate of return on mobile investments, it can negatively impact a state's real economy. The higher corporate taxes directly lower the after-tax rate of return on the firm's operations in the state. In response, the firm is likely to shift payroll, property, and even sales to other states to reduce the percentage of total combined income subject to the higher tax rate. This shift will continue until output prices increase or the number of workers or the amounts paid to workers and capital in the state fall enough to increase the firm's before-tax net income from operations in the tax-increase state.

The shifting process ends when the after-tax rate of return is restored to a competitive level. Note that the adjustment process results in reduced employment, investment, and overall economic activity in the state. These are changes in real economic activities, not just changes in a state's share of a fixed level of the taxpayer's U.S.-wide corporate income. Economic theory suggests that the combination of relatively fixed in-state labor and increasingly mobile capital (including intangibles, machinery and equipment, and structures) across state and national borders will result in corporate tax increases being borne by labor in the state through fewer jobs (or lower wages over time) or by in-state consumers through higher prices for goods and services.[20] In other words, the burden of the higher corporate taxes will fall primarily on the residents of a state, not on capital investors.

... the burden of the higher corporate taxes will fall primarily on the residents of a state, not on capital investors.

B. Tax simulations of impacts of corporate income tax changes

State tax policy simulation model analysis also suggests that a shift from separate to combined reporting for corporate income taxes can reduce the level of jobs and investment in a state. In a recent study, E&Y estimated the potential economic and fiscal impacts of adopting combined reporting in Maryland.[21] Policy options that E&Y was asked to analyze included a corporate income tax increase and a shift to combined reporting.

The first step in modeling the expected economic impacts is to estimate the increase in tax liabilities from combined reporting (the "static" revenue impact). E&Y used the $25 million impact estimate reported in the fiscal note prepared by the

… a shift from separate to combined reporting for corporate income taxes can reduce the level of jobs and investment in a state.

Maryland Department of Legislative Services described earlier. Starting with the $25 million net change, E&Y distributed the change by industry. The estimated revenue impact for each industry was then used as inputs into an economic model of Maryland's economy.[22] The model incorporates empirical estimates from the economic literature on the response of investment and employment to changes in the cost of investing (cost of capital) in the state. The economic model was used to translate the change in each industry's cost of capital (equal to the change in tax liabilities) into changes in economic output, income, and jobs recognizing the complex interactions of all the sectors in Maryland's economy.

The results of the simulation show that the negative impact of adopting combined reporting on the Maryland economy, in terms of lost jobs per dollar of increased tax revenue, is actually slightly larger than the negative job impact from increasing the corporate income tax rate. This difference is primarily due to differences in the distribution of net tax changes by industry between rate changes and adopting combined reporting.

These results are consistent with recent empirical studies of the impact of business tax changes on state economies. As summarized by a nationally-recognized public finance economist, "… the majority view among economists is that the long-run effect of a 10 percent cut in state and local business taxes, holding other effects on business location constant, is to raise business activity in a state by about 2 percent."[23] Conversely, if combined reporting raises net business taxes by 10 percent, economic activity would fall by 2 percent, based on this "elasticity" of response. The negative impact on jobs will vary with the composition of a state's economy and the size and industry distribution of winners and losers.[24]

C. Expanded interstate growth comparisons

As already noted, some proponents of combined reporting have suggested that adopting combined reporting may not have a negative impact on a state's economy. This conclusion is sometimes based on simple comparisons of economic growth between states with unitary combined reporting and separate filing. Such comparisons are an oversimplification that does not hold constant key economic and demographic factors that determine differences in state growth rates. For example, prior trends, tax policy, or demographic factors could not have predicted the growth of Silicon Valley in California in the 1990s.

Job growth comparisons

Table 7 illustrates the limitations of this simple comparison approach in trying to identify the impact of combined reporting on a state's economy. The table provides a high-level comparison of private-sector job growth rates for separate filing and combined filing tax states. Unlike the comparisons of changes in manufacturing jobs only that have been used to evaluate the economic performance of combined and separate filing states, the employment data in the table cover all private-sector employees including the fast-growing financial and service sectors of the economy. The 24-year period covers the years between the adoption of combined reporting in Minnesota and Illinois and the first effective year of Vermont's adoption of combined reporting.

The first column in Table 7 shows the private-sector employment growth rate between 1982 and 2006. The second column shows population growth over the same period. The third column shows the difference between the employment and population growth rates. For example, in California, the employment growth rate (67 percent) exceeded the population growth rate (47 percent) by 20 percentage points. The weighted average growth rate differences are reported at the top of the combined reporting and separate filing state groups.

Even a cursory state-by-state comparison of the job and population growth rates indicates that the difference in the job growth rates between combined reporting and separate filing states is due primarily to the region in which a state is located, not its corporate income tax structure. The second column in Table illustrates this point. The combined states have aggregate population growth ratios that are almost 63 percent higher than the rate for separate filing states.

The subtraction of population growth in the third column is a simple way to "control" for other state-specific growth factors that are not directly related to corporate taxation. A comparison of the aggregate growth rate differences suggests that job growth (relative to population growth rates) has been about 6 percent higher in the separate filing states. The use of population growth as a single measure of all the complex factors explaining changes in a state's private-sector employment is a vast oversimplification. However, it does show that adjusting job growth measures for population changes provides additional insight into the source of differences in interstate job growth.

Table 7
Job Growth by State, Combined and Separate Filing States (1982-2006)

State	Employment growth	Population growth	Employment/ population growth
Combined Total:	**72%**	**39%**	**33%**
Alaska	76	49	27
Arizona	174	113	61
California	67	47	20
Colorado	90	55	35
Hawaii	69	43	26
Idaho	129	51	79
Illinois	42	12	30
Kansas	50	15	35
Maine	63	16	46
Minnesota	73	25	48
Montana	79	17	61
Nebraska	60	12	49
New Hampshire	79	39	40
North Dakota	50	-5	55
Oregon	93	39	54
Utah	146	64	82
Separate Filing Total:	**59%**	**24%**	**35%**
Alabama	68	17	50
Arkansas	71	23	48
Connecticut	29	12	18
District of Columbia	39	-8	48
Delaware	82	42	40
Florida	124	73	51
Georgia	108	66	43
Indiana	56	15	41
Iowa	50	3	47
Kentucky	62	14	48
Louisiana	26	-1	27
Maryland	79	31	48
Massachusetts	37	12	26
Michigan	52	11	41
Mississippi	54	14	40
Missouri	52	19	33
New Jersey	44	17	27
New Mexico	91	53	38
New York	29	10	19
North Carolina	86	47	39
Ohio	43	7	36
Oklahoma	31	29	1
Pennsylvania	37	5	32
Rhode Island	35	12	23
South Carolina	76	35	41
South Dakota	88	13	74
Tennessee	81	30	51
Texas	71	12	60
Virginia	91	39	52
Vermont	68	20	48
West Virginia	28	-7	34
Wisconsin	61	18	44

Note: Controlling for population growth, job growth is nearly the same from 1982 to 2006 for combined reporting and separate filing states.

… job growth … has been about 6 percent higher in the separate filing states.

Regression analysis

The job and population growth information from Table 7 was further analyzed using linear regression analysis. The regression analysis related the state-by-state job growth numbers to differences in population growth rates, average levels of private-sector wages and a variable that identifies combined reporting states.[25] After accounting for the other factors, the coefficient on the combined reporting variable is not significantly different from zero. In other words, this equation using highly-aggregated data does not find an independent impact of combined reporting on state job growth for all states combined.[26]

D. Recent state-by-state data on investment trends

A final source of information for comparing the economic performance of states with combined and separate reporting is E&Y's annual 50-state study of new capital investment and new and retained jobs for major business investment projects.[27] The information on project investments was compiled by E&Y from both public and private data sources and information from state economic development agencies. The E&Y study provides a snapshot of where recent major investments are being made in the U.S. by both domestic and foreign companies.

Table 8 provides the state-by-state information on new and retained jobs that are associated with the announced investments included in each of the past three years of projects (2004 through 2006). To scale for differences in the size of state economies, the three-year sum of project jobs is divided by the 2006 measure of private-sector gross state product (GSP), the most comprehensive measure of the level of annual economic activity in a state.

The figures in the Jobs column in Table 8 present the ratios of new and retained jobs per $1 billion of GSP. For example, over the three-year period, announced projects in California accounted for 22.4 jobs per $1 billion of 2006 GSP, a relatively small number compared to most other states. The states are divided into combined and separate filing states; the combined states include those that had combined reporting in effect prior to the 2006 implementation of combined reporting in Vermont.

The average figures (sum of jobs divided by the sum of GSP in each group) for the two groups of states are presented in the last rows of Table 8. There is a significant difference in the number of new or retained project jobs relative to $1 billion of GSP: the ratio is 134 for separate filing states and 50 for combined reporting states. A number of separate filing states in the Southeast and the Midwest show the highest job gain relative to GSP from major investments over the last three years.

Table 8
New and Retained Jobs from Mobile Investments, per $1 billion of Gross State Product (2004-2006)

Combined filing		Separate filing	
State	**Jobs***	**State**	**Jobs***
Alaska	n.a.	Alabama	334.6
Arizona	17.2	Arkansas	47.3
California	22.4	Connecticut	61.3
Colorado	14.8	Delaware	56.7
Hawaii	n.a.	District of Columbia	11.4
Idaho	72.6	Florida	109.3
Illinois	93.9	Georgia	218.1
Kansas	193.0	Idaho	72.6
Maine	53.5	Indiana	258.2
Minnesota	103.3	Iowa	230.2
Montana	24.8	Kentucky	321.3
Nebraska	122.9	Louisiana	129.2
New Hampshire	15.0	Maryland	106.7
North Dakota	74.4	Massachusetts	11.1
Oregon	17.2	Michigan	199.7
Utah	145.3	Mississippi	171.8
Average	**50.0**	Missouri	126.7
		New Jersey	28.6
		New Mexico	112.8
		New York	65.0
		North Carolina	208.2
		Ohio	145.5
		Oklahoma	241.5
		Pennsylvania	86.2
		Rhode Island	92.7
		South Carolina	200.9
		South Dakota	34.6
		Tennessee	183.0
		Texas	136.0
		Vermont	6.0
		Virginia	270.3
		West Virginia	133.3
		Wisconsin	80.5
		Average	**134.2**

*Figures are 3-year sums of new jobs per $1 billion of gross state product.

While this comparison also does not control for other factors that explain the differences in the ratios, it does show that separate filing states have recently been more successful in attracting new investments that add or retain jobs. This new investment is the source of future growth in state investment, employment, productivity and real household income.

... separate filing states in the Southeast and the Midwest show the highest job gain relative to GSP from major investments over the last three years.

E. Summary of economic impacts

This study does not provide a comprehensive analysis of all the factors that explain differences in the growth of jobs across the states. It does look at additional sources of information that can be used to begin addressing the question of what the economic impact will be if a state adopts combined reporting given the mix of combined and separate filing states. Given the fact that combined reporting will result in increases in corporate income taxes on a significant number of multistate companies, even if the net change in tax revenue is small, economic theory predicts that combined reporting will have a negative impact on the state's economic growth if it also raises tax revenue. Economic modeling of the impacts using a comprehensive model of Maryland's economy supports this conclusion.

In addition, there is recent evidence that separate filing states are attracting substantially more new investment and employment than are combined reporting states, although this difference cannot be directly attributable to variation in the structure of state corporate income taxes. Finally, after controlling for population growth, a variable that is not "explained" by differences in corporate income tax systems, comparisons of job growth rates find that separate filing states have slightly higher job growth rates. While this additional analysis does not "prove" that a shift to combined reporting by a single state will harm the state's economy, it does suggest that legislators should be more concerned about the possible negative effects on investment and jobs when debating the merits of adopting combined reporting.

... legislators should be more concerned about the possible negative effects on investment and jobs when debating the merits of adopting combined reporting.

IV. COMPLIANCE AND ADMINISTRATIVE IMPACTS

Combined reporting creates complexities in corporate income tax systems that can add to taxpayer compliance costs and state administrative costs. The following sections outline the complex steps that are involved in implementing combined reporting for state corporate income taxes. The steps include determining 1) the affiliated companies to include in a unitary group, 2) the taxable income of the unitary group, and 3) a state's share of the taxable income.

Determining the unitary group

In determining if affiliated corporations are engaged in a unitary business, taxpayers and tax administrators must first address the challenging question of how to define the trade or business that is unitary. This involves examining the economic relationships between divisions within a single company or interactions and interdependencies among affiliated corporations linked by common ownership. Members of a unitary group must be linked by more than a passive investment relationship; there must be an exchange or flow of economic value among affiliates that exceeds the flows between independent, unrelated business entities. Therefore, a finding of a unitary relationship must be based on a determination of the economic relationship among commonly owned corporations.

Taxpayers are often left to determine which corporations to include in the unitary group without detailed guidance from state statutes or, in many cases, without detailed regulations. The economic relationships must be traced by identifying the activities undertaken by each division or subsidiary and the resulting flows of goods and services, often by product or service line, between related corporations. In the case of corporations with a number of business activities that are not in the same line of business or are not related processes in one line of business, the unitary determinations involve not only quantitative measures, but also qualitative dimensions. These qualitative dimensions introduce both controversy and uncertainty into the corporate tax system. As a result, taxpayers and tax administrators often disagree on the affiliated corporations that meet the unitary test. More complex audits and appeals and increased litigation can be expected as a result of the unitary determination in states adopting combined reporting.

The complexity in determining the affiliated corporations to be included in a unitary group can be seen in a recent New York State Department of Taxation and Finance explanation of the rules for complying with the 2007 expanded requirements for mandatory filing of a combined report.[28] Under the new law, combined reporting is required when there are "substantial intercompany transfers" among related corporations. The rules list ten specific steps (several of which involve repeated rounds of calculations) to follow in determining if a combined return is required and, if so, which firms to include. The initial step requires each taxpayer to determine all related corporations that meet specific ownership requirements. In following steps, taxpayers continually expand the number of corporations to be included in the unitary return by identifying every corporation with substantial intercompany transfers with any other corporation included in a prior step. In determining whether substantial intercompany transactions exist, taxpayers must examine the "facts and circumstances" for all activities and transactions between all related companies and the taxpayer in each step.[29]

More complex audits and appeals and increased litigation can be expected as a result of the unitary determination in states adopting combined reporting.

Combined reporting also involves substantial administrative costs. To evaluate the taxpayer's determination of a unitary relationship, state auditors must look beyond accounting and tax return information. They must rely on publicly available information or ask taxpayers for detailed information on ownership shares, organizational charts, directories of officers and directors for each affiliate, inter-corporate reporting requirements and communications, annual changes in corporate structure and operations each year and descriptions of inter-corporate transactions, including financial flows related to loans and the production and use of intangible property, in evaluating ownership and economic factors that determine a unitary relationship. Service flows include research, insurance, training, purchasing, advertising accounting, human relations, administration and computing.

In effect, auditors must determine how a taxpayer and its affiliates operate at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation's operational and tax staffs to gather this operational information. Determining the scope of the unitary group is a complicated, subjective, and costly process that is not required in separate filing states.[30]

Combined reporting also involves substantial administrative costs.

The determination of the unitary relationship must be done annually in light of on-going changes in business operations and structure such as mergers, acquisitions and divestitures. In other words, the unitary concept is a dynamic one that must be continually evaluated. In addition, it involves examining the economic relationships between all affiliated companies, not just those that have nexus in the taxing state.

Calculating combined income

Once the unitary group is defined, the net income to be included on a combined report must be determined. This step is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most combined reporting states, the group of corporations included in a federal consolidated return differs from the members of a combined group. This occurs because most states use a different ownership test for inclusion, and more importantly, state combined groups may include only firms that are unitary in operation, a concept that has no federal counterpart. Included groups and their taxable income may also differ across states because of different state-specific requirements for determining which corporations are unitary.

This step also involves identifying the split between apportionable business income and allocable non-business income. This is a determination that, in theory, requires examining the relationship between income sources and the business operations of each corporation included in a unitary business. Again, the determination applies to all firms in the unitary group, not just those corporations with nexus in the taxing state that were already separate filers in a state before the adoption of combined reporting. It also involves accurately attributing related expenses to both business and non-business income.

It should also be noted that transfer pricing issues still arise under combined reporting. Only the inter-corporate transactions among the companies included in the unitary group are eliminated in determining combined income. Transfer pricing issues will still remain for any transactions between the unitary group and affiliated companies not included in the unitary group.

Apportioning income

The final determination is calculating the apportionment percentage to be applied to the combined income of the unitary group in determining the state's share of the income. The factors included in the apportionment formula should be related geographically to the production of the unitary group's income. Factors that are related to non-business income and non-unitary businesses should not be included in the apportionment formula. These factors have to be determined separately for each corporation in the combined group and for each combined reporting state.

An additional complication under combined reporting is the need to eliminate sales among members of the combined group to avoid including the sales multiple times in the apportionment formula. In making these adjustments taxpayers have to eliminate sales among the unitary members but not sales between affiliated corporations that are not in the unitary group. This increases the number of additional calculations in determining apportioned net income in combined reporting states. In addition, factors normally have to be calculated (and inter-corporate sales eliminated) for all members of the unitary group, not just members with nexus.

In addition to variations in apportionment formulas among the states that apply to all corporate taxpayers, further compliance costs related to combined reporting result from variations across states in the methods used to calculate the apportionment factors. For example, the numerators of apportionment factors may include or exclude the dollar amounts of factors for members of the unitary group that do not have nexus in a state. As another example, states vary in the treatment of factors from foreign subsidiaries that are associated with foreign income, such as dividends from foreign subsidiaries, included in the combined income of a unitary group. All of these variations add to compliance and administrative costs.

V. CONCLUSIONS

This study has provided a detailed analysis of the mechanics of combined reporting. It shows that switching from separate filing to combined reporting can decrease, increase or leave state tax collections unchanged depending upon the complex economic relationships among corporations included in a combined group. Because of this complexity, the overall revenue impact of adopting combined reporting is very difficult to predict reliably. As a result, significant uncertainty is associated with bill analyses prepared by state revenue estimators. A comparison of these estimates suggests that the additional revenues generated by combined reporting may be fairly modest, particularly in separate-filing states that have already adopted expense disallowances for affiliated corporations.

While the proponents of combined reporting have focused on the benefits in terms of reducing tax planning opportunities, the paper points out additional costs related to combined reporting that state legislators need to consider. These include the potential negative economic impacts of increasing effective corporate tax rates on corporations operating in a state. The higher effective tax rates are expected to reduce investment and jobs in a state. This negative impact on a state's business tax competitiveness affects all taxpayers facing higher effective rates, not just those using tax planning techniques. The additional compliance, administrative and litigation costs associated with combined reporting should also be included in a balanced evaluation of combined reporting.

The analysis in this paper suggests that combined reporting is not a panacea for addressing the problem of how to determine accurately multistate business income that is attributable to economic activity in a state. While proponents argue that it helps to overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under combined reporting create new distortions in assigning income to different states. The combined reporting assumption that all corporations in an affiliated unitary group have the same profitability per dollar of factors (payroll, property and/or sales) is not consistent with either economic theory or business experience. Consequently, combined reporting may reduce the link between income tax liabilities and where income is actually earned even in the absence of distorted transfer prices or income shifting strategies. In this situation, many corporate taxpayers may conclude that there is a significant risk that combined reporting will arbitrarily attribute more income to a state than is justified by the level of a corporation's real economic activity in the state.

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State legislators should carefully evaluate the revenue, economic development, and tax administration and compliance impacts before adopting combined reporting. The impacts are complex and, in some cases, uncertain. Given this uncertainty, legislators should consider all the options available for achieving their tax policy and/or revenue objectives at a lower cost in terms of the unintended consequences associated with combined reporting.

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APPENDIX: STATE ESTIMATES OF COMBINED REPORTING REVENUE IMPACTS

This Appendix provides a more detailed discussion of state-by-state estimates of the static revenue impacts of proposals to adopt combined reporting. It includes a detailed discussion of the methodology and data used to prepare the estimates. The sources of the information include bill analyses prepared during legislative sessions, tax agency studies, state tax studies and testimony before tax committees and tax commissions.

Minnesota

The Minnesota legislature adopted mandatory combined reporting in 1982.[31] Combined reporting was adopted with limited debate about the tax policy issues related to the bill, but considerable discussion over the revenue estimates. Because Minnesota corporate taxpayers filed tax returns on a separate entity basis prior to the law change, there was no state tax return data that could be used directly to determine combined filing groups and their tax liabilities under combined reporting. Based on a survey of other states with combined reporting, Minnesota assumed a 15 percent increase in tax collections from adopting combined reporting. At the time, a 15 percent increase in corporate income taxes generated $63 million (over 18 months). Recognizing the high degree of uncertainty in estimating the revenue impacts of the law change, lawmakers were warned that the impact could range from $23 and $103 million, an unusually wide range for a bill analysis. In almost all tax bill analyses in Minnesota, a single number (point estimate) is provided for revenue impacts.

Because the law adopting combined reporting also required a report to the legislature on some elements of the revenue impacts of the law change, Minnesota provides a unique, post-law-change evaluation of the impact of combined reporting. Comparing actual liabilities for firms filing combined returns in 1982-83 with recomputed liabilities as if they had filed separate returns, the Department of Revenue found that combined reporting actually reduced tax liabilities by roughly nine percent on initial combined returns. The decline was partially due to the conversion of unused separate entity losses into current loss offsets for 100 percent Minnesota unitary groups and bank holding companies filing combined reports.[32]

Based on the calculations from actual combined reports, the estimates of the additional revenue raised from combined reporting were lowered to zero for each fiscal year through 1985, four years after mandatory combined reporting went

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into effect. Even if the adoption of combined reporting leads to higher corporate income tax collections over the longer run, the Minnesota ex-post evaluation does suggest that the initial impact of adopting combined unitary reporting may be a smaller revenue increase than forecasted or actually a decrease in revenues. An actual short-run reduction in revenue may occur if the stock of NOLs carried into the new system is significant. The Minnesota experience clearly illustrates the difficulty in reliably forecasting corporate income tax changes when a state moves from separate returns to combined reporting.

Wisconsin

The Wisconsin Department of Revenue prepared revenue estimates of a proposal to adopt mandatory combined reporting in 2003.[33] Similar to the Minnesota experience, Wisconsin was also constrained by the lack of data on corporate tax returns filed on a separate entity basis. The method chosen to estimate the revenue impact of combined reporting was to integrate 1994-1995 Wisconsin tax return information with Minnesota Department of Revenue data for taxpayers filing combined reports in Minnesota, a mandatory combined reporting state.

Wisconsin research staff identified large state corporate income taxpayers and asked Minnesota to match each Wisconsin taxpayer to a Minnesota group based on federal taxpayer identification numbers. Minnesota identified the combined groups and Minnesota nexus taxpayers that were linked to the identified Wisconsin separate filers. This taxpayer list was then used by Wisconsin to pull separate filing information for the taxpayers provided by Minnesota. The Wisconsin staff then merged the Minnesota and Wisconsin taxpayer information. This database was used to estimate the impact of combined reporting.

A noteworthy limitation on the Minnesota taxpayer data was the fact that it did not include information on banks. The Wisconsin researchers developed independent estimates for the banks. While the estimates discussed during the presentation were only preliminary, combined reporting was expected to generate $75 million based on tax year 1996 collections. However, only $25 million was estimated to come from non-bank taxpayers. The $75 million figure was 11.7 percent of the corresponding total Wisconsin corporate income tax collections. For non-bank taxpayers, the $25 million tax increase was 4.2 percent of non-bank corporate tax collections, a figure that is more applicable in states that tax banks and other financial institutions under separate tax systems.

In July 2007, the Wisconsin Legislative Fiscal Bureau estimated the full-year impact of adopting mandatory combined reporting at $90 million for FY 2009. This estimate is 10.5 percent of the projected total corporate income tax collections under current law. No separate estimate was available for the non-bank impact from combined reporting in the July 2007 estimates. However, a better gauge of the revenue impact of combined reporting may be estimated by the non-bank impact. Because Wisconsin has more recently aggressively challenged the use of Nevada-based, intangible asset holding companies owned by banks, the state may already have collected a substantial portion of the estimated $90 million through targeted compliance activities under their separate filing system. If the $90 million estimate is adjusted to remove the same portion of the total attributed to banks in the 2003 estimates, the additional revenue from combined reporting would drop to $30 million or 3.5 percent of projected revenues. This is the percentage show in the summary table.

Pennsylvania

Pennsylvania's experience in estimating the corporate tax impacts of adopting combined reporting provides a clear example of how NOL provisions may significantly affect the estimates. In 2004, the Pennsylvania Department of Revenue (DOR) presented their preliminary estimates of the revenue impact of adopting combined reporting at a meeting of the Pennsylvania Business Tax Reform Commission.[34] Similar to the methodology used by Wisconsin, the DOR also relied on Minnesota corporate income tax data (for tax year 2000), using combined income and apportionment data for Minnesota filers with Pennsylvania and IRS corporate tax data, to derive Pennsylvania-specific estimates. In addition to identifying the affiliates that may be required to file as a unitary group, Pennsylvania also used the combined dataset to estimate the impact of carryforward NOLs.

According to the treatment of NOLs, the estimated increases in corporate taxes expected from combined reporting ranged from $150 million to $411 million.[35] The larger tax increase assumed that the separate company NOLs carried into the new system were capped at $2 million per year per entity (with a 20-year carryover) and that no cap was imposed on NOLs earned by the group. The much lower tax increase estimate assumed that NOLs (carried in from separate filing) were uncapped for an individual company and could be used by all members of a unitary group without any annual cap. In other words, full utilization of NOLs reduced the projected net gain in corporate tax revenue by 64 percent; for manufacturing the reduction in additional taxes was nearly 80 percent.

Another way to understand this difference in impact estimates is to note that the relatively large estimate of net revenue from combined reporting in Pennsylvania results from the state's unique cap on NOLs and denying the full use of precombination NOLs. For this reason, the higher Pennsylvania revenue estimates cannot be used as a basis for estimating the revenue impacts of adopting combined reporting in other states that allow full NOL offsets.

The Pennsylvania debate over combined reporting provides a clear example of the importance of NOLs in determining the short- to intermediate-run revenue impacts of adopting combined reporting. It also illustrates the difficulties involved in determining how to integrate precombination losses into a new combined reporting system. The Pennsylvania Tax Commission report's discussion of combined reporting considered a number of options, ranging from disallowing any carryovers to allowing full, uncapped carryovers that can be used by the full unitary group.[36] The recommendation to continue the cap on NOLs generated prior to combined reporting was designed to maximize the revenue impact of adopting combined reporting.

To summarize the revenue impacts, the $411 million estimate for increased corporate income tax revenue from combined reporting represented 21.7 percent of estimated Pennsylvania tax collections in 2000. However, allowing full use of NOLs would have generated $150 million, a much smaller 7.9 percent increase.

The Pennsylvania estimates also show that a shift to combined reporting creates significant winners and losers. The $150 million estimate results from the offsetting of large tax increases and decreases. For the combined groups that were identified from the Minnesota data (excluding regional firms), the losers paid $187 million more in taxes and the winners paid $133 million less, for a net change of only $54 million.[37] There were an estimated 2,546 groups with tax increases and 2,097 groups with tax decreases. Small errors in estimating both increases and decreases from the Minnesota sample can have large impacts on the net change estimated. For example, if tax increases are overestimated by 10 percent and decreases are underestimated by 10 percent, the estimated net change from combined reporting would drop by 60 percent to only $22 million.

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There are additional issues with the estimating methodology that suggest that even the smaller estimate still overstates the probable impact of adopting combined reporting in Pennsylvania. These include:

- The relatively small number of Minnesota taxpayer groups actually used in the estimating process (152 out of over 4,600 groups supplied by Minnesota) presents a challenge in extrapolating the Minnesota data to all Pennsylvania taxpayers.
- There were a number of large regional firms that have nexus in Pennsylvania but were not included in a Minnesota combined group. The impact on these firms had to be estimated with less detailed information on combined group entities and apportionment factors.
- The apportionment factors and NOL information for the Minnesota sample firms was determined by Minnesota, not Pennsylvania, tax provisions.
- The estimates do not allow for the carry-in NOLs to be used by the entire unitary group, a treatment inconsistent with the theory of combining the income (and losses) of a unitary group.
- There was a lack of detailed information on the cumulative unitary group NOLs or unused credits that could potentially be used to offset tax increases from combined reporting.

Maryland

In 2004, the Maryland Department of Legislative Services estimated the fiscal impact of a bill requiring water's edge mandatory combined reporting (SB 727). The bill included corporations located in "tax havens" in the unitary group. The fiscal note estimated that combined reporting would raise $55 million each year through FY 2009.[38] However, the estimate was not based on any Maryland-specific tax return information. The estimate was, in fact, prepared by the Multistate Tax Commission in a 2004 study.

The Department of Legislative Services reestimated the revenue impact of combined reporting in the 2007 fiscal note for SB393. In this analysis, the estimated, on-going impact of combined reporting was reduced by 55 percent to $25 million annually.[39] The primary reason for the 55 percent reduction in the estimate of the revenue impact appears to be the fact that a large portion of the revenue expected earlier from combined reporting was picked up by expense addback legislation adopted by the legislature in 2004.[40] The $25 million increase is 3.0 percent of corporate income tax collections in fiscal year 2006.

The fiscal note points out that the impact "cannot be reliably estimated." Again, the estimate was based on national data and, in addition, estimates prepared by other states.[41] The Department also acknowledged that they did not have Maryland taxpayer information to use in the estimating process, primarily because the Department did not have access to confidential taxpayer information.

The 2007 Maryland budget bill did not impose mandatory combined reporting. However, it did require for all tax years beginning after 31 December 2007, that corporate taxpayers report information to the Comptroller for each entity in an affiliated group, including firms that are not currently Maryland taxpayers. Taxpayers must calculate and report the tax liability of a water's edge unitary group as if Maryland had already adopted combined reporting. This information will be used by the Comptroller's Office to estimate the impact of adopting combined reporting in Maryland.

Iowa

Iowa currently offers taxpayers the choice between filing separate or consolidated returns with affiliated companies doing business in Iowa. The governor's budget recommendations for fiscal year 2009 included a proposal for mandatory combined reporting estimated to raise $75 million in 2009. This would be an increase of 16.7 percent in forecasted 2008 corporate income tax revenues. The proposal appears to require mandatory filing of a combined return following federal consolidated return provisions for determining an affiliated group.

A 2007 Department of Revenue study estimating the revenue impact of requiring combined reporting for all corporate taxpayers provides some background information on the estimating methodology.[42] The study used federal consolidated corporate income tax data for federal filers that matched Iowa taxpayer identification numbers (including both separate and consolidated state filers). Federal and Iowa tax data were combined to estimate the revenue changes for mandatory combined filing. The Iowa results show the challenges of trying to use federal consolidated return information to estimate state combined filing proposals:

- Only 51 percent of Iowa separate filers (not matched to federal separate filers) could be linked to a federal consolidated return.
- For those Iowa taxpayers linked to a federal consolidated return, the Department had to calculate the major Iowa line-item subtractions and additions that convert federal income into the state income concept.
- For Iowa taxpayers filing separate returns, the study estimated that the increase due to combined filing (based on 2001 data) was $31 million. The increase for Iowa taxpayers currently electing to file state consolidated returns would increase by a similar $30 million in 2003. Apparently, a move to mandatory combined reporting is expected to substantially increase the income apportioned to Iowa for consolidated nexus groups because of the addition of factors and income for non-nexus affiliated companies.
- As the study pointed out, the estimates do not include any allowance for the unlocking of state NOL carryovers on combined returns. In addition, only NOLs reported on Iowa returns were used in the calculations; no information was available for firms in the federal consolidated group that were not Iowa taxpayers. As noted earlier, the estimated net impacts of adopting combined reporting are sensitive to the size of NOLs and the provisions affecting the use of NOLs by members of the combined group.
- Another important limitation of the study was the assumption that the members of the state combined group would mirror the firms reported on federal consolidated returns. In other words, it is assumed that all members of the federal consolidated group are unitary in operation, despite the fact that there is no unitary requirement (or concept) for federal consolidation. State revenue estimates that are based on combined income including non-unitary members of the federal consolidated group will overstate the revenue from combined reporting. In addition, companies taxed under alternative state tax systems, such as insurance companies and banks, were not eliminated from the state calculations.

In conclusion, if the $75 million net revenue estimate included in the governor's 2009 budget recommendations is based on the study's methodology, the estimate may be significantly overstated.

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Massachusetts

In 2007, the governor recommended mandatory combined reporting. The estimated revenue increase for fiscal year 2009 was $188 million, 8.9 percent of projected corporate income tax collections.

Massachusetts adopted addback provisions in 2003. Addback is required for otherwise deductible royalty expenses and related interest expenses paid to related entities with exemptions. Compared to the estimates produced by several other states with addback statutes, Massachusetts appears to have estimated a significantly higher percentage increase in corporate taxes from combined reporting.

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New York

For tax years beginning 1 January 2007, New York requires mandatory combined reporting for related corporations with substantial inter-corporate transactions. Prior to the change, taxpayers could file separate returns in the presence of substantial intercompany transactions if they could demonstrate that these transactions were conducted at arm's-length prices. While New York asserts that they are not a combined reporting state, the new filing requirements are much closer in effect to combined reporting.

The estimated impact of the law change was an increase of $315 million, 6.0 percent of corporation franchise (income) taxes.[43] New York estimators derived the revenue estimate from auditor-feedback and New York corporate taxpayer information. It is not clear whether the estimate reflects New York's requirement for corporate taxpayers to add back selected royalty expenses, including interest payments related to intangible assets, paid to related companies in determining taxable income. The addback provision should reduce the additional revenue expected from expanding the mandatory combined filing requirements in New York.

West Virginia

West Virginia adopted mandatory combined reporting for the corporate net income tax in 2007 for tax years beginning in 2009. The full-year revenue impact, as reported in the Fiscal Note Summary for SB 749, was estimated at $24.3 million or an increase of 10 percent of estimated fiscal year 2009 corporate income taxes; the increase is 6.5 percent for combined corporate income and business franchise tax collections. The fiscal note states that the estimate was "based on the experience of other states that have adopted combined reporting." As noted in the discussion of the estimating experience in other states, differences in taxpayer characteristics and state corporate tax features make it difficult to extrapolate revenue impacts from estimates made in different states.

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New Mexico

HB 51 introduced in the 2008 legislative session makes combined reporting mandatory beginning for tax year 2008. New Mexico currently permits taxpayers to elect to file a consolidated or a combined return. The fiscal impact report for the bill estimates that the change will generate $90 million in additional revenue, an increase of 20 percent in corporate tax collections when fully phased in by fiscal year 2009. The fiscal report does not describe the methodology used to estimate the revenue impact.

The fiscal impact report does note that in fiscal year 2005 taxpayers electing to file combined returns accounted for 14 percent of all tax payments and taxpayers electing to file a consolidated return accounted for 32 percent of all payments. As discussed in the Pennsylvania example, any revenue increase from shifting to a combined reporting system is the net effect of large increases and losses for different taxpayers. The New Mexico fiscal note implies that the election of either combined or consolidated filing has already partially reduced corporate income tax collections compared to a separately filing system. Therefore, the impact of adopting mandatory combined filing will primarily be to increase taxes for the companies that elected to file separately under current law.

Given the fact that New Mexico currently allows taxpayers with an election to file combined or consolidated returns (including domestic corporations that meet federal rules for common ownership), the relative size of the New Mexico revenue impact estimate of adopting mandatory combined reporting is not applicable to other states that are considering moving from separate to mandatory combined filing systems.

ENDNOTES

1. The concept of a "unitary business" is a constitutional requirement that limits the states' authority to determine the income of a multistate enterprise taxable in a state. The criteria used to determine whether a group of business entities or divisions are unitary are derived from state statutes and regulations and state and federal case law. These criteria are often based on a "flow of value" among the entities and divisions and include the following: unity of ownership, unity of operation and unity of use. Due to varying state definitions and case law decisions, the entities included in a unitary group are likely to vary significantly from state to state.
2. There are 20 corporate income tax states that can be described as combined reporting states, including New York and Michigan. In addition, Texas is using the combined reporting approach to determine the tax base under their modified gross receipts taxes that replaced corporate income taxes.
3. A group of related corporations may consist of multiple unitary groups. Although ownership is one test to determine whether separate legal entities are engaged in a unitary business, it is not the sole test. The number of unitary groups, and the composition of those unitary groups, will vary significantly for each corporate group and each state.
4. For a detailed discussion of the proponents view see Michael J. McIntyre, Paull Mines and Richard D. Pomp, *"Designing a Combined Reporting Regime for a State Corporate Income Tax,"* Louisiana Law Review, pp. 699-761 (Summer 2001). A more recent summary is provided in Michael Mazarov, "State Corporate Tax Shelters and the Need for Combined Reporting," *State Tax Notes* (November 26, 2007).
5. It is also assumed that the income being combined for the two companies is U.S.-wide income, not world-wide income. This is consistent with the companies making a water's-edge election for state corporate income tax purposes.
6. The calculations in the examples are consistent with the approach to combined reporting that respects the separate entities of the taxpayer members of a combined group. In this approach each corporation reports the unitary group's combined income on its own tax return and uses its own in-state factors (divided by the group's U.S.-wide factors) to apportion the combined income to a state. (This is often described as the *Joyce* approach to apportioning combined income based on a California corporate tax court case.) This approach is also consistent with Multistate Tax Commission Model Statute for Combined Reporting, as described in "Report of the Hearing Officer Regarding the Proposed Model Statute for Combined Reporting," Multistate Tax Commission (April 25, 2005).
7. Under combined reporting the in-state numerators of the two companies do not change. However, the sum of each factor for the two firms becomes the new denominator in the calculation of the overall apportionment ratio. The new apportionment ratios under combined reporting equal 3.6% for Company A and 13.9% for Company B.
8. While payroll and property are the sources of value added, state apportionment formulas also include destination sales in the formula to reflect a market state's interest in a portion of the income. The inclusion of sales in the apportionment formula weakens the link between income and the location of payroll and property, the factors that create value added. For states using sales only apportionment formulas, there is no direct link between the location of payroll and property that creates income and the apportionment formula that assigns the income to a state. Adding combined reporting to single sales factor apportionment compounds the disconnect between where income is produced and where income is apportioned. The exclusion of intangible capital, a growing source of income, from the property factor further adds to this disconnect. These features add to the perception among many business taxpayers that the current corporate income tax system is overstating the taxable income generated by economic activity in many states.
9. For simplicity, this calculation ignores the elimination of sales between the two companies. It also assumes that sales of Company 1 are not included in the numerators of the combined apportionment factors. (This is often described as the *Joyce* approach to apportioning combined income based on a California corporate tax court case.)
10. H.B. 768 was passed by the House Education Appropriations Committee on April 16, 2008.
11. Proponents of combined reporting would argue that state taxable income may not be reported correctly, due to improper transfer pricing and/or shifting of assets or liabilities between affiliated companies. Distinguishing improper actions from business-driven actions is difficult.
12. Pennsylvania's percentage is from tax year 2002 returns that were heavily influenced by the sharp reduction in corporate profits and the increase in actual losses due to the 2001 recession. Minnesota's percentage may also have been affected by the recession to a lesser extent.
13. This result is not unique to state income tax systems. At the federal level, approximately one-half of Subchapter C corporations have no taxable income in a given year, and approximately two-thirds of C corporations have no tax liability in a given year after subtracting special deductions, net operating loss carryforwards and tax credits. The percentage of C corporation returns without taxable income ranged from 45-52% between 1999 and 2005. The percentage of returns without tax liability ranged from 61-69% during the same period. (Source: IRS Statistics of Income data from the *Complete Corporate Report*, years 1999-2005.)
14. The example assumes that the sales into State A for the headquarters company are not included in the numerator (State A sales) of the apportionment formula under combined reporting.
15. In theory, the elimination of intercompany transactions would also result in a redistribution in the profits attributable to the manufacturing and distribution subsidiaries with no change in total combined profits. This redistribution is not shown in the table.
16. This same "unlocking" effect may occur with unused credits if a state allows credits to be used by any member of a combined group. Unlike NOLs that most states allow to be carried over to future years with some limits, tax credits may be lost if not used in the year in which they are earned by the taxpayer. Tax credits that went unused under separate filing because of insufficient taxable income and tax liabilities may be converted to used credits if the income of the unitary group increases under combined reporting.
17. Michael Mazarov, "Growing Number of States Considering a Key Corporate Tax Reform," Center on Budget and Policy Priorities," 12 September 2007, p. 9.
18. Gregory C. Fajt, Secretary, Pennsylvania Department of Revenue, Testimony before the House Finance Committee, 14 April 2005, p. 4. Secretary Fajt described the assertion that combined reporting will be bad for the state's economy as a "myth."
19. Several theoretical studies of the impact of combined reporting and apportionment on the allocation of economic activity among the states suggest that combined reporting, compared to separate filing, may increase the responsiveness of economic activity to state corporate income tax changes. After analyzing different simulations of the impact of tax rate changes for hypothetical groups of combined and separate filing states, a study concluded that shifts in sales, payroll and property factors are "far more sensitive" to changes in state corporate income tax rates under combined filing vs. separate filing tax systems. (Michael G. Williams, Charles W. Swenson, and Terry L. Lease, "Effects of Unitary vs. Nonunitary State Income Taxes on Interstate Resource Allocation: Some Analytical and Simulation Results," *The Journal of the American Taxation Association,* Spring 2001, p. 54). Also see Roger Gordon and John D. Wilson, "An Examination of Multijurisdictional Corporate Income Taxation Under Formula Apportionment," *Econometrica*, November 1986.
20. See Minnesota Department of Revenue, *2007 Minnesota Tax Incidence Study* (March 2007) for a discussion of how state and local business tax burdens are distributed among workers, investors, and households.

21. See Ernst & Young LLP, *Economic and Fiscal Impact Analysis of Maryland Tax Policy Options* (September 2007). The study was prepared for the Maryland Chamber of Commerce and associated local chambers and other organizations.
22. The dynamic impact simulations were done using a Regional Economic Models, Inc. (REMI) model of the Maryland economy. This model is used widely by state agencies as well as private-sector analysts.
23. Timothy J. Bartik, et al., *Michigan's Economic Competitiveness and Public Policy*, the W.E. Upjohn Institute for Employment Research (August 2006).
24. There is some evidence that investment decisions of multinational corporations are even more sensitive to state tax changes. In a study of foreign direct investment in individual states, the author found that a roughly 10 percent increase in state corporate tax rates would result in a 6 percent reduction in investment in the state. (See James R. Hines, Jr., "Altered States: Taxes and Location of Foreign Direct Investment in America," *The American Economic Review* (December 1996).
25. Regression equation: Job Growth = 0.62 + 0.036 CRdummy + 1.15 Population Growth - 0.01 Average Salary

T Statistic: (3.89)(0.81) (12.60) (-3.30)

R-squared = 0.81

Job Growth is the 1982-2006 growth in private-sector employment, CRdummy is a dummy variable with a value of 1.0 for combined reporting states, Population Growth is the 1982-2006 growth in population, and average salary is an average of the beginning and ending level of private-sector salaries.
26. The average salary measure serves as one measure of private-sector costs in a state. As expected, job growth is lower in states with higher wages.
27. See Ernst & Young LLP, *"The 2007 U.S. Investment Monitor* (2007) for further details on the data and methodology. The projects included in the studies are announced projects with a minimum of $20 million in capital investment and 20 new or retained jobs.
28. New York State Department of Taxation and Finance, Combined Reporting for General Business Corporations, TSB-M-07(6)C, 25 June 2007. For a more comprehensive discussion of the complexities involved in complying with the expanded New York State combined reporting requirements, see Kenneth T. Zemsky, "Understanding the New Developments Regarding Combined Filing in New York," *Journal of Multistate Taxation* (March/April 2008).
29. The rules list six specific types of transactions that have to be examined including intercorporate receipts, expenses and asset transfers.
30. On the other hand, separate filing states involve tax compliance and administrative costs related to the determination and auditing of transfer prices applied to transactions between affiliated companies.
31. The precursor to the combined reporting bill was a bill passed by the legislature in special session that required world-wide combined reporting for major oil companies. The bill was supported by a state organization affiliated with the national Citizens/Labor Energy Coalition. The bill was vetoed by the governor. (See Arthur C. Roemer, "Minnesota Taxation of Unitary Corporations," *Minnesota Tax Journal*, December 1982.) This article discusses the initial revenue estimates for the combined reporting bill adopted in 1982.
32. A draft report, "Unitary Primer," prepared by the Department of Revenue in January 1984 explained that these losses were not taken into account in preparing the initial revenue estimates. It is also possible that the weakness in the U.S. economy in the early 1980s produced a larger stock of unused NOLs than anticipated in the revenue estimates.
33. As reported by Eng Braun, Wisconsin Division of Research and Policy, Wisconsin Department of Revenue, *Corporate Tax Modeling for Combined Reporting*, presentation to the Federation of Tax Administrators Conference on Revenue Estimating and Tax Research, September 2003.
34. "Fiscal Impact of Combined Reporting on the Pennsylvania Corporate Net Income Tax" (27 May 2004) and "Revenue Estimate Update" (20 October 2004), presentations to the Pennsylvania Business Tax Reform Commission by Brenda S. Warburton, Research Director, Pennsylvania Department of Revenue.
35. The $150 million figure is estimated based on information in the 27 May 2004 Department of Revenue presentation on the ratio of additional revenue under the capped and uncapped (by individual firm) NOL options. The $150 million does not, however, allow for the carry-in NOLs to be used by the entire unitary group.
36. Pennsylvania Business Tax Reform Commission Report, November 2004 (Chapter 14, "Modifications of Existing Pennsylvania Net Operating Losses")
37. The distributions of winners and losers are from the estimates presented by the Department of Taxation on 27 May 2004. The ratio of winners to losers from these earlier estimates was applied to the October revised estimates to derive the tax change amounts for winners and losers reported here. These figures do not include the large regional groups estimated separately.
38. The estimate reported in the Maryland fiscal note did not include any separate estimate of possibly higher revenue from the tax haven component of the bill.
39. This was the low-end of an estimated range of $25 to $50 million. As pointed out in the fiscal note, the $25 million figure is more likely in the "near term."
40. The addback provisions increase state corporate income taxes by disallowing deductions for certain expenses paid to out-of-state affiliates. Combined reporting would also increase taxes in this situation in the absence of addback provisions. In effect, Maryland already added this revenue during the prior year by adopting addbacks, reducing the expected additional revenue from combined reporting. According to a recent *Estimated Maryland Revenues Report* from the Maryland Board of Revenue Estimates (13 December 2006), the new addback provisions resulted in at least $44.1 million in additional tax revenue in 2004.
41. It is interesting to note that the Maryland 2007 analysis refers to the Pennsylvania Department of Revenue estimates of combined reporting discussed above. As noted earlier, the Pennsylvania estimates relied heavily on Minnesota corporate tax return information. It is not clear how the Pennsylvania results were actually used in the Maryland estimating process.
42. "Combined Reporting: An Option for Apportioning Iowa Corporate Income Tax," Tax Research and Program Analysis Section, Iowa Department of Revenue (March 2007).
43. The percentage increase was based on the increase divided by the actual fiscal year 2007 corporate franchise tax, corporation and utility tax, and the income component of insurance taxes.

Council On State Taxation
122 C Street, NW, Suite 330
Washington, DC 20001
Phone: (202) 484-5222
Fax: (202) 484-5229
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Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance

By John L. Mikesell, Indiana University January 2007

Executive Summary

Gross receipts taxes had largely disappeared as an important revenue source for state governments by the later years of the twentieth century, usually after considerable effort by state business groups to eliminate them. Analysts and scholars presumed that these taxes—also known as "turnover taxes"—had forever been replaced with options that made more sense as ways of distributing the cost of government and had less undesirable impact on the taxpaying public, including businesses, and generally lost interest in them. In recent years, however, such broad-base, low-rate taxes have again entered state tax policy discussions. With this re-emergence comes a need for a new analysis of gross receipts taxes to aid policymakers who are unfamiliar with their structure and drawbacks.

This examination of American and European experience with gross receipts taxation has identified several significant conclusions about the tax. These may be summarized:

Broad base: The gross receipts tax base can be broad, broader than the total value of production of the economy, but it lacks any link either to capacity to bear the cost of government services or to the amount of government services used—the normal standards for assigning tax burdens.

Low rate: Whether a gross receipts tax has a low rate depends on how much revenue the government intends to raise from it. Unlike most taxes, the effective rate of a gross receipts tax is higher than the statutory (or advertised) rate. A broad-base, low-rate gross receipts tax is unlikely to contribute a major share of tax revenue to a modern state government.

Stable revenue: A gross receipts tax appears to be roughly as stable as a retail sales tax. Its variations do not contribute to the overall stability of total state revenue because its fluctuations follow generally the same pattern as other major taxes.

Economic neutrality: A gross receipts tax interferes with private market decisions. Its pyramiding creates a haphazard pattern of incentives and disincentives for business operations. Most significantly, it establishes artificial incentive for vertical integration and discriminates against contracting work with independent suppliers and the advantages of scale and specialization that production by independent firms can bring.

John L. Mikesell is a professor of public finance and policy analysis and director of the Master of Public Affairs program at the Indiana University School of Public and Environmental Affairs. He has published numerous articles in sales and property taxation and his public finance textbook is widely used in graduate public administration programs.

Competitiveness: A gross receipts tax interferes with the capacity of individuals and businesses to compete with those in other states and other parts of the world. The tax embedded in prices grows as the share of a production chain within the state increases, so there is incentive to purchase business inputs from outside the state. It discourages capital investment by adding to the cost of factories, machinery, and equipment, and the disincentive increases as more of those capital goods are produced in the taxing state. This tax structure does not promote the growth and development of the state.

Fairness: A gross receipts tax does not treat equally situated businesses the same. Firms with the same net income will face radically different effective tax rates on that income, depending on their profit margins. Low-margin firms will be at great disadvantage relative to higher-margin firms, regardless of their overall profitability. Many new and expanding firms have low margins (or even are initially unprofitable) and the gross receipts tax reduces the chance that these firms will survive. This also is not consistent with a climate for growth and development.

Transparency: A gross receipts tax is a stealth tax with its true burden hidden from taxpayers. Hiding the cost of government is inconsistent with efficient and responsive provision of government services and contrary to the fundamentals of democratic government.

There is no sensible case for gross receipts taxation. The old turnover taxes—typically adopted as desperation measures in fiscal crisis—were replaced with taxes that created fewer economic problems. They do not belong in any program of tax reform.

Introduction

Gross receipts taxes had largely disappeared as an important revenue source for state governments by the last decade of the twentieth century, usually after considerable effort by state business groups to eliminate the tax. In recent years, however, such broad-base, low-rate taxes have again been discussed as an element of state revenue reform. The earlier American (and international) experience with these taxes appears to have been forgotten, as well as the fundamental principles of tax policy that they violate. Indeed, little analysis has been done on these taxes in recent years, probably because analysts and scholars presumed that gross receipts taxes had forever been replaced with options that better distributed the cost of government and had less undesirable impact on the taxpaying public, including American businesses. The re-emergence of these taxes creates a need for a new analysis of gross receipts taxes to aid policymakers who are unfamiliar with their structure and drawbacks.

Gross Receipts Taxation and the Proper Treatment of Businesses in a Tax System

A gross receipts tax, also called a "turnover tax," is a tax on receipts of a business. The tax is levied every time a product "turns over" (or changes owners) in the chain of production and distribution from resource extraction to the eventual customer. These taxes are not income taxes because the tax applies to business receipts, not business profits (there is no allowance for the costs encountered by the business in generating those receipts); thus, they do not tax according to the affluence of the business and its owners. The tax is not a retail sales tax, even though some retail sales taxes are legally defined as taxes on gross receipts. In contrast to retail sales taxes, the gross receipts taxes have no mechanism to limit application of the taxes to retail transactions, are not accompanied by compensating use taxes on purchases made out of state, lack a mechanism to exclude from the taxable gross base any tax added to the purchase price by merchants, and lack the commodity exemptions that characterize retail sales taxes; thus, they are not taxes on household consumption.[1] And the taxes are not proxy charges for government services provided to the business because there is no link between the services received by the business and gross receipts of the business. Often they are proposed as a tax on the "privilege" of doing business, somewhat related to the sense of a poll tax on the privilege of existing in a jurisdiction and about equally defensible.

These are general taxes on gross receipts of all

[1] A number of state retail sales taxes are legally gross receipts taxes with incidence legally on the vendor, including taxes in Arizona, California, Connecticut, Hawaii, Kentucky, Michigan, Nevada, New Mexico, North Dakota, South Dakota, Tennessee, and Wisconsin. [John F. Due and John L. Mikesell, *Sales Taxation, State and Local Structure and Administration* (Washington, D. C.: Urban Institute, 1994) and Research Institute of America, *2006 Guide to Sales and Use Taxes* (New York: RIA, 2005)] They may or may not have legal language about shifting to the customer, but that is irrelevant to what happens with the burden. These are all retail sales taxes, not gross receipts taxes, because they have the basic retail sales tax features outlined here. Some believe consumption to be the best single index for distribution of the cost of government. Nicholas Kaldor expresses the idea as follows: with consumption taxation, "…each individual [measures tax capacity] for himself when, in the light of all his present circumstances and future prospects, he decides on the scale of his personal living expenses. Thus a tax based on actual spending rates each individual's spending capacity according to the yardstick which he applies to himself." Nicholas Kaldor, *An Expenditure Tax* (London: Allen and Unwin, 1955), 47

businesses—sellers of both goods and services—without allowance for costs of the business or for receipts from sales made to other businesses. Although the actual incidence of a gross receipts tax depends on market conditions, under most circumstances the tax is likely to be reflected in product prices as it flows to the final customer. And the final price is likely to reflect the gross receipts tax added at each point that the product and the inputs used to make the product changed hands in the distribution flow. This is even the case when the tax is legally a business privilege tax.

Gross receipts taxation is an element in a perpetual tax policy puzzle: the proper treatment of businesses in a tax system.[2] To require payment of tax by business entities is convenient because economic activity is more concentrated in businesses than in households and because businesses are generally more familiar with the requirements of financial recordkeeping and reporting than the average household. Collecting taxes from business is thus administratively economical and convenient. It appears reasonable because private businesses are the source of economic prosperity in a market economy and the government must seek financial support from the places that have resources available. It is politically attractive because placing a tax on business appears to relieve the fiscal burden from households—where the voters are. And it is logical for businesses to pay for the public services that allow them to protect their operations, to prosper financially, and to grow.

But those guiding concepts are less robust than they might seem. Businesses never represent the final resting place of the tax burden, but rather serve as a conduit of the tax burden to households, either through higher prices paid for goods and services sold by businesses, through lower returns received from the sale of services or other resources to those businesses, or through reduced net returns to business owners. A business will adjust to taxes imposed on it, and those adjustments will increase the tax burden on households; there is nowhere else for it to go. This reality complicates the design of appropriate taxation of businesses. Rather than designing policy to tax business, a more useful approach is to recognize the role of business as a conduit to households and to structure taxes accordingly.

In particular, the policy issues involve designing tax structures that do the least harm to the productive operation of the market economy, that allow households to understand with a fair degree of accuracy how high a tax burden they are bearing, that require businesses to pay for government services that they directly and explicitly consume, and that cause ultimate tax burdens to be sensibly distributed among households. Analysis of gross receipts taxation needs to be done within the policy context of efficient, equitable, and transparent transfer of resources from private to public use, not in a context of determining the proper share of total taxes a business ought to pay. The issues to consider are how business taxes are transmitted to households, and how to mitigate the adverse economic and social impacts from that transference.

Analysis of gross receipts taxation needs to be done within the policy context of efficient, equitable, and transparent transfer of resources from private to public use, not in a context of determining the proper share of total taxes a business ought to pay.

One point about business taxation cannot be overlooked: as a matter of economic efficiency, if a business uses a government service, it should pay for that service. Thomas Pogue clearly summarizes the logic: "…the most compelling *economic reason* [for business taxation] is to charge businesses for costs they generate but would otherwise not take into account in deciding what, where, and how to produce. This can be termed the *social cost* rationale, because the object is to confront producers with the full cost to society of the inputs they use in producing goods and services. Under this rationale, business taxes are a means of internalizing the costs of otherwise unpriced inputs used in production."[3] That policy will induce businesses to take account of the resources required to produce government services, to treat them as economic and not free goods, and to be judicious in their use. But gross receipts taxes do not serve that purpose.

[2] Some states levy gross receipts taxes on certain types of businesses, like public utilities. These are much narrower in coverage than the taxes considered here.

[3] Thomas F. Pogue, "Principles of Business Taxation: How and Why Should Businesses Be Taxed?" in W. Bartley Hildreth and James A. Richardson, eds., *Handbook on Taxation* (New York: Marcel Dekker, 1999), p. 192.

Gross Receipts Taxation as an Element in Tax Systems

Gross receipts taxes have a long history, dating back to the thirteenth century in Europe and to the mid-nineteenth century in the United States. This history provides a useful framework in which to analyze their current role in the tax system and their economic and political effects. The taxes became important in France and Germany in the post World War I year, and the Nazis exported them to the countries they intended to annex (Austria, Luxemburg, and the Netherlands).[4] They continued as important revenue sources in Europe until replaced by national value-added taxes in the 1960s and 1970s.

The earliest American taxes based on sales receipts were business occupation taxes on total sales, purchases, or receipts, which developed during the nineteenth century in mid-Atlantic states (Pennsylvania, Virginia, Connecticut, and Delaware) as replacements for lump-sum occupational taxes. They were fractional rate taxes with multiple rates classified by type of business and were intended to be charges for the privilege of doing business. (Of course, governmental intent does not actually determine who bears the ultimate burden of any tax.) They were usually adopted as license taxes, but had a component calculated as a percentage of gross receipts beyond the lump-sum payment. These taxes were levied at very low rates, yielded minimal revenue, and had high administrative costs as a percentage of revenue collected (as much as 15 percent of collections in Pennsylvania and 7 percent in Connecticut).[5]

Gross receipts taxes became more serious instruments of state finance in the late 1920s and 1930s with adoptions in West Virginia, Mississippi, Georgia, Indiana, Delaware, and Washington, generally enacted to help with the collapse of state finances during the Great Depression and to reduce property taxes burdens (the primary source of state revenue up to that point). In 2005, Ohio adopted such a tax, even as all other states but Delaware and Washington had repealed theirs.[6] Hence, there is a body of experience for reference as states consider whether adopting a new gross receipts tax would constitute real tax reform.

The Arguments for Gross Receipts Taxation

Proponents of state gross receipts taxes argue that they are low-rate, broad-based, and stable revenue sources. These are the same basic arguments that were made for such taxes in the 1930s, even though the economic conditions of the early twenty-first century hardly compare with those of the Great Depression. The following was written in 1939 but could well have been written by current gross receipts tax supporters:

> Turnover taxes are defended on the grounds that they serve to broaden the tax base, compelling every citizen to bear his share of the cost of government; that they place the tax burden on those who have money to spend; and that they encourage business activity and home ownership by relieving property tax burdens. More compelling than any of these considerations, however, is the fact that turnover taxes are capable of producing large amounts of revenue at relatively low collection costs. Popularity of turnover taxes is due also to the widespread belief that the yield of such taxes is more stable than the yields of most other types of levies.[7]

But there is another political reason for these taxes, clearly described by John Due in his analysis of the European turnover taxes: the fact that they are hidden from the public is a substantial advantage

[4] The French tax was earlier, but the Spanish *alcavala* is more widely known because Adam Smith suggested that the greater prosperity of Great Britain compared to that in Spain and the generally low state of development of manufacturing in Spain in the eighteenth century was attributable in considerable part to the administrative burden of that tax. [Adam Smith, *Wealth of Nations* (New York: Modern Library, 1937), p. 850.]

[5] Neil Jacoby, *Retail Sales Taxation* (Chicago: Commerce Clearing House, 1939), p. 34, 51. Gross receipts taxes—in the form of business license taxes that calculated a portion of the license fee according to the entity's gross receipts—were also levied in Alaska and Louisiana. Neither tax produced significant revenue. The former was repealed in 1979 and the latter in 1982.

[6] Texas also enacted a new business tax in 2006, to become effective in 2008. The tax applies to businesses organized as corporations, limited liability companies, limited partnerships, and business trusts, and not to taxable businesses with less than $300,000 total revenue per year. The base, "taxable margin," equals the lesser of 70 percent of total revenue or total revenue reduced by either cost of goods sold or compensation expense. The statute creates its own limited definition of cost of goods sold. The tax rate is 1% with a special rate of 0.5 % for retailers and wholesalers. This tax is not included here because it is more a badly designed business profits tax, like those that emerged in the newly independent states of the former Soviet Union, than either traditional or newer gross receipts taxes. Gross receipts-based alternative minimum corporate income taxes have recently been adopted in New Jersey (2002, the Alternate Minimum Assessment) and in Kentucky (2005, the Alternate Minimum Calculation). The New Jersey tax was eliminated in 2006. These taxes combine all the problems of minimum income taxation in general—excess compliance and administrative cost, penalization of the unsuccessful business, undesirable incentive impacts, doubtful equity basis—with those of taxation according to gross receipts. A corporate gross income tax was an alternate minimum corporate income tax in Indiana from 1963 (when the gross income tax was converted into a retail sales tax, a personal income tax, and a corporate net income tax) until 2002 (when the corporate gross tax was finally phased out).

"because it lessens opposition to the tax and thus makes it politically possible to obtain a high yield."[8] Because the customer sees none of the tax embedded at each exchange in the production and distribution process, not even the final retail exchange, the customer is entirely unaware of the tax, thus permitting the government to finance this portion of its operations in an entirely stealthy manner.

Turnover taxes were particularly important for Germany and France in the aftermath of World War I, a conflict that destroyed their fiscal systems. As Haig and Shoup observed, "The morale of taxpayers was at a low ebb, and taxes 'hidden' in prices, collected through relatively convenient business channels, and to be paid ultimately by the consumer in small bits day by day were apparently more attractive than an increase in rates of already existing taxes."[9] They were an element of fiscal pragmatism: compared to more complicated revenue sources, these gross receipts taxes had the advantage of generating revenue in those difficult economic conditions. They could yield substantial revenue at relatively low statutory rates. They continued even in the years after World War II because the countries saw no other feasible source to finance their operations.

How well do the arguments for gross receipts taxes stand up in the current economic environment? The political utility of stealth taxation violates concepts of democratic governance, and the other arguments are far less compelling than they might initially appear.

LOW RATE

The rate of any tax depends on how much revenue is to be raised. Rates for gross receipts taxes will be much higher if the state intends to make the tax a major contributor to its revenue portfolio, as was the case with the now-repealed taxes in West Virginia and Indiana, and as is the case with the existing tax in Washington State.[10] Any tax can be low-rate if revenue expectations are low; this is not a unique or necessary feature of a gross receipts tax.

Some examples of turnover taxes in various states can shed light on the revenue impact of these taxes.

West Virginia

The 1921 West Virginia gross sales tax was the first state gross receipts tax to yield fiscally significant revenue. The tax produced more than half of all state tax revenue from 1922 to 1925 and more than one-third through 1930, initially at rates ranging from 0.20 percent to 0.40 percent, depending on business category, but increased in 1925.[11] This tax was finally repealed in the late 1980s, after much effort by businesses in the state. By 1986, the Business and Occupation Tax had 26 different classifications of taxable activities, with legal rates ranging from 0.24 percent for wholesaling to 7.77 percent for natural gas production (rates had been somewhat higher in the early years of that decade), and produced 26.2 percent of state tax revenue.[12] Tax yields were concentrated in a few business categories: in fiscal year 1968, 30 percent of total yield was collected from the "manufacturing, compounding, or preparing of products" class and 65 percent of yield came from just four classes (manufacturing, coal production, contracting, and retailing).[13]

Delaware

When the Delaware gross receipts tax was enacted in 1913, its modest rates yielded modest revenue. In recent years, the yield has changed—via changes in rates and basis for calculating the tax—in response to a need to close state fiscal deficits. The tax produced an average of 4.00 percent of state tax revenue in the 1970 – 1975 period, steadily increased to average 8.01 percent in the 1980 – 1995 period, and steadily declined to produce 5.95 percent in the 2000 – 2005 period, the result of structural changes made in the tax in accord with fiscal need.[14] The tax yielded 6.1 percent of state general fund revenue in fiscal year 2005[15] To generate as much revenue as that same

[7] Bryant Putney, "Turnover Taxes in the United States," *Editorial Research Reports* (Congressional Quarterly), February 2, 1939, p. 83.

[8] John F. Due, *Sales Taxation* (Urbana, Illinois: University of Illinois Press, 1957): 58.

[9] Robert Murray Haig et al., *The Sales Tax in the American States* (New York: Columbia University Press, 1934): 5. Other European countries levied sales taxes that did not have the full multi-stage application of these turnover taxes.

[10] The effective rate of a gross receipts tax will, of course, be higher than the advertised rate because the tax applies at multiple points in the production/distribution process.

[11] Jacoby, *op. cit.*, 59.

[12] U. S. Bureau of Census, *State Tax Collections in 1987* (Washington, D.C.: U.S. Government Printing Office, 1988).

[13] Vance Q. Alvis, "Turnover Taxation in West Virginia," *West Virginia University Legislative Fiscal Studies, State Tax Study Staff Papers* 1 (September 1970), p. 23.

[14] Delaware Department of Finance Fiscal Notebook [http://www.state.de.us/finance/publications/fiscal_notebook_05/Section02/Section2.pdf]

[15] Delaware Department of Finance Fiscal Notebook, *op. cit.*

state's individual income tax (which produced about five times as much revenue for the state, 30.7 percent of the total), for instance, would require much higher gross receipts tax rates.[16] Tax rates presently range from 0.077 percent (farm machinery retailers and commercial feed dealers) to 1.536 percent (lessees), according to type of business activity.

Washington

The Washington State Business and Occupation Tax (1933 – present) applies at rates ranging from 0.275 to 1.5 percent, depending on the category of business. In fiscal year 2005, it produced $2,269.1 million for the state, 16.4 percent of total state tax revenue, behind only the retail sales and use tax ($6,620.2 million) in yield.[17] The state levies neither individual nor corporate income taxes, so the opportunities for alternative revenue are limited.

Indiana

The Indiana Gross Income Tax (1933 – 1962), the broadest transaction tax ever levied in the United States, was a turnover tax plus an income tax: a tax on gross receipts of wholesale sales (including manufacturing, mining, farming, etc.), display advertising, retail sales, and laundry and dry cleaning sales, on wages, salary, and other labor income, property income of all types, sales of services, and sales of property. The tax was the largest single source of state tax revenue from 1936 until its restructuring in 1963, producing 83.7 percent of total state tax revenue in 1962.[18] In that year, it was replaced with a conventional retail sales tax, a personal income tax, and a corporate income tax. The gross income tax remained as a corporate minimum tax. In 1965, when it was collected only from corporations whose calculated net income tax liabilities were lower than their gross tax liabilities (generally the less profitable and loss-making firms and firms with considerable multi-state activity whose total net income was reduced by apportionment), the tax produced 17.3 percent of state tax revenue. The share diminished over time, as other tax rates increased and the statutory rate for the corporate gross tax was phased downward. By 1991, its yield had fallen to 5.4 percent of the total.[19] This last remnant of the tax was finally repealed in 2002.

Ohio

Ohio enacted a gross receipts tax on all commercial activity from July 1, 2005, phasing in from a rate of 0.06 percent to an eventual rate of 0.26 percent after March 2009. The tax is on pace to yield around $600 million in fiscal year 2007, compared with a forecast of total state tax revenue of $19.4 billion for the year. When the rate is fully phased in, it is expected to yield $1.55 billion—only 8 percent of even fiscal year 2007 total tax expectations—and that amount will certainly be higher by the 2010 full-phase-in date.[20] Even when fully operational, the tax is not structured to be a major revenue producer for the state.

Neither of the Depression-era turnover taxes in Mississippi and Georgia produced significant revenue and both were levied only for a couple of years. The Mississippi tax was transformed into the first retail sales tax in the United States through an increased rate on retail sales, exclusion of pre-retail sales from taxation, and an allowance for vendors to exclude tax collected from purchasers from their own gross tax base.

It is a maxim of tax policy that, other things being equal, low tax rates are preferable to high rates: economic distortions increase as effective tax rates rise, and any inequities among taxpayers are magnified by higher rates. But this assumes that the tax produces meaningful revenue. Collection of any tax involves both compliance costs for the taxpayer and administrative costs to the revenue agency, and many of these costs are independent of the amount of revenue generated by the tax. A low-rate tax that produces modest revenue may have very high compliance and administrative costs relative to that revenue. In such circumstances, the appropriate revenue policy is to eliminate the low-rate tax entirely

[16] Because high rates have a negative effect on the size of the base, it is not clear what gross receipts tax would be sufficient to generate that amount of revenue. Base effects may, in fact, be so severe that that revenue total may be impossible from the tax.

[17] Washington Department of Revenue, "Summary of Washington State Tax Collections, Fiscal Years 2004 and 2005." [http://dor.wa.gov/Docs/Reports/2005/Tax_Statistics_2005/Table1.xls]

[18] Bureau of Census, Census of Governments: 1962. Vol. IV, No. 4, *Compendium of Government Finances.* (Washington, D.C.: U.S. Government Printing Office, 1964), p. 90.

[19] Bureau of Census, *State Government Tax Collections* (Washington, D.C.: U. S. Government Printing Office, various years).

[20] Dennis J. Willard, "Ohio Tax Reaps More Than Expected," *CentreDaily.com*, November 27, 2006 [http://www.centredaily.com/mld/centredaily/news/nation/16106239.htm] and State of Ohio, *Executive Budget, Fiscal Years 2006 and 2007.* Columbus, Ohio: Office of Management and Budget, 2005.

and raise that modest revenue from a more productive source. Another maxim of tax policy is that no rate/no tax is even better than a low rate. A low rate is a desirable objective for tax policy, but only if the tax in question produces meaningful revenue.

An unspoken but certainly important element in the preference for low statutory rates, at least in regard to this particular tax, is the political reality that the citizenry might not notice the tax. And citizens who do not notice a tax are less likely to object, regardless of the tax's attributes or of how wastefully proceeds of that tax are spent. A tax whose impact is on businesses and whose legal rate is low will not generate the public discussion of a tax whose impact is more apparent. While such a strategy of obscuring the cost of government is at odds with normal conceptions of representative democracy, it cannot be denied that it is part of modern fiscal politics.

BROAD BASE

A gross receipts tax applies on each business transaction.[21] It encompasses the entire market production of the state and includes intermediate transactions leading up to the final product. The base is thus larger than the gross state product because it includes both the final value of product and the value of transactions leading up to that final production. Suppose, for example, that a company manufactures and sells an automobile. The value of that automobile would be measured as part of the gross state product. A turnover tax would apply to those gross receipts. However, that tax would also apply when tire manufacturers sold tires to the company to install on the automobile, when steel manufacturers sold sheet steel to be fabricated into the body of the car, when utilities sold power and water to the automobile manufacturer and to the tire maker, and so on.[22] Hence, it is apparent that the gross receipts or turnover base exceeds the value of final production (or gross product) of the state. The gross receipts base is broad. But is it reasonable to have an annual tax on a flow whose base is larger than the sum of economic production in the state?

The following data illustrate the irrationality of such a large base.

Washington

The total base of the Washington State Business and Occupation tax, the most significant gross receipts tax remaining in the United States, was $474,813.8 million in calendar year 2005. Washington gross state product in that year was only $268,502 million.[23] The tax base is 177 percent of the total economic product of the state because of taxation of intermediate transactions in the flow of production. Only the flow of not-previously-taxed finished goods into the state and the flow of taxed unfinished goods out of the state keep the base-to-product ratio from being even greater.

Indiana

The fiscal details of the Indiana gross income tax similarly show the impact of taxing the same economic flow at multiple stages of production. In 1962, total gross income reported for the tax was $32,818 million: $20,481.7 million taxed at 0.375

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percent (mostly the gross receipts component of the tax) and $12,336.2 million taxed at 1.5 percent (mostly the personal income component, but also including receipts from the sale of services). Exclusions reduced the taxable total to $24,773 million.[24] This compares with state personal income in that year of $11,343 million, retail trade of around

[21] It may even include gross receipts of service providers, even providers of professional services, which states are reluctant to include in their retail sales tax bases. Also, the taxes may include some receipts of non-profit entities otherwise outside both retail sales and income taxes.

[22] If the automobile company owned the tire company, for instance, no tax would apply to the acquisition of the tires. Thus, the vertically integrated firm would have an advantage over its competitors.

[23] Washington State Department of Revenue, *Quarterly Business Review: Calendar Year 2005* (Olympia: Washington State Department of Revenue, 2006) and U. S. Bureau of Economic Analysis, *Western States Led Economic Growth in 2005* (BEA 06 – 23) [http://www.bea.gov/bea/newsrelarchive/2006/gsp0606.pdf]

[24] Charles F. Bonser, "Analysis of Major Business Taxes Levied by Indiana," in Charles F. Bonser, *et. al., Business Taxation in Indiana* (Indianapolis, Indiana: Commission on State Tax and Financing Policy, 1966), p. 23.

$6,216 million, and gross state product of roughly $15,000 million.[25] The gross receipts base was around 137 percent of total production in the state. Economic activity in the state was clearly taxed multiple times during production, with the result that effective tax rates on consumer purchases were much higher than the statuary rates.

A broad base does not by itself make a tax a good choice. A poll tax and a flat tax on all business entities would, for example, be broad-base taxes but there is no reason to believe that either would be a good choice for raising significant revenues. Coverage of an economically sensible base should be as broad as possible, without exemptions or special provisions that create inequities and distortions. Broad coverage of a reasonable base, not broad coverage alone, is the accepted standard.

In some discussions, it is suggested that such a broad tax presents a way to make everyone pay for the government services they receive.[26] But the gross receipts tax represents a poor means for dividing the cost of government according to benefits from government. As the Washington State Tax Study observes, the "benefits received" basis for taxation "…is most relevant when a tax is levied specifically for the purpose of providing a particular government service to a specific group of taxpayers…[It is] impractical for much of government spending because the 'benefits' received cannot be determined for each taxpayer."[27] The gross receipts of a business are associated with no particular governmental service and differences in gross receipts are not a useful measure of whether the business has consumed greater or lesser amounts of government services. Gross receipts taxation fails to make sense as a way of dividing the cost of providing government services.

Table 1
Stability Characteristics of State Tax Bases, 1995 – 2005

	Washington Business and Occupation Tax Base	Washington Retail Sales Tax Base	Oregon Adjusted Gross Income	Oregon Corporate Income Tax Revenue
Annual Change (mean)	5.28%	5.89%	5.09%	4.96%
Standard Deviation	0.0461	0.0387	0.0537	0.2655
Highest Change	10.87%	9.79%	11.70%	41.90%
Lowest Change	–3.23%	1.00%	–4.50%	39.20%
Correlation with B&O Base	_	0.8802	0.9192	0.8947

Note: Oregon Adjusted Gross Income for 1995 – 2004 only.
Source: Washington Department of Revenue, *Quarterly Business Review, A Compilation of Statistics on Gross Income, Taxable Retail Sales and Accrued Tax Liability as Reported by Washington State Excise Taxpayers* (various years) [http://dor.wa.gov/content/statistics/]; Oregon Department of Revenue, *Oregon Personal Income Tax Statistics* (various years) [http://www.oregon.gov/DOR/STATS/index.shmtl]; and U.S. Bureau of Census, *State Tax Collections* (various years) [http://www.census.gov/govs/www/statetax.html]

REVENUE STABILITY

Another virtue attributed to the gross receipts tax is stability; its revenue is not subject to the fluctuations of other state tax bases.[28] Whether gross receipts taxes are actually more stable has not been given much attention, certainly not recently.

A test can be conducted with the Washington Business and Occupation Tax. In Table 1, relevant data are presented for the Business and Occupation Tax, the Washington retail sales tax, and, for comparison with major taxes not levied by Washington state, the Oregon individual and corporate income taxes. Washington and Oregon, as neighbors, would generally be subject to approximately the same economic environment, so this presents a reasonable test of the stability of the gross receipts tax compared to these other major taxes. The data are for the reported bases of the Business and Occupation and retail sales taxes (total gross receipts and gross retail sales), total adjusted gross income reported for the individual income tax in Oregon, and reported Oregon corporate net income tax collections (the total base of the corporate tax was not available, but there have been no statutory rate changes over the years examined here). These data for 1995 through 2005 can be examined to establish the degree of stability inherent in each of the taxes. The summary statistics in Table 1 shed light on the extent to which a gross receipts tax base in practice is more stable than other significant taxes.

The average change in the gross receipts tax base was 5.3% over the period of analysis. That is slightly below the average change for the retail sales tax base and somewhat above that for the individual and corporate income taxes. There is not much difference between the four bases in terms of annual rates of change.

The standard deviation measures how spread out the percentage change numbers are or, in other words, whether the annual change percentages are always about the same (considerable stability in the rate of change) or whether there is considerable variability. In this comparison, the gross receipts base is not quite as stable as the retail sales base (0.0461 versus 0.0387), more stable than the individual income tax base, and very much more stable than the corporate income tax. The greater stability of the retail sales tax base may be due to this tax's exclusion of business purchases, particularly purchases of production infrastructure, to a greater extent than the gross receipts base, and such purchases are themselves quite sensitive to economic change and the state of the economy.

Table 1 also presents the highest and lowest annual change percentage for each tax in the period examined. The breadth of swing (highest change minus lowest change) is greatest for the corporate income tax, by a huge margin, and lowest for the retail sales tax. The swing for the gross receipts tax is slightly less than for the individual income tax but more than for the retail sales tax.

An unstable revenue source can add to the stability of the total revenue portfolio if its instability works to counteract the instability of other sources. This happens if change in the source is negatively correlated with change in other sources. However, this does not appear to be the case for the gross receipts base. It is positively correlated with the retail sales base and also with the two Oregon income taxes (again working under the assumption that what happens in Oregon is a good reflection of what would happen with a comparable base in Washington).

On the basis of Washington's evidence, the gross receipts tax appears to be slightly less stable than the retail sales tax but more stable than taxes on corporate profits or individual income. The variation in the gross receipts tax would not appear to contribute to the overall stability of a state tax system.

Problems with Gross Receipts Taxation

A gross receipts tax violates accepted principles of sound business taxation. In particular, it creates problems in terms of economic neutrality, competitiveness, fairness, and transparency.

ECONOMIC NEUTRALITY

A tax (and a tax system) should raise revenue in a way that has minimal effect on economic choices made by individuals and businesses. It ought not interfere with the functioning of the competitive market as it allocates resources to the betterment of society. When taxes distort decisions, the result is a higher cost of getting goods and services to the public than would otherwise be necessary and lower potential living standards for the citizenry than would otherwise be attainable. A tax that distorts the functioning of the market is a loss for everyone; any special advantage from the distortion is less than the loss incurred by the rest of the economy. Politicians and government officials are far less capable of allocating resources than is the allocative mechanism of the private market.

The pyramiding effect of general gross receipts taxes creates the primary non-neutral element of these taxes. As the tax applies to goods and services sold by one company to another, those taxes paid constitute a production cost to the purchasing company. The tax is paid several times as a product moves to the final consumer, and the amount of tax depends on the number of exchanges in the production chain.

A firm can gain advantage by merging with its suppliers, thus eliminating an exchange in the production chain at which the tax applies. This creates an artificial incentive for vertical integration, favoring larger enterprises over their smaller competitors. This is problematic. As John Due maintains, "The fundamental objection to the turnover tax is its severe discrimination against nonintegrated production and distribution systems."[29] A firm that is not economically integrated will find it difficult to shift the tax because of competition from integrated firms. A small business that purchases its inventory from distributors will have even more difficulty competing with large firms that handle inventory internally or purchase directly from manufacturers. And product from out-of-state will be advantaged compared to product produced within the state because of gross receipts tax that has been embedded in the cost during the chain of production. The more fabrication is done out of state, the greater the cost advantage will be.

Unfortunately, vertical integration means that even the largest firms must handle a variety of dissimilar tasks, losing the advantages of economies of

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[25] U.S. Department of Commerce, Bureau of Economic Analysis [http://www.bea.gov] and U. S. Bureau of Census, *Census of Business 1963: Vol. 2, Retail Trade — Area Statistics, Part 2, Indiana to New York* (Washington, D.C.: U.S. Government Printing Office, 1966), p. 16-5. The gross state product is approximate, based on the ratio of state personal income to gross state product in the two preceding years, because gross state product estimates are not available for 1962. Retail trade is also approximate, based on linear interpolation between Census data for 1958 and 1963.

[26] The base of a gross receipts tax may be constructed so that it is not, in fact, broad in impact. Exemption thresholds for payment of tax in Delaware have been designed so that the tax impact is concentrated in a few large firms: 82 percent of businesses in the state fall below the threshold and 85 percent of collections come from only 800 companies. [Al Mascitti, "Contrary to GOP, Gross Receipts Tax Not Really Ailing Small Businesses," *News Journal (Wilmington, Delaware)*, June 12, 2005: p. 18.]

[27] Washington State Tax Structure Study Committee, *Tax Alternatives for Washington State* (November 2002) [http://dor.wa.gov/content/statistics/wataxstudy/Final_Report.htm], p. 4.

[28] Of course, a completely stable tax base—one that is unchanged from year to year—would not be desirable. Therefore, the objective is a sort of dynamic stability or a pattern of consistent growth over the years.

[29] John F. Due, *Government Finance: An Economic Analysis* Revised edition. (Homewood, Illinois: Richard D. Irwin, 1959), p. 322.

scale and specialization that contracting with independent firms can provide. This reduces the ability of firms to compete with firms from other states and other countries. The gross receipts tax lesson: outsource as little as possible, but if outsourcing is to be done, do it with out-of-state firms.

The following examples of turnover taxes in various jurisdictions illustrate these distortions.

Washington

The Washington State Tax Study found that the Business and Occupation Tax pyramided an average of 2.5 times in the product flow, but some products pyramid 1.5 times while others pyramid as many as five or six times.[30] As a result, the effective tax rate—tax paid relative to value added by a business—varied substantially from industry to industry. That creates a haphazard pattern of incentives and disincentives that impedes the flow of capital to activities yielding the best economic return and therefore dampens the state's economic development prospects. The effective rate averages 250 percent of the advertised one, and businesses have a considerable incentive to arrange their operations to avoid the tax.

France

France adopted its commodity transfer tax in 1920 with a rate of 1 percent plus 0.1 percent for distribution to local governments and "made all those who habitually or occasionally sold articles of commerce or articles manufactured by themselves, even though no profit should arise, subject to the tax."[31] The government clearly understood that commodities would be taxed more than once as they moved through the production and distribution chain, initially assuming for revenue estimates that a commodity would experience five such exchanges. Manipulations to avoid taxable transactions between suppliers or producers were common: "…dealers in some way manage to become commission merchants and brokers, and direct encouragement is given to the formation of large units out of smaller ones in such a way as to prevent the application of the tax."[32] This distortion of market decisions operated to the detriment of the national economy and added unnecessary costs to the operation of businesses. Problems and distortions from the tax were apparent to all, but they were accepted because no better way was seen to raise the revenue in the post World War I era.

Germany

The German turnover tax showed how the cumulative burden of the tax varied according to the number of transactions between production and final sale and the relative content of labor versus materials in product price. A study done in 1952 showed the effective tax rates on selected commodities to range from 3.2 percent for electricity to 12.5 percent on linen bedspreads, a finding even more interesting because electricity was legally exempt from the tax.[33] The tax on pre-retail transactions built a varying tax burden that was not related to any governmental intent—and was invisible to the public. The low statutory rate pyramided into a much higher effective tax rate, and the taxpayer had no way of knowing what the actual rate was.

The problems are clear. First, the cumulative burden of the tax varies across products according to the number of transactions the product has gone through from production to final sale. Each exchange in the production and distribution channel is taxed, so the more exchanges, the higher the accumulated turnover tax burden. Effective tax rates and burdens on those purchasing products will not depend on the intent of the government but on a series of factors that include the number of transactions involved in getting the product to market and the relative content of labor versus materials in the price of the final product. Second, the taxes artificially encourage economic integration and discourage outsourcing to small busi-

[30] Washington State Tax Study, *op. cit.*, p. 24.

[31] *Ibid*, p. 172.

[32] William Raymond Green, *The Theory and Practice of Modern Taxation* (New York: Commerce Clearing House, 1938), p. 177. There was advantage to being a middleman without taking title to the goods and hence avoiding the tax. This was the source of much administrative complexity. (Carl Shoup, "The Sales Tax in France—Simplicity?" *Bulletin of the National Tax Association,* XVI (October 1930), 16 – 17.

[33] IFO-Institut fur Wirtstschaftsforschung, *Untersuchungen zur Grossen Steuerreform* (Munich: 1953), p. 109 cited in John F. Due, *Sales Taxation* (Urbana, Illinois: University of Illinois Press, 1957), p. 60.

[34] Germany attempted for a time to balance competition between vertically integrated and non-integrated firms by trying to tax internal transfers and, for a time, through lower wholesale rates, but operation of the tax became extremely complicated.

[35] Charles E. McLure, Jr., "How—and How Not—to Tax Business," *State Tax Notes* 36 (April 4, 2005), 31 – 32.

[36] Data for 2002 to 2003 from Office of Advocacy, U.S. Small Business Administration [http://www.sba.gov/advo/research/dyn_stmsa03.pdf] and from U.S. Bureau of Census [http://censtats.census.gov/cgi-bin/usac/usacomp.pl].

nesses. Because purchases of inputs or services from outside the business would be subject to turnover taxation while transfers of services within units of the business would not, the system establishes a bias toward economic integration. When a firm purchases a supplier or a producer purchases a distribution enterprise, the tax component of the final product price declines, to the competitive advantage of that business.[34]

A low legal rate becomes a much higher effective rate as a product moves through the production and distribution chain to the final customer. And both households and businesses have an economic incentive to avoid higher effective rates, making choices that work to the detriment of economic development, growth, and progress. A tax whose effective rate depends on the length of the chain from production to final consumer cannot be judged appropriate for any market economy. Charles McLure summarizes: "The taxation of business inputs violates the principle of economic neutrality by discriminating against businesses and industries that must incur these costs and by encouraging self-supply, even when that is not the most efficient way to obtain an otherwise taxed product. By increasing costs, taxing business inputs makes [the state's] producers less competitive in both export and local markets."[35]

COMPETITIVENESS

A state's tax system should not interfere with the capacity of individuals and businesses to compete for business with entities in other states and throughout the world. Even small rate differences are important in competitive decisions. Embedding gross receipts tax in the prices charged by state producers when those producers purchase materials, inventory, services, and other inputs from within the state makes it more difficult for state producers to compete with firms from other states that do not face such taxes. A tax that encourages businesses to look to out-of-state suppliers is not conducive to a strong economy. And the small margins created by even low-rate taxes matter. For example, the Ohio Commercial Activity Tax was revised before it had been in operation for even a year to exclude from taxation the receipts from tangible personal property delivered into the state for shipment outside the state through "qualified distribution centers." Without this provision, it was feared that Ohio distribution businesses would be at a competitive disadvantage. The provision adds complexity to an otherwise simple tax.

The gross receipts tax presents a special problem for capital-intensive industries. Such firms purchase their factories, machinery, equipment, fixtures, etc., from other businesses. Self-supply is seldom an option for significant capital assets. Therefore, the cost of purchasing production and distribution infrastructure is increased by the application of the gross receipts tax and by the gross receipts tax that has been embedded in the purchase price through exchanges in the chain of production that created that equipment. The more of this chain that has taken place within the state, the greater the inflation of the cost of the equipment. Indeed, the tax discriminates against the use of capital in the production process: it must be paid on capital when it is produced but not on labor, so it encourages substitution of labor for capital in the production process. It is unclear why any state would want, first, to discourage capital investment by its businesses and, second, to discourage production of capital equipment within its borders. This is not a good strategy for a state's economic growth and development.

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The distortion problems may be most severe for new and expanding businesses. Businesses that are just starting operations often operate at a loss or with only low profits. A tax that is driven by a business' gross receipts, rather than its economic capacity, makes it difficult for the business to survive, to become profitable, and to grow. Some evidence of this problem can be seen in enterprise data from Washington, where the Business and Occupation Tax applies to gross receipts rather than to profits of the firm. Data from the U.S. Small Business Administration show total business establishment births and small business establishment births, both measured as shares of total business establishments, to be 8.9 percent and 16.3 percent, respectively, above the national average. But total and small business death rates exceed the national average by 8.9 percent and 14.1 percent.[36] The Business and Occupation

Tax is not likely the sole cause of this unfortunate pattern, but it certainly makes a contribution.

The European countries levying turnover taxes were keenly concerned about their impact on international competitiveness. With the turnover tax, exports were disadvantaged because of the tax embedded in the price of products offered for the international market, and imports were advantaged because there was no multi-stage turnover tax included in offered prices (except for any turnover tax imposed by the country of origin). In essence, the turnover tax discouraged exports and encouraged imports, to the detriment of domestic production and employment. This problem became more critical for businesses as European countries moved toward greater economic integration and more open borders for international trade in the 1950s and 1960s. When France innovated the value-added tax, a tax that could remove tax from the prices of traded goods, countries rather quickly substituted it for the turnover taxes. The economic distortions were less with the new tax: it did not harm international competitive positions, it did not artificially encourage vertical integration, and it could produce large amounts of revenue.[37] When France demonstrated that such a tax could successfully be collected, it was no surprise that European countries moved to replace their turnover taxes with such a tax.

Businesses have created strategies to minimize the competitive impact of the tax, incurring some extra costs with the strategies, but at less cost than the amount of tax saved. These strategies are a natural outcome of the need for businesses to remain competitive. Recent experiences are most apparent in Washington and West Virginia.

Two strategies identified by a Washington State tax study show how the gross receipts tax induced some businesses to change their organizational structure:[38]

> A Washington State manufacturer creates an out-of-state subsidiary to legally be the primary manufacturer. The subsidiary imports goods into Washington and contracts with the Washington entity as a processor to complete the manufacture of the goods. The manufacturer pays tax on the contract payments it receives as the processor, rather than on the value of the goods produced.
>
> A Washington wholesaler establishes itself as the purchasing agent in dealings with its customers. The agent purchases goods from manufacturers and transfers them to retailers in exchange for a commission. The wholesaler (purchasing agent) owes tax on the commission, rather than on the value of the goods the retailer receives.

Similar manipulations of business practices were apparent as businesses worked to minimize the West Virginia tax:

> The business and occupation tax applied "to the entire amount of the general contract and then again to the dollar value of sub-contracts let by the general contractor. If sub-contracts are made by the initial sub-contractor, at each successive stage the entire dollar amount of all these sub-contracts is taxed. The total tax liability in such circumstances could readily add up to a rate of 10 or 12 percent on some portions of the original general contract. This duplication of the tax base results in a prohibitive total tax burden. The total tax paid by contractors on a given general contract can be reduced by various devices, including the avoidance of sub-contracts and excluding from the contract price the materials used in performing a contract. Sub-contracts may be eliminated by having the firm which lets the contract enter directly into separate contracts with each subcontractor, so that the dollar amount of the general contract is only for the work actually performed by the general contractor. The value of materials used by the contractor is excluded from the contract, such materials being purchased by the firm which lets the contract. This device is more easily employed by larger firms, which can take advantage of quantity discounts, than by the smaller firms."[39]

The examples have in common the objective of reducing the amount of Business and Occupation Tax owed, not of improving business operations. There will be extra costs in the business arrangement but those costs are less than the amount of tax

[37] A turnover tax was an important revenue source for the Soviet Union also. The tax levied highly differentiated, product-specific tax rates, making it more like a large system of selective excises than a general gross receipts tax and certainly maximizing its economic distortions, dislocations, and inequities. But the Soviet system was not terribly concerned about interference with market choices.

[38] Washington State Tax Study, p. 113.

[39] Vance Quentin Alvis, "The West Virginia Gross Sales Tax," *West Virginia University Business and Economic Studies,* 7 (June 1960), pp. 70 – 71.

saved. The gross receipts tax manages to distort economic practices, to cause businesses to contract in a more awkward and expensive fashion, and to create bias against smaller firms.

FAIRNESS

A first concern in establishing the fairness of a tax is to determine whether the tax base makes logical sense for dividing the cost of government services. The two generally accepted standards are ability to pay and benefits received. According to the first measure, economic entities that have more ability to afford the cost of government services should pay more for those services. Gross receipts measures scale of operations but, in contrast to measures of profitability, fails to tell much about relative capacity to bear that cost. Entities with high gross receipts may be on the steps of bankruptcy court—or already there—while small firms may be entirely successful, just as some large entities may be profitable and some small ones may be abject failures. Gross receipts by itself is not an acceptable guide for the affluence and economic ability of an entity. This provides a partial explanation of why the Washington Business and Occupation Tax and a number of earlier gross receipts taxes applied different tax rates for different types of business activity. But political clout and ease of shifting the tax forward in higher prices shaped the rate patterns as much as likely affluence—and, within business types, there are usually both successful and unsuccessful individual businesses, meaning that the gross receipts tax remains a poor tool for taxing according to ability to bear the cost of government.

The fairness issue emerges across businesses as well, where it is an accepted principle of tax policy that equally situated businesses should be treated equally by the tax system. Different sorts of business are treated in distinctly different fashion by the gross receipts tax. The tax bears particularly hard on low-margin, high-turnover businesses in competitive industries. Such firms are less likely to be able to include the gross receipts tax in their prices and are more likely to have to absorb the tax out of their profits. But they are operating on a low margin and, accordingly, the tax threatens their survival. As businesses fail, margins in those industries will increase for the remaining firms, but that provides little comfort to the owners of businesses that have not survived. Low-profit margin firms face economic challenges under the best of circumstances and a gross receipts tax makes their challenges even more difficult. During recessions, firms are more likely to face marginal profitability and greater customer resistance to prices that cover the gross receipts tax.

Table 2
Median Effective Tax Rates for Major Industries, Washington State Business and Occupation Tax, 1984

Major Industry Class	Lowest in Class	Highest in Class
Agriculture, Forestry, Fishing, and Mining	5.8% (no subclasses)	
Contracting	7.2% (heavy roads)	10.7% (plumbing and heating)
Manufacturing	3.1% (petroleum)	24.8% (aluminum)
Transportation	1.3% (water)	4.8% (trucking)
Utilities	2.7% (communications)	10.0% (electric, water, gas)
Wholesale	10.2% (other durables; hardware, plumbing)	25.0% (petroleum)
Retail	2.4% (real estate)	38.2% (auto dealers)
Service	0.0% (hotel, motel)	21.7% (other services)

Source: Robert P. Strauss, "A Study of Alternate Tax Structures for the State of Washington," Center for Public Financial Management, Carnegie Mellon University, July 16, 1987.

A tax that applies without regard to profitability is likely to cause more firms to go out of business in those circumstances.

The problem is apparent in effective rates from the Washington Business and Occupation Tax. Table 2 presents median effective tax rates for representative firms in major industry classes and subclasses in 1984. The rates, calculated as Business and Occupation Tax paid as a percent of the firm's net income, vary widely across industries and across firms within major industry class. The table shows only the extreme class variations, but there are significant other disparities. For example, groceries faced an effective rate of 18.6 percent while eating and drinking establishments faced a rate of only 7.4 percent. It is difficult to see this range in effective rates and not conclude that the tax is unfair in its treatment of businesses. Firms with high turnover in relation to profits face higher effective rates than do those with high profits relative to turnover, and that pattern has nothing to do with the capacity of a firm to bear the cost of government nor does it have anything to do with the cost of providing government services to a firm. It is simply a reflection of unfair and inefficient tax policy.

Another inequity is in regard to the balance between firms serving in-state and out-of-state markets. The Ohio Commercial Activity Tax provides an illustration of the effect. Gross receipts from sales made out of state by an Ohio company are exempt from the tax; gross receipts from sales of exactly the same items made in-state are fully taxable. Therefore, two firms of equivalent economic size and profitability, one with most of its operations serving an out-of-state market and one with most of its operations serving the Ohio market, would face significantly different commercial activity tax bills and different effective tax rates. There is no standard of taxation that would support such variation and inequity in tax rates.

Finally, a gross receipts tax will place a tax burden on exempt entities. Even though state gross receipts taxes often (but not always) excuse non-profit organizations from paying tax on their receipts, they still must bear the burden of the tax that is embedded in their purchases. To the extent that they purchase from suppliers who have been subject to the tax, they will bear the tax embedded in the price of the product or service. Even if the purchaser or item being purchased is given tax-exempt status, prices paid will include gross receipts tax elements from earlier stages of the production and distribution process. The pyramiding nature of the tax makes the impact unavoidable.

TRANSPARENCY

The Washington State Tax Study observes: "People should know when they pay taxes and how much they pay. A good tax system is designed to ensure that the tax burdens on residents are clear and evident."[40] How are citizens to make reasonable decisions about government services if they do not know how much those services cost and who will be expected to pay for them? Transparency in taxation is a bedrock of democratic choice. Unfortunately, the extent to which lawmakers subscribe to this principle is less certain because, while provision of government services is politically popular, the levy of taxes is not. This problem is particularly serious in regard to questions of taxation of business entities.

A gross receipts tax violates transparency in two important ways. First, the tax may be imposed on a business but its burden will be borne by a household—as consumer, as owner of production inputs (including labor), or as business owner. It is not easy to identify which households end up bearing the burden. Richard Bird appropriately sums up the situation: "…it is not always clear exactly which people—owners, workers, or consumers—end up paying business taxes, but somebody definitely will pay. Hiding who really pays the bills is not a good way to ensure accountable public sector decisions."[41]

The second violation of transparency involves the pyramiding of tax imposed on pre-retail purchases in the production chain. The tax imposed on pre-retail transactions will be embedded in the production cost at each stage of the production chain, serving to raise the price paid in following transactions. When the final consumer purchases the product, its price reflects several pyramided layers of gross receipts tax, and it is impossible to know to what extent taxes increased the price. The final purchaser cannot know how much tax is actually reflected in the price, even if the customer understands what the tax rate is on the final transaction. The household bearing the burden of the tax does not know the amount of that burden, a clear violation of fiscal transparency and an impediment to informed decisionmaking about government operations. With most taxes, exemptions, deductions, and other provisions cause the effective tax rate to be lower than the statutory (or advertised) tax rate. The gross receipts tax is different: pyramiding makes the effective rate higher than the statutory rate.

Conclusion

This examination of American and European experiences with gross receipts taxation has identified several significant conclusions about the tax in modern fiscal systems. These may be summarized:

Broad base: The gross receipts tax base is broader than the total value of economic production. However, breadth itself is not a meaningful standard for evaluating a tax. The base is not logical as an indicator of either capacity to bear the cost of government or consumption of government services.

Low rate: Statutory gross receipts tax rates may be low, but not necessarily. Whether the legal rate is high or low depends on how much revenue the government intends to raise. Even with its broad base, a low rate on gross receipts is unlikely to contribute a major share of revenue to a modern state government. Low-rate, low-yield taxes often have high administrative and compliance costs relative to the amount of revenue generated.

Stable Revenue: A gross receipts tax appears to be roughly as stable as a retail sales tax. Its variations do not add overall stability of total state revenue because its fluctuations follow generally the same pattern as other major taxes.

Economic neutrality: A gross receipts tax distorts private market decisions. Its pyramiding creates a haphazard pattern of incentives and disincentives for business operations. It creates artificial incentive for vertical integration and discriminates against

[40] Washington State Tax Structure Study Committee, *op. cit.*, p. 5.

[41] Richard M. Bird, "A New Look at Local Business Taxes," *Tax Notes International*, 30 (May 19, 2003), p. 695.

contracting work with independent suppliers and the advantages of scale and specialization that production by independent firms can bring.

Competitiveness: A gross receipts tax interferes with the capacity of individuals and business to compete with those in other states and other parts of the world. The tax embedded in prices grows as the share of production within the state increases, so there is incentive to purchase business inputs from outside the state. And businesses must deal with the embedded gross receipts tax when they sell to out-of-state customers. Possibly most significantly, the tax discourages capital investment by adding to the cost of factories, machinery, and equipment, with the extent of disincentive dependent on how much of those capital goods are produced in the state. This tax structure does not promote growth and development of the state.

Fairness: A gross receipts tax does not treat equally situated businesses the same. Firms with the same net income will face radically different effective tax rates on that income, and low-margin firms will be at a great disadvantage. Many new and expanding firms have low profit margins (or even are initially unprofitable) and the gross receipts tax reduces the chance that these firms will survive. This also is not consistent with a climate for growth and development.

Transparency: A gross receipts tax is a stealth tax, with its true burden concealed from the public. The public does not see the tax because it is legally imposed on businesses and they have no way of seeing the pyramiding that converts a low legal rate into a much higher effective rate. Hiding the cost of government does not lead to efficient and responsive provision of government services and is entirely contrary to the fundamentals of democratic government.

It is sometimes suggested that gross receipts taxes allow simple compliance and administration; the concept of the tax is clear, and there is no need for the many deductions and adjustments required for a tax on profits. But the inherent inequities and disincentives of this simple tax create a demand for complications—for relief of industries in trouble or unable to shift the tax, or for relief of in-state businesses through differential rates, exemptions, and special treatment for certain economic activities. The response to these problems dissolves the simplicity and creates a new set of complications unique to the gross receipts tax. An illogical base cannot be insulated from the practical need for corrections to repair the effects of its fundamental defects. The problems become greater when revenue demands made on the tax are increased.

Many new and expanding firms have low profit margins (or even are initially unprofitable) and the gross receipts tax reduces the chance that these firms will survive.

No sensible case can be made for imposing gross receipts taxes in the modern economic environment. The old turnover taxes, typically adopted as desperation measures in fiscal crisis, were replaced with taxes that created fewer economic problems. Gross receipts taxes should never be seen as an element of positive tax reform. They were abandoned for good reason.

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122 C Street, NW, Suite 330
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Communications Director
Bill Ahern

Editor
Alicia Hansen

Tax Foundation
2001 L Street, NW, Suite 1050
Washington, DC 20036

ph. 202.464.6200
fx. 202.464.6201

www.TaxFoundation.org
TF@TaxFoundation.org