

# Tax & Budget

BULLETIN

No. 19 • April 2004

## State Corporate Income Taxes Should Be Repealed

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All taxes create economic distortions and impose compliance burdens on the private sector. However, some taxes are particularly inefficient because they create large burdens while raising little government revenue. State corporate income taxes are perhaps the most inefficient taxes in the nation. They generate only a small share of state revenues but “consume an inordinate amount of intellectual firepower and economic resources in terms of planning, compliance, and administration.”<sup>1</sup> As such, states should consider repealing corporate income taxes as wasteful and unneeded parts of their fiscal systems.

### Declining Share of State Revenues

All states except Nevada, South Dakota, Washington, and Wyoming impose corporate income taxes.<sup>2</sup> State corporate income taxes raised \$32 billion in 2001, accounting for just 5.7 percent of state tax revenues and 2.7 percent of total state revenues.<sup>3</sup> These shares have declined since the late 1970s partly because corporate profits are more mobile than ever and companies have been effective at reducing their tax bills. In addition, government policies have reduced the corporate tax base. For example, rule changes have led to a rise in businesses organized as limited liability companies (LLCs), which are not generally required to pay corporate income taxes.

### High Compliance Costs

While states are receiving relatively less revenue from the corporate income tax, the tax continues to distort business decisionmaking and impose large compliance costs on firms. One survey found that business compliance costs for the state corporate tax were about twice as high as for the federal corporate tax, relative to tax collected.<sup>4</sup> The state corporate tax raises only about one-fifth as much as the federal tax, but has compliance costs that are more than two-fifths as high.

### Carving Up the Tax Base

Many corporations carry out production, distribution, and other activities in numerous states. What share of a firm’s national profits should each state be entitled to tax? In the past, a three-factor formula of property, payroll, and sales occurring in each state was used to “apportion” a firm’s profits between state governments. Today, varied and inconsistent formulas are used, and the definitions of the factors are subject to much debate and dispute.

With large differences in corporate tax rules between states, companies have incentives to restructure in order to minimize their tax burden. For example, firms can save money by moving labor-intensive production to states that de-emphasize payroll in their apportionment formulas. Tax-saving opportunities also arise because of differential taxation of intangible assets. For example, Delaware does not tax the earnings from intangible assets, thus firms should move trademarks to subsidiaries in that state.

For corporations, the complexity of state tax planning is magnified because of uncertainty in the rules for “nexus.” That is, there is no clear standard for how much presence a company must have in a state before it is required to pay tax. Indeed, there is increasing litigation over nexus issues, which wastes resources and creates a roadblock to interstate commerce because businesses fear triggering new state taxes when they expand.

### More Complexities

State corporate income taxes have all the complexities of the federal corporate tax, plus further problems:

- **Different state and federal tax rules.** Businesses need to keep track of different income tax rules for every state they operate in. In addition, state rules can differ from federal tax rules. For example, about 20 states did not follow the recent federal depreciation changes that allowed partial capital expensing.

- **Business vs. nonbusiness income.** State corporate taxes require that firms separate “business income” from “nonbusiness income.” Business income is apportioned between the states while nonbusiness income (such as interest) is assigned to the state of commercial domicile. This distinction is surprisingly complex and is subject to many legal disputes with different rules in each state. Once again, businesses have many opportunities to pursue tax-cutting ideas such as converting business income to nonbusiness income and then moving it to a low-tax state.
- **Separate vs. combined reporting.** Some states allow separate reporting for each company in a corporate group. Other states require combined reporting with the whole corporate group filing together. This creates many tax-planning issues for companies, such as whether to operate facilities in the various states as internal divisions or separate subsidiaries. A related tax-planning issue for companies involves how each state treats firms’ foreign affiliates.
- **Other complexities.** Businesses can shift profits from high-tax to low-tax states in many ways. One way is transfer pricing, which can move profits between states by altering the prices of goods shipped between related corporate entities. Holding companies are another planning tool. They can be established to carry out certain activities in states where they are not subject to tax, such as Nevada and Delaware.

In sum, state corporate tax systems are all different, complex, and require extensive business tax planning. As corporate profits have become more mobile, states have increased their enforcement and added complex new rules to stop supposed abuses of often ambiguous laws. As an editor of *State Tax Notes* observes: “The only people who really make money from the state corporate income tax system are the major law firms and big accounting firms.”<sup>5</sup> Rather than continuing the costly battle between corporate tax lawyers and state tax administrators, states should throw in the towel on the corporate income tax.

### Swiss Cheese

One might have sympathy for state governments in their losing battle to grab a share of the mobile corporate tax base if they had not turned the tax into a Swiss cheese of narrow loopholes.<sup>6</sup> “Incentive packages” for favored companies and fancy credits for job creation, job training, and other activities have proliferated. Such narrow breaks

are unfair to businesses that pay the full tax load, and they open up government officials to corruption as firms lobby for special deals. Also, narrow breaks add to complexity in administration. For example, there are calls for states to spend more time and money monitoring firms that receive job credits to see if they actually create jobs. The reality is that even if corporate taxes were a good idea in theory, state politicians have shown that they are incapable of enacting simple and efficient corporate taxes in practice.

### Hidden Burden on Individuals

State tax systems should be efficient, but they should also be transparent so that citizens can understand how much the government costs them. The corporate tax is not transparent and hence causes much confusion. For example, Virginia’s governor Mark Warner says that he wants to increase corporate taxes because “individual taxpayers carry too much of the tax burden.” But Warner should know that individuals carry the burden of all the state’s taxes, including corporate taxes. One view is that the state corporate tax burden falls on individuals based on the apportionment factors of property, payroll, and sales. Thus, as states have moved to emphasize the sales factor in their apportionment formulas in recent years, the state corporate tax burden falls increasingly on consumers.

### Conclusion

State politicians have created a costly and complex mess with corporate income taxes. As the mobility of corporate profits continues to rise, the corporate tax will become more inefficient and tougher for states to enforce. The solution is to repeal them, with the modest revenue losses to state governments made up with cuts to state business subsidies. The result would be more efficient state fiscal systems that did not favor any particular industry but promoted higher growth in all industries.

<sup>1</sup> David Brunori, “Stop Taxing Corporate Income,” *State Tax Notes*, June 25, 2002. See also Kirk J. Stark, “The Quiet Revolution in U.S. Subnational Corporate Income Taxation,” *State Tax Notes*, March 4, 2002.

<sup>2</sup> Note that Texas has a franchise tax on corporations, which is similar to a corporate income tax.

<sup>3</sup> U.S. Bureau of the Census, “State Government Finances: 2001,” [www.census.gov/govs/www/state.html](http://www.census.gov/govs/www/state.html).

<sup>4</sup> Joel Slemrod and Marsha Blumenthal, “The Income Tax Compliance Cost of Big Business,” Tax Foundation, November 1993.

<sup>5</sup> Brunori.

<sup>6</sup> Peter Fisher, “Tax Incentives and the Disappearing State Corporate Income Tax,” *State Tax Notes*, March 4, 2002.