Reforming State Tax Systems

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XIV

Business Taxes

by

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Over the next several years, it is likely that many states will be reviewing their business taxes with the objective of modernizing or "reforming" them. They are going to perform these reviews more frequently than in the past for several reasons.

First, since 1981, federal tax policy toward business has gone through several major changes. In 1981, federal tax policy toward business sought to liberalize depreciation rules because of the severe inflation of the 1970s; thus, federal business taxes were reduced substantially. In 1982 and 1984, Congress began to limit such tax reductions, and, among other things, began lengthening the useful lives of certain assets (for example, office buildings) and eliminated some of the more generous business tax reductions contained in the 1981 legislation (for example, Safe Harbor Leasing). Judging by both President Reagan's tax reform initiative,[1] and the legislation passed by the House of Representatives on December 17, 1985,[2] federal business tax increases seem quite likely. Since more than 35 states with state corporate income taxes use a variant of federal taxable income as the starting point for determining their tax base, each state will have to decide if it wants to accept this new direction in federal business tax policy.

To the extent such increases in federal business taxes occur with a simultaneous lowering of the marginal tax rate, deductions for state business taxes will be less beneficial, and state business taxes relatively more important in overall business tax planning.[3] Of related interest is the fact that 25 years ago, state corporation tax collections were 1/18th of their federal counterpart, while 15 years ago such collections were 1/10th. In 1982-83, state corporate income tax collections were one-third of federal corporate income tax collections. Thus, state business taxes are growing in relative importance in the federal system of government both in financing public services and in business tax planning.

Second, there continues to be reaction to the 1983 U.S. Supreme Court case liberalizing state use of the worldwide unitary concept of taxation. Ironically, while the *Container* decision gave the states more latitude in applying worldwide combination to their business tax structure, the adverse political reaction from America's Japanese and British trading partners (both governments and firms with foreign headquarters) and the adverse domestic reaction by multinational corporations with U.S. headquarters have been so strong that a number of states have modified or limited their now constitutional application of the worldwide principle.[4] It is likely that such pressures for a water's edge approach will continue, and states that tax more broadly will be reviewing their policies.

Thus, in view of this increased likelihood of state business tax law change, or business tax "reform," it is timely to discuss what the components of such reform might include and what ingredients are needed to achieve legislative action. This chapter has several purposes:

(1) To classify major state business taxes;
(2) To discuss different views of what constitutes business tax reform at the state level;
(3) To discuss a number of emerging business tax issues that are likely to arise during legislative consideration and suggest how to deal with them; and
(4) To identify the analytical ingredients needed to achieve competing definitions of reform.

The perspective here is that of both an academic who has observed this process and of one who has been an agent of the legislative process, having most recently worked with the state of West Virginia and having assisted in the restructuring of its system of gross receipts and profits taxes. Where appropriate, changes made in West Virginia are used to illustrate the sorts of business tax reforms that, in the author's judgment, constitute solid progress.[5]

A Typology of Business Taxes

This section provides an overview of the various types of state taxes levied directly on business. Conceptually, taxes are imposed either on a measured economic *flow* or on a measured economic *stock*. There are three types of flow taxes: gross receipts taxes, value added taxes, and income taxes. The relationships among these taxes can be expressed by a series of simple definitions:

Value Added = Gross Receipts − External Purchases

Income = Gross Receipts − External Purchases − Internal Costs

Since, in general, total sales equal gross receipts for a firm, a gross receipts tax is equivalent to a general sales tax although the gross receipts tax is "paid" by business, while a sales tax is "paid" by the customer. A sales tax on specific types of sales is equivalent to a gross receipts tax on certain types of business. Of the three types of flow taxes, a gross receipts tax has the broadest base, a value added tax has the next largest base, and an income tax has the smallest base.

Only four states—Hawaii, Indiana, Washington, and West Virginia (until July 1987)—impose a broad business gross receipts tax, while 45 states impose broad sales taxes.

All states impose various forms of a specific gross receipts tax on items such as insurance, and 39 impose specific gross receipts taxes on various utility services (natural gas, electricity, telephone, and forms of transportation).

Only one state, Michigan, imposes a form of value added tax.

Forty-four states impose some form of a tax on net income. Michigan, Nevada, South Dakota, Texas, Washington, and Wyoming are the exceptions. These taxes differ materially among the states in terms of tax rates, method of apportionment, definition of taxable income, and definition of the taxable unit.

With respect to the business wealth taxes, there are essentially four types of such taxes that relate conceptually to the liability side of a firm's balance sheet. The four types, in order of increasing tax base size, are:

Capital stock = Par value of common stock
Stated capital = Capital stock + premium obtained from sale of common stock + proceeds of sale of preferred stock
Net equity = Stated capital + appropriated and unappropriated earnings − treasury stock
Invested capital = Net equity + long-term debt

Thirty-one states use some form of a business wealth tax: nine use the capital stock base; four, the stated capital base; 15, the net equity base; and three, the invested capital base.

Of the various direct state business taxes, the corporation net income tax is the most significant fiscally. In 1985, it represented 8.2 percent of total state tax collections. Gross receipts taxes levied on public utilities accounted for 2.9 percent, the various forms of business wealth taxes for 3.3 percent, excise taxes on insurance premiums for 2.1 percent, and severance taxes for 3.4 percent of 1985 state tax collections.

The Meanings of Business Tax Reform

Three distinct views on the meaning of business tax reform are worth articulating:

(1) The perspective on reform derived from the precepts of a "good" tax system;
(2) The perspective on reform based on the taxpayers' interests; and,
(3) The perspective on reform based on the tax collector's interests.

For there to be ultimately significant business tax law change, these views must be accommodated and compromised in the political process.

Business Tax Reform as a Derivative of a "Good" Tax System

This definition of reform usually depends on first identifying whether one is appealing to the benefit theory of taxation or the ability-to-pay theory of taxation in the taxation of business, and then applying the four principles of a good tax system. That is, given that one believes that business should be taxed at all,[6] the question arises whether such taxation should be related to specific benefits or to business' ability to pay. The answer to this question is probably more philosophic than empirical. Once answered, the task remains of deducing from the four principles how the benefit or ability-to-pay tax should be structured. Those principles are:

- A good tax system should achieve socially articulated distributional objectives;[7]
- A good tax system should be economically neutral (sometimes also called economically "efficient") and not alter consumer and business choices unintentionally in the process of raising revenues;
- A good tax system should be simple, certain, and inexpensive for the taxpayer to comply with, and easy and economical for the tax collector to administer; and
- A good tax system should raise sufficient revenues to finance socially desired public services.

These four principles have several practical implications that limit the nature of business taxes to be imposed. First, with respect to equity, it must be recognized that achieving vertical equity in the taxation of business is technically quite difficult because any system of progressive tax rates creates an incentive for a business to subdivide into units whose tax base falls into the lowest marginal tax rate bracket. Thus, one finds the argument for a proportional business tax rate to be quite compelling. It also should be noted that just as there is a need at the state level, as well as at the federal level, to coordinate the top marginal tax rate of individuals and corporations in order to be neutral regarding incentives for incorporation or dis-incorporation, there is good reason to set the top personal tax rate and the business tax rate at roughly the same level, especially if both are levied on comparable measures of income. Clearly, a top personal tax rate of 4 percent and a top business tax rate of 7 percent will cause small firms to become sole proprietorships and vice versa.

If one accepts the proposition that state business tax rates should be proportional, then the remaining equity issue is horizontal equity. Achieving horizontal equity implies that the observed effective tax rate among firms, subjected to the same measurement of tax base, should be the same. It also follows from the second principle of a good tax system, economic neutrality or economic efficiency, that the tax "wedge" facing firms that compete generally should be the same. Thus, if the observed pattern of effective tax rates is the same across firms, it follows that the efficiency goal is being served as well.

Another corollary of these last two considerations is that firms that compete with each other should be taxed in the same manner; that is, the base should be measured in the same manner. It follows that the broader the definition of the base, the lower the tax rate can be to yield any given revenue target. In the discussion of newly deregulated markets in the next paragraph, this turns out to be an important principle to honor because firms come to such new markets from both regulated and nonregulated sectors.

It should be clear that the coordination of various tax instruments should be sought to achieve the desired uniformity in effective tax rates. It is bad tax policy, for example, to subject the sales of one firm to both a gross receipts tax and a consumer sales tax because of historical tax structures, while not imposing the same taxes on a new entrant into the same market. Again, this consideration is important in newly deregulated markets in which nonregulated firms may be subject to neither tax (but subject to general business taxes), while historically regulated firms must pay various forms of gross receipts taxes as well as general business taxes.

Second, achieving simplicity in a structure of business taxation is aided if the tax system is *not* classified. It also should be noted, however, that relying on the Internal Revenue Code as a starting point in the definition of taxable income, given the complexity of the code, is apt to lead to a complex business tax structure, albeit one that business taxpayers must deal with at the federal level.

Third, revenue adequacy and revenue stability are difficult objectives to achieve with business taxes. Corporate profits are notoriously volatile, and with the provision of net operating loss carry-back and loss carry-forward, being able to forecast business taxes is even more difficult. On the other hand, states are empowered to tax property, and the resulting business wealth or so-called franchise taxes inherently are more stable in terms of tax base from year to year than are profits.

Applying these four principles to practical business tax reform does have some meaningful implications and places some parameters on overall strategies for business tax reform.

Business Tax Reform from Business' Viewpoint

Business taxpayers are similar to individual taxpayers in that they have multiple and conflicting views on the meaning of tax

Second, in large companies with a multiple presence in a state, sometimes the parent company takes a position on a business tax issue that is different from one or several of its subsidiaries because the parent has made an internal compromise on the overall tax policy position of the corporation.

More interesting is the occasional practice of a parent corporation to allow its subsidiaries to move separately in state capitols and to allow each to express a different view. Sometimes large companies have as much difficulty deciding on their own public policy position as does a senate, house, and governor who are all of the same party. The result is that the parent company simply takes the view that things will work out in the long run with subsidiaries running off in opposite directions. Needless to say, this outcome often is confusing for legislators (and staff) trying to understand the interests of a particular company.

It is also possible for a company to change its position *over time* on a major tax issue in a fashion that can be at odds materially with the shareholders' interests. This situation usually happens when a lawsuit is initially won; however, the subsequent risk to the state's budget becomes so large that the successful litigants anxiously become advocates of a legislative remedy that results in no refund. This scenario is sufficiently complicated to warrant further explanation.

It is common for a company, or a group of companies within an industry, to take issue with a provision of a state business tax law. This opposition gets expressed through litigation, with the issue ultimately being resolved by the state supreme court or the U.S. Supreme Court. In such situations, the amount of state tax revenue at risk, should the state lose, can be quite substantial since victory can mean opening up past years of tax returns in favor of the taxpayers.[10] When the equivalent of such business tax class action suits against the state is won by the litigants, the dollar amounts can easily run into the tens of millions of dollars. Such court victories give state budget officers, tax committee chairmen, and governors great cause for worry. Usually, the result is panic legislation that one way or another plugs the hole in the fiscal dike. What is remarkable about such remedial legislation is that it is usually the litigants who agree to the legislative patch that reimposes a tax equal to the amount that otherwise would have to be refunded. The net effect of such litigation in dollars and cents turns out to be zero.[11]

Equally curious about this change in a company's position on a tax issue is that the agreement to the imposition of a new tax, or agreement to a retroactive tax equal to the amount of the refund due, is clearly at odds with the shareholders' interests. However, one has yet to hear of a successful shareholders' suit against management because it agreed not to press its victory in the courts all the way to the bank.[12]

As a result of this review of various business attitudes toward tax reform, it is fair to say that such views are likely to be heterogeneous, if not contradictory. There is probably, on balance, a strong element of tax minimization in business' initial position on what constitutes business tax reform, but numerous circumstances occur when other considerations may be more compelling to favor some sort of tax increase. Recognizing this complexity is the first step toward being realistic about the nature and prospects of legislating business tax reform. It goes without saying that successful legislation must deal with the major business taxpayers in the state and their position(s) among the range of possible ones just outlined.

The Government Position on Business Tax Reform and the Notion of Permanent Agendas

During more normal periods, several government perspectives on business tax reform are pervasive across state capitols: (1) the eventual necessity of dealing with tax issues that are on the permanent agenda of the state;[13] (2) the need to correct errors in previous legislation and respond to federal changes; and (3) the desire to make minor changes that have limited revenue implications and that are designed to achieve limited equity or political goals.

Every state has a history of issues and proposed tax law changes that fail for lack of sufficient votes. Such issues and proposed changes are brought up again over the years. The agenda varies from state to state and can reflect the industrial composition of a state's economy as well as its overall tax structure. The source of the issue, or irritant more properly viewed, can be historical accident[14] or the tidal wave of change that can occur to a state's economy, and for which its tax laws no longer are relevant.

Pennsylvania, for example, in the late 19th century enacted a business tax on the "actual value" of a corporation's capital stock, in effect imposing a form of business wealth tax; however, the enabling legislation passed in the third quarter of the 19th century provided no guidance on what "actual value" meant or how it should be determined. One does not know why the legislators agreed to such vague words; one conjecture is that they did so because that was all they could agree to. Obviously, systems of capital accounts must have been maintained that would have allowed a more precise definition of the tax base than simply "actual value of the capital stock." One can infer only that industrial views were sufficiently disparate that the definition simply was left to be worked out through practice.

Since its enactment, Pennsylvania's capital stock tax was an irritant to the state's business community as it constantly debated and negotiated the meaning of its capital stock tax, company by company, year by year. Tax study commissions met every few years and called for reform of the capital stock tax; after 100 years, this permanent agenda item was taken off the list by legislation that defined the term vis-à-vis a method of measurement.[15]

Other types of permanent agenda items include correcting what are considered long-time "abuses" in which certain classes of taxpayers are provided either very beneficial treatment, usually through exemption from a tax, or in which a class of taxpayers suffers from various forms of discriminatory (higher) tax treatment that are viewed as unduly burdensome.

Usually such "adverse" permanent agenda items are raised only by the more heavily taxed business owners; however, since the correction of such undue burdens entails a lower level of revenue, those in the adverse position have significant difficulty in finding enough allies to motivate legislative change. Other business taxpayers in a more favorable position recognize that the financing of such improved equity will be at their expense since legislators generally do not try to finance enhanced business tax fairness through higher personal taxes.

On the other hand, those permanent agenda items that involve favorable circumstances accorded through exemptions or exclusions usually are raised as targets for legislation by tax administrators and governors who are looking for additional revenues but do not want to disturb the entire industrial landscape, or are raised as targets by more heavily taxed businesses looking for relief.

Beyond such permanent agenda items, there is usually a set of administrative reforms that tax administrators want to see legislated, a set of minor tax bills that seek to clarify court decisions (or sometimes overturn them), or correction of technical errors. Typically, these types of tax bills are not construed by participants to constitute reform, but they are usually a major portion of the volume of state business tax legislation.

Some would call the provision of particular incentives, especially to attract a large industrial facility such as GM's Saturn plant, a form of business tax reform. This is somewhat of a misnomer, however, for the elimination or reduction of taxes for certain preferred taxpayers is really the use of the tax code for special social purposes.

Summary of Views Toward Business Tax Reform

This review of three different perspectives on what constitutes business tax reform is somewhat unsettling, for it is clear that it suggests that wide chasms can exist among participants in the tax revision process. Realism requires that such views need to be respected.

It should be pointed out that the notion of a "fair share" of taxes for business as a whole has not been included in this discussion of views, despite the fact that it is the presumed meat of many speeches by elected officials and business executives. However, other than looking at effective tax rates in relation to some agreed-upon measure of ability to pay,[16] and arguing that it ought to be the same for economic efficiency and horizontal equity reasons, the notion of "fair share" is elusive. Whether taxes, somehow otherwise measured, are too high or too low is difficult to substantiate intellectually. One reason for the difficulty in forging such a linkage involves the imprecise nature of the benefits of government services available to business, as opposed to individuals.

Having presented some notions of what business tax reform can mean, this chapter now turns to identifying the analytical ingredients for achieving such reform. The analytical ingredients involve first an understanding of the fundamental economic environment that affects state revenues and a state's citizens. Second, a set of data is needed that will allow legislators and the executive branch to identify the impacts of various policy proposals on various forms of business. Third, a set of evaluation criteria is needed to sort out proposals.

Recent Federal Policy Changes and the Implications for State Business Tax Policy

Changes Resulting from Federal Deregulation of Industries

Since 1978, significant portions of the national economy have been deregulated. Table 1 displays the industries that have been deregulated, the relevant federal legislation, and the national shares of employment in those industries. More than 5 percent of

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Railroads	1980	"Staggers Act" of 1980 + ICC Regulations	356.0	.3
Trucking	1980	Motor Carrier Act of 1980	1,365.1	1.3
Banking	1980	Deregulation and Monetary Control Act	2,451.7	2.3
Buses	1980	Bus Regulatory Reform Act of 1982	290.3	.3
Telephone	1983	Court Decision	923.7	.9
			5,916.6	5.4%

national employment occurs in industries that were formerly regulated by the states and the federal government. As is clear, the economic assumptions underlying many state business taxes based on monopolistic control no longer are correct, and there is a need to revise these statutes so that they conform to the realities of the marketplace.

Those companies that historically have been regulated and now are facing competition in the marketplace are pressuring for tax treatment comparable to that imposed on general, mercantile corporations. Given that a state is going to tax businesses, the central logic of business tax reform for these industries must be that businesses be taxed on the same basis. The failure to change the taxation of historically regulated companies that now are facing significant competition will shift resources to the more lightly taxed companies and away from those that continue to be more heavily taxed, since the after-tax rates of return will be more favorable for the more lightly taxed companies.

The significant deregulation that has occurred has changed the economics of firms in these industries, and in some instances, has led them to litigate against some aspects of historically industry-specific taxes. For example, many states are experiencing significant litigation over whether certain new charges, called "access charges," that resulted from federal deregulation of the interstate

telephone market, are properly excluded from the base of existing gross receipts taxes. Prior to deregulation, the imposition of a new form of charge would not be a major tax issue because the carrier would be able to calculate its rate of return and have the appropriate regulatory commission alter its pricing structure should its tax burden rise.

While there is good reason to treat these formerly regulated industries on the same basis, care also should be given to how the state wants to tax final consumption by households of those goods and services produced by such industries. For example, one may find the argument that the market for interstate telephone and related services is now competitive and seek to tax all sellers of such services on the same basis—for example, with a business franchise and corporate net income tax. There remains the question of whether one wants to tax final consumption (by households) of such services since they already may be taxed under the retail sales tax. To avoid double taxation, one then is led to eliminate the utility gross receipts tax on interstate telephone and related services or maintain the existing tax on all sellers of the service, whether regulated historically or not, and impose a tax on the household purchase of interstate and intrastate telephone and related services.

Of related interest is the likelihood that competition will have the effect of driving *down* prices in various markets, with the result that historic gross receipts tax revenues are likely to decline. Not only is it likely that prices will drop, but it is also likely that this new era of deregulation brings with it a greater price sensitivity on the part of consumers that may well cause further decline in revenues. This is likely to be the case not only in the telecommunications industry but also in the transportation industry. These revenue considerations again may be used to argue for looking toward general business taxes as a structure to impose rather than continuing to rely on various forms of excise or gross receipts taxes.

Folding more industries into the general business tax base is attractive for a number of additional, strategic reasons. First, it eliminates some of the distasteful aspects of the searchlight effect discussed earlier. Companies will benefit generally if they cannot be split off for special legislative consideration since the history of classified tax systems always has involved a complete search across the landscape over time. From the long-run view of businesses, they are better off if they are viewed as one broad entity. Second, from the view of government, a broad, consistently defined tax base is likely to be more stable in terms of long run

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Of related interest is the likelihood that competition will have the effect of driving *down* prices in various markets, with the result that historic gross receipts tax revenues are likely to decline. Not only is it likely that prices will drop, but it is also likely that this new era of deregulation brings with it a greater price sensitivity on the part of consumers that may well cause further decline in revenues. This is likely to be the case not only in the telecommunications industry but also in the transportation industry. These revenue considerations again may be used to argue for looking toward general business taxes as a structure to impose rather than continuing to rely on various forms of excise or gross receipts taxes.

Folding more industries into the general business tax base is attractive for a number of additional, strategic reasons. First, it eliminates some of the distasteful aspects of the searchlight effect discussed earlier. Companies will benefit generally if they cannot be split off for special legislative consideration since the history of classified tax systems always has involved a complete search across the landscape over time. From the long-run view of businesses, they are better off if they are viewed as one broad entity. Second, from the view of government, a broad, consistently defined tax base is likely to be more stable in terms of long run

revenues than one that has many special rules, for such rules inevitably create incentives for firms to move toward the more favorable classification in terms of their representations on their tax returns (or subsequently in court) that can lead to surprises for tax administrators.

Space limitations preclude a complete analysis, industry by industry, of the emerging tax policy issues that have arisen at the state level due to deregulation. Next, three industries are discussed in terms of how one might begin to tax them in light of their deregulated status: (1) financial institutions; (2) the transportation industry; and (3) the telecommunications industry. In each instance, attention is drawn to the new tax treatment accorded such industries as the result of major business tax reform in West Virginia.

Banks and Financial Institutions. The deregulation of banking and the innovative occurrence of interstate banking strongly suggest that various types of banks, commercial banks, mutual savings banks, and other thrifts should be treated similar to any mercantile corporation. Doing so will put them on the same basis as nonbank lending institutions that have competed in various lending markets without federal and state regulation.

There are two fundamental problems in the state taxation of banks if states seek to tax banks like other corporations:

(1) How to recognize various federal securities, both on the balance sheet and on the income statement, in a manner that is consistent with federal statutes and various U.S. Supreme Court cases; and
(2) In light of interstate banking, how to attribute the measured tax base to each state in which the bank or financial institution has some activity.

Fortunately, some progress has been made in the courts in terms of what can be in the base so that there is something left to tax; however, the question remains of how banking activity should be apportioned.

On March 19, 1985, the U.S. Supreme Court held in *First National Bank of Atlanta, etc., Appellant v. Bartow Board of Tax Assessors et al.*[17] that Section 3701 of Title 31 of the U.S. Code, dealing with the taxation of banks, permitted the limited pro-rata deduction for U.S. obligations from Georgia's bankshare tax base, and upheld the Georgia Supreme Court's reconstruction of the Georgia bankshares tax. Essentially, what this decision does is allow a state, in the case of a bankshares tax on banks' general net worth, to deduct the "percentage of assets attributable to federal obligations from determining the taxable base."[18] As a result, any general tax on any company's net worth, which reduced the net worth proportionately by the proportion of federal securities held, would not be problematical vis-à-vis federal statutes. It would seem to follow that an analogous reduction in a company's net income, in recognition of federal securities held, also would be permissible.

As a consequence, it is now technically possible to define the tax base of banks and nonbanks on an even basis.[19]

Legislation enacted in West Virginia in April 1985 takes advantage of this decision and eliminates any historical distinction between various forms of financial institutions. Thus, the income and net worth of any business entity (incorporated or unincorporated)[20] is adjusted as permitted by the *First National Bank of Atlanta* decision and the tax applied when the law becomes effective July 1, 1987. Significant questions arose as to whether West Virginia securities should be treated differentially from those of other states, and whether such differential treatment would be found discriminatory.

The second problem that arises in taxing banks like other general businesses involves the question of apportionment. For banks that are active only within a state, the issue of attribution of income does not arise; however, for larger banks, whose lending and related service activities cross state boundaries, let alone national boundaries, there are significant problems. The problem at hand involves the applicability of the three-factor apportionment formula that has been widely used by the states in some fashion for general apportionment. Levinson (1981) argues persuasively that sales, payroll, and property are not reflective of those economic factors that generate income for banks and financial institutions. Recall that property and payroll were included in such formulae because they represent common factors of production for many different types of businesses. For financial institutions, the most significant factor of production is *deposits*; however, whether geographic attribution of deposits is possible, given the volume of transactions by financial institutions on an hourly basis, is an open question.

The Transportation Industry. A review of the effects of recent federal legislation and regulatory changes at the Interstate Commerce Commission affecting trucking and buses indicates[21] that these two transportation forms are now clearly competitive. A number of states tax trucking and buses on a gross receipts basis, in addition to imposing various license and gasoline taxes that seek to relate the benefits (or damage) of the vehicle from (or for) the public roads. Gross receipts taxation no longer would appear to be justified, and movement toward either an income tax or an income tax and business wealth tax would be indicated. Since a form of benefit taxation exists through license taxes, there may be reason to apply only an income tax.

The primary issue remaining for transportation, as in the case of banks, involves apportionment. Two avenues would appear open: One could use historical concepts such as mileage or passenger/ton miles within a state vis-à-vis total such mileage or use the three-factor apportionment factor. To the extent that such physical measures more properly approach separate accounting, they would appear preferable.[22]

With regard to railroads, the situation would appear to be more complex. Moore (1984) indicates that "two-thirds of railroad rates are now free from maximum-rate regulation,"[23] which in turn suggests that in certain areas of the country the assumption of competition may be appropriate, while in others some form of local or regional monopoly is still operative. Whether such "market dominance" is operative should be the first question to answer in examining the propriety of taxing railroads on a competitive basis.

Again, the subsequent issue of taxation on a competitive basis involves how to achieve appropriate apportionment. As with trucking, apportionment of interstate gross receipts for railroads often has been on a physical ton-miles basis. To the extent this measure more perfectly reflects separate accounting, then it should be favored over use of the three-factor formula. Especially in the case of railroads, there is a problem in measuring the numerator of the property factor since a large portion of the property in fact moves through each state over time, and railroads have an incentive to move such property beneficially to escape such levies.

The Communications Industry. Historically, virtually all of the states have taxed telephone, telegraph, and related communications activities on a gross receipts basis. Interstate activity has been allocated or apportioned on the basis of a physical measure such as wire-miles of telephone cable. Over the past several years, it has become clear that the transmission of data and video data involves technologies that are increasingly similar to those used for the digital switching of voice communication. Distinctions among the technologies are blurring; however, the tax and regulatory treatment of firms engaged in essentially the same activities varies dramatically. Firms engaged in data-related activities generally are taxed under general business taxes and are not subject to such gross receipts taxes, while those firms engaged in voice communication (e.g., telephone communication) are taxed under various utility gross receipts taxes and also consumer sales taxes.

Nonregulated interstate companies such as MCI and Sprint have been actively competing with AT&T since divestiture, and local telephone companies must give their customers a choice as to which long-distance carrier they want to subscribe to. While local telephone service remains regulated by state regulatory agencies, a new phenomenon called "bypass" has become quite important to local telephone companies. Large business customers of local telephone service increasingly are installing their own telephones and related equipment within their organizations and bypassing local telephone service by using their own equipment in conjunction with privately owned, shared, leased, or subcontracted interstate services. As a result, local telephone revenues from business purchases have been falling, sometimes precipitously. Historically, local *residential* telephone rates have had a strong element of subsidy from local business telephone rates; however, as bypass becomes increasingly prominent, local telephone companies will be forced to price local business services closer to marginal cost with the result that local residential rates will go up substantially. This new phenomenon of "bypass" has the effect of creating local competitive pressures in what appears to be a regulated market.[24]

The West Virginia Telecommunications Tax is novel in several respects. First, the subject of the tax is quite broad and is telecommunications *activity* rather than certain, historically regulated firms. The term *telecommunications* means information transfer via telephone, radio, light, light wave, radio telephone, telegraph; it encompasses not only voice transmissions but also symbolic, encoded, and data transfers. Second, apportionment of interstate gross receipts is on the basis of relative communication pathways weighted by the number of channels. In turn, a *pathway* is a conduit, cable, microwave satellite, fiber optic cable; a *communications channel* is the smallest discrete circuit through which such telecommunication activity can be transmitted without destroying the information.[25]

Since the West Virginia consumer sales tax does not tax telephone services, the net effect of the new structure is to tax all forms of telecommunications activity at the same 4 percent rate. Unfortunately, business purchases of such services are taxed under the new structure, and in that sense, the new structure is comparable to historical gross receipts taxes levied on regulated utilities. A major challenge in forming such new tax instruments that are analogous to consumer sales taxes collected from the seller is to structure a system of exemptions for business purchases of such services. The very real threat of bypass by businesses should lend some impetus to the effort to tax only final consumption.

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The Proposed Federal Spreadsheet Approach to the Unitary Tax Problem: Prospects and Alternatives

As is well known, the Reagan administration has strongly favored the states moving from a worldwide approach to the definition of a unitary business to that of a "water's edge" approach; however, the working group that met for better than a year to work out differences between the states and multinational business was not able to get complete agreement on the part of several states, especially California, of what this would entail in terms of the treatment of dividends received and certain subsidiaries.

In July 1985, the U.S. Treasury Department released the so-called "spreadsheet" proposal under which the IRS would collect from larger corporations an information return that would report the firm's calculation for each state's tax liability.[26] Further, the IRS would provide such information back to each state that was not requiring worldwide unitary taxation. In effect, this was an incentive for states to narrow their reach, which had been broadened by *Container,* to water's edge. Certain multistage agencies also could get such "spreadsheet" information.

Aside from the value of encouraging states to move uniformly to a water's edge concept and away from the worldwide unitary approach that has become so contentious to America's trading partners, several possible problems with this approach to attributing income from the federal return to various states may limit its utility. These problems are both technical and political.

Since the federal Form 1120 is available to any state that passes legislation requiring it to be filed with the state return, it is not obvious what will be gained by having the IRS collect and turn over such data.[27] To the extent that states continue to define the numerators of their apportionment formulas differently as well as the filing unit, it is not clear what will be gained by this new procedure.

With regard to the states relying on a new, external authority for the administration of their corporate income taxes, one may question whether there will be any benefits. In 1972, as part of General Revenue Sharing, Congress enacted the optional federal collection of state individual income taxes. To date, no state has elected to have the IRS collect its personal taxes. Part of the reason for such reluctance is concern over the delegation of authority for audit to an external body, and the lack of state judicial standing that might accompany such a delegation of authority.

As an alternative to the Treasury "spreadsheet" approach to solving the reporting complexities of multistate companies, the recent West Virginia business tax reform legislation simply increases the information required at time of filing and takes full advantage of the salutory effects of signing on the jurat. In particular, the West Virginia legislation requires: (1) the mandatory provision of the federally filed 1120 return and supporting schedules of the taxpayer or its parent, including those schedules showing consolidations of the income statement and balance sheets; and (2) a signed, written explanation of the relationship between the state tax return and the federal return. Also, the denominators of the apportionment fractions in the West Virginia statutes are clearly related to the relevant items on the federal (or pro forma) return, so that the apportionment fractions relate to the same unit as the income base does.[28]

While there is no experience yet with this new approach to the reporting problem, it would appear to have several distinct advantages over relying on an external body. First, there is no delegation of authority. Second, the state is provided at the outset a signed explanation of how the state factors and income relate to various federal schedules. This information provides immediately to the audit staff the requisite information for further analysis if there is a question. Since the statement is signed and part of the state's tax compliance process, it should have a greater impact on the veracity of information provided than the Treasury spreadsheet approach. Under the Treasury plan, it would appear that the information provided to the IRS would be of an informational nature. At the same time, the West Virginia approach maintains the essential privacy in the relationship between taxpayer and tax collector, while the Treasury approach relies on external bodies to achieve compliance.

It also should be noted in this regard that the West Virginia approach does not necessarily require a state to use the same definition of the filing unit as that provided in the Internal Revenue Code. The completed federal Form 1120 provides information about 50 percent subsidiaries as well as those owned 80 percent or more, so that a state wanting to define the filing unit more broadly would have a basis for doing so.

Given the deep differences among business taxpayers, state tax administrators, and the U.S. Treasury, it is difficult to envision how any sort of federal legislation that accomplishes the objectives of the "spreadsheet" will occur. The experience with the United Kingdom Treaty on the floor of the U.S. Senate some years ago is a vivid example.

On the other hand, it is clear that should the Treasury and IRS want to help states in administering their various corporate income taxes, they can do so now without legislation. All the IRS needs to do is create a form analogous to Form 851 that shows the subsidiaries and their federal employer information number. On this

new form, e.g., Form 851A, the IRS need only require the taxpayer to show by state the amount of different state and local taxes paid that are deducted for federal purposes.

Through this new mechanism, any state requiring the filing of the federal return in conjunction with the state return then would see not only income taxes by state (and implicitly the base used), but also various sales taxes and local property taxes. This approach amounts to requiring firms to provide, on a mandated form, backup material for the firm's claimed deductions of state and local taxes. This method would provide most of the benefits of the spreadsheet, but without the need for legislation.

The IRS would be under some obligation to audit such information since it is directly related to the calculation of federal taxable income. Under the "spreadsheet" approach, there would be no federal interest in the geo-allocation of income among the states. The development of such a form by the IRS and Treasury is clearly within the regulatory authority of the Secretary of the Treasury[29] and in all likelihood would not constitute an undue burden for business.

Proposed Federal Depreciation Changes: A Proposal to Decouple State Depreciation Rules with One Set of Records

As noted initially, it is likely that Congress will continue to reduce the value of depreciation deductions by changing (lengthening) federal depreciation schedules. Movement from the accelerated cost recovery system (ACRS) to longer useful lives was contained in the "Treasury I" and "Treasury II" tax reform proposals and is also part of the House-passed bill. The question naturally arises whether states will want to decouple further from federal depreciation rules. A primary argument against such decoupling has been that it would require multiple sets of records.

One approach to decoupling that could be based on federally required and collected information would be to use the reconciliation between earnings and profits reported under financial accounting rules and earnings and profits reported under tax accounting rules. Schedule M of Form 1120 reports financial depreciation that is generally less generous than tax depreciation and would allow a state to provide such depreciation deductions in lieu of whatever Congress happens to decide is in fashion. To achieve a stated revenue target, one actually would *lower* the corporate tax rate since financial depreciation is less generous than tax depreciation.

Analytical Needs for Achieving Business Tax Reform

It is unreasonable to expect major actors in business tax legislation to agree on substantial changes unless the revenue and interindustry effects of such change are documented empirically in a trustworthy manner. Indeed, when West Virginia reformed its business taxes, which represent 40 percent of the total tax revenues in the state, concern was so severe about revenues that not only did the legislature and executive branch require the analysis of two years of data, but it also enacted the sweeping changes with an effective date that was two years after the date of enactment so that the tax department could examine two additional years of taxpayer data.

Space does not permit an extensive discussion of how one goes about collecting and constructing large-scale business tax simulation models;[30] however, there are several important points to be borne in mind with regard to such efforts.

Building a data base from state administrative records is tedious and time-consuming work. Like the federal government, most states maintain only minimal information about business taxpayers in machine-readable form. Usually, initial information about incorporation and mailing addresses and accounting data are all that are recorded. Very little is routinely keypunched from the physical returns, in part because such returns are long and highly complicated. Since many states impose a variety of business taxes, the first question one faces is which taxes/returns for each business are of interest. One recalls that most states impose some form of a business wealth tax and some form of a corporate income tax on most mercantile corporations. For historically regulated industries such as banking, transportation, communications, and insurance, a variety of special levies are imposed separately.

The second issue that inevitably arises involves the year or years of data that are to be examined. Note that there is necessarily a lag in the data for modeling purposes because of extensions of time to file and the length of time involved in achieving "settlement"—i.e., the point at which the taxpayer and tax collector agree on the figures. Statutory changes in federal net operating loss provisions have the effect of reopening state corporate income tax returns. Related to these considerations is the matter of the "representative year." Inevitably, one must choose a year or several years that are reflective of current or expected economic conditions. If one is not sensitive to this initially, one can be criticized later that the economy has changed dramatically since

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the data were collected. It may be of some comfort that federal analysts face the same imponderable problems, with sometimes unsettling results.[31]

Other issues related to collecting business tax data include the availability of reliable industrial affiliation codes[32] and the size of the sample. Since a number of states have input-output tables of their economies, some value exists in choosing the same industrial codes so that one can examine potential behavioral responses to proposed business tax law changes.[33] It is useful also to limit the number of industries to those that would fit on one page of paper to avoid getting lost in the detail and to see broad swings through a state's economy of possible policy changes. This limitation means approximately 45 to 55 industries.

If one uses 55 industries and insists upon at least 30 firms per industry in order to have some statistical reliability, then the sample size is about 1,700. When one also recognizes that the largest 200 firms probably pay 80 percent of the business taxes, then the problem can be a bit smaller; however, one must enumerate the large firms and add randomly selected small firms to the list.

To the extent one is examining an entirely *new* tax, for which there are no statewide revenue totals for current law, then one needs a larger sample to be statistically comfortable with the results. Where current administrative records at the state level do not contain the necessary data, one must go to federal sources (e.g., the IRS, and/or the taxpayer) for such information.

After locating the tax returns, collecting additional information from the IRS (under applicable disclosure statutes), and keypunching and verifying the data, one must weight the resulting sample to achieve statewide or industrywide revenue estimates. This is a time-consuming and artistic enterprise.

Overall, the entire process of collection and data processing takes about a year to do the first time and three-fourths of a year the second time. With such a data base, the analyst in the revenue agency (and *only* the revenue agency because of disclosure statutes)[34] is in a position to ask questions of the model. It is hoped that data were collected with such questions in mind, so that one does not have to go back to the administrative records or the taxpayer to collect the "missing" variables.

The construction of such a model can answer a wide variety of "what-if" scenarios that legislators, revenue commissioners, and governors may have in mind. It should be remembered, however, that such representations of reality are static or nonbehavioral. There is widespread disagreement in Washington, D.C., about how sensible such assumptions are. Given the need to balance state budgets annually, this means one can assume, at least for the first year, the possible responses of companies to changes in business tax laws.

The two objectives of tax reform that such models can analyze involve the revenue levels and equity of the possible changes. Looking at total revenues by industry gives an indication of the budgetary implications (and, implicitly, the politics of business tax reform). Examining the effective tax rates of representative business taxpayers will indicate possible equity and neutrality effects. Because business taxpayers are quite varied in situation, there is merit in looking at the median taxpayer under current law and under the proposal.

In April 1985, West Virginia rewrote its business tax laws in several important ways. First, a system of gross receipts taxation called the Business and Occupation Tax was eliminated and replaced with a new system of net worth and severance taxes. The corporate net income tax rate was raised, and the base was broadened. Second, all transportation and freight companies previously taxed under a gross receipts tax were put under the system of net worth and income taxes.

The new system of taxation materially evens out the distribution of effective tax rates. The analysis documenting this fact significantly affected the political process and led to ultimate passage of the legislation.

Conclusion

It is likely that pressures will grow over the next several years for states to reform or change their business taxes. For some states, the rationale for change will involve the need to stay "competitive" with neighboring states to attract industry and jobs. For others, it simply will reflect pressures to raise revenues. Most states still need to respond to major changes in a number of important industries: financial services, telecommunications, and transportation.

Business tax reform has several meanings, but taxing business on a consistent, broad basis and dealing with the unincorporated sector are good starting points. The business view of tax reform is greatly influenced by short-term considerations and the implications of proposed changes for cash flow. Large companies, however, often have diverse internal views of what constitutes reform: What may be desirable for one subsidiary may be problematical for another. It is likely that the business view will be heterogeneous and may well change over time. On the other hand, the goals of a good tax system are well known and are important ingredients for avoiding major errors in redesigning business tax systems. For tax reform to take place, there must be accommodation in these diverse perspectives.

Suggestions are made with regard to how states might tax previously regulated industries. A recent U.S. Supreme Court decision now makes it possible to take all financial institutions on the same basis as other business entities by proportionately reducing the tax base (income or wealth) in recognition of holdings of federal securities. This was done recently in West Virginia's tax legislation. Also, recent West Virginia legislation contains contemporary definitions of telecommunications as well as suggestions of when to tax transportation companies on a monopoly versus a competitive basis.

With respect to the proposed federal legislation on spreadsheets, which would have the IRS collect multistate tax data and report them back to certain states, it is suggested that this procedure could lead to loss of state interest as would be likely under federal collection of state individual income taxes. An alternative procedure contained in recent West Virginia legislation requires taxpayers to report apportionment denominators from their federal tax returns and explain through a written, signed statement the relationship between their state return and their federal return. This procedure has certain advantages.

Of the pending federal tax law changes that could affect state business taxes, the most likely is the redefinition of depreciation charges. To the extent that states want to "decouple" their depreciation schedules from ACRS or its successor and yet maintain "one set of books," it is suggested that they rely on depreciation reported on federal Form 1120. Since this depreciation is less generous than that used in calculating federal liability, the states would be able to maintain revenues and cut tax rates on income.

Notes

1. The White House, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity,* May 29, 1985.

2. See H.R. 3838 as passed by the U.S. House of Representatives, December 17, 1985.

3. For example, compare the value of deducting $1 of state taxes when one's federal tax rate is 50 percent to the situation when one's federal tax rate is 27 percent.

4. In 1984, 12 states initially employed some version of the worldwide unitary concept; however, by the close of 1984, three states (Florida, Massachusetts, and Oregon) abandoned it, while three more states abandoned it in 1985 (Colorado, Indiana, and Utah). Idaho, New Hampshire, and California abandoned it in 1986, leaving only Alaska, Montana, and North Dakota with worldwide unitary as of December 1986.

5. See the Conference Substitute to H.B. 1693 enacted by the West Virginia Legislature on April 8, 1985.

6. There is a point of view that holds that business should not be taxed, because only individuals own businesses, and individuals are taxed separately. However, most states, out of the belief that many holders of corporate shares do not pay tax (e.g., pension funds), out of opportunism, out of the need to have a "portfolio" of tax sources, or out of the belief that businesses either benefit as entities from public services and therefore should support their financing, or are separate "individuals" with separate abilities to pay, have concluded that business should be taxed on some basis. What the ultimate incidence is of such business taxes has been a matter of continued research and speculation in the academic community. In the long run, it seems reasonable to assume that labor and capital are mobile and will move in response to sizable differentials in after-tax rates of return that are caused by differential state business tax policies. Changes in markets can materially affect the incidence of state business taxes. For example, it is quite likely that the increased competition in the automobile industry has affected materially the ability of some states to "export" their business taxes.

7. These objectives may be defined further in how the tax system should treat taxpayers in the same circumstance to achieve horizontal equity, and how the tax system should treat taxpayers with differing abilities to pay to achieve agreed-upon levels of progressivity in the tax system.

8. Kentucky's recent tax legislation is an example of such farsightedness; higher business taxes were tied to higher educational spending that the business community saw directly related to their long-term needs for better educated workers.

9. I suspect this explains why many states use a sales factor in their apportionment formulas, as it is seen as a way of exporting the cost of public services to those companies that have only a mercantile interest in the state.

10. Three examples that come immediately to mind involve a lawsuit brought several years ago by many of the commercial banks in Pennsylvania, the pending case brought by electric power companies in West Virginia, and a pending gross receipts case in Washington state.

11. Undoubtedly, there are cases when the litigants hold fast and insist that such revenue-generating legislation apply not only to their industry but also to all others, and in effect spread the tax increase throughout the business community. Needless to say, other industries take a dim view of this sort of burden-sharing, and there usually is a behind-the-scenes struggle about whether the industry of complaint must bear the retroactive tax increase.

12. My friends in the business community inform me that because I am an economist I am necessarily unable to recognize the intangible value of winning a legal point, but not collecting at the tax refund window. To me, this position sounds like the English attitude toward sports; that is, "it's

27. The proposal additionally does allow states to share such information with each other by proposing to change Section 6103(d) of the code. However, it is obvious that states now can do this by simply employing each other for "tax administration purposes," which is currently permitted under 6103.

28. The model legislation of the MultiState Tax Commission does not, in this author's judgment, clearly require this. Undoubtedly, some taxpayers may have taken advantage of the resulting ambiguity.

29. See Section 6011 of the Internal Revenue Code.

30. For a more complete discussion, see Strauss (1985).

31. In late summer 1985, the Joint Committee on Taxation released its revenue estimates for President Reagan's tax bill. Simply using 1983 personal income tax returns, aged to 1986, instead of using 1982 personal income tax returns, aged to 1986, changed the estimate of the revenue gain of eliminating the deductibility of state and local taxes by $25 billion!

32. Large firms are often in multiple lines of business nationally and regionally, and classification can become difficult. Also, there can be conceptual questions about whether, say, General Motors, which may not have a manufacturing facility in a state, is a wholesaler of manufactured cars, or just a manufacturer who sells into the state.

33. See Strauss and Wittenberg (1985) for an example of such an analysis with West Virginia data.

34. See Section 6103 of the Internal Revenue Code.

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not winning that counts, but how you play the game!"

13. Such issues often are raised by bipartisan tax study commissions whose recommendations are not embraced or enacted immediately.

14. I include in the term *historical accident* the constraints imposed by state constitutions that may require "uniformity" or preclude an income tax. Such constraints may have been imposed in a very different economic setting and no longer apply to a modern, interdependent economy.

15. There may be a lesson in this in the sense that accepting legislative vagueness may be tantamount to accepting future litigation. However, given the ingenuity and growing numbers of tax attorneys, it seems reasonable to expect that there always will be litigation of statutory meanings.

16. This is not a small matter since companies are capable of demonstrating that they are financial successes to their shareholders while simultaneously demonstrating financial failure to tax collectors. At issue, of course, is what constitutes "income."

17. Docket No. 83-1620, March 19, 1985.

18. See *The United States Law Week,* 3-19-85, 53 LW 4329.

19. It is not clear to the author that the exception within Section 3701, U.S. Revised Statutes, for nondiscriminatory franchise taxes really means that a general franchise tax on net worth, including the value of federal securities, if applied to all businesses, would be permissible. To date, no state has attempted to legislate such a tax.

20. The taxation of unincorporated business by the new legislation follows the historical pattern in West Virginia of taxing "activities" rather than "entities" and deserves some further comment since most states do not impose business taxes on the unincorporated sector. Because partnerships and joint ventures have become important organizational forms nationally for tax shelter and other purposes, it was felt important to continue to tax the unincorporated sector, with the exception of sole proprietorships, and give recognition for resulting balance sheet taxes in the taxation of individual-level incomes by according a credit for such benefit taxes paid. By requiring the filing of federal partnership returns as well as corporation returns, this approach to taxing business should be workable.

21. See Pinkston (1984) for empirical evidence on buses, and Moore (1983) for empirical evidence on trucking.

22. Exact attribution of income to each state is not a practical benchmark to try to achieve since it has well-known limitations. On the other hand, it may impose fewer economic distortions than, say, formula apportionment. For further development of this view, see Feldman and Strauss (1985), and Conrad (1985a and 1985b) for a related view. For more benign views on the effects of state corporation income taxes, see McLure (1980), and Mieszkowski and Morgan (1984).

23. Moore (1983), p. 34.

24. The widespread presence of cable television in most metropolitan areas poses another medium-term alternative to traditional local residential and business telephone services.

25. See Article 13B of Chapter 11 of the West Virginia code, as amended effective July 1, 1987, and as contained in H.B. 1693 as passed by the West Virginia Legislature on April 8, 1985.

26. See U.S. Treasury (1985), and H.R. 3980 and S. 1974, introduced in late 1985, which provide access to such "spreadsheet" information as well as restricting states' use of the worldwide unitary method.

27. The proposal additionally does allow states to share such information with each other by proposing to change Section 6103(d) of the code. However, it is obvious that states now can do this by simply employing each other for "tax administration purposes," which is currently permitted under 6103.

28. The model legislation of the MultiState Tax Commission does not, in this author's judgment, clearly require this. Undoubtedly, some taxpayers may have taken advantage of the resulting ambiguity.

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32. Large firms are often in multiple lines of business nationally and regionally, and classification can become difficult. Also, there can be conceptual questions about whether, say, General Motors, which may not have a manufacturing facility in a state, is a wholesaler of manufactured cars, or just a manufacturer who sells into the state.

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