Corporate Income Tax Reform

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Introduction

Corporate income tax reform activity has significantly increased in Maryland and several other states in the wake of highly publicized cases involving corporate income tax avoidance at both the federal and state levels, including the widespread use of so-called Delaware Holding Companies (DHCs) and related techniques to shift income between states to avoid state corporate income taxes. Aggressive tax avoidance strategies by corporations have contributed, at least in part, to a long-term decline in corporate income tax revenues over the past 20 years relative to total taxes collected and the economy, both at the federal and state levels. The need for additional revenues during the recent economic downturn has led to heightened concern by state legislatures about the vulnerability of state corporate income taxes to aggressive tax planning.

National Trends

Recently, state corporate income taxes have become the subject of renewed interest to both state and federal policymakers. The cause of this elevated interest may be the gradual decline in revenue generated by the tax as compared to other revenue sources, as well as the expansion of electronic commerce and federal tax policy changes that affect state corporate income taxes. While state corporate income taxes represent a relatively small portion of total state tax revenue in most states (less than 5.2 percent of total state tax revenue in 2003), corporate income taxes still generated $28.5 billion in 2003. On average, from fiscal 1994 to 1998, states collected approximately $29.2 billion in corporate income tax revenues − 5.3 percent of all own-source revenues and 22 percent of personal income taxes collected. From fiscal 1999 to 2003, states collected, on average, $29.7 billion in corporate income tax revenues, representing 4.2 percent of all own-source revenues and 16 percent of total personal income taxes collected.

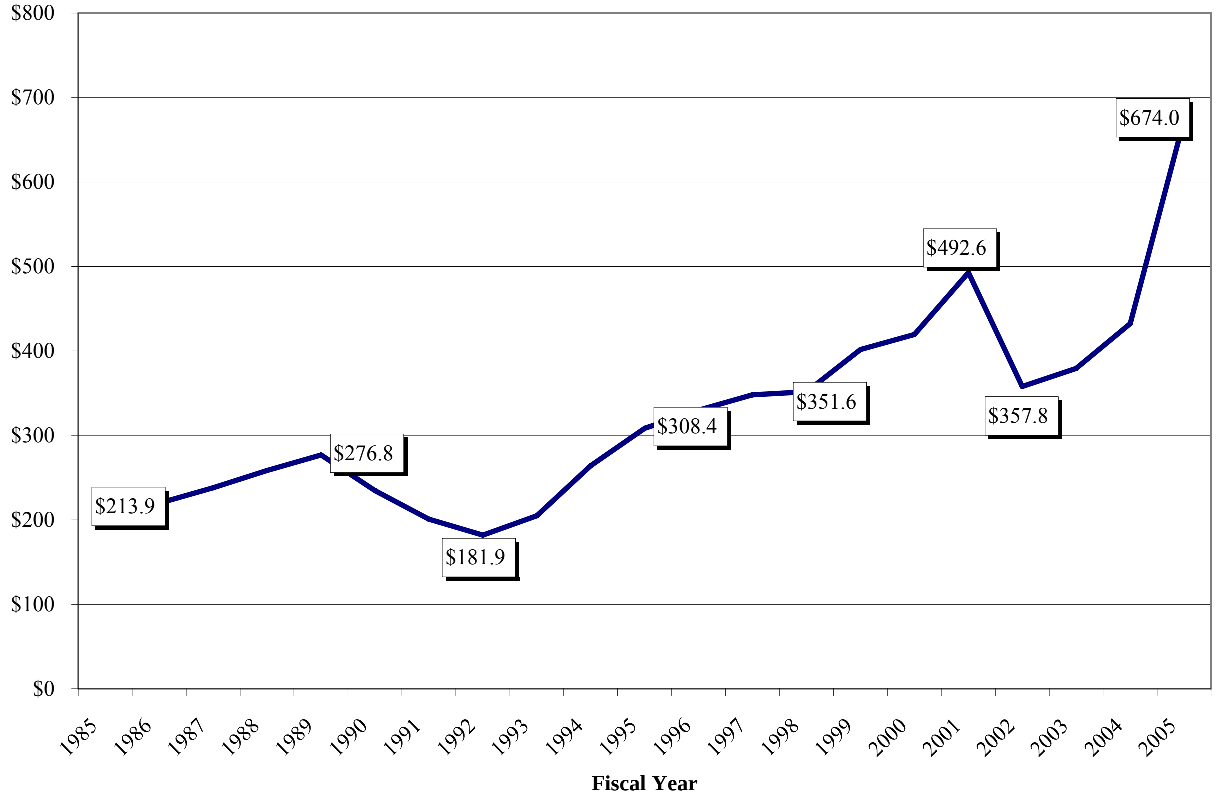
Researchers have employed a variety of measures to assess corporate income tax revenues relative to other factors, including gross domestic product (GDP), corporate profits before taxes, and total taxes collected by states. These measures show that total corporate income tax revenues have declined relative to other state revenue collections and economic activity. For example, from fiscal 1972 to 1981, total state corporate income tax revenues comprised an annual average of 0.43 percent of GDP, compared with 0.33 percent of GDP from fiscal 1994 to 2003.

Maryland's Corporate Income Tax

Each Maryland corporation and every other corporation that conducts business within Maryland must pay the corporate income tax, assessed at a rate of 7 percent. The tax base is the portion of federal taxable income, as determined for federal income tax purposes and adjusted for certain Maryland addition and subtraction modifications, that is allocable to Maryland. Federal taxable income for this purpose is the difference between total federal income and total federal deductions (including any special deductions). The next step is to calculate a corporation's Maryland taxable income. The Maryland taxable income of a corporation that operates wholly within the State is equal to its Maryland modified income. Corporations engaged in multistate operations are required to determine the portion of their modified income attributable to Maryland, based on the amount of their trade or business carried out in Maryland. Corporations are generally required to use either a double weighted sales factor (payroll and property being the other factors) or, in the case of a manufacturing corporation, a single sales factor. The apportionment factor is multiplied by a corporation's modified income to determine Maryland taxable income. The Maryland tax liability of a corporation equals the Maryland taxable income multiplied by the tax rate less any tax credits.

Exhibit 1 lists the total annual corporate income tax revenue collected from fiscal 1985 to 2005, excluding one-time DHC settlement revenues received in fiscal 2005 and one-time tax amnesty revenues received in fiscal 2002.

Exhibit 1
Maryland Corporate Income Tax Revenues
Fiscal 1985 – 2005
($ in Millions)



Source: Department of Legislative Services

Exhibit 2 compares the Maryland corporate income tax with other states in the region. In general, Maryland relies less on the corporate income tax than these states and ranks relatively low in corporate income tax burden measures.

Exhibit 2

Maryland Corporate Income Tax Comparison to Nearby States

	Percentage of Total Taxes			Per Capita		Percentage of Personal Income	
	Percent	Rank	Top Tax Rate	Amount	Rank	Percent	Rank
Maryland	3.6	35	7.00	$66	27	0.2%	39
Delaware	9.2	7	8.70	312	3	1.0%	2
District of Columbia	n/a	n/a	9.98	371	2	0.8%	4
New Jersey	9	8	9.00	128	8	0.3%	11
North Carolina	5.0	19	6.90	80	17	0.3%	20
Pennsylvania	6.6	14	9.99	97	14	0.3%	15
Virginia	3.0	43	6.00	42	44	0.1%	44
West Virginia	4.8	21	9.00	122	10	0.5%	7
U.S. Average	**5.2**			**$98**		**0.3%**	

(1) The percentage of total taxes is for fiscal 2004, tax rate information is for tax year 2005, and tax burden rankings are for fiscal 2002.

(2) For the rankings, 1 indicates the highest.

Source: U.S. Census Bureau; Department of Legislative Services

Since 1985, Maryland corporate income tax revenue changes have diverged from the overall experience in other states. From fiscal 1985 through 1998, Maryland corporate income tax revenues grew more slowly than in other states, increasing by a total of 64 percent compared with 77 percent for all states. From fiscal 1999 through 2003, overall corporate income tax revenues decreased in Maryland and all states, but Maryland experienced a lesser decline of 4.5 percent compared with a national decrease of 7.5 percent.

In fiscal 2005, corporate income tax revenues surged by over 50 percent as compared to fiscal 2004 collections. With this increase, corporate income tax revenues overtook State lottery revenues to become the third largest source of general fund revenues. This increase is in contrast to a long-term trend of decreasing corporate income tax revenues relative to other State revenues. Given the volatility of corporate income tax revenues, it is unclear if revenue attainment will continue at this increased amount or revert to the long-term trend of decreasing importance relative to other revenues.

Factors Influencing Revenues

State Tax Policies

The December 2003 Fiscal Survey of States reported that states, in the aggregate, enacted net tax reductions every year from fiscal 1995 through 2001. Even though these tax reductions are not separated into types of tax by the Fiscal Survey, recent research indicates that part of this reduction includes reduced corporate income tax burdens. The corporate income tax burden decrease has primarily taken two interrelated forms: (1) discretionary concessions that are offered as part of an incentive package to recruit or maintain businesses; and (2) incentives built directly into the tax code. Incentives for automobile manufacturing plants are one example of discretionary concessions, where Tennessee provided $150 million in tax abatements for a Saturn production plant and Alabama provided $300 million for a Mercedes Benz plant and $250 million for a Hyundai plant.

Statutory incentives include rate decreases, credits, and base reducing actions such as altering apportionment factors. Between 1991 and 1993, for example, 33 states enacted or significantly expanded tax incentives related to business location factors. Beginning in the mid-1990s, Maryland created numerous business tax credits for economic development, job creation, and research and development. In 2001, the State allowed manufacturers with multistate operations to apportion income to the State based on a single sales factor instead of the double-weighted sales factor required for all other multistate businesses.

Tax Planning Techniques

Another explanation for the relative decline in state corporate income tax revenues is that corporations are more effectively avoiding state taxes through tax planning techniques. The Multistate Tax Commission (MTC) concluded in a recent study that “various corporations are increasingly taking advantages of structural weaknesses and loopholes in the state corporate tax system.” The MTC estimated that in 2001, states lost $12.4 billion, or 35 percent of total collections, to tax avoidance techniques. Commonly employed tax avoidance strategies include the use of related entities to shield income and taking advantage of differences in state corporate tax policies to create “nowhere” income that is never taxed by any state.

A number of states, including Maryland, allow or require that taxes on income be computed on the basis of the books and records of separate corporate entities without regard to the fact that the entity may be a member of a commonly owned and controlled group of entities functioning as a single business. Corporations have the ability to reduce taxes in an individual state or states by forming entities to either geographically or functionally isolate certain transactions or activities of the business within a separate entity. States have experienced a number of problems with the use of separate entities as a means of avoiding state income taxes.

Tax planning techniques are effective in part because states are not uniform in their corporate income tax policies. States define income differently, allow different deductions and credits, employ different apportionment rules and formulas, and differ in how to combine or consolidate the results of related corporate entities. This lack of consistency creates opportunities for tax planning to take advantage of these differences to create "nowhere" income.

Federal Tax Policies

Federal tax policy can influence state corporate income tax bases as most states rely on federal income for the calculation of state tax liability. Examples of federal legislation that impacted state corporate income tax bases include the Economic Recovery Tax Act of 1981, the Tax Reform Act of 1986, and recent federal legislation enacted since 2001. States, however, can limit the effects of federal legislation by decoupling from federal provisions that decrease state tax bases. Since 2002, Maryland has decoupled from federal provisions regarding bonus depreciation, net operating losses, increased expensing under Section 179 of the Internal Revenue Code, and a deduction allowed for qualified production activities income.

Other Factors

Other possible factors influencing state corporate income tax revenues include economic factors and changes in corporate operations. While cyclical economic effects influence corporate income taxes over the short-term, most researchers do not believe that these effects are responsible for long-term state corporate income tax trends.

The Council on State Taxation (COST), whose members are 575 major corporations engaged in interstate and international business, has asserted that the MTC study overstated the characterization of "tax sheltering" and that it is not possible to separate the revenue declines arising from policy changes as compared to tax avoidance. COST contends that other considerations, such as shifts in operations by corporations overseas, are also contributing to the decrease in state corporate income tax revenues.

Federal and state tax policies also allow for pass-through taxation for limited liability corporations and S corporations. Since 1997, S corporations have been the most prevalent type of federal corporate filing, and these filings have increased at an average annual rate of nearly 9 percent since the enactment of the Tax Reform Act of 1986. Filing as an S corporation allows income and expenses to pass through the corporate structure to shareholders, who are then generally responsible for any resulting tax liability. This treatment is unlike taxable corporations, which incur a tax liability first at the corporate level on their net incomes and capital gains and again when profits are distributed to shareholders in the form of dividends.

Constitutional and Statutory Considerations

The application of state corporate income taxes to multistate corporate enterprises is complex because of the significant federal constitutional and statutory limitations on the authority of states to tax interstate businesses. In addition to federal constitutional requirements that a corporation must have a sufficient connection or "nexus" with the State before the State can tax the corporation, a federal statute, P.L. 86-272, further limits the jurisdiction of states to impose income taxes on interstate enterprises, prohibiting a state from imposing a net income tax on a person's income derived within the state if the person's activities within the state are limited to protected activities (related to the solicitation of orders within the state) as specified in P.L. 86-272.

The U.S. Constitution's Commerce Clause also requires that a state's corporate income tax be "fairly apportioned" in the case of a multijurisdictional corporation. This requirement is reflected in the allocation of an interstate corporation's income among states through formulary apportionment if the multistate operations of the enterprise constitute a "unitary business," i.e., where the operations of the business within the State and outside the State are interdependent and contribute to one another.

Maryland law has long recognized the "unitary business principle" in the taxation of multistate corporations by requiring formulary apportionment to determine the Maryland income of multistate corporations. However, under current Maryland law, the application of the unitary business principle is limited in the case of affiliated groups of related corporations because of the requirement that each separate corporation must file a separate income tax return and determine its own taxable income on a separate basis. For a multi-corporate group, the unitary business principle is restricted to consider only the isolated income and business activities of each separate legal entity. Even though the activities of related corporations may constitute a single unitary business, the affiliated corporations that lack nexus with the State (or are protected from taxation by P.L. 86-272) are not subject to the State's income tax and neither the net income nor the apportionment factors of those affiliated corporations are taken into account on the corporate income tax return of any related corporation that is subject to the tax.

Delaware Holding Company Legislation

In 2004, the General Assembly passed legislation to restrict the ability of corporations to use Delaware Holding Companies to shift income away from the State for tax purposes (Chapter 556 of 2004). Chapter 556 requires an addition modification under the Maryland corporate income tax for the amount of specified payments made to a related party that are deducted for federal income tax purposes. Additional legislation, Chapter 557 of 2004, created a statutory settlement period for the Comptroller to settle DHC-related litigation.

The Department of Legislative Services estimated that Chapter 556 would increase corporate income tax revenues by $55 million on an annualized basis. Based on limited data so far, the Comptroller's Office estimates that Chapter 556 will increase corporate income tax revenues by approximately $60 million annually. The amount of annual revenue gain, however, is expected to decline over time as fewer corporations are expected to utilize these types of transactions and perhaps employ other tax planning strategies. The settlement period netted approximately $199 million in one-time revenues, $151 million for the general fund, and $48 million for the Transportation Trust Fund.

The Delaware Holding Company legislation addressed one well-publicized technique for avoiding state income tax in a "separate reporting" jurisdiction such as Maryland. However, the requirement for separate reporting by each member of an affiliated group of corporations leaves the Maryland corporate income tax vulnerable to other state income tax avoidance strategies. These strategies include other uses of Delaware Holding Companies not addressed by the 2004 Maryland legislation, "transfer pricing" manipulation, and the use of subsidiaries to isolate profitable activities of an enterprise from nexus with the State.

2005 Corporate Income Tax Reform Proposals

During the 2005 session, additional proposals for corporate tax reform were introduced to reduce the vulnerability of the Maryland corporate income tax to tax avoidance techniques. First, House Bill 62 and Senate Bill 403/House Bill 676 would have required mandatory "combined reporting" by affiliated groups of related corporations, in lieu of the separate reporting required under the current tax. House Bill 62 would also have required that foreign affiliates incorporated in a "tax haven" country be included in the combined group for purposes of the Maryland income tax. Proposals for combined reporting were also introduced in the 2003 and 2004 sessions.

A separate proposal was introduced in Senate Bill 748/House Bill 1135, which would have imposed a minimum tax on corporations based on gross receipts or gross profits, similar to the "alternative minimum assessment" adopted in New Jersey in 2002.

Combined Reporting

2005 Legislation

The combined reporting proposals introduced in the 2005 session would have required unitary groups of affiliated corporations to compute Maryland taxable income using the "combined reporting" method instead of the separate entity reporting required under current law. Under combined reporting, the combined income of all members of the unitary group is taken into account as the starting point for determining Maryland taxable income. The combined taxable income is then apportioned to Maryland using the combined apportionment factors of all the members of the group.

Under Senate Bill 403/House Bill 676, the members of the unitary group for purposes of combined reporting would have been determined under the "Water's Edge" method, essentially including within the combined group those affiliated corporations incorporated in the United States and certain other affiliated corporations with a substantial presence in the United States.

House Bill 62, attempting to also address the use of certain "offshore" tax shelters, would have differed from the other two bills in this regard, requiring a "Modified Water's Edge" method for determining the unitary group by including any affiliated corporation in a unitary relationship with the taxpayer that is incorporated in certain "tax haven countries," as specified by the bill.

Other States

Seventeen states currently provide for mandatory combined reporting: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, Utah, and Vermont. In addition, in several other states, under certain circumstances, combined or "consolidated" reporting either is required, allowed at the election of the taxpayer, or may be required at the discretion of the tax administrator. Several states have considered adopting mandatory combined reporting in the past few years; these include Connecticut, Iowa, Massachusetts, Missouri, Pennsylvania, and Wisconsin.

Revenues

Over the years, there has been considerable uncertainty as to the fiscal impact of combined reporting. In the case of corporate income taxes, due to the volatility of profits over time and sensitivity to corporate structure and inter-company transactions, the accepted form of revenue estimation is to directly simulate the tax accounting changes to a representative panel of sample tax returns. Due to the confidentiality of tax return data, however, the Department of Legislative Services lacks access to this data.

The Pennsylvania Department of Revenue recently produced an in-depth fiscal estimate of implementing combined reporting in that state using actual tax data. The Department of Revenue estimated the impact of combined reporting by matching the tax returns of corporations that filed in Pennsylvania to federal return data and data from the Minnesota Department of Revenue, which requires combined reporting.

The Department of Revenue estimated a variety of policies combined with implementing combined reporting; Pennsylvania limits to $2 million the amount of net operating losses a corporation can carry forward. The department estimated that combined reporting would generate an additional $480 million in annual corporate income tax revenues with the net operating loss limitation in place. If the net operating loss provision was repealed, however, combined reporting generated an additional $190 million annually in corporate income taxes.

The Pennsylvania analysis estimated that larger corporations would bear a larger share of the increased tax burden under combined reporting. **Exhibit 3** lists the expected distributional effect by the federal income of a corporation filing in Pennsylvania.

Exhibit 3
Combined Reporting Tax Impact in Pennsylvania, by Federal Income Size

Federal Income	Percentage of Additional Tax Revenues
Negative	-0.5%
$0	0.0%
$1 to $1 million	0.7%
$1 million – $10 million	3.2%
$10 million – $100 million	16.4%
$100 million – $1 billion	63.7%
Greater than $1 billion	16.5%

Source: Pennsylvania Department of Revenue

Unlike Maryland, Pennsylvania does not currently have statutory provisions designed to prevent tax planning strategies employed by utilizing DHCs. The Pennsylvania Department of Revenue, in a separate analysis, estimated that Pennsylvania loses $100 million annually from the use of DHCs.

Legislative Services estimates that combined reporting will increase corporate income tax revenues, but the magnitude of the increase cannot be reliably estimated. Based on revenue estimates for combined reporting in other states, the MTC estimate of Maryland corporate income tax revenue lost to tax sheltering, and the effect of the estimated increase in revenue due to the DHC law, Legislative Services estimates that this increase could range from $25 to $50 million annually, with the lower range of the estimate more likely in the near term. To the extent that corporations employ alternative tax planning strategies in the future not covered by the DHC law, revenue increases from implementing combined reporting will be greater.

Discussion

Combined reporting is said to be the logical extension of the unitary business principle. It has long been recognized that when the in-state and out-of-state operations of a multistate enterprise are interdependent on and contribute to one another so as to constitute a "unitary business," the income of the multistate enterprise that is attributable to a particular state typically can not be accurately reflected by an assignment of income based on a separate geographical accounting that only includes the enterprise's in-state activities. Rather, the income attributable to each jurisdiction is better measured by considering the total income of the entire "unitary business" of the enterprise and apportioning that income to the state based on the operations of the entire unitary business both within and outside the state. The fact that a multistate enterprise may be organized as separately incorporated subsidiaries, instead of divisions within one legal entity, does not alter the rationale for attributing the income of the unitary business among jurisdictions by means of formulary apportionment of the total income of the entire unitary business.

Several benefits have been cited in support of combined reporting. First, it would provide for similar tax treatment of similarly situated multistate enterprises, without regard to corporate structures. By eliminating the different tax consequences resulting from formal differences in corporate structure, combined reporting would reduce or eliminate the effectiveness of using Delaware Holding Companies and other tax avoidance techniques that have been developed to take advantage of the weaknesses inherent in separate reporting. By nullifying the various tax avoidance strategies available to multistate companies under separate reporting, combined reporting would also improve the economic neutrality of the corporate income tax in at least two ways. First, combined reporting would eliminate a competitive disadvantage on exclusively local firms that are unable to take advantage of the cross-border tax avoidance techniques available to multistate firms under separate reporting. Combined reporting also tends to improve the economic neutrality of the tax by reducing the motivation for tax avoidance behavior by multistate firms.

The primary argument made against combined reporting is that the concept of the "unitary business" is overly complicated and could lead to costly and time-consuming litigation regarding the scope of the unitary business. Even in jurisdictions that have had experience with combined reporting for many years, taxpayer disputes regarding the scope of the unitary business that are decades old remain unresolved. In regard to this objection to combined reporting, while for certain corporate groups the scope of the unitary business may be unclear, for many, the scope of the unitary business would not be in question.

Moreover, many of the corporate groups that would be subject to combined reporting in Maryland will have already made a determination as to what constitutes the unitary business of the enterprise for the purpose of combined reporting in other states. Of course, there has also been extensive litigation in Maryland and numerous other separate reporting states regarding the use of Delaware Holding Companies and other related party structures and transactions used to avoid the corporate income tax. Although not as common as in combined reporting jurisdictions, disputes regarding the scope of the unitary business can also occur in separate reporting jurisdictions and have in fact occurred in Maryland.

In some respects, combined reporting would be more complicated to administer than separate reporting. Converting from separate reporting to combined reporting would likely be a challenging transition, requiring a significant educational and clarification process for both taxpayers and the tax administrator.

On the other hand, combined reporting would, in many other respects, reduce administrative burdens on both tax administrators and taxpayers by eliminating the need to examine intercompany transactions. Under separate reporting, aggressive tax enforcement theoretically requires an extensive examination of intercompany transactions between corporations subject to the Maryland tax and their out-of-state affiliates on a case-by-case basis; this is to determine whether income has been improperly shifted through the use of artificially high or low charges for intercompany transactions. Detecting and proving that a company has manipulated intercompany transfer prices can be extremely difficult. Under combined reporting, these intercompany transactions among affiliated companies would be disregarded and not need to be considered.

It has also been argued that adoption of combined reporting would be viewed as business-unfriendly and stifle economic development in the State. Aside from the fact that some businesses have opposed combined reporting, there does not appear to be any evidence in support of this assertion. As noted previously, for exclusively local firms, combined reporting will serve to level the playing field under the corporate income tax by removing an advantage available only to interstate firms to avoid the tax under separate reporting.

In addition, many multistate businesses favor combined reporting as a simplification because it is closer in many respects to the consolidated reporting already used for federal income tax purposes by many corporate groups. In written testimony submitted for House Bill 62 and House Bill 676, the Council on State Taxation noted that for taxpayers as a whole, combined reporting is a neutral concept, under which some will pay more and some will pay less. In addition, studies done in 2004 by Ernst and Young for COST and for the Maryland Chamber of Commerce pointed out that corporate income taxes are only one relatively small portion of the overall taxes paid by businesses to states. According to those studies, the Maryland corporate income tax accounts for less than 5 percent of all the state and local taxes imposed on businesses in Maryland. As a result, even a substantial increase in the Maryland corporate income tax arguably would not have a significant impact on the State's relative tax competitiveness.

It has also been suggested that combined reporting will result in a revenue loss for the State. While it would be expected that some companies will pay less and others will pay more under combined reporting, the suggestion that only companies whose tax would be reduced through combined reporting would immediately comply, and those with increased tax would litigate the question of what constitutes a unitary business is questionable. As noted above, most of the corporate groups that would be required to use combined reporting in Maryland have experience with the method in other states. Although issues regarding the scope of the unitary business can arise, in many cases, the scope of the unitary business is clear.

Alternative Minimum Assessment/Gross Receipts Tax

2005 Legislation

Another approach to corporate income tax reform was proposed in Senate Bill 748/ House Bill 1135, which would have subjected corporations doing business in Maryland to an alternative minimum assessment (AMA). The AMA, modeled after New Jersey's AMA adopted in 2002, would be based on either the gross receipts or gross profits of the corporation. Corporate taxpayers would be required to select either the gross receipts or gross profits assessment method. If the AMA calculated under the method elected by the taxpayer exceeded the State corporate income tax, the corporation would be required to pay the amount of the excess as additional tax. The bills expressly provided that the AMA tax would apply to any corporation with business activity in the State sufficient enough to give the State jurisdiction to impose the tax under the Constitution and statutes of the United States, even if the corporation was protected from the corporate income tax under P.L. 86-272.

Under the gross profits method, gross profits of up to $1 million would be exempt from the AMA, with graduated rates ranging from 0.25 percent for gross profits between $1 million and $10 million to 0.8 percent for gross profits in excess of $37.5 million. Under the gross receipts method, gross receipts up to $2 million would be exempt from the AMA, with graduated rates ranging from 0.125 percent for gross receipts between $2 million and $20 million to 0.4 percent for gross receipts in excess of $75 million. The bills established a maximum AMA for any tax year of $5 million, or $20 million for affiliated groups of corporations.

Under the bills, for any tax year in which the State corporate income tax exceeded the AMA for that tax year, the corporation could claim a credit against the State income tax in the amount of any AMA tax paid for any previous tax year.

Other States

As an alternative approach in response to state corporate tax avoidance, several states have considered an alternative business tax based on gross receipts. Gross receipts taxes have recently been adopted by states either as an alternative minimum to the state corporate income tax (New Jersey, 2002; Kentucky, 2005) or as a replacement for the corporate income tax (Ohio, 2005). These taxes are intended to insure the collection of taxes from profitable companies that pay little or no income taxes because of tax planning techniques that artificially reduce taxable income. In addition, it may be possible for a state to impose a gross receipts tax on a multistate enterprise that has avoided nexus with the state for corporate income tax purposes, because the federal statutory limitations on a state's jurisdiction to tax out-of-state businesses imposed by P.L. 86-272 expressly apply only to net income taxes.

· **New Jersey Alternative Minimum Assessment**

New Jersey in 2002 adopted an AMA for corporations as part of a wide ranging business tax reform bill that also included new fees, short-term revenue raisers, and permanent changes to the corporation income tax designed to close loopholes. The AMA is a provision requiring corporations to pay the greater of the New Jersey corporation income tax or an alternative amount determined based on either "gross receipts" or "gross profit" of the corporation.

At the election of the taxpayer, the New Jersey AMA is based on either gross receipts or gross profits. Allowing the assessment to be based on gross profits (gross receipts less the cost of goods sold) is an attempt to address the problem posed under the gross receipts tax for high volume, low margin businesses. Different graduated rates of assessment are specified in the law, depending on which base the taxpayer elects, with an exemption of $1 million for gross profits or $2 million for gross receipts. Tax rates range from 0.25 to 0.8 percent for gross profits and from 0.125 to 0.4 percent for gross receipts. The maximum AMA for a corporation is $5 million, and for affiliated groups, the combined AMA liability is capped at $20 million.

- **Ohio Commercial Activity Tax**

In 2005, Ohio enacted legislation to completely phase out its corporation income tax (as well as an existing state property tax imposed on inventory, manufacturing equipment, and other business tangible personal property) and instead impose a new business privilege tax measured by gross receipts. The new Ohio commercial activity tax (CAT) is a broad-based, low rate business privilege tax measured by gross receipts. With limited exclusions (e.g., nonprofit organizations, financial institutions and affiliates, dealers in intangibles, insurance companies and affiliates, and some public utilities), the CAT applies to all types of businesses regardless of the type of business organization, including retailers, manufacturers, and service providers (including lawyers, accountants, and doctors). Excluded persons remain subject to the corporate franchise tax or other special state taxes for certain industries. For two years, the sale of motor fuel is exempt from the tax.

Gross receipts subject to the tax include most business types of receipts from the sale (or rental) of property or for the performance of services, not including wages, interest, dividends, or capital gains. The CAT applies to gross receipts that are sourced to Ohio under specific rules set forth in the legislation. Receipts from the sale of property are taxable if the property is delivered in the state, and receipts for services are apportioned to the state based on where the purchaser benefits from the service, based primarily on the physical location where the purchaser uses. The legislation states that the new tax is not subject to P.L. 86-272.

Affiliated entities can elect to file as a "consolidated taxpayer," in which case receipts received between members of the group are not subject to the CAT but all affiliated entities must be included in the group, even if they lack nexus with the state. If an affiliated group does not elect to file as a consolidated taxpayer, it must file as a "combined taxpayer," in which case only those members that have nexus to Ohio are included, but all intercompany receipts between members of the group are included in the tax base.

The Ohio CAT is being phased in over five years. The CAT on the first $1 million of receipts is a flat $150, and taxpayers with receipts under $150,000 are exempt from the tax. When fully phased in, the rate of the CAT on gross receipts over $1 million will be 0.26 percent. By statute, the CAT rate is subject to upward or downward adjustment by the Tax Commissioner if actual revenue collections from the tax vary by 10 percent or more from projections.

· **Kentucky Alternative Minimum Tax**

In 2005, Kentucky enacted legislation to impose an AMT on corporations and other business entities that are subject to Kentucky's corporate income tax. The Kentucky alternative minimum tax is the lesser of an amount based on gross receipts (9 ½ cents per $100 of gross receipts) or an amount based on Kentucky gross profits (75 cents per $100 of Kentucky gross profits). Kentucky corporate taxpayers are also subject to a minimum tax of $175. "Gross receipts" for purposes of the tax is the numerator of the sales factor used for the apportionment formula under the net income tax, and "Kentucky gross profits" equals gross receipts reduced by returns and allowances less the cost of goods sold. Certain organizations are exempt from the alternative minimum tax, including regulated investment companies, public service corporations, and qualified exempt organizations, but there are no exemptions for any amount of gross receipts or gross profits. The Kentucky AMT rates apply beginning with the first dollar of gross receipts or gross profits.

Revenues

Based on the total amount of AMA tax revenues collected by New Jersey in tax year 2002, the adoption of an alternative minimum assessment in Maryland as proposed in Senate Bill 748/House Bill 1135 could increase annual general fund revenues by approximately $128 million, and Transportation Trust Fund revenues could increase by approximately $41 million annually.

Discussion

Several potential benefits have been cited in support of gross receipts taxes on businesses. First, the "benefits principle" of taxation – that the beneficiaries of public services should pay for those benefits – arguably favors a gross receipts tax over a net income tax because profitability is not necessary for firms to benefit from public services. In addition, the use of a gross receipts tax base would provide a more stable revenue source because it would not be influenced by dramatic fluctuations in short-term corporate profits. A gross receipts tax would also be simpler in some respects, with lower compliance and administration costs, because it does not involve the complex determination of net income. A broad base and low tax rates, typical under a gross receipts tax, are cited as additional benefits.

On the other hand, gross receipts taxes on businesses are subject to criticism as violating several important principles of good tax policy. The most fundamental of these criticisms is that any "economic neutrality" purportedly provided by the broad base and low rates under a gross receipts tax is arguably illusory. In contrast to a retail sales tax, which in theory applies only to sales to ultimate consumers (with exemptions for purchases for resale and for purchases for use in production activities), a gross receipts tax applies at each level of production or distribution, resulting in potential multiple layers of taxation for various products or services before they reach the ultimate consumer. Because of this possibility of tax "pyramiding," the burden of gross receipts taxation can fall indiscriminately and unevenly for different products and services.

The pyramiding of the tax under a gross receipts tax also tends to favor large, vertically integrated businesses which are able to avoid multiple layers of taxation under a gross receipts tax. A gross receipts tax can also violate economic neutrality by affecting different industries differently, with a heavier tax burden on low-margin industries dependent on large volume and high receipts for profitability.

Gross receipts taxes have also been criticized as being unfair because they are not based on the "ability to pay." Because it applies to both profitable and unprofitable businesses, a gross receipts tax could drive a marginal or start-up enterprise out of business, ultimately reducing competition. The apparent simplicity in the administration of a gross receipts tax may also be illusory. Although "net income" would not need to be calculated, the need to allocate receipts of a multistate enterprise would introduce complexity. In addition, the apparent simplicity of gross receipts taxes would be reduced if separate tax rates were provided for different industries having different profit margins, to avoid having the tax burden fall more heavily on low-margin industries.