Analysis of a Business Net Receipts Tax

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Ernst & Young

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Outline

- Description of business tax reforms in other states
- What are the new, non-income state business taxes?
- Description of the net receipts tax concept
- Discussion of estimating methodology and preliminary estimates of the tax base for a CA net receipts tax
- Discussion of preliminary estimates of the economic incidence of a CA net receipts tax
- Questions and answers

Ernst & Young was engaged by the California Commission on the 21st Century Economy to conduct an independent, objective and factual analysis of the revenue impacts of an alternative California business tax base. Ernst & Young's analysis and presentation expresses no position on any tax policy proposals being discussed by the Commission.

What are states trying to accomplish with business tax reform?

- Improve business tax *system* competitiveness
  - Reduce taxes on mobile capital, including property taxes
  - Shift taxes to "out-of-state" taxpayers – move from origin to destination-based taxes; relax P.L. 86-272 constraint
- Find a more stable source of business tax revenue
  - Corporate income taxes fell 24% in last recession, increased 115% in 5 years, and have fallen more than 20% in this recession
- Tax all forms of doing business, not just corporations, to broaden the base, lower tax rates, reduce distortions
- Find an effective way to tax services and cross-border sales – issues of taxing business inputs and protection of *Quill*
- Changing perspective from ability-to-pay to benefits-received rationale for business taxes

Taxonomy of new state business taxes

Tax Base	Examples	Description of Tax Base
General gross receipts tax (GRT)	OH CAT, WA B&O	Gross receipts (GR) with few, if any, deductions
	TX tax base option	70% of GR
Modified GRT	1 of 2 new MI bases	GR minus purchases of goods from other firms
Value-added tax (VAT)	MI SBT (1975), earlier BAT (1953) NH BET (1993)	GR minus purchases from other firms Minimum tax based on modified VA (credit against corporate income tax
Gross margin tax	TX tax base option; NJ AMA	Gross receipts minus cost of goods sold (COGS)
Labor-adjust. GRT	TX tax base option	Gross receipts minus labor costs
Business income tax	1 of 2 new MI bases	GR minus labor costs, depreciation, interest paid, all purchases from other firms
Corporate inc. tax	Current CA tax	Same as bus. inc., but limited to corporations

Business tax rate comparisons

Tax rates needed to replace state and local corporate income taxes ($50 billion a year nationally)

Corporate income tax	5.8%
Business income tax	3.3%
Valued added tax	1.1%
Gross receipts tax	0.3%

Value added tax base is over five times larger than corporate income tax base

Recent state business tax reforms

► Ohio Reform (2005)

- New commercial activity tax (CAT): 0.26% times gross receipts in excess of $1m ($150 minimum tax); minimum filing threshold of $150,000
- Applies to all forms of doing business and most industries; economic nexus adopted
- Eliminated local business tangible property tax, corporate income tax & net worth tax; cut business taxes $1.4b (-9%)
- Destination sales; P.L. 86-272 not applicable; combined filing or elective consolidation with deduct. for intercompany sales
- Phased in over five years
- Revenue in first few years came in 10% above original est.

Recent business tax reforms (cont.)

- ► Texas (2006)
  - Taxable margin tax: 1.0% general rate (0.5% for whole. & retail) times selected base (70% of GR, GR – COGS, or GR – compensation); taxes most forms of doing business
  - $3.4b increase in business entity taxes; 18% cut in business personal property tax; no net change in total business taxes
  - Destination sales apportionment; P.L. 86-272 not applicable; mandatory combined reporting
  - No phase in of new tax
  - First-yr. collections came in 20% short of estimate
  - Legislature just passed bill to increase the minimum filing threshold from $300,000 to $600,000 permanently and to $1m for two years – expected to become law

Recent business tax reforms (cont.)

- Michigan (2007)
  - SBT ($1.8b) replaced with new system: business income tax (4.95%) plus 0.8% times modified GRT
  - GRT provides 2/3 of taxes; minimum filing threshold of $350,000
  - Applies to most bus.; destination taxes; economic nexus
  - GRT pyramiding reduced by subtract. purchases of tangible property
  - New entity taxes of $3.5b with $1.6b of new, targeted credits
  - Significant property tax reductions
  - Overall package shifts taxes from manufacturing to services

Recent business tax reforms (cont.)

► New Hampshire (1993)

- Adopted business enterprise tax (BET) – modified VAT that excludes rent paid and retained earnings from base
- Applies to all forms of business (as does profits tax)
- Firms pay both the BET (at 0.75%) and the business profits tax (8.5%), but the business profits tax allows a credit for BET taxes – BET functions as a minimum tax
- Minimum filing threshold for the BET is $150,000 of everywhere gross receipts or $75,000 of NH “value added” NH
- Reasons for adoption: stability, “neutral” consumption tax without economic distortions of profits or sales taxes, broadened base by extending tax to all forms of business and industries (0.5% of CIT firms paid 70% of tax), added new multistate taxpayers (P.L. 86-272)

Observations from other states' tax reform experience

- Modified gross receipts or value added taxes should create more stable business tax bases – countercyclical?
- Taxpayers with little or no profits will strongly object to non-income based business taxes
- Approach to calculating a state VAT may not be a big issue: MI used both addition (SBT) and subtraction (BAT) methods; NH uses the addition approach
- The immediate expensing of capital equipment presents unique challenges – potentially large subtractions for investing in other states; MI had migrated to an investment tax credit limited to instate investment

What is the proposed net receipts tax (NRT)?

- Tax base is the value a firm adds to purchases of goods and services from other firms. Can be measured as:
  - Total receipts minus all purchases from other firms, *or*
  - Firm's payments for labor and capital: labor costs, profits (retained or paid out), and interest, rent & royalties paid
- Key feature is the treatment of capital purchases: like other input purchases, capital purchases are subtracted (immediate expensing) with no future depreciation
- NRT can be described as a consumption-type VAT; does not tax "normal" income from capital investments
- Subtraction of all input purchases (goods and services) eliminates GRT pyramiding (double taxation)
- NRT can be thought of as a consumption tax (sales tax) or an entity-level business tax

Estimating assumptions for proposed NRT

- NRT applies to both corporations and pass-through business entities
- It applies to firms in almost all industries except:
  - federal, state and local governments
  - non-profits, including education and health services
  - religious and charitable institutions
  - financial services and insurance (no change from current tax)
- There is a small business exemption: a firm with less than $500,000 of CA tax base does not have to file a return
- The tax base is apportioned to CA using a single destination sales factor apportionment formula – exports are subtracted and imports are added in calculating the NRT base

Estimated CA net receipts tax base
(billions, 2007 levels of economic activity)

Industry	CA Gross Value Added	Capital Expend.	NRT Base	Small Bus. Exempt.	Taxable Net Receipts: Amount	Taxable Net Receipts: % Dist.
Ag, Mining	$78	-$51	$27	-$4	$23	2%
Construction	125	-8	117	-14	102	11%
Manufacturing	228	-26	203	-1	202	21%
Transportation	38	-8	30	-3	27	3%
Info. & Comm.	76	-13	62	-1	62	7%
Utilities	34	-10	23	0	23	2%
Wholesale Trade	84	-8	76	-1	75	8%
Retail Trade	155	-13	142	-11	131	14%
Real Estate	129	-56	73	-10	63	7%
Services	332	-38	294	-60	234	25%
Total	**$1,279**	**-$232**	**$1,047**	**-$105**	**$942**	**100%**

Estimated California NRT tax revenue

Tax Rate	Taxes (billions)
0.5%	$4.7
1.0	9.4
1.5	14.1
2.0	18.8
3.0	28.3
4.0	37.7
5.0	47.1
6.0	56.5

Note: These are static estimates with no dynamic impacts.

Methodology for estimating economic incidence of a NRT

- Methodology follows that used in the Minnesota tax incidence study – looks at long run incidence of taxes
- Tax incidence model determines how taxes that are legally imposed on businesses are ultimately “shifted” to CA residents through changes in prices to consumers, labor, capital, and land – *economic incidence*
- A firm’s ability to shift taxes to consumers in higher prices depends upon market conditions (local or national markets). If taxes cannot be shifted forward in prices, they will be shifted backward to immobile labor and capital through lower earnings

Methodology for estimating economic incidence of a NRT (cont.)

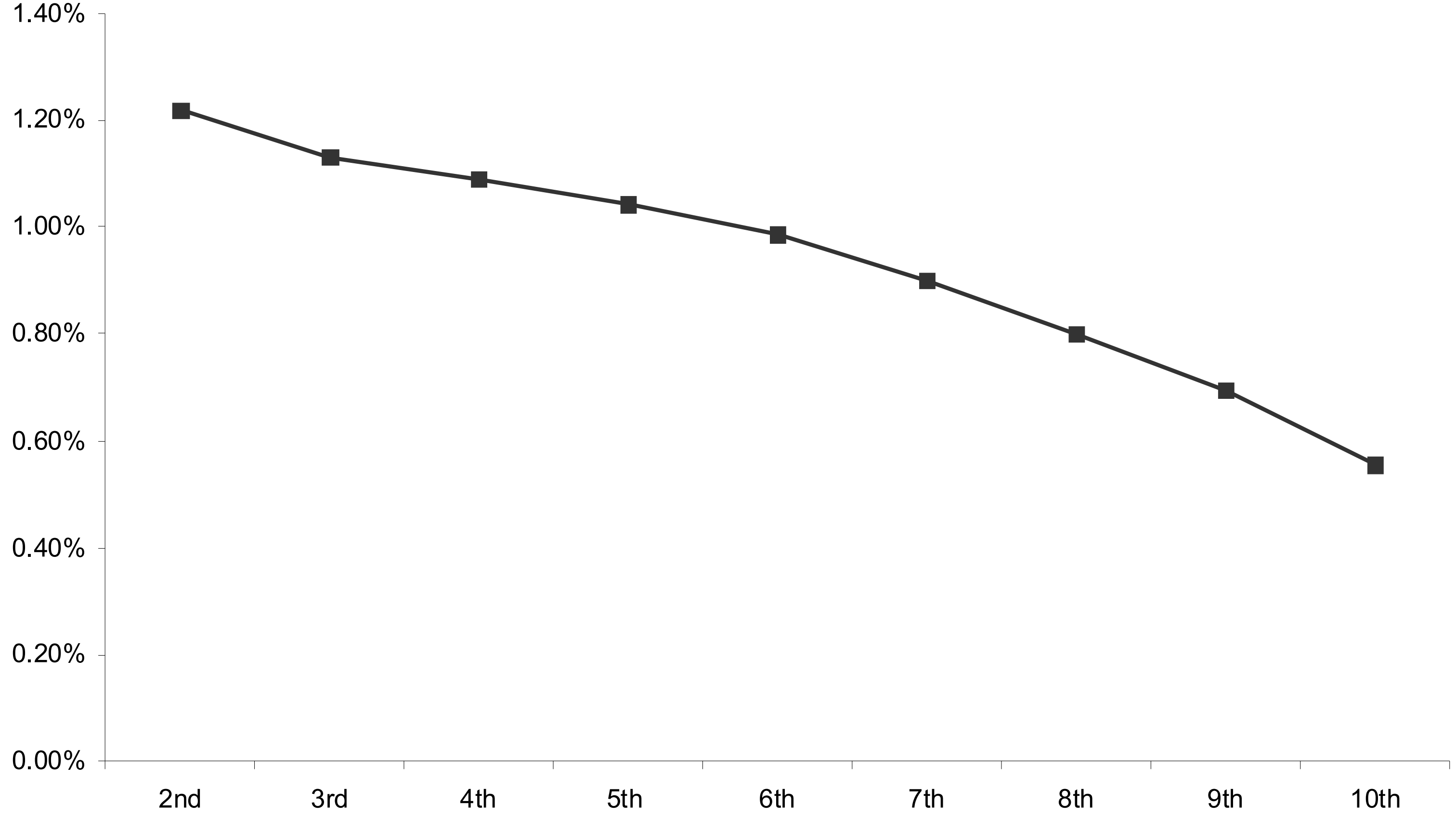
- Net receipts tax is added to existing state and local business taxes to analyze its economic incidence
- Impacts of taxes on prices depends upon the level of CA taxes relative to taxes in other states.
- Incidence analysis is done industry-by-industry based on differences between CA tax rates and U.S. average rates – tax rates are measured relative to value added
- An important determinant of the incidence of the NRT is the apportionment formula for multistate companies – the analysis assumes a single sales factor formula

Preliminary incidence results for a CA NRT

- Initial division of a $10 billion NRT
  - Higher prices for CA consumers (71%)
  - Lower CA labor income (19%)
  - Lower CA capital income (9%)
  - Exported taxes (1%)
- The initial NRT tax burdens are then allocated by AGI brackets to determine the household distribution of the tax burden (*economic incidence*)
- With apportionment based on destination sales (sales in or into CA), the NRT's incidence is similar to the retail sales tax.

Preliminary incidence results for a CA NRT – Distribution by income deciles

Effective tax rates (taxes/AGI)



Lessons learned from other states

- Business tax reform packages have included multiple taxes – focus on the system of state-local business taxes
- Not requiring a revenue neutral package of business tax changes provides flexibility to mitigate tax redistributions
- Importance of identifying winners and losers due to the significant shifts in tax liabilities among firms & households
- Important to involve the business community in the policy debate and the design of alternative business taxes
- Pay attention to the transition issues: phaseins, impacts on balance sheet tax items
- Focus on the long-run economic benefits of a more competitive state-local business tax system; expect targeted tax credits to be continued in new systems

Lessons learned from other states (cont.)

- Taxes that apply to all business forms may be "politically" more stable than corporate income taxes – all firms are affected by rate changes, for example
- *But:* "One lesson of the [MI] SBT experience is that efficient design features are readily sacrificed at the alter of practical politics." (Jim Hines, "MI's Flirtation with the SBT," 2003)
- In other words, it may be difficult to defend and preserve a state VAT over time – continuous pressures to add ability-to-pay features
- It is difficult to understand what a state VAT is. It *is not* a gross receipts tax, a business profits tax, or a tax on labor. It *is* a consumption tax, collected as an annual business entity tax, and apportioned to a state