The Politics of State Taxation

Stop Taxing Corporate Income

by David Brunori

"The Politics of State Taxation" is a column by State Tax Notes *Contributing Editor David Brunori, who welcomes comments at dbrunori@tax.org.*

Recently, I had the honor of speaking at the annual meeting of the Federation of Tax Administrators in Nashville, Tenn. I was asked to speak about current trends in state corporate taxation. In preparing for my talk I had a revelation: States should stop taxing corporate income.

Don't get me wrong. I am an unapologetic believer in taxing corporate profits. I think that the business community benefits from our great society, and it is fair to levy a tax on those beneficiaries.

Yet, despite my bias, I think its time we ended the charade that is the state corporate income tax system. Stop taxing corporations? That goes against my every instinct. And it probably goes against most of our readers' instincts as well.

But I stood before the Department of Revenue staff, people who understand the tax system better than anyone else, to say that we should stop pretending that the corporate tax is (1) an important source of revenue — because it's not — and (2) that we (society) have the will to fix the myriad of problems facing the tax — because we don't.

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We cannot fix the problems that plague the tax. So maybe its time to throw in the towel and stop taxing corporate profits, at least at the state level.

For years, people like me have been whining about how much trouble the tax is in. Very well-meaning people have decried the continuous decline in corporate tax revenue. They have criticized efforts on the part of the business community to minimize their corporate tax burdens, even when those efforts are both rational and legal. They have criticized legislators for not having the political will and courage to take on the corporate interests even though the political and business interests are often in sync. I think that we should stop whining about the demise of the corporate income tax and get on with our lives.

If you doubt the magnitude of the problem, I will relay some of my favorite examples.

Oregon, a state with a long and proud progressive tradition, raises more money from its lottery than from its corporate tax. This is a state that thinks it's immoral to tax consumption but has no problem paying the bills by taking money from its poorest citizens, who are tricked into thinking that their number is going to come in any day now. When Oregon runs ads for its lottery, it neglects to tell you that you have a better chance of being hit by lightning six or seven times in your life than of winning its jackpot.

I have talked to legislators in Oregon — Democrats — who are not the least troubled by this fact.

Montana — the heartland as far as progressive taxes are concerned — raises three times as much from excise taxes as it does from corporate income taxes. A legislator from Montana told me that the gasoline excise tax was better than the corporate tax because it did not hurt economic development and was voluntary in the sense that people controlled how much tax they paid by how much they drove. This was from a guy in Montana, where you have to drive 40 miles to buy milk.

Maine is another state with, by most state standards, a progressive history. Maine raises more money from taxing tobacco than it does from taxing corporate profits.

Connecticut — the state with the highest per capita tax burden in the country — raises almost as much money from its amusement tax as it does from its corporate income tax.

In New Jersey, according to the state treasurer, 77 percent of all registered corporations paid only the statutory minimum tax of $200. Ten corporations in New Jersey, all of which paid the minimum $200, had combined profits attributable to business in the state of $2 billion.

There are, of course, many more anecdotes. But if the corporate income tax cannot play a meaningful role in these states, what is the point? I think, and many others have long thought, it is clear that the states have long stopped taxing corporate income effectively. In 2001, the states collected $31.2 billion in corporate tax revenue. That is about 5 percent of total state tax revenue. Five percent! The corporate income tax accounts for only about 2 percent of total state revenue if intergovernmental aid and other nontax revenue are included.

As readers are well aware, this pales in comparison with the general sales tax — about 31 percent. It pales in comparison with the personal income tax — about 33 percent. It pales in comparison with aggregate excise taxes — about 20 percent. It certainly pales in comparison with aggregate user fees and charges. Did you know that the states raised five times more revenue from various charges and fees than they did from taxing corporate income last year?

In any event, the corporate income tax does not raise much money, at least not as a percentage of total state tax revenue. But the tax consumes an inordinate amount of intellectual firepower and economic resources in terms of planning, compliance, and administration. Think about who works in the field. Corporate tax lawyers and accountants, whether employed in private practice or the government, are among the smartest tax professionals around. Next time you attend a conference, check out the folks talking about corporate taxes. They are a very impressive lot.

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Lots of very smart — and expensive — people are continuously trying to figure out how to avoid the tax (through planning), deal with auditors, collect the tax, litigate the tax, play the violin over how the tax deters economic growth, and complain endlessly about falling corporate tax revenue. The best and brightest spend a lot of time consumed with state corporate income taxation. And I simply do not think it is worth it anymore.

I am aware of several people (including myself) who are conducting research on the costs of administering and complying with the corporate tax. Our preliminary — and I should stress preliminary — research indicates that the ratio of compliance/administrative costs to revenue is the worst — by far — of any tax. That is, taxpayers and state governments spend more money for every corporate tax dollar collected than for any other tax. This is not the easiest research to conduct because neither corporations nor state revenue departments are quick to volunteer such information. Still, the tax is probably the most inefficient, least cost-effective revenue source available to the states.

Who Cares?

So who wants to keep taxing corporate income? The business community does not want to tax corporate income. In fact, I am unaware of any business leaders, who want to tax corporate income. If they are, they are keeping pretty quiet. Even the more enlightened business leaders, who see the need for a strong public sector, do not want to tax corporate profits. I have talked to many business executives who would rather see a progressive personal income tax than more entity-level business taxes.

Perhaps the people are demanding that corporations ante up in support of government. But there seems to be no popular support for strengthening corporate taxes. The people — normal folks who are not thinking about formulary apportionment — do not seem to care one way or another.

Popular ambivalence practically ensures that the political debate on the issue will be one-sided. Legislators are inundated with the message that corporate taxes cost jobs, deter economic growth, and will send businesses packing to other states. Whether true or not, the message resonates because there are few alternatives taken seriously by the political elite.

I note that there are some organizations, such as the Center on Budget and Policy Priorities, that do excellent work critiquing state corporate taxes. But for every Michael Mazerov who conducts thoughtful research, there are hundreds of business lobbyists illustrating the real and imagined evils of business taxation. Those who advocate strong corporate tax systems are outgunned at practically every turn.

I actually believe that the only people who really make money from the state corporate income tax system are the major law firms and big accounting firms. In fact, I have talked to many partners in law and accounting corporate state and local tax practices. It is a funny thing — private practitioners in the law and accounting firms have little interest in repealing the tax. Not that I blame them. I have had many corporate tax practitioners tell me off the record that the tax pays the mortgage, and the car note, and the vacations to Europe, etc. . . . The shame is that these really smart people are busily guarding their clients against a tax that has little relevance. While they may prosper personally, they are part of a system that is adding little to society.

The truth is that a small segment of the private bar and accounting profession is making lots of money figuring out how to plan around the tax. The only others with whom I spoke who really like the tax are state economic development officers. Why would they like the tax? It is because the system allows them to give tax breaks to companies promising to locate to or remain in their state. I had a very wise man tell me that the corporate tax is like the cookie jar for those in the economic development business.

The Problems Are Legion

We all know the causes of the problem of corporate tax decline. They have been beaten to death in the literature. But I am going to beat them some more because they deserve beating. In no particular order:

Tax Incentives. Scholars have written extensively on the subject of tax incentives, which most believe violate every principle of sound tax policy. There are lots of things wrong with them (besides the fact that they are often unnecessary). But the problem for today is that they shrink the tax base. States have given out billions of dollars in corporate tax incentives over the past quarter century. More and more companies do not have to pay corporate taxes.

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Some people say that incentives are inevitable. That is, given the federal system in which we live and work, there is nothing any of us can do to prevent them. Some people say that incentives work in the sense that the state is better off economically after the incentives were granted than before. All of this may be true. But that is a discussion for another day. The bottom line is that tax incentives shrink the corporate tax base.

Complicating that is a whole industry of really intelligent people who do nothing but try to find corporate tax incentives for companies looking to expand or relocate their operations. The large accounting firms have whole departments whose sole purpose is finding and negotiating tax incentives.

To be sure, society has taken some important steps to curb incentive abuse. We now have reporting requirements and clawback provisions in some jurisdictions that help make sure that corporations that receive public money keep their end of the bargain. Too few states have such safeguards, but pressure is mounting to adopt more. But what cannot be denied is the fact that corporate tax incentives riddle the tax base. And there is little political interest in ending their use.

Separate Accounting. Another cause of the continuing decline is the failure of half the states to require combined reporting. That an otherwise unitary business can set up a subsidiary in a no- or low-tax state to shift corporate profits is in my opinion shameful. In separate-entity states — usually Delaware or Nevada — a corporation sets up a subsidiary. The corporation transfers intangible property to the subsidiary and then leases it back for some or all of the corporation's profits. The subsidiary does not pay tax. The corporation does not pay tax. It is a beautiful thing.

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A business lobbyist in Missouri chastised me for harping on this. She said that there were legitimate business reasons for setting up Delaware holding companies. I could not think of any. And when pressed, she really could not either.

I understand the theory behind separate-entity reporting. We want to respect the corporate organization. But many, I dare say most, of these corporations were established for one reason: tax avoidance. They have no employees. They own no tangible property, no offices, no pencils, and no coffee machines. They exist in the desk of a lawyer in Wilmington, Del.

The private bar and accounting firms are very well-versed in designing transactions and entities that take advantage of doing business in separate entity states. Sure, they lose once in a while (*Geoffrey, Kmart*), but they win — at least in beating the taxman — much more often than they lose.

Despite some rare, and in my opinion courageous, efforts, there is not much desire on the part of state legislators to address the problems associated with separate accounting.

Business/Nonbusiness Income. A no less commanding figure than Walter Hellerstein called the law surrounding business/nonbusiness income a mess. Gain from the sale of corporate assets is routinely allocated (usually to no- or low-tax states). Nothing ever occurs in the "ordinary course" of business. Every transaction is characterized as "highly unusual." So if a corporation has assets from its regular business that it would like to get rid of, it simply puts them into a subsidiary, waits a little while, and sells the shares of the subsidiary. Business income is transformed into nonbusiness income in a flash.

Now wise men such as Hellerstein describe the problem as adversely affecting both corporate taxpayers and the states. I think that the problem is much more serious for the states. Through careful planning, corporations can order their affairs in a way that allows them to take advantage of favorable law in certain states. While the states vary in their treatment of business and nonbusiness income, the corporations can — and do — plan around the variations.

And if you think that there is little legislative appeal to solving the problem of separate accounting, you can forget about states fixing the business/nonbusiness income problem. It is well off the radar screen.

Passthrough Entities. The limited liability company and limited liability partnership revolution has not been good to the corporate income tax. The trend in recent years has been to create LLCs rather than traditional C corporations (when there are no particular reasons for a C corp entity such as raising capital through the markets). It is difficult to determine how much corporate revenue has or will be lost because of the new entities. But there is a loss.

Playing With Apportionment Formulas. The other phenomenon that has decimated the corporate tax in recent years has been the movement to single-sales-factor apportionment formulas. That follows the earlier movement toward double-weighted sales formulas. I believe that the lack of uniformity in apportionment formulas is the single largest cause of corporate tax revenue decline.

There are two problems. First, only corporations that will reap substantial benefits lobby their legislators for single-weighted sales formulas. They are usually the largest manufacturing corporations in the state.

Second, the fact that some states use single-factor apportionment, some use more heavily weighted sales factors, some don't tax corporate income, and a few still use the traditional three-factor formula, creates a plethora of planning opportunities. And it is those planning opportunities that allow corporations to radically lower their tax burdens.

In the end, the states that watered down their three-factor formulas have lost a lot — some estimates go as high as a billion dollars a year — of corporate tax revenue.

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Some public-spirited people manage to convince legislators that single-sales-factor apportionment is merely a giveaway to corporations. This happened recently in New Jersey. But the trend has been to increase the weight of the sales factor, and there does not appear to be significant support for altering that course.

Why Tax Corporate Income?

We know the problems with the tax. We also know the policy reasons for taxing corporate income.

Need Money. The most obvious reason to tax corporate profits is that the states need more money. This is especially true now. Police officers, teachers, and department of revenue employees need to be paid. Taxing corporate income — with even a little more effort — would probably close the budget gaps in every state.

Diversify the Tax Base. Another reason for taxing corporate profits is that it helps diversify the tax base, which has long been considered a good thing. Most public finance experts believe that the government should impose a variety of taxes at a low rate. The corporate income tax could, if given the chance, play an effective role in alleviating pressures on other types of taxes.

Protect the Income Tax. Traditionally, the reason given for taxing corporate income has been to protect the personal income tax. And many people a lot smarter than me have opined on this subject. I guess the theory is that folks will form corporations and retain earnings (that is, not pay dividends) and everyone escapes taxation. But over the past quarter century, the corporate income tax has declined, while the personal income tax has been a bull. I am not sure which tax needs more protecting.

A Benefits Theory of Corporate Taxation. For me, the best reason for taxing corporations is that they benefit from services provided by the state. Corporations enjoy police, fire, health, education, and transportation services. And they should pay for those services at least a little. Now the true beneficiaries of the public services provided to corporations are the shareholders. And the shareholders generally do not reside in the state — this is especially true of publicly traded and multinational corporations.

The best reason for taxing corporations is that they benefit from services provided by the state.

The only way of ensuring that the shareholders will pay for benefits provided by the state is through a corporate income tax. And if the corporations do not pay taxes, then the shareholders will not be paying either. Business types will tell you that corporations create jobs (and further business for suppliers). Their employees and vendors pay taxes. Of course, their employees and vendors are also receiving benefits from the state. Business types will also tell you that they pay a lot of property taxes (which is often true). But property taxes take care of local government — not the state.

I do not know if this "benefits" theory of corporate taxation works. Every time I try it out on people smarter than me (which is basically every time I talk about it), I get confused looks. But it's the best theory that I can come up with.

So What Do We Do?

Theoretically, we know what needs to be done to strengthen the state corporate tax. The most common suggestions are: requiring combined reporting; curbing the use of incentives; broadening the definition of "nonbusiness income" to its constitutional limits; and achieving a level of uniformity in the application of apportionment formulas. Sound familiar? They should. Leading public finance thinkers have been saying these things for years.

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But there is little public support for such reforms. The public is ambivalent at best. And few political leaders will lead the fight for reform. Taking a position that is counter to many powerful business interests requires a level of political bravery rarely seen in the tax field.

I say that with a lot of sadness because I firmly believe that strengthening the state corporate income tax is the right thing to do. Gov. James McGreevey (D) has taken some steps to fix this problem in New Jersey. Missouri Gov. Bob Holden (D) also tried unsuccessfully. No one else seems to care — even though many states are hemorrhaging money. There does not seem to be any hope. The political opposition to corporate tax reform is so great, the mantra that corporate taxes deter economic growth and cost jobs is repeated so often, that for every McGreevey out there still carrying on the fight, several thousand have given up.

Yet, if you do not fix the problems, the decline in corporate tax revenue, at least as a percentage of overall revenue, will only continue. The corporate tax structure presents a plethora of planning opportunities that can be used to legally minimize tax burdens. It is perfectly logical for the business community to pursue them. And an increasingly talented and technically savvy private tax professional is more than capable of maximizing the investment in tax planning. The states are locked in an ongoing competition to attract business. There is no indication that the competition will ease. Thus, it is not likely that states will give up on the idea of tax incentives or apportionment rules favoring in-state business.

At some minimum level of revenue (either in dollars or a percent of total tax revenue), a tax becomes irrelevant. That is, it does not matter if revenue is falling because no one is counting on it. At a still lower level of revenue, a tax becomes a burden on government and its citizens — it is not cost-effective to collect. And resources would be better spent elsewhere.

The state corporate income tax is at that juncture now. ✰