A NEW APPROACH TO STATE CORPORATE TAXATION

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INTRODUCTION

State corporate income taxes generally conform to the basic design and provisions of the federal tax. The federal corporate income tax operates as a separate tax from the federal individual income tax. This means that corporate income is taxed twice: first at the corporate level as it is earned, and again at the individual shareholder level when (after-tax) corporate income is distributed to shareholders as dividends or shareholders realize capital gains on the sale of the corporation's stock.

Three significant economic distortions arise from this "double tax" design. First, because partnerships, LLCs, and other noncorporate businesses are only taxed once, at the individual owner level, the corporate income tax discourages forming a business as a corporation. Second, because undistributed corporate income is taxed at a lower rate than distributed corporate income, the corporate income tax distorts the decision away from distributing income in favor of retaining income. Third, because corporate income (the return to equity holders) is generally taxed at a higher rate than interest on loans (the return to lenders, many of which are tax exempt), the corporate income tax distorts the decision away from financing with equity in favor of financing with debt. The federal corporate income tax also contains a number of provisions that narrow, and therefore distort, its base. Most important among these distortions are provisions that result in mistiming of deductions and income, such as the provisions for accelerated forms of cost recovery for investments, including the "bonus depreciation" provisions of the 2008 and 2009 stimulus bills. In addition to understating certain types of income, these provisions also differentially reduce the effective tax rate on alternative forms of investment, distorting investment choices. Another important distortion arises from the deduction for domestic production activities, which favors certain activities over others.

At the state level the "double tax" issue differs between large and small corporations. For large corporations, the "double tax" primarily arises from the taxes of different states — the corporate level tax of the state in which the corporation operates, and the individual-level tax of the state(s) in which the shareholders reside. The corporate-level tax imposed on a large corporation by the state in which it operates is necessary to equalize the tax treatment of corporations and noncorporate businesses operating in the state, since the entire income earned in the state by noncorporate businesses is taxed by the state, regardless of where the owners reside. For this reason, a separate corporate-level tax imposed by the state in which a large corporation operates has a separate justification from the federal corporate tax, even if this state tax can be thought of as resulting in a "double tax" because another state or states tax the dividends and capital gains of shareholders. For small corporations, however, both the corporation and the shareholders are likely to be taxed by the same state, so the state can design its tax system to mitigate the "double tax" on the income of small corporations.

In addition to economic distortions due to conformity with the federal tax, other distortions arise from state corporate income tax provisions that determine the appropriate amount of tax to impose on the income of multi-state businesses. These businesses are typically part of a large number of related entities that may have multiple transactions among them. Such transactions include sales, asset transfers, cost sharing arrangements, charges for services and royalties for the use of intangibles. The number and complexity of these transactions make the determination of the income attributable to each state very difficult. The distortions due to state corporate income taxes affect the level and location of investment and economic activity. Also, these distortions may be exacerbated by effect of special provisions on the actual or perceived "business climate" of a state.

States have introduced special provisions that attempt to properly match the income and expenses of a multi-state corporation to the activities in a state. These special provisions include (1) mandatory combined reporting; (2) authority to reallocate income, deductions, and other items between related entities; (3) "add-back" and "anti-passive investment company" legislation; (4) minimum

taxes; and (4) significant franchise taxes. These rules tend to be complex, requiring significant compliance resources from both corporations and state tax agencies. They also have generated significant litigation. In addition, the actual or perceived "business climate" of a state may be heavily influenced by presence and nature of such rules.

State corporate income taxes are "pro-cyclical," exacerbating the drop in state revenues in downturns. The U.S. General Accountability Office (2004) reports that 32.7 percent of large U.S. corporations reported no tax liability in 1995, and that percentage rose to 45.3 percent by 2000. Nationally, corporate income tax revenues declined 12.2 percent in the year ending June 2009, after declining 7.3 percent in the year ending June 2008, a cumulative decline of 19.7 percent, after growth of 15.4 percent between June 2006 and June 2007. Auerbach (1984, p. 5) notes that corporate income tax revenues have declined steadily as a fraction of U.S. GNP over the past three decades. He adds that "one reason for the decline in corporate tax collections since 1953 has been a decline in corporate profitability. Another has been the reduction (from 52 percent to 46 percent) in the corporate tax rate. However, the most important factor has been the introduction of several investment incentives...." More recently, Gupta et. al., (2009) document a similar decline in total state corporate income tax collections relative to total state taxes from 1982 until 2002. Fox et. al. (2007) note that state corporate income tax revenues as a share of profits are falling.

Also, the federal corporate income tax is complex, and the provisions states have added also tend to be complex. This complexity results in significant compliance costs for both corporations and state tax agencies. This complexity has also generated significant, expensive litigation. Brunori (2002, pp. 47-48) notes that the state corporate income tax "consumes an inordinate amount of intellectual firepower and economic resources in terms of planning, compliance, and administration." Slemrod and Blumenthal (1993) estimated that the average state corporate income tax compliance cost for large (Fortune 500) corporations was 30.5 percent of total compliance costs of $2.11 million, or about $0.64 million. Adjusted for changes in the CPI, state compliance costs today would average nearly $1 million, or $21,000 per state for all corporate income tax states. Importantly, Slemrod and Blumenthal found that these costs rose much more slowly than company size and increased significantly if the corporation was in a tax appeal or litigation.

State corporate income taxes are generally the result of apportionment of the total income (or tax on total income) among the states in which the corporation operates. A multi-state business's corporate income tax liability in a state where it has income tax nexus, is given by the following formula:

$$T = [(P_i/P)^* F^P + (W_i/W)^* F^W + (S_i/S)^* F^S] * t * \pi,$$

where T is the corporate income tax in state i, F^P is the factor weight on property, F^W is the factor weight on payroll, F^S is the factor weight on sales, P is the total property of the firm, P_i is the property in state i, W is the total payroll of the firm, W_i is the payroll in state i, S is the total sales of the firm and S_i is the sales in state i, t is the corporate income tax rate in state i, and π is the total profits (taxable income) of the corporation.

McLure (1980, 1981) uses these factors to show that the apportioned state corporate income tax is equivalent to a tax on the apportionment factors. He concludes (McLure, 1980, p. 342), "therefore, any single state would seem to be well-advised at least to replace the corporation income tax with a tax levied directly on corporate sales, payrolls and property...". Similarly, Gordon (1986, p. 221) concludes, "On efficiency grounds, taxes should be designed to minimize the extent to which economic decisions are made to avoid taxes, for any amount of revenue raised. This report has argued that corporate [income] taxes create greater efficiency costs than would a combination of property, payroll, and sales taxes."

We use the McLure-Gordon prescription as the basis of a proposal to replace the state corporate income tax with a corporate franchise tax based on the level of in-state apportionment factors (property, payroll and sales) above specified threshold levels. The rationale for this new approach is fourfold: (1) the current state corporate income tax is highly inefficient; (2) the factors provide a reasonable proxy for benefits received, but under a corporate income tax are taxed very unevenly, exacerbating inefficiencies; (3) the franchise tax thresholds remove tax from smaller firms that would incur disproportionate compliance costs and greatly reduce compliance costs for large firms; and (4) revenue from the franchise tax would be much more stable.

The remainder of the paper is organized as follows. The second section describes the methodology used, the third section presents empirical results, and the fourth section discusses the summary and conclusions.

METHODOLOGY

State corporate income taxes are generally the result of apportionment of the total income (or tax on total income) among the states in which the corporation operates. Historically three factors, property (the ratio of property in the state to total property), payroll (the ratio of payroll in the state to total payroll), and sales (the ratio of sales in the state to total sales), were equally weighted in the apportionment formula, but many states now weight sales more heavily. Using the historical three factor formula and McLure's notation from above, the state corporate income tax can be expressed as:

$$T = P_i\,(t\pi/P)/3 + W_i\,(t\pi/W)/3 + S_i\,(t\pi/S)/3,$$

where T is the corporate income tax in state i, P is the total property of the corporation, P_i is the property in state i, W is the total payroll for the corporation, W_i is the payroll in state i, S is the total sales for the corporation, S_i is the sales in state i, t is the corporate income tax rate in state i, and π is the total profits (taxable income) of the corporation. The terms in McLure's formula, $(t\pi/P)/3$, $(t\pi/W)/3$, and $(t\pi/S)/3$ are simply the effective rate of tax imposed by state i on P_i, W_i, and S_i, respectively. In practice, the effective rates on factors vary significantly across factors and across companies (see below), distorting input and location choices.

As a case study, we pick the thresholds for each of the apportionment factors and the effective rate such that corporate income tax rates are reduced to zero over a period of four years with the tax base remaining unchanged. This new approach is described and analyzed below as it could be implemented in New Mexico, but the essential features could apply in any state with a corporate income tax. The specific implementation would reduce New Mexico corporate income tax rates in steps between 2010 and 2013 and repeal the corporate income tax altogether in 2014, with the revenue in each year replaced by setting the appropriate rate for the new corporate franchise tax.[1]

Corporate income tax rates in New Mexico are 4.8 percent on the first $500,000 of net (taxable) income, 6.4 percent on the next $500,000 of net income, and 7.6 percent on net income over $1 million. In our case study, corporate income tax rates would be reduced over the 2010 – 2013 period. In 2010, the rate on the first $250,000 of net income is reduced to zero. In 2011, the zero rate extends to $500,000 and the top rate is reduced to 6.9 percent. In 2012, the rate for net income in excess of $500,000 is reduced to 5.9 percent. In 2013, the rate for net income in excess of $500,000 is reduced to 4.9 percent. The New Mexico corporate income tax would be repealed for taxable years beginning on or after January 1, 2014. The new franchise tax amount would be based on a corporation's property, payroll, and sales (as currently defined for apportionment of corporate income tax) in excess of a property threshold of $5 million, a payroll threshold of $1.2 million, and a sales threshold of $9.3 million. The rate of the new corporate franchise tax would be phased in to maintain revenue neutrality of the proposal. In the first year, 2010, the rate would be 0.04 percent. In 2011, the rate would be 0.08 percent, in 2012, 0.14 percent, and in 2013, 0.17 percent. Finally, in 2014 and thereafter, with the corporate income tax repealed, the rate would be 0.22 percent. The tentative franchise tax (New Mexico property, payroll, and sales times the applicable rate for the year) would be reduced, but not below zero, by the corporation's (and any related corporations') income tax liability for the year.

EMPIRICAL RESULTS

The following tables show the impact of the new approach by industry in 2014, when the corporate income tax has been repealed. These tables are based on New Mexico corporate income tax returns filed in 2006, extrapolated to 2014. Table 1 below shows the impact by industry for all corporations operating in New Mexico, Table 2 shows the impact on companies with a tax reduction, and Table 3 shows the impact on companies with a tax increase.

Of the 19,380 corporations operating in New Mexico, 7,776 (40 percent) would pay corporate income tax under current law in 2014. Under the proposal, corporate taxes would be reduced for 7,103 corporations, over 91 percent of all corporations that would pay corporate income tax under current law in 2014. The new franchise tax would apply only to 1,653 very large corporations. Nearly

Table 1

Effect on All Corporations Operating in New Mexico by Industry, 2014

Industry	Number of Companies	Under Current Law[4]		Change in Corporate Tax Liability		
		Number of Returns	Amount ($ millions)	Income Tax	Franchise Tax	Total
Oil and Gas	185	110	81.5	(81.5)	93.6	12.1
Other Mining	694	410	55.7	(55.7)	24.4	(31.4)
Utilities[1]	101	38	10.5	(10.5)	24.6	14.2
Manufacturing	1,605	699	73.9	(73.9)	70.6	(3.3)
Retail Trade	1,536	715	18.4	(18.4)	46.7	28.3
Information[2]	614	207	46.6	(46.6)	19.0	(27.6)
Finance and Insurance	1,819	505	15.8	(15.8)	16.5	0.7
Professional, Scientific & Technical Services[3]	2,319	878	6.4	(6.4)	13.6	7.2
All Other Industries	10,507	4,214	85.8	(85.8)	85.5	(0.2)
Total	**19,380**	**7,776**	**394.6**	**(394.6)**	**394.6**	**0.0**

Industry	Corporate Tax Liability Under Proposal					
	Corporate Income Tax		Franchise Tax[5]		Total	
	Number of Returns	Amount ($ millions)	Number of Returns	Amount ($ millions)	Number of Returns	Amount ($ millions)
Oil and Gas	0	0.0	42	93.6	42	93.6
Other Mining	0	0.0	93	24.4	93	24.4
Utilities[1]	0	0.0	14	24.6	14	24.6
Manufacturing	0	0.0	275	70.6	275	70.6
Retail Trade	0	0.0	139	46.7	139	46.7
Information[2]	0	0.0	67	19.0	67	19.0
Finance and Insurance	0	0.0	106	16.5	106	16.5
Professional, Scientific & Technical Services[3]	0	0.0	137	13.6	137	13.6
All Other Industries	0	0.0	780	85.5	780	85.5
Total	**0**	**0.0**	**1,653**	**394.6**	**1,653**	**394.6**

[1]Utilities include electrical generation, electrical transmission, natural gas distribution, and water supply.

[2]Information includes telecommunications (telephone, mobile phone, Internet providers, cable, and satellite), radio and television broadcasting, and newspaper and magazine publishing.

[3]Professional services include legal services, architectural services, accounting and business consulting; scientific and technical services include research, computer hardware and software services, and repair services for appliances and technical equipment.

[4]Corporate income tax liability before credits. Excludes current $50 franchise tax.

[5]Franchise Tax Thresholds: $5 Million for Property, $1.2 Million for Payroll and $9.3 Million for Sales; Franchise Tax Rate in 2014 is 0.0022 (0.22%).

Table 2

Effect on All Corporations Operating in New Mexico with a Tax Reduction by Industry, 2014

		Under Current Law[4]		*Change in Corporate Tax Liability*		
Industry	*Number of Companies*	*Number of Returns*	*Amount ($ millions)*	*Income Tax*	*Franchise Tax*	*Total*
Oil and Gas	94	94	66.3	(66.3)	46.4	(19.9)
Other Mining	376	376	54.1	(54.1)	15.7	(38.4)
Utilities[1]	31	31	4.6	(4.6)	1.0	(3.6)
Manufacturing	616	616	50.6	(50.6)	27.3	(23.3)
Retail Trade	650	650	7.0	(7.0)	2.5	(4.5)
Information[2]	188	188	45.9	(45.9)	4.1	(41.7)
Finance and Insurance	457	457	12.5	(12.5)	2.0	(10.5)
Professional, Scientific & Technical Services[3]	810	810	4.5	(4.5)	1.4	(3.2)
All Other Industries	3,881	3,881	59.1	(59.1)	15.6	(43.5)
Total	**7,103**	**7,103**	**304.6**	**(304.6)**	**116.0**	**(188.6)**

	Corporate Tax Liability Under Proposal					
	Corporate Income Tax		*Franchise Tax*[5]		*Total*	
Industry	*Number of Returns*	*Amount ($ millions)*	*Number of Returns*	*Amount ($ millions)*	*Number of Returns*	*Amount ($ millions)*
Oil and Gas	0	0.0	12	46.4	12	46.4
Other Mining	0	0.0	53	15.7	53	15.7
Utilities[1]	0	0.0	3	1.0	3	1.0
Manufacturing	0	0.0	95	27.3	95	27.3
Retail Trade	0	0.0	34	2.5	34	2.5
Information[2]	0	0.0	21	4.1	21	4.1
Finance and Insurance	0	0.0	33	2.0	33	2.0
Professional, Scientific & Technical Services[3]	0	0.0	56	1.4	56	1.4
All Other Industries	0	0.0	231	15.6	231	15.6
Total	**0**	**0.0**	**538**	**116.0**	**538**	**116.0**

[1]Utilities include electrical generation, electrical transmission, natural gas distribution, and water supply.

[2]Information includes telecommunications (telephone, mobile phone, Internet providers, cable, and satellite), radio and television broadcasting, and newspaper and magazine publishing.

[3]Professional services include legal services, architectural services, accounting and business consulting; scientific and technical services include research, computer hardware and software services, and repair services for appliances and technical equipment.

[4]Corporate income tax liability before credits. Excludes current $50 franchise tax.

[5]Franchise Tax Thresholds: $5 Million for Property, $1.2 Million for Payroll and $9.3 Million for Sales; Franchise Tax Rate in 2014 is 0.0022 (0.22%).

Table 3

Effect on All Corporations Operating in New Mexico with a Tax Increase by Industry, 2014

Industry	Number of Companies	Under Current Law[4]		Change in Corporate Tax Liability		
		Number of Returns	Amount ($ millions)	Income Tax	Franchise Tax	Total
Oil and Gas	30	14	15.1	(15.1)	47.1	32.0
Other Mining	40	18	1.6	(1.6)	8.6	7.0
Utilities[1]	11	7	5.9	(5.9)	23.7	17.8
Manufacturing	180	63	23.3	(23.3)	43.3	20.0
Retail Trade	105	56	11.4	(11.4)	44.2	32.7
Information[2]	46	8	0.7	(0.7)	14.8	14.2
Finance and Insurance	73	19	3.3	(3.3)	14.5	11.2
Professional, Scientific & Technical Services[3]	81	24	1.9	(1.9)	12.3	10.4
All Other Industries	549	201	26.7	(26.7)	70.0	43.3
Total	**1,115**	**410**	**90.0**	**(90.0)**	**278.6**	**188.6**

Industry	Corporate Tax Liability Under Proposal					
	Corporate Income Tax		Franchise Tax[5]		Total	
	Number of Returns	Amount ($ millions)	Number of Returns	Amount ($ millions)	Number of Returns	Amount ($ millions)
Oil and Gas	0	0.0	30	47.1	30	47.1
Other Mining	0	0.0	40	8.6	40	8.6
Utilities[1]	0	0.0	11	23.7	11	23.7
Manufacturing	0	0.0	180	43.3	180	43.3
Retail Trade	0	0.0	105	44.2	105	44.2
Information[2]	0	0.0	46	14.8	46	14.8
Finance and Insurance	0	0.0	73	14.5	73	14.5
Professional, Scientific & Technical Services[3]	0	0.0	81	12.3	81	12.3
All Other Industries	0	0.0	549	70.0	549	70.0
Total	**0**	**0.0**	**1,115**	**278.6**	**1,115**	**278.6**

[1]Utilities include electrical generation, electrical transmission, natural gas distribution, and water supply.

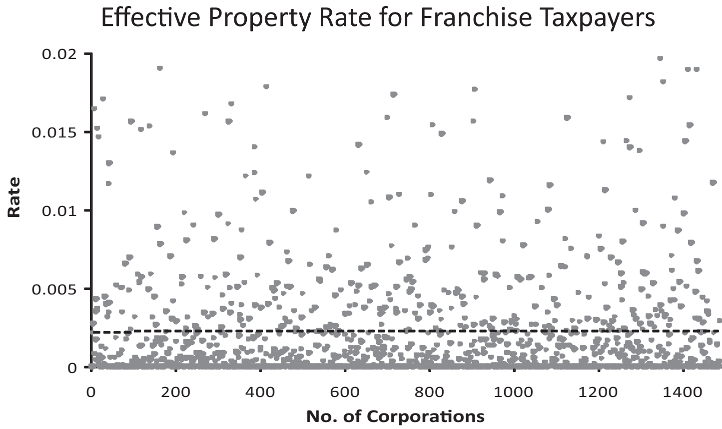
[2]Information includes telecommunications (telephone, mobile phone, Internet providers, cable, and satellite), radio and television broadcasting, and newspaper and magazine publishing.

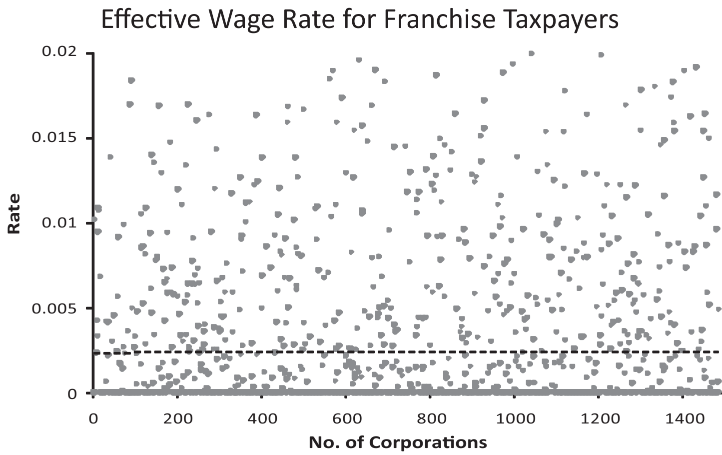
[3]Professional services include legal services, architectural services, accounting and business consulting; scientific and technical services include research, computer hardware and software services, and repair services for appliances and technical equipment.

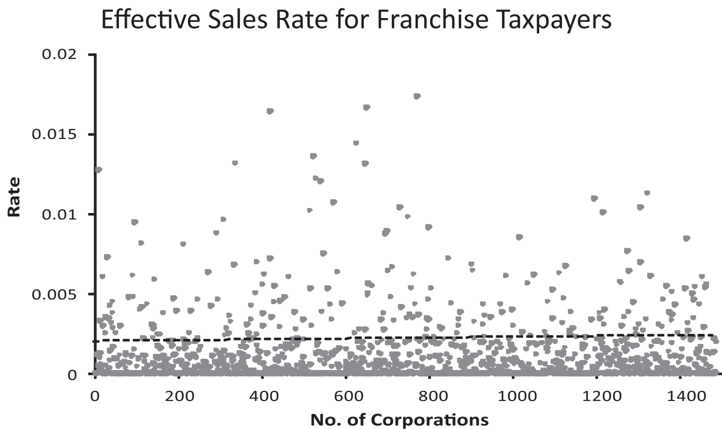
[4]Corporate income tax liability before credits. Excludes current $50 franchise tax.

[5]Franchise Tax Thresholds: $5 Million for Property, $1.2 Million for Payroll and $9.3 Million for Sales; Franchise Tax Rate in 2014 is 0.0022 (0.22%).

Figures 1 - 3: **Effective Property, Wage, and Sales Tax Rate for Franchise Taxpayers in New Mexico for the Year 2014 (based on 2006 data)**







one-third of these corporations (538) would still have a net tax reduction because their corporate income tax reduction is larger than their franchise tax. The remaining 1,115 corporations paying the new franchise tax would have net tax increases. Only 410, or about one-third, of these corporations would pay corporate income tax under current law. By industry, retail trade would have the largest tax increase, followed by utilities and oil and gas; other mining would have the largest tax reduction, followed by information.

The previous discussion of McLure's (1980, 1981) analysis indicated that there is significant variation in the effective tax rate on each apportionment factor under current corporate income taxes. This variation is illustrated in the following scatter plots. Figures 1, 2, and 3 show the effective rate on each factor in New Mexico for large corporations. Note that New Mexico uses even weights for all three factors, with the exception that manufacturers can elect to use a double-weighted sales factor. The dashed line in each scatter plot is the (uniform) franchise tax rate (.22% percent that would apply in 2014.

SUMMARY AND CONCLUSIONS

It is well known that state corporate income taxes are distortionary, have high compliance costs, and are an unreliable source of revenue; they need to be replaced by other forms of taxation. We argue that replacing the state corporate income tax with a factor-based franchise tax would significantly improve state taxation of corporations. The proposed change would remove the distortions inherent in the current corporate income tax, including the highly uneven effective rates on apportionment factors, and reasonably relate corporate tax liabilities to benefits received. The compliance cost of the new franchise tax would also be an order of magnitude less than the corporate income tax, in part because the franchise tax thresholds would remove from tax smaller corporations, which have disproportionate current compliance costs. The factor-based franchise tax would have a much more stable base, helping to remove uncertainty from budget forecasting and decision making.

Notes

[1] As part of the proposal (not modeled here), related business entities would be defined as corporations and partnerships and LLCs not taxed as corporations in which the corporation holds (directly or indirectly) more than a 20 percent ownership interest. Also, business entities with a common owner (of more than 20 percent) would be deemed related and an ownership of 80 percent or more would be treated as 100 percent ownership. This type of provision is necessary to avoid having corporate activity split into smaller corporate or noncorporate entities to avoid the new franchise tax.

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