State Value Added Taxes

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Outline

- A broad-based state-level value-added tax
- Reasons cited for adopting a state VAT
- Concerns about a state VAT
- Analyzing a Business Activities Tax (BAT) for Minnesota
- Will the VAT be a part of future reforms?

A broad-based, state-level VAT

- Flat-rate value-added tax collected from all businesses.
  - Base = payments to the factors of production
  - Base = labor comp. + profits + interest paid + rent
  - Base = receipts - purchases from other businesses
- With a full deduction for capital purchases, it is a form of consumption tax, not an income tax.

Related taxes

- [The late] Michigan Single Business Tax (SBT)
- New Hampshire Business Enterprise Tax (BET)
- Provincial VATs (Canada, India)
  - Keen: "…while VAT is widely heralded as a good tax for countries trading with one another it is also generally regarded as a bad tax to give to lower-level jurisdictions in a federation…. Can the VAT be run in a federal system other than as a federal tax?"
- Michigan Modified Gross Receipts Tax (if purchases of services were deductible)

Apportionment matters

- For multi-state enterprises, tax base would have to be apportioned.
  - Apportion by in-state sales: destination-based VAT
  - Apportion by origin factors (payroll, property): origin-based tax
- Is the state-level VAT a tax on consumption or a way to tax businesses for the value of public services?
  - What tax(es) would it replace?

Apportionment matters

- McLure: "A BAT apportioned according to sales only is a tax on all sales made in Minnesota, levied at an effective rate that depends on the statutory rate and the ratio of value added to sales throughout the nation."
- Cline and Wilson: A higher apportionment weight on sales➔more of the burden of a state VAT is borne by the state's consumers.
- New Hampshire's approach
  - Add up the portion of labor compensation that is sited in-state and apportioned dividends and interest.

Reasons cited for considering a VAT

- In theory, the VAT is a neutral tax: it doesn't distort business decisions.
- The VAT levels the playing field among business firms, because it is levied on all business types, not just C-corps.
- The VAT might apply to a broader range of out-of-state firms than the state corporate income tax.
- Within the state, if all businesses are registered, the VAT doesn't cascade.

Reasons cited for considering a VAT

- Possibly more stable revenue (because labor compensation accounts for a large percentage of the base).
  - Compensation was 69 percent of the MI SBT base.
- An immediate deduction for capital expenses might encourage investment.
- An origin-based VAT is perceived as a tax on the value of public services the firm uses.
  - Firms benefit from public services (education, transportation services, etc.) in proportion to the amount of labor and capital they use.

Concerns about a VAT

- Imposing an entity-level tax (other than the minimum fee) on all non-corporate businesses would be novel.
- The base might become less stable as an increasing percentage of labor compensation is made up of relatively volatile bonuses and stock options.
- Some businesses will have to pay tax in years that they have no income.
- The VAT is sometimes seen as a tax on payroll, and thus unfair to labor-intensive businesses.

Concerns about a VAT

- A state legislature may enact a tax that is not a pure VAT.
  - Depending on how the tax is apportioned, the VAT base may not represent value-added generated within state.
  - If you step away from the immediate capital deduction, as MI did, it is no longer a consumption tax/VAT.
- Uncertain legal status.
- What are the nexus rules for a VAT?
  - Quill: requires physical presence for sales tax.
  - HR 3220: could require physical presence for VAT.
  - Litigation about nexus standard of MI SBT.

Interest in a VAT in Minnesota

- Considered by the MN legislature in 1997.
  ➔Mandated study of replacing the Corporate Franchise Tax (CFT) with a **Business Activity Tax (BAT)**—a form of subtraction-method VAT.
- In 2005 Growth & Justice proposed replacing the CFT with a 2.5% BAT as part of a package of tax proposals.
- Interest in business tax reform, in general.

Nexus issues

Corporate Franchise Tax: C-corps, domiciled anywhere, that conduct a trade or business in Minnesota.

- Not necessarily with a physical presence in MN.
- PubL 86-272 protects companies that have no physical presence and have solicitation of sales as their only activity.

Sales Tax: Businesses that have a physical presence in MN and make taxable sales in MN

BAT: (Assume) Any firm doing business in MN.

Analyzing the effects of a state-level BAT

- Build a dataset that includes the population of firms doing business in the state.
- Identify the current tax liability for these firms.
- Simulate the BAT base for each of these firms from data elements included in the dataset.
- Apportion the BAT base.
- Calculate the revenue-neutral BAT rate equal to current tax liability divided by the aggregate BAT base.
- Apply the revenue-neutral tax rate to the simulated BAT base and calculate the change in tax liability for each firm.

The database

Current Minnesota filers:
- C-corporations filing a Minnesota Form M-4
- S-corporations filing a Minnesota Form M-8
- Partnerships filing a Minnesota Form M-3
- Individual M-1 filers who reported business income on attached Federal Schedules C (sole proprietorship), E (rental income), or F (farm income)

Non-entity-level filers:
- Additional firms that withheld income tax for employees or remitted sales tax in 1999.
- Excluding businesses already accounted for above.

Omitted businesses:
- PubL 86-272 firms—many are likely included in the above category, but we do not know how many are not.
- S-corps and partnerships below the receipts threshhold—may be included above, and they should file anyway.
- Mail order or e-commerce firms that are not registered for the state sales tax.

The database

Total Businesses Liable for BAT				
Type of Business	**Number**	**1999 CFT Liability**	**Percent**	**Average Tax**
Total C-corps	60,956	$708,177,185	98%	$11,812
Total S-corps	59,815	12,670,783	2	212
Total Partnerships	34,051	5,356,039	1	157
Total Sole Props*	420,498	0	0	0
Total Farms*	84,431	0	0	0
Total Rent-earners*	169,619	0	0	0
Total Other (FI, Coops, LLCs)	2,319	0	0	0
Total Businesses	831,689	$726,204,007	100%	$874

*Each Schedule C, E, or F is counted as a single business taxpayer.

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Revenue-neutral BAT rate

- Replacing the CFT and minimum fee revenues with a broad-based BAT on all firms doing business in Minnesota would have required a BAT rate of 0.71% in 1999.
- Note that the revenue-neutral rate would differ in other tax years, because of differences in CFT revenues and BAT base.

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Revenue-neutral BAT rates

	Revenue-neutral rate
All firms	.71%
All firms, 100K exempt amount	.86%
All firms, $500K exempt amount	1.02%
All firms, $1,000K exempt amount	1.12%
State corporate taxpayers only, 100% sales apportionment	1.58%
State corporate taxpayers, current-law (1999) apportionment	1.45%

Effects by type of firm

- For M-4 filers (C-corps), BAT liability calculated at the revenue-neutral rate is less than CFT liability, generating an overall tax cut for M-4 filers of $391 million.
- About 20,000 M-4 filers have a tax cut, with an average change of -$26,000. About 32,000 M-4 filers have a tax increase, with an average change of about $7,000. About 9,000 M-4 filers had no liability under either the CFT or the BAT.
- All other entity groups are estimated to face aggregate tax increases.

Small business exemption

- Allow each taxpayer, including each member of a unitary group, to exempt the first $X of its BAT base.
- Effect on businesses that pay no CFT or minimum fee (file Schedule C, E, F, sales tax, withholding):

Exempt amount	Revenue-neutral BAT rate	Number paying no BAT (1,000s)	Percent of businesses exempt	Number paying BAT (1,000s)
$0	.71%	0	0%	677
$100K	.86%	542	80.1%	135
$500K	1.02%	538	83.9%	135
$1,000K	1.12%	569	84.1%	107

Will the VAT be considered as part of future state tax reforms?

- Part of the discussion, but movement away from MI SBT dampened enthusiasm.
- To replace what taxes? With what goals in mind?
  - 2009 Gov. Tax Reform Commission: repeal CFT, expand sales and cigarette tax
- Innovations for a destination-based subfederal VAT (McLure, Keen: CIVAT, VIVAT)
- How will the forces that are affecting the corporate income tax base affect the VAT base?
- What is the tax called vs. what it actually is

Will the VAT be considered as part of future state tax reforms?

Considerations:

- Nexus
- Small businesses
- Financial services
- Winning and losing industries
- Apportionment
- Revenue stability over time

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