Citizens Finance Review Commission

Gross Receipts or Franchise Tax as an Alternative to Income Taxes on Business

Prepared for the Citizens Finance Review Commission

by

James Barash
Management KPMG LLP

This paper is the result of the author and a review by many people. Therefore, to attribute the author with the various positions taken in this paper without other confirmation would be misleading. Rather, the author attempted to disclose as fully and succinctly as possible the various different opinions and literature on any given topic to aid the CFRC in its deliberations.

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<u>Gross Receipts or Franchise Tax as an Alternative to Income Taxes on Business</u>

The purpose of this paper, prepared for the CFRC, is to first describe how the Arizona imposes income tax on businesses and than compare and contrast the pros and cons of replacing or supplementing Arizona's existing income tax on businesses with a gross receipt or franchise tax.

The analysis and recommendations made in the following discussion are not made pursuant to any political advocacy context.

***"Gross Receipts" Taxes & "Franchise" Taxes* What Are They?**

The Arizona Business Income Tax

Imposition and Nexus - Generally, the tax is imposed on subchapter C corporations, associations, trusts, and limited liability corporations treated as taxable entities for federal income tax purposes doing business within the state. To be subject to the income tax, business must have a "nexus" with the state. "Nexus" occurs when the activities of the business within the state give the state the jurisdiction to impose or apply the income tax on or to the business. Generally, any business activity within the state will give the business nexus. This type of nexus is typically referred to as "constitutional nexus" because the state is entitled to impose its tax upon any business within the limitations of the U.S. Constitution upon a state's power to tax. However, pursuant to Public Law 86-272, businesses that merely solicit the sale of only tangible personal property within a state can have nexus in a state beyond constitutional nexus and may not be subject to income tax within the state.

Tax Base and Apportionment - The tax base for the Arizona income tax on businesses is federal taxable income, adjusted for statutory tax additions and subtractions not included in the measure of the business' federal taxable income. Multistate businesses are required to apportion business income within and without the state based upon a statutory formula of the average property, payroll and sales within the state. Non-business income is excluded from the apportionable tax base and allocated to the specific state where of where the income was derived.

Unitary Combined, Consolidated and Separate Entity Reporting - Arizona uses a unitary concept to impose its income on a business, regardless if the business is transacted in a single entity or through operationally integrated relationships existing among and between multiple individuals and entities. Accordingly, to the extent there is no unitary relationship between related entities, the business legal entity will compute its income tax base and tax at a separate entity level. However, if a unitary relationship exists among and between more than a single business legal entity, the entities are required to compute the taxable income and tax as if the multiple legal entities were a single taxpayer.

Alternatively, Arizona permits affiliated corporations that meet the requirements to consolidate for federal income tax purposes to elect to compute their taxable income and tax using the same affiliated group of corporations for reporting Arizona purposes.

Tax Rates - Businesses organized in corporate entities pay tax on income apportioned and allocated to Arizona at a flat rate of 6.968%. Businesses organized into S-corporations, partnerships, limited liability companies (electing to be treated as partnerships) and other entities termed "pass-through" entities, determine and distribute their business apportioned or non-business allocated income to their respective pass-through owners. In the case of tiered levels of pass-through entity ownership, the income continues to "pass-through" in-turn until the income is distributed either to a taxable business entity (as discussed above), or an individual.

Note: Some of the several inherent benefits to organizing a business within a "pass-through" entity are as follows:

- For both federal and state income tax purposes, the "pass-through" business entity is only taxed at the individual owner level rather than at both the corporate entity and individual levels.
- For state income tax purposes, business "pass-through" owners that are individuals generally are taxed at graduated rates that are normally lower than the fixed corporate income tax rates. The maximum Arizona individual tax rate is 5.04% instead of 6.968%.

On the other hand, non-pass-through corporate entities do structure themselves in many states to reduce their effective state income tax rate. However, due to the Arizona requirement to report income on a unitary basis (as discussed above), this opportunity is not available in Arizona.

Please see attached chart in ***Appendix A.*** This chart demonstrates that corporate income taxes and personal income taxes accounted for approximately 6% and 27% of the total taxes raised in Arizona in 2001, respectively. However, it is important to note that a percentage of state tax revenue from business income is not derived from corporate income taxes because pass-through businesses pay income tax at the personal income tax level. Using Internal Revenue Service statistical figures of pass-through businesses, Ernst & Young[1] claims that 13.1% of individual income was earned from non-corporate businesses. The Ernst & Young study assumed that individuals were taxed at the maximum marginal state personal income tax rates. Accordingly, it could be reasoned that approximately 3.5% of the total Arizona tax revenue was derived from pass-through business income distributed to Arizona individuals subject to personal income taxes (i.e., applying the Ernst & Young figure of 13.1% to the 27% amount of 2001 Arizona tax revenue from personal income taxes). Accordingly, it can be estimated that approximately 9%-10% of Arizona's total 2001 tax revenue was derived from taxes on business net income of both corporations and pass-through entities, rather than the approximately 6% from corporate entities alone.

State "Gross Receipts" Tax Systems and How They Differ From State Income Taxes

Imposition: In general, states with business gross receipts taxes impose the tax on the gross receipts of almost all businesses for the privilege of doing business in the state. These taxes are sometimes also referred to as business license taxes in some states.

In some gross receipts tax states, the state imposes no taxes on the net income of the business. However, some other states impose a gross receipts tax only to the extent that the amount of the gross receipts tax exceeds the measure of the tax on business net income.

Unitary Combined, Consolidated and Separate Entity Reporting - Like many income tax states, state tax on business gross receipt is imposed on C corporations, associations, trusts, and taxable limited liability corporations doing business in state. However, taxable gross receipts and tax is generally determined on a separate entity basis. In addition, "pass-through" entities are also generally subject to gross receipts taxes at the entity level where the gross receipts are were derived. However, gross receipt tax states generally provide some type of "relief" to "pass-through" owners in order to avoid double state taxation of both the gross receipts and net income derived by the "pass-through" business. Such "relief generally is in the form of a reduction to the "pass-through" owner's tax base in the amount of the gross receipts or net income that was previously taxed.

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[1] Total State and Local Tax Burdens – Fiscal Year 2003 Update; Robert Cline, Will Fox, Tom Neubig, and Andrew Phillips; Prepared for the Council on State Taxation .

Nexus: Unlike income tax, there is no protection similar to Public Law 86-272 for the solicitation of tangible personal property for gross receipts tax purposes. Therefore, the mere activity of soliciting business from the sale of tangible personal property within the state may give the business constitutional nexus and provide the state with the jurisdiction to impose the gross receipt tax.

Enactment: As discussed above, the majority of states that currently impose business gross receipts taxes have imposed the tax in the same way for decades in response to the imposition of the federal income tax. This point is important in considering if a tax on business gross receipts can replace the Arizona business income tax. However, this is not true for states that impose gross receipt or franchise tax as a supplement to an income tax on businesses. Many states, such as New Jersey, and Indiana enacted an additional supplemental tax, based on a form of gross receipts, in addition to an existing franchise or income tax after a corporate income tax had been in existence for a long period of time.

Tax Base, Deductions and Exemptions: Unlike income taxes, a gross receipts tax base generally includes all gross receipts of a business, including services, without deductions commonly taken to arrive at taxable income. Common sales tax exemptions such as sales for resale, manufacturing and research are typically not exempt in business gross receipt tax. However and as discussed above, one common gross receipt exemption is for income or gross receipts received from another business that is subject to the gross receipts tax. This exemption prevents "tiering" of tax upon the same gross receipts.

Tax Rate: Gross receipt taxes generally apply rate below 2%. In addition, taxes upon gross receipts can vary widely, depending upon the type of business in which the taxpayer is engaged and/or what type of revenue that the gross receipt is derived. See the chart in ***Figure 1*** below for a comparison of gross receipt tax rates.

State "Gross Receipts" Tax Systems in Contrast to State Sales & Use Taxes

Unlike gross receipt taxes, the imposition of state sales and use taxes generally are limited to taxable purchases of tangible personal property and limited services. In addition, the legal incidence of a sales and use tax is generally imposed upon the particular consumers that engages in a taxable purchase transaction (not the business/seller). [Please note however, if both registered (and/or doing business in a state with a sales/use tax) a business is normally under a fiduciary responsibility to remit sales taxes collected from purchasers in the state.]

Sales and use tax systems generally also have abundant exemptions (such as purchases made for use in manufacturing, for resale, or for use in research, etc). In addition, sales and use tax systems also have abundant deductions for sellers under a fiduciary responsibility to collect and remit the tax, including bad debts on sales taxes accrued by never collected.

It is also important to note that many of the states that impose a tax on the gross receipt of a business also impose sales and use tax on the taxable purchases of taxable purchasers within the state. Therefore, businesses in these states are subject to tax on both the gross receipts of the business, plus the sales or use tax on purchases made and consumed by the business in the state.

Gross Receipts Tax Systems in Contrast to Arizona's Transaction Privilege Tax ("TPT")

The principle distinction between other states with a gross receipt tax and Arizona is that the other states impose the legal incident of the sales tax on purchasers instead of imposing the tax upon the businesses that make the taxable sales. Accordingly, the majority of the states with gross receipts tax separate the legal incidence of the gross receipt tax on the business and legal incidence of the sales tax on the purchaser. In contrast, if the TPT system were to remain fundamentally unchanged, Arizona would impose the legal incident of a gross receipt tax upon businesses subject to a TPT upon the same business gross receipts. This distinction could be viewed by the business community as an effective increase in sales tax rates on all businesses rather than an elimination of business income taxes. However, the amount of tax revenue collected from the TPT system should remain constant.

Problems with Replacing a Corporate Income Tax With A Business Gross Receipt Tax

A potential and highly visible inequity problem may arise with replacing a corporate income tax system with a businesses gross receipts tax is that owners of "pass-through" businesses would be subject to both a tax on the gross receipts of the business, plus a personal income tax on profits distributed from the business. In addition, income received from a non-pass-though business in the form of dividends could also be subject to gross receipts tax by its recipient in a tier upon tier effect. However, as discussed above, inequities similar to those discussed above already exists for businesses and individuals within the income tax structure of the State (i.e., individual pass-through owners pay tax on business income at a rate less than corporations; and dividend received deductions vary widely depending upon ownership type, function and amount.).

Accordingly, a potential solution for preventing double taxation of business gross receipts or net income distributed to both "pass-through" and non-pass-through owners would be to exempt the profits distributed to both "pass-through" and non-pass-through businesses.

However, a problem with allowing individual owners of "pass-through" businesses to deduct profits distributed from "pass-through" businesses is that there the state could lose a substantial amount of general fund revenue from individual taxes on business profits. Pursuant to the Ernst & Young study (see discussion above and chart at **Appendix A**), the tax revenue loss could be as much as 13.1% of personal income taxes collected which could amount to as much as 3.5% of total taxes collect. Accordingly, the business gross receipts tax rate (imposed on every corporation and pass-through entity) would have to be set at a high enough level to supplement the tax revenue loss from individual income taxes on pass-through business income.

What Are Some Of The States Have Gross Receipts Taxes?

Some of the "hand-full" of states that impose a tax on gross receipts are the following:

- Washington has a gross receipts tax, called the "business and occupation tax" (also known as the "B&O") instead of a tax on net income.
- Although actually referred to as a value added tax, the Michigan "single business tax" (or, "SBT") has a tax base similar to a gross receipts tax. The Michigan SBT resembles a gross receipts tax because it has a tax base that is comprised of the net income of a business with many common deductions added back to the tax SBT base (such as wages, depreciation, cost of sales, interest, etc.).
- Indiana and New Jersey each impose a "gross income tax" and "alternative minimum assessment"("AMA"), respectively. These taxes, based on gross receipts, differ from those above in that they supplement (and do not replace) a tax system based on net income. The tax is usually paid if the measure of the net income tax is zero or below that of the gross receipts tax. These taxes are termed "in-lieu of" taxes.

As discussed above, the gross receipts tax base is generally very broad because the tax is generally imposed upon all "pass-through" and non-pass-through business entities and sole proprietors, with rare exceptions. For example, Indiana allows partnerships to escape the gross income tax but taxes the individual owner instead. However, Michigan imposes the SBT at the business level for all entities.

In addition, gross receipts taxes generally have few exemptions. For example, Washington provides many legislated exemptions for the B&O to industries in favored activities such as blood/bone banks and Christmas tree plantation.

The rates used by the above states vary widely as follows:

Figure 1. – Comparison of Gross Receipt Tax Rates

State	Gross Receipt Tax	Rate	Exemptions	Tax In-lieu or Supplement to Income Tax
Michigan	Single Business Tax ("SBT")	2.2%	Many	In-Lieu
Indiana	Gross Income Tax	0.3% - 1.2% (note 1)	Many	Supplement
New Jersey	Alternative Minimum	0.125% - 0.4% (notes 1 & 2)	Few	Supplement

	Assessment			
Washington	Business and Occupation Tax ("B&O")	0.138% - 1.5%(note 1)	Many (note 3)	In-Lieu

Note1: Rate depends upon the business industry or activity. Generally service businesses are subject to higher rates than manufacturers and retailers.
Note 2: Tax applied only on tax bases in excess to $2 million.
Note 3: Exemptions depend on taxpayer activity and industry.

State "Franchise" Tax Systems in Contrast to State Sales & Use Taxes

Imposition: Franchise taxes are generally imposed upon the "net worth" of a corporate (non-pass-through) business doing business within the franchise tax state. The franchise (or "net worth") tax base is an amount that typically represented by the retained earnings of a business (i.e., the value of the assets, less liabilities of a business). Also added to the franchise tax base by many states, are the amounts of long-term and deferred liabilities, such as deferred taxes and long-term notes payable.

Unitary Combined, Consolidated, and Separate Entity Reporting: Unlike income taxes, taxes most states with franchise taxes require entities to compute the franchise tax base only on a single entity stand-alone basis. Consolidation or unitary combination of entities is generally not a reporting option.

However, franchise taxes are typically not imposed on non-corporate pass-through businesses. Accordingly, in almost all states with franchise/net worth taxes, these taxes are imposed as an addition to or "in-lieu of" to an existing tax based on income. Therefore, franchise/net worth taxes are capable of raising only a fraction of the tax that is raised from corporate income tax systems (See chart at ***Appendix 1.***).

Exemptions: In an effort to duplicate taxation of the franchise tax base of a parents and their corporate subsidiaries, some franchise tax states exempt subsidiary capital from the corporate parent's tax base.

Nexus: Similar to gross receipt taxes, business with constitutional nexus in a state can be subject to franchise tax. In addition, there is no protection similar to Public Law 86-272 for franchise tax purposes.

Apportionment: Similar to corporate income taxes, businesses operating in multiple states generally apportion the franchise tax base using apportionment factor formulas.

How Would Gross Receipt or Franchise Taxes be Administered

As discussed above, setting up and administering a new gross receipts or franchise tax regimes to either replace or supplement the Arizona corporate income tax would be daunting. In addition, providing exemptions to individual and corporate owners of pass-through entities for gross receipt taxes on businesses would also add complexity. Legislation would be necessary, likely with a two-thirds vote to pass. In addition, taxpayer education and massive reconfiguration to existing Department of Revenue computer systems would also be required.

Impact on Existing Revenue Systems

Income tax and franchise tax funds are generally deposited directly to the state general fund and should not impact any other revenue streams. However, the amount of TPT revenue collected by the state helps determine the amount of revenue sharing and allocation available to the cities. Thus, if the gross receipt tax were implemented such that more tax is collected by the state than currently in an income tax regime, then the cities would share in the increase in collections. The converse also holds true.

However, please note that the Washington B&O does not share revenues with Cities. Accordingly, many cities in Washington collect their own taxes in a similar B&O regime.

Cost

As discussed above, the cost of changing and administering a new gross receipt or franchise taxes would be very large due to the modifications required to Department of Revenue computer systems.

Policy Considerations

- *Equity –*

  In a gross receipt tax system all business taxpayers regardless of the entity structure chosen by the business generally pay gross receipt taxes. However, because the taxes do not consider profit, there is constant pressure on the legislature to grant new preferential tax rates and exemptions for industries that are in economic difficulty or in a poor position to pass the tax along in their pricing structure.

Gross receipt taxes impose a heavy burden on new and small businesses that have not reached a maximum level of efficiency. Thus, gross receipt taxes do not encourage economic development. As a result established profitable businesses are favored to the detriment of new and small business.

Finally, the gross receipt tax favors low-volume, high-profit types of business activities. For example, compare the profit margins of two different service industries: legal services, with typical net profits before taxes of about 18 percent, and barber and beauty shops with an average of about 5 percent. Yet the applicable B&O tax rate is the same 1.5 percent for both. Thus, compared with profits for the firm, the effective B&O tax rate is only 8.3 percent for legal services but 30 percent for barber and beauty shops.

Conversely, franchise taxes discriminate the tax burden toward the undistributed retained earnings of successful corporate businesses and avoid pass-through businesses and new startup businesses without a long-term history of profits.

In addition, since most states with a franchise tax apply the tax on a single entity basis, there is also a potential for inequity between businesses enterprises operating in multiple states and other businesses that operate in Arizona alone. A multistate business with multiple entities can force a subsidiary possessing nexus in a franchise tax state to pay a dividend to a parent entity with nexus only in a non-franchise tax state in which related party dividends are eliminated from the income tax base. The result of the dividend payment is to reduce the net worth (i.e., retained earnings) and tax base of the entity with nexus in the franchise tax state. Therefore, additional rules and complexity is required in order to avoid this type of planning and the resulting tax base erosion.

- ***Economic Vitality***

In addition to the equity reasons discussed above, a gross receipt tax or franchise tax as a replacement of, or supplement to, a corporate income tax also struggles with economic vitality because a small minority of other competitor states have a similar and consistent tax structures.

- ***Volatility –***

Gross receipts taxes in contrast to income taxes are much less volatile. In fact, gross receipts taxes have less volatility than the TPT. Gross receipt taxes are collected from a broad range of businesses and revenue types (regardless of whether the businesses were profitable or not). Gross receipt taxes are also not as vulnerable to economic downturns as are net income taxes.

Franchise taxes theoretically are less volatile than corporate income taxes because they apply the ongoing value of the business instead of the periodic profit or loss of the business. However, the franchise tax base is in actuality more volatile than income taxes because of the numerous planning strategies available to taxpayers to exploit pass-through entities and dividend payments to manage and reduce the franchise tax base.

- ***Simplicity -***

Generally, gross receipts and franchise tax systems are easy to administer and comply with because they are easy to understand, simple to calculate and auditing is relatively uncomplicated. In contrast income taxes on businesses is somewhat more complex due to the wide range of complex concepts such as unitary combinations, business/non-business income, and tax credits. In addition, for a Washington B&O type regime, the complex determination of net income is avoided, and there is essentially little need to apportion income among states for most multistate operations. Washington, however, does have an apportionment mechanism for service and other business types.

In addition, it is easier for businesses to project their sales and/or ongoing franchise value than their taxable periodic net incomes subject to state tax. Accordingly, it is also easier to pass the cost of the gross receipts and franchise taxes along to customers in the form of higher prices.

Economic Impact

From a tax revenue collection perspective, two of the principle benefits of a gross receipt tax system over a corporate income tax system are as follows:

- All businesses entities are generally subject to the tax (rather than non-pass-through/non-corporate entities alone).
- Virtually all businesses, whether operating in a net loss or profit position, are subject to the tax. However, this revenue benefit creates great inequity both between profit and loss businesses, as well as for businesses operating in industries with different profit margins.

However, pursuant to the chart at **Appendix A**, the economic impact of replacing or supplementing the corporate income tax with either a gross receipt or franchise tax appears to create little additional tax revenues to state general funds.

Recommendation – A principle benefit of a gross receipt tax is to expand the base to all types of business entities (instead of imposing the tax on corporate entities alone). In addition, the tax rate for franchise and gross receipt taxes are generally lower much than corporate income tax rates. Accordingly, it may be worth additional study and consideration to consider the following actions:

- Impose a fixed and equal income tax rate on business income regardless of if earned by a taxable corporation or pass-through owner individual. This would require creating an additional state personal income tax rate and applying that rate to individual income derived from pass-through businesses.
- Lower the effective state income tax rate applicable to all types of business income.

Potential Benefits:

- *Equity:* The corporate income tax system would become more equitable because the same rates would apply regard to type of business entity.
- *Simplicity:* Creating a framework to govern an additional rate to apply to an individual's non-corporate earnings is already in place. Therefore, a personal income tax rate increase on one type of income would required to add a new less resources than creating an entire regime for computing a gross receipt or franchise tax base and tax.
- *Vitality:* It is hypothesized that Arizona personal income graduated tax rates are highly progressive when compared to graduated rates in other competitor states. Accordingly, it is possible that lowering the overall business tax rate to be closer to the maximum marginal personal income tax rate may foster growth and attract additional businesses to Arizona.
- *Volatility:* For small businesses (the lifeblood of the economy) a higher rate imposed on small business earnings of individuals may be more volatile than if a lower rate were applied. Conversely, a lower rate applied to large business corporate earnings

would be less volatile if it is assumed that additional core export jobs will be created in the state.

Appendix A.

Analysis of State Tax Revenue Sources

Corporate Income, Personal Income, Business Franchise, Business Gross Receipts and Sales/Use Taxes

State	Corporate Income Tax (%%)	Personal Income Tax On Non Corporate Profits (%%)	Franchise Tax (%%)	Gross Reciept Tax (%%)	Total Taxes on Business Income (%%)	Personal Income Tax (%%)	Amount of Individual Income from non-corporate profits - Per EY Study (Note 1)	Personal Income Tax On Non Corporate Profits (%%)	Sales and Use Tax (%%)	Total Tax Revenue from Corporate Income, Gross Receipt, Franchise, Personal Income, and Sales/Use Taxes (%%)	Source:
	a	*b = h*	*c*	*d*	*e=sum(a..d)*	*f*	*g*	*h = f* g*	*j*	*k=e+f-h+j*	
Arizona	6.4%	3.6%	0.0%	0.0%	10.0%	27.2%	13.1%	3.6%	46.4%	80.0%	2001 Federation of Tax Administrators
Indiana	8.1%	0.0%	0.0%	0.0%	8.1%	37.0%		0.0%	35.3%	80.4%	2001 Federation of Tax Administrators
Michigan	0.0%	0.0%	0.0%	10.0%	10.0%	32.5%		0.0%	36.8%	79.3%	MI Dept of Tres: Annual Report 2000-2001
New Jersey	6.8%	5.4%	0.0%	0.0%	12.2%	41.5%	13.1%	5.4%	29.9%	78.2%	2001 Federation of Tax Administrators
Pennsylvania	7.2%	4.8%	4.7%	0.0%	16.7%	36.6%	13.1%	4.8%	31.3%	79.8%	http://www.revenue.state.pa.us/revenue/lib/revenue/2001-02_stat_supp.pdf PA-2001: The PA Tax

												Compendium
**	Tennessee	13.4%	0.0%	7.7%	0.0%	21.1%	0.8%		0.0%	55.1%	77.0%	2001 Federation of Tax Administrators
**	Texas	0.0%	0.0%	3.5%	0.0%	3.5%	0.0%		0.0%	26.3%	29.8%	TX Comptroller: 2002 Texas Revenue by source
**	Washington	0.0%	0.0%	0.0%	21.5%	21.5%	0.0%		0.0%	49.5%	71.0%	http://dor.wa.gov/docs/reports/2001/Tax_Statistics_2001/Chart_1.pdf

** These states have to fund a higher percentage of their general fund from business taxes because each has little or no personal income tax system.

%% As a Percent of Total State Tax Revenue Collected (Excludes Local Tax Revenues Collected).

Note 1: Total State and Local Tax Burdens – Fiscal Year 2003 Update; Robert Cline, Will Fox, Tom Neubig, and Andrew Phillips; Prepared for the Council on State Taxation; 1/3/2003.

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