WHITHER GROSS RECEIPTS TAXES

Prepared for the Revenue and Transportation Interim Committee
by
Jeff Martin, Legislative Research Analyst
Montana Legislative Service Division

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INTRODUCTION

Gross receipts taxes have perplexed tax analysts and, until recently, have generally been disregarded or discarded by most states. Since 2002, several states, including New Jersey, Kentucky, Ohio, and Texas, have enacted some form of gross receipts taxes, and several other states, including Illinois, Maine, and Montana, have considered modified gross receipts taxes. Michigan has dumped its single business tax (based on value added) and imposed a corporation income tax and a gross receipts tax. Only Delaware, New Mexico, and Washington have long-standing gross receipt taxes. New Mexico's tax may more accurately be regarded as a broad-based sales tax.[1]

The purpose of this paper is to provide a brief background on gross receipts taxes and to review some of the salient features of the new taxes enacted in Ohio and Michigan.

In order to generate additional revenue during the Great Depression, states began diversifying their tax revenue bases by imposing new taxes on business activity. Six states had adopted a corporate income tax before 1917. By 1930, 10 additional states had adopted the tax, with 15 states joining the ranks in the 1930s. Only a few states adopted a gross receipts tax: Delaware, Georgia, Indiana, Mississippi, Washington, and West Virginia. Previously states had relied almost exclusively on property taxes and excise taxes. States may be turning again to a gross receipts tax to generate new revenue or enhance revenue, promote economic development, and reform flawed and biased tax systems.[2]

One rationale for the taxation of businesses is the benefits-received principle.[3] [4] At the local level, businesses pay property taxes for police and fire protection as well as educational services. At the state level, they pay for such things as transportation infrastructure and the legal system.

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[1] Thomas F. Pogue, "The Gross Receipts Tax: A New Approach to Business Taxation", *National Tax Journal*, Vol. LX, No. 4 (December 2007), p. 799.

[2] William A. Testa and Richard H. Mattoon, "Is There a Role for Gross Receipts Taxation?", *National Tax Journal*, Vol. LX, No. 4 (December 2007), p. 821.

[3] The benefits-received principle is the equity viewpoint that persons who receive benefits from goods and services provided by government should bear the tax burden in proportion to benefits received. By contrast, the ability-to-pay principle is the equity viewpoint that the amount of tax burden should be related to an person's economic ability to bear the burden.

[4] Another rationale to tax corporations based on net income is to protect the individual income tax base by including certain corporate income, such as retained earnings, in the corporation tax base. If corporate income were not taxed, shareholders could hide income within the corporation. However, shareholders are subject to double taxation when dividends are paid.

Business owners or shareholders of the corporation benefit from public services, and business taxes provide a means of assessing a tax on those beneficiaries.[5]

GROSS RECEIPTS TAXES

A gross receipts tax is a tax on the gross revenue of a business operating within a state. Unlike a corporate income tax, a gross receipts tax typically applies to most business entities, including regular corporations, small business corporations, limited liability companies, partnerships, and sole proprietorships. The tax applies to productive activity beyond profits and return on capital.[6]

William Testa and Richard Mattoon list several elements of a gross receipts tax that seemingly meet the criteria of a good tax system. The tax is imposed on a broad base with low tax rates. The tax should be easy to administer and comply with because the tax base is easier to identify and calculate. In addition, the tax may be more stable than the corporate income tax.[7] However, John Mikesell compared the stability of Washington's business and occupation tax with the state's retail sales tax and with Oregon's individual income tax and corporate income tax. According to Mikesell, the business and occupation tax is not quite as stable as the retail sales tax, but is more stable than Oregon's individual income tax and much more stable than corporate income tax. Because the variations in these taxes may coincide, the business and occupation tax does not appear to contribute to the overall stability of the state's tax system.[8]

Despite the apparent virtues of the gross receipts tax, the tax is not viewed favorably by many tax analysts. One of its significant drawbacks is tax pyramiding, or the tax building upon itself in the production and distribution process. The effective tax rate (in this case, the "real" tax rate on gross receipts and not the measure of taxes paid as a percent of income) on intermediate sales of goods and services may be higher than the nominal rate. One of the problems is that pyramiding can distort relative prices and alter resource allocation.[9] As such it can have an effect on economic choices made by individuals and businesses.[10]

Washington and New Mexico each conducted a study of tax pyramiding of its gross receipts tax. Washington's business and occupation tax is imposed on gross income with no deductions for the cost of doing business (although certain deductions, exemptions, or credits may be allowed); tax

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[5] Sarah Beth Coffey, "The Questionable Link Between State Corporate Income Taxes and Economic Development", *State Tax Notes*, Vol. 38, No. 3 (Falls Church, VA: October 10, 2005), p. 213.

[6] Testa and Mattoon, *op. cit*., p. 822.

[7] Testa and Mattoon, *op. cit*., pp. 823-824.

[8] John L. Mikesell, "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance", Background Paper, January 2007, Number 53, Tax Foundation (Council of State Taxation), pp. 8-9.

[9] Pogue, *op. cit.*, p. 803. Pogue also points out that tax rate differentials caused by pyramiding do not accurately reflect differences is social costs imposed by businesses.

[10] Mikesell, *op. cit.*, p. 9.

rates vary by economic sector, ranging from 0.471% for retail trade to 1.5% for services.[11] In Washington, the statewide average tax rate is 0.61%, but on a value-added basis the effective tax rate is 1.53%.[12] New Mexico imposes a 5% gross receipts tax, but generally excludes business-to-business sales. The New Mexico study found the average "pyramiding tax rate" was 1.35%, but the rate was 2.68% for manufacturing and 2.66% for transportation and warehousing.[13] There appears to be some difference of opinion on the effect of variations in effective tax rates.[14]

Gross receipts taxes affect the transparency of the tax system. First, it is not easy to identify who bears the burden of the tax, and second, tax pyramiding makes it is impossible to know how much of the tax is reflected in the price.[15]

Other concerns about a gross receipts tax include fairness and competitiveness. The tax may fall more heavily on low-margin, high-turnover businesses in a competitive market. It is unlikely these types of businesses can pass on the tax, and it may affect a business's ability to compete.[16] In addition, the tax may impede capital investment.

OHIO

In 2005, following a tax reform study, Ohio enacted a major overhaul to its tax structure. The legislation made changes in the way businesses, individuals, and personal property are taxed.[17] Below is a summary of some of the significant provisions.[18]

Commercial activity tax

The legislation phases out the corporation franchise tax over 5 years. The franchise tax rate (not accounting for the phaseout rates) is the greater of $50 (or $1,000 for certain corporations) or 5.1% of the first $50,000 of the value of the taxpayer's shares of stock determined by net income plus 8.5% of the value in excess of $50,000; or 4 mills times the value of issued and outstanding

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[11] Beginning July 1, 2004, and ending June 30, 2024, tax rates were reduced significantly for certain activities, including manufacturing and selling of aircraft, harvesting timber and manufacturing of wood products, manufacturing of aluminum, and solar energy systems.

[12] Testa and Mattoon, *op. cit.*, p. 826. From Washington State Tax Structure Committee, "Tax Alternatives for Washington State: A Report to the Legislature", Olympia, Washington, November 2002, p. 41, Table 1.

[13] *Ibid.*, p. 826. From New Mexico Tax Research Institute, "Pyramiding Transactions Taxes in New Mexico: A Report on the Gross Receipts Tax", Albuquerque, New Mexico, September 2005.

[14] Pogue, *op. cit.*, p. 804.

[15] Mikesell, *op. cit.*, p. 14.

[16] *Ibid.*, p. 13.

[17] The tax reform provisions were contained in Ohio's budget bill (HB 66, Laws 2005).

[18] Unless otherwise noted, the summary is derived from A.M. SUB. HB 66, Bill Analysis, Ohio Legislative Service Commission, at http://www.legislature.state.oh.us/analysis.cfm?ID=126_HB_66&ACT=As%20Enrolled&hf=analyses126/05-hb66-126.htm, retrieved January 11, 2008.

shares of stock.

Beginning July 1, 2005, most businesses, regardless of entity type (e.g., C corporation, partnership, limited liability company, S corporation, sole proprietor, business trust, estate, etc.), were subject to the new commercial activity tax.[19] It is a broad-based, low-rate business privilege tax that is determined on the basis of gross receipts. It applies to businesses with taxable gross receipts in excess of $150,000. When the tax is fully phased in (2009), the annual tax is equal to $150 on taxable gross receipts up to $1 million plus 0.26% of taxable gross receipts in excess of $1 million.

The Ohio Legislature had several goals in enacting the commercial activity tax. One was to improve the business climate in Ohio by lowering taxes on domestic production, especially manufacturing, and by excluding exports from the tax. A second goal was to tax businesses more uniformly than the taxes that were replaced (e.g., the taxation of services would be more in line with the taxation of manufacturers). The third goal was to replace a franchise tax that may have been subject to excessive tax planning.[20]

If revenue from the tax varies from revenue estimates by more than 10%, the tax rate may be adjusted upward or downward without legislative action. The tax rate is increased if there is a revenue shortfall or decreased if there is excess revenue. Revenue collected in excess of the 10% threshold is deposited into a budget stabilization fund and to a fund that is used to return taxes to commercial activity taxpayers through a tax credit.

Financial institutions, dealers in intangibles, insurance companies and their affiliates, public utilities, and nonprofit organizations are not subject to the new tax. Taxable businesses will continue to be subject to the specific type of taxes they already pay. For example, utilities pay a public utility excise tax.

Gross receipts include the total amount realized, without deduction for the cost of goods sold or other expenses incurred, from activities that contribute to gross income, including:

- sales from the sale, exchange, or other disposition of property, including sales (exclusive of excise taxes) of tobacco products, motor fuels, and alcoholic beverages;
- performance of services; and
- rents, royalties, and interest on installment sales.

Gross receipts do not include (not a complete list, 27 items listed):

- employee compensation;
- interest, dividends, and federally defined capital gains;
- proceeds from loans, stocks, bonds, trusts, pension plans, or certificates of deposit;
- damages received from litigation;

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[19]The franchise tax applies mainly to C corporations.

[20] Pogue, *op. cit.*, p. 809.

- property, money, or other compensation received by an agent in excess of commissions or fees;
- contributions to capital; or
- sales and use taxes collected by vendor.

As noted above, exports are excluded from the commercial activity tax but imports are subject to the tax. As such, it is a destination-based tax designed to promote economic development within Ohio. Receipts from the sale of services are sourced to the location where the purchaser receives the benefit of the service, not where the services are performed. Likewise, products are sourced to the location of ultimate delivery, not where the products are produced.[21]

On the other hand, receipts from imports to Ohio are taxed by establishing a "bright line" nexus standard. Businesses domiciled in Ohio are subject to the tax, as are out-of-state businesses that have at least $50,000 of property in the state at any time during the calendar year, $50,000 of payroll, taxable gross receipts of at least $500,000, or 25% of total property, total payroll, or total gross receipts in Ohio. This definition corresponds to the Multistate Tax Commission's business activity tax nexus standard, making Ohio the first state to adopt the standard.[22]

Commonly owned businesses (more than 50% common ownership) must elect to file a combined or consolidated return for the commercial activity tax. Taxpayers who file a combined return must include all related entities with Ohio nexus and pay taxes on interentity transactions. Taxpayers who file a consolidated return must include all related entities, including entities that are otherwise exempt from the tax, even if they do not have nexus in Ohio. Under this filing option, interentity transactions are not included in gross receipts, but other gross receipts of the group are included. The purpose of these filing requirements is to prevent businesses from creating multiple entities to take advantage of the $1 million threshold for paying the minimum tax.

Businesses cannot invoice the commercial activities tax, thus reducing the transparency of the tax. Finally, there are complicated rules for accounting for net operating losses under the old tax.

Property taxes

The act made significant changes in the taxation of business equipment and telecommunications personal property. The act provides for a phased-in elimination of the property tax on most other personal property, including inventories, beginning in tax year 2006. The tax on personal property, including inventories, will be eliminated in tax year 2009. Personal property was taxed at 25% of value and is phased out in equal increments. Under prior law, inventories would not have been subject to property taxation after 2016.

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[21] *Ibid.*, p. 810.

[22] "CAT Got Your Tongue? Navigating the Complexities of Ohio's New Commercial Activity Tax", KPMG, http://www.us.kpmg.com/microsite/tax/salt/perspectives/Fall_2005-02.asp.

The act exempts from property taxation machinery and equipment that is first used by a business after December 31, 2004. The exemption applies to manufacturing machinery and equipment used in manufacturing, mining or refining, or combining different materials. In addition, oil and natural gas recovery equipment is exempt from taxation beginning in tax year 2006 if it is installed on the premises or leased premises of the owner.

Beginning in tax year 2007, the taxation of telecommunications personal property will be phased out over a 5-year period. All telecommunications property will be exempt from taxation beginning in tax year 2011. Previously, telecommunications property placed in service after 1996 was taxed at 25% of its value.[23] The act also changed the assessment method of telecommunications property. It will be assessed as business personal property rather than as utility property, but the value will be still be apportioned among taxing units. Other public utility property is subject to taxation, but at generally lower rates than under previous law.

Reimbursement of local taxing units

The act provides for the reimbursement to local taxing jurisdictions, including schools (less offsets for increased state aid), for the loss of revenue attributable to the phaseout and elimination of most personal property taxes. In the first 5 years, local taxing jurisdictions are fully reimbursed (excluding the revenue effect of the previously enacted inventory phaseout); during the next 7 years the reimbursements are phased out. The final reimbursement to local taxing jurisdiction occurs in tax year 2018. Revenue from the commercial activity tax is used to replace lost revenue from the corporate franchise tax and personal property taxes. A portion of the revenue from the tax is deposited into separate funds to reimburse local governments and school districts.

Individual income taxes

There are nine individual income tax brackets under Ohio law. Under prior law, tax rates ranged from 0.743% on the first $5,000 of taxable income to 7.5% on the amount in excess of $200,000. The act reduces the tax rates in each bracket by 21% over 5 years. In tax year 2009, the new rates will range from 0.587% on the first $5,000 of taxable income to 5.925% on the amount in excess of $200,000. The act postpones indexing income brackets to inflation until 2010. Under prior law, indexing was scheduled to begin in 2005.

Individual income taxpayers whose adjusted gross income (less exemptions) is equal to or less than $10,000 may claim a nonrefundable credit.

MICHIGAN

In 1976, Michigan enacted the single business tax, a "modified" consumption value-added tax, to replace seven other business taxes: the corporate profits tax, the corporation franchise tax, business intangibles tax, the personal property tax on inventory, financial institutions tax,

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[23] Telecommunications property placed in service before 1996 was taxed at 67% of its value, but the rate would have been reduced to 25% in 2007.

insurance company privilege fee, and savings and loan company fee. In 1975, Michigan's corporate profit tax rate was 7.5%, which was relatively high compared to other states. In addition, the corporate franchise tax imposed an additional tax burden on corporations and was subject to litigation.[24] The single business tax rate was 2.35%.

In 2007, Michigan revamped its business tax structure by replacing the single business tax with the Michigan Business Tax. The purpose of the legislation was to create a less complex tax system that was similar to tax systems in other states and that was less subject to litigation.[25] Previously, the Legislature had provided for the phaseout and elimination of the single business tax. Successive legislatures had moved up the phaseout date but had not developed an alternative tax structure until the 2007 session. Below is a summary of some the significant provisions.[26]

The single business tax expired on December 31, 2007. Senate Bill 94, enacted in 2007, imposes two new business taxes (essentially a dual tax for most businesses). The first is a 4.95% tax on business income (regardless of the form of business) and the other is an 0.8% tax on modified gross receipts (less purchases from other businesses). The purpose of the gross receipts tax is to reduce the revenue volatility associated with a tax on net income. Insurance companies and financial institutions are subject to separate taxes.

The calculation of the business income tax starts with federal taxable income derived from a business activity (which may exclude income from a nonbusiness activity, such as the sale of property). The tax does not apply to business activity related to federal interstate commerce limitations as provided in Public Law 86-272. That law generally prohibits states from taxing businesses whose state income is derived from the solicitation of orders of tangible personal property (i.e., lacking substantial nexus in the state).

The modified gross income tax applies to a business's gross receipts, less purchases from other businesses, including, among other things, inventory, depreciable assets, and other materials and supplies. The modified gross receipts tax has a broader nexus standard than the business income tax. It applies to businesses with gross receipts in excess of $350,000 that have a physical presence in Michigan of at least 1 day or that actively solicit sales in the state. The tax is phased in through a credit mechanism for businesses with gross receipts between $350,000 and $700,000.

Unitary businesses are required to file a combined return (as is the case in Montana) for each tax.

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[24]"The Value Added Tax", by John Wieferman, in Rethinking Texas Taxes: Final Report of the Select Committee on Tax Equity, Vol. 2 (Select Committee on Tax Equity, Austin, Texas, January 1989), p. 247.

[25]"The Michigan Business Tax Replaces the State's Much Vilified SBT", by Steven E. Grob and Wayne D. Roberts, in Journal of Multistate Taxation and Incentives, Vol. 17, No. 7, October 2007. Reproduced by permission of Journal of Multistate Taxation and Incentives.

[26]Derived from the Grob and Roberts report and from "A Summary of Senate Bill No. 94, and House Bills 4369-4372 As Enrolled", prepared by the House Fiscal Agency, July 1, 2007. Available on the Internet at http://www.legislature.mi.gov.

The combined reporting requirement only applies to U.S. members of the unitary business. Michigan uses the sales factor to allocate and apportion income or gross receipts of a unitary business.[27] Giving more weight to the sales factor (in Michigan's case 100%) in the apportionment formula is promoted for economic development in order to attract more investment to the state, either by expansion of existing multistate businesses or the location of new multistate businesses in the state. Giving greater weight to sales in the apportionment of income increases the tax on some multistate corporations and decreases it on others; it has no effect on businesses domiciled in the state. The sales factor benefits businesses that have more sales in other states than in the taxing state. Gross receipts from the sale of services are sourced to Michigan in proportion to the benefits of the services that are received in Michigan.

Entities exempt from the new taxes include all governments; charitable and educational institutions exempt from federal income taxes; nonprofit cooperative housing associations; the production of agricultural goods; farmers' cooperatives; and a few others.

Insurance companies and financial institutions are also exempt from both taxes. However, insurance companies will pay a tax of 1.25% (up from 1.07%) of gross direct premiums written, and financial institutions will pay a franchise tax of 0.235% of net capital. Insurance companies will be subject to sales and use taxes.

The legislation retained most economic development credits and several miscellaneous credits under the single business tax. It also created several new credits, including but not limited to a compensation credit, an investment credit, a research and development credit, a credit for firms adding at least 20 employees, and a credit for inventory of new automobile dealers.

Property tax relief

The Michigan tax on personal property has been criticized as an impediment to businesses locating within the state, particularly since nearby states have reduced or eliminated their personal property taxes.[28] Senate Bill 94 provides a refundable personal property tax credit for certain business personal property:

- 35% of personal property taxes paid after December 31, 2007, on industrial personal property located on industrial real property;
- for tax year 2008, 23% of utility property taxes paid on certain telephone property. For subsequent tax years the credit is 13.5% of telephone utility property.
- 10% of utility property taxes paid after December 31, 2007, on natural gas pipelines.

The credit is not allowed for property taxes paid on commercial personal property.

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[27] The sales factor is a fraction, the numerator of which is the taxpayer's total sales in Michigan during the tax year and the denominator of which is total sales everywhere. Montana uses a three-factor formula to apportion income: property, payroll, and sales. Each factor is given equal weight.

[28] Grob and Roberts, *op. cit.*

Additional property tax relief was contained in several other bills. The passage of the new business taxes and these other property tax bills were contingent on each other. House Bill 4369 exempts industrial personal property from the 18 school operating mills and exempts commercial personal property from 12 of the 18 school operating mills. House Bill 4370 exempts industrial personal property from the 6-mill state education tax. House Bill 4371 exempts industrial personal property subject to the industrial facilities tax from the portion of that tax attributable to the school operating mills and the state education tax. House Bill 4372 provided that "[i]t is the intent of the legislature to address potential revenue shortfalls for the payment of tax increment financing obligations that may result from the [property tax] exemptions".

Revenue implications

The legislative package is designed to be revenue-neutral with respect to the elimination of the single business tax and to the property tax cuts. The School Aid Fund is reimbursed for the property tax exemptions (12 or 18 mills) from the school operating mills.

The legislation also provides a taxpayer rebate if revenue from the new taxes and the former single business tax exceeds a specified amount. If collections from the Michigan Business Tax (excluding the tax on insurance companies) and the single business tax exceed $2.398 billion in fiscal year 2008, half of the excess will be deposited in the state's budget stabilization fund and the rest will be returned to business taxpayers. In fiscal years 2009 and 2010, the $2.398 billion revenue limit is adjusted by 1% and 2.01%, respectively, and by the percentage change in Michigan personal income from the previous year.[29] If the excess revenue is less than $5 million, the excess is deposited in the stabilization fund.

Will the new tax scheme do what it is supposed to do?

The new Michigan Business Tax is designed to shift a significant portion of the state's business taxes to businesses located out of state. This is accomplished by the 100% sales apportionment factor. Other objectives were to have a less complicated tax structure that was more in line with other states and less subject to litigation.[30]

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[29] *Ibid.*

[30] *Ibid.*