Why Are We Taxing Corporate Income?

by David Brunori

In 2003 I proposed that states repeal their corporate income taxes. I was not motivated by ideology, but by the belief that the state corporate income tax is inefficient and ineffective. The points I was trying to make were that:

- the corporate income tax did not raise a lot of money;
- without combined reporting and other safeguards, it would never make a lot of money;
- it consumed an inordinate amount of resources (planning, litigating, auditing); and
- we should stop pretending it mattered because it doesn't.

I was really being polemic. What I was trying to do is get policymakers to consider what needed to be done to strengthen the tax. Personally, I think the states should adopt combined reporting, expand the definition of business income, use throwback rules, and curb tax incentives. I also think that all states should use a uniform apportionment formula and work with the Multistate Tax Commission. Of course, if states are unwilling to do what it takes to make the tax meaningful, they should repeal it.

But it occurred to me that supporters of the corporate income tax have not articulated reasons for strengthening the tax. Before we undertake corporate tax reform, we should identify why a strong state corporate tax is important.

Is it because we need the money? We certainly need the money. But the state corporate income tax does not raise a lot of money relative to other taxes. In 2009 it raised about $40 billion. If we're keeping the tax because we need the money, we should impose it the right way. Stop watering down apportionment formulas and handing out tax incentives, and adopt combined reporting.

Do we want a strong tax because corporations derive benefits from the government? Businesses enjoy the protections and benefits of the state public safety apparatus, infrastructure, the courts, and the schools. I have always believed that was a strong justification for taxing corporate profits. But if it's true, why do we use single-sales-factor or double-weighted sales apportionment formulas? Those formulas encourage corporations to invest and employ more without incurring higher taxes. That's not the definition of a benefits tax.

> ***If you think the tax is important, you should be able to articulate a reason for imposing it.***

Perhaps we want to tax corporate profits as a means of redistributing wealth. That is, do we tax corporations to increase the overall progressivity of the system? Most of my liberal friends justify the tax that way. Many believe that the corporate tax burden falls squarely on the heads of fat-cat shareholders. But many if not most American workers are shareholders through 401(k) or pension plans. Besides, there has been a 40-year debate over the incidence of the tax. Some economists believe it falls on owners of capital in the form of lower returns. Some think it falls on consumers in the form of higher prices. Lots of people think it falls on labor in the form of lower wages. I have no idea what the answer is.

We can articulate policy reasons for taxing sin, personal income, and consumption. But we can't easily identify policy reasons for taxing corporate income. This question is important for several reasons. First, we do need the money. And corporate profits have steadily risen over the decades while corporate tax revenue has not kept pace. Second, corporate tax rates matter in the global economy. Third, we do spend an inordinate amount of resources dealing with the tax. But most important, state corporate taxes will increasingly come under attack in this country. Ohio has jettisoned its tax. There have been proposals in Rhode Island and other states to do the same. If you think the tax is important, you should be able to articulate a reason for imposing it.

Repealing the Corporate Income Tax in South Carolina

South Carolina Republican gubernatorial candidate Nikki Haley is making repeal of the corporate

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income tax a focal point of her campaign. She obviously sees no reason to impose the tax. She is likely to win. And from what I understand, there are many legislators who support her proposal to repeal the tax. The problem with Haley's plan is that she offers no source of funding to offset the lost revenue. The tax raises about $220 million a year. But she is not offering specific budget cuts to offset the lost revenue. That would make repealing the tax more difficult. But that the candidate likely to win is strongly advocating repeal illustrates my point. The folks in South Carolina who favor a corporate tax will have to articulate why it's needed.

Oops

Back in June, the Rhode Island Department of Revenue estimated that those making more than $10 million a year would pay about $5.22 million more in personal income taxes under the state's new law. But the department has revised those projections and now believes that those really rich guys will pay about $500,000 less in personal income taxes under the new law. Gov. Don Carcieri (R) says that is a good thing. But lots of liberal lawmakers supported the tax-cutting plan with the understanding that the wealthiest in the state would not benefit.

Speaking of Rhode Island

Some conservatives are upset because Rhode Island is threatening to shut down 900 businesses for failure to remit sales tax to the state. But the citizens and business community in the state should be applauding. If a business is collecting sales tax and not remitting it to the state, it's cheating. And that is unfair to the thousands of businesses in the state that pay their taxes and obey the law.

Good for Gov. Schwarzenegger

California Gov. Arnold Schwarzenegger (R) recently called for an expansion of the sales tax to all services and a lowering of the sales tax rate. That, of course, is classic good tax policy, and the governor should be praised. The governor said that the United States is a service-oriented economy and that it was unfair and inefficient not to tax half the consumption in the state. The California Taxpayers' Association — never interested in sound tax policy — immediately rejected the governor's idea. The association won't support higher taxes on anything, even as part of a revenue-neutral plan. That attitude makes reform impossible.

An Interesting Argument

Idaho Rep. Phil Hart (R) owes the state $53,000 in income taxes, penalties, and interest. Actually, he doesn't think he owes anything, and he appealed to the Board of Tax Appeals. But his appeal was untimely and rejected by the board. So in fact Hart does owe the money. Hart says that because he is a legislator he should have been given more time — the deadline should have been waived for him.

Really? Hart is a tax protester who stopped filing tax returns in 1996 because he thought the income tax was unconstitutional. He's lucky he's not in jail.

Fodder for Tax Professors

Some of us believe that the sales tax should be imposed on all final personal consumption, lest all kinds of ridiculous distinctions appear. In New York, bagels purchased for "takeout" are not subject to sales tax. They are designated as food for home consumption and exempt. If you eat your bagel in the bagel store, you are taxed, of course. But if you get your "takeout" bagels sliced, they are subject to tax. Perhaps this distinction has something to do with the possibility that if it is sliced, you might eat the bagel in car before you get home. Some have speculated that the tax is justified because of the additional service of slicing the bagel. I just think it illustrates how wacky the sales tax can be sometimes.

More importantly, who buys bagels sliced with nothing on them, anyway? And what is up with people from New York saying you can't get a decent bagel, pizza, or Chinese food outside the city?

Speaking of Wackiness . . .

If you run a blog in Philadelphia, the city wants you to pay a $300-a-year business license tax. It doesn't matter if your blog makes a profit, the city needs the money. If I were a blogger in Philadelphia, I would move to the suburbs. Of course, I would have to sell my house in this depressing real estate market. Luckily, I blog tax free on tax.com. ✰

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