STATE GENERAL BUSINESS TAXES ONE MORE TIME:

CORPORATE INCOME TAX, GROSS RECEIPTS TAX OR VALUE ADDED TAX

Summary

Based on their work for the Connecticut State and Local Tax Study Panel, three well known public finance economists (Robert Ebel, LeAnn Luna and Matthew Murray), examine the advantages and disadvantages of three broad business taxes imposed at the state level.

Key Findings

- Equivalent revenue can be raised from a 9.0% corporate income tax rate, a 0.64% value added tax rate or a 0.22% gross receipts tax rate. This demonstrates that the gross receipts base is the broadest, roughly three times broader than the value added tax. By contrast, the corporate income tax base is extremely narrow relative to these entity-based taxes.
- The corporate income tax is becoming obsolete at the state level as demonstrated by its failure to capture trends in the nation's economy, demography, and the changing structure of the business organization. The tax base has also been eroded by intense inter-state competition for economic development. The result is a tax that has declined sharply relative to other major taxes and the economy over the past three decades.
- Moving to an entity-based tax such as the gross receipts tax or the value added tax, if enacted with tax base integrity (broad base/low rate), is a viable reform option that provides a strategy for fiscal modernization.
- The value added tax is generally preferred on a theoretical basis because it conforms closely to the benefit principle for business taxation and it is economically neutral (meaning it minimizes economic distortions). However, if enacted at the state level, it generally takes the form of an origin based tax. This puts exporting industries at a competitive disadvantage because they would be double taxed when they sell in states with destination based taxes as most are.
- The gross receipts tax has been the choice of states (Ohio, Nevada and Texas) reforming their business tax structure in recent years. It has the broadest base and is a destination based tax meaning it avoids the risks of double taxation for exporting companies. It is also consistent with a single sales factor corporate apportionment formula which states have increasingly shifted to. The major downside is the non-neutrality caused by the possibility of tax pyramiding. Industries with a large amount of intermediate transactions are most subject to this risk. These effects cannot be eliminated but they can be minimized by a low overall rate (Ohio) or a tiered rate (Nevada, Washington).

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Table 1
Taxonomy of Business Taxes

Broad Base	Tax Base	Examples	Description of Tax Base	Low Rate
	Gross receipts tax	Ohio CAT, Washington B&O, Nevada	Gross receipts (GR) with few, if any, deductions	
	Gross margins tax	Texas	GR minus cost of goods sold, or GR minus compensation, or 30 percent total revenue	
	Net receipts tax/Subtraction method VAT	Proposed in California	GR minus purchases from other firms, resulting in incomplete border adjustments	
	Credit invoice VAT	Pure VAT	GR minus purchases from other firms	
Narrow Base	Corporate income tax	Traditional business entity tax imposed in 45 states; applies to C corps only	GR minus labor costs, depreciation, interest, purchases from other firms, other operating expenses	High Rate

Source: Cline and Neubig (2008), Table 4, updated for recent reforms

is levied on corporate and non-corporate business enterprises alike (unless explicitly excluded, as is typical for religious, charitable, and similar 501(c)(3) organizations). The result is a readily identifiable very broad base that can produce a given flow of revenues at a very low (often less than one percent) statutory rate. The tax form for a relatively pure GRT is extremely simple and can fit on one page.

Table 2
Revenue Neutral Substitution of the Connecticut CIT with GRT or VAT

Tax Base	Description	Examples	Connecticut Statutory Rate Required to Generate an Equal CIT Yield (2012)	Traditional Apportionment Factor(s)
Gross receipts tax (GRT)	Total gross receipts from sales of goods and services levied on corporate and non-corporate taxpayers. Financial institutions subject to in-lieu taxation on net income.	Ohio CAT, Washington B&O, Nevada	0.221% with no small business threshold 0.251% with $1 million threshold	Destination-based sourcing: Sales
Value added tax	Subtraction method: Gross receipts less all purchases from other businesses, including capital goods, which may be fully expensed (Consumption Variant) or deducted by using depreciation (Income Variant). Addition Method: Sum of the returns / payments to private factors of production (wages+ rent+ interest+ profit) Levied on corporate and non-corporate taxpayers alike. Financial institutions subject to in-lieu taxation on net income.	Michigan Business Activities Tax (1953–1967); Michigan Single Business Tax (1976–2012) New Hampshire (a business enterprise tax complements a business profits tax)	0.640% with no small business threshold 0.730% with $1 million threshold	Origin/cost of production sourcing: Property and payroll or property, payroll, and sales Property, payroll and sales
Corporate net income (profits) tax	Gross receipts minus all "ordinary and business" deductions. Generally, does not apply to subchapter S corporations.	Connecticut, along with 44 other states and DC	9.0%	Property, payroll, and sales, with various weights on sales

Source: Connecticut Tax Panel, 2015