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## ALTERNATIVE STATE BUSINESS TAX SYSTEMS: A COMPARISON OF STATE INCOME AND GROSS RECEIPTS TAXES

Nationally, there has been increased attention at the state level in a gross receipts tax as a replacement for the standard state corporate income tax.<sup>1</sup> Washington State has imposed a gross receipts tax since 1935.<sup>2</sup> In 2005, this tax structure was also adopted in Ohio. And in May 2006, Texas lawmakers voted to replace their franchise tax with a gross receipts tax. The reasons given for such a move include tax simplification and increased economic competitiveness, very much the same forces that are fueling the discussions of a Federal sales tax.

The expected gains associated with a move to a gross receipts tax are relative to the original tax system being replaced. Both Ohio and Texas replaced a franchise tax<sup>3</sup> with the gross receipts tax. In most other states, the main form of state corporate taxation is a modified version of the Federal corporate income tax. Since there are substantial differences between an income tax and a franchise tax, it is not clear that states currently taxing corporations according to their corporate income would benefit by moving to a gross receipts tax.

This paper compares a gross receipts tax with the standard state corporate income tax. The basis for

comparison involves several criteria such as the relative tax burdens, efficiency, the degree of progressivity, revenue stability and adequacy, complexity and administrative costs. To provide a benchmark for our comparison of the different features of the state corporate income tax and gross receipts tax, the paper begins with a general discussion of the criteria of a sound tax system followed by a discussion of both the common form of the state corporate income tax and the gross receipts tax.

### What is a Sound Tax System?

The American Institute of Certified Public Accountants (AICPA, 2001) developed ten “guiding principles” of good tax policy; principles that aid the evaluation of proposals to adjust or change tax rules and tax systems. These principles include equity/fairness, certainty, convenience of payment, economy of collection, simplicity, and neutrality. Other principles include economic growth and efficiency, transparency and visibility, minimum tax gap, and adequate government revenues.

## **Gross Receipts Taxes**

A gross receipts tax, also referred to as a turnover tax, is measured on the value of products sold, gross proceeds of sale (or total revenue), or gross income of the business. The specific definition of a gross receipts tax base is decided by officials when designing the tax. There are currently two gross receipts tax systems operating in the United States, one in Ohio and one in Washington State. Both bases include gross receipts from the sale of goods and services and from the operation of a business. The Washington State base includes all revenue to the firm including interest income, dividend income, rental and royalty income, and both short and long term capital gains. In this way, the Washington State tax is actually a gross income tax since all forms of income are subject to tax. The Ohio tax base, on the other hand, includes gross receipts from the sale or operation of the business as well as rental and royalty income but excludes from the base interest earnings, dividends received, and capital gains.<sup>4</sup> Thus, the Ohio version of the gross receipts tax bears more resemblance to a business sales tax or consumption tax since it does not tax the return to capital.

## **State Corporate Income Tax (SCIT)**

In 2004, the major tax on corporations in 40 out of 50 states was some form of a corporate income tax. In general, this is a tax on corporate income as defined at the Federal level with several modifications imposed at the state level. For instance, the Federal definition of corporate income allows for more generous depreciation deductions than many states.<sup>5</sup> By the same token, some states offer deductions that are not allowed at the Federal level.<sup>6</sup> After computing the state corporate income tax base, corporate income is apportioned to represent the percent of total income that is earned in the state. The state tax rate, significantly lower than the 35 percent Federal rate, is applied to this adjusted, apportioned base to yield a firm's state tax liability.

## **Advantages of Gross Receipts Taxes over the State Corporate Income Tax**

A gross receipts tax has some advantages over a corporate income tax. First, it is usually, as is the case in both Ohio and Washington, imposed on all business entities. This is not a necessary characteristic of the gross receipts tax as it could be applied to only a select type of business entities. Second, the wide tax base makes it a more stable source of revenue. Third, since a gross receipts tax is not a tax on net income or profits, it does

not penalize business entities for being profitable. Lastly, while the gross receipts tax can be levied in a very simple form, both the Washington and Ohio versions contain fairly intricate rules.

## **Disadvantages of Gross Receipts Taxes**

A major disadvantage of the gross receipts tax is that though it may not be passed on to consumers directly, it can be and probably is passed on to consumers indirectly via price increases. This effect can lead to tax cascading or pyramiding in which taxes are imposed upon earlier taxes. The cascading effect increases as the number of taxable transactions in the production process increase. Because of the cascading, gross receipt tax systems impose a lower burden on vertically integrated firms or production processes with fewer steps from beginning to end, such as services. Another disadvantage of the gross receipts tax is that firms can have a positive tax liability even when they do not make a profit. That is because a firm's tax liability under a gross receipts tax is not reduced for the cost of business inputs, labor, interest payments, or capital investments. This tends to be particularly burdensome for startup firms with low sales but high business costs. This issue has been addressed by the Washington and Ohio tax systems by imposing filing thresholds that exempt a base level of gross receipts.

## **Empirical Comparison of a Gross Receipts Tax with the State Corporate Income Tax**

This paper considers the potential effect of replacing a traditional state corporate income tax with a gross receipts tax. However, based on the results of the analysis presented in this paper, the gross receipts tax is not a complete elixir for the woes of the state corporate income tax. The results are summarized in Table A. In some categories, the gross receipts tax comes out as an improvement over the traditional SCIT when judged against the criteria of a sound tax system. For instance, the tax base of the gross receipts tax is much broader and inclusive than that of the corporate income tax. Furthermore, the gross receipts tax base is less volatile over time compared to the corporate income tax. On the other hand, based on this analysis, the gross receipts tax burden is larger on average and regressive relative to the traditional corporate income tax. Our last measure of complexity found that while conceptually the gross receipts tax is less complex, this tax is not immune to the pressures to offer special preferences to firms and industries. The more any tax system gives in to these pressures, no matter how justified, the more complex the tax system becomes. Based on these findings then, we cannot say that the gross receipts tax system is an improvement over an existing state corporate income tax. This

**TABLE A. SUMMARY OF TAX MEASURES**

<b>Measure/Tax System</b>	<b>Corporate Income Tax</b>	<b>Gross Receipts Tax</b>
Size of Tax Base	only applies to corporations; allows deductions for the cost of earning income; size of base varies from 0.44 percent to 5 percent of gross receipts;	is levied on all business entities, has fewer deductions and exclusions compared to traditional CIT;
Size of Tax Burden Per Firm	average burden for firms in sample=1.0 percent of total assets;	average burden for firms in sample=1.7 percent of total assets;
Distribution of Tax Burden	generally progressive in nature; higher estimated burden for manufacturing firms;	generally regressive in nature; higher estimated burden for manufacturing firms;
Revenue Stability	coefficient of variation for all firms = 21 percent; for manufacturing firms = 30 percent;	coefficient of variation for all firms = 13 percent; for manufacturing firms = 7 percent;
Complexity	very complex with considerable compliance costs for firms; has a long history of special preferences for firms and industries;	conceptually less complex than the traditional CIT but not immune to pressures to offer special treatment for firms and industries;

will depend on the particular characteristics of the state and their priorities in setting tax policy.

## NOTES

1. See Mikesell (2007) for a similar discussion of this topic.
2. Delaware, West Virginia, and Hawaii also levy taxes on gross receipts. In the case of Hawaii and Delaware, the tax is levied in addition to the corporate income tax for those doing business in the state. In the case of West Virginia, the tax is levied on the receipts from the provision of health care services.
3. A franchise tax is a privilege tax imposed on each corporation and limited liability company chartered or organized in a jurisdiction (or state) or doing business in that jurisdiction. The base varies from state to state and may consist of net taxable capital, net earned surplus, income, or a flat fee. "Corporation" also includes (but is not limited to) a bank, state limited banking associations, as well as savings and loan association.
4. Interest on credit sales is included in the base. Gross receipts from the sale of real property located in Ohio are also included in the base.
5. These deductions include the Bonus Depreciation and the Qualified Productions Activity deduction. These deductions were not adopted by all states and consequently firms operating in some states have to add back this deduction at the state level when determining their state corporate income.
6. Most states allow companies special tax credits.

## REFERENCES

- AICPA. (2001). *Guiding Principles for Evaluating Tax Proposals*. New York: American Institute of Certified Public Accountants, Inc.
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