Alternate Business Taxes

Business Activity Tax. During the 1996 and 1997 sessions, the Senate Tax Committee included a business activity tax (BAT) in its omnibus tax bill. In 1996, the BAT provision was eliminated on the Senate floor; however, in 1997, the Senate included a BAT as part of its property tax reform legislation. In the end, the Legislature agreed to study the BAT.

A BAT is a tax paid by all businesses regardless of their legal status (C-corporations, S-corporations, partnerships, sole proprietorships, etc.). Its tax base will vary depending on how the law is drafted, but generally, it includes compensation, the value of employee benefits, other taxes paid and net income. Deductions include capital expenditures and a standard exemption ($500,000 in the 1997 Senate bill). The BAT also includes an apportionment formula for determining how much of a multistate business's activity should be allocated to Minnesota. The apportionment formula used in the 1997 Senate tax bill was 100-percent sales, i.e. the percentage of a company's sales made to Minnesota customers.

Proponents of a BAT believe it is a way to tax companies that sell goods or provide services in Minnesota but have no physical presence in the state. The proponents hope that a significant percentage of the revenue generated from a BAT would come from out-of-state firms; however, not all companies that would have a Minnesota BAT liability will be easily identified. It is unclear whether the theoretical revenue estimates will ever be realized.

Another common argument for adopting a BAT is that business's share of state tax revenue is declining. Proponents use the corporate income tax as proof of their claim. It has declined from 10.4 percent of total state tax revenue in FY 1977 to a projected 5.6 percent in FY 2006. However, if the sales tax on business inputs and the statewide property tax are included, Minnesota businesses are expected to provide a greater share of Minnesota's state tax revenue in FY 2006 than 28 years earlier – an estimated 24.2 percent in FY 2006 compared to 19.4 percent in FY 1977. This analysis does not consider the trend of companies changing their legal status from C-corporations that pay the corporate income tax to S-corporations that do not but rather pay taxes through the personal income tax.

Business Entity Tax. A business entity tax (BET) is also a tax paid by all types of businesses. The tax base is federal gross income plus the cost of goods sold less pass-through income (income from partnerships, S-corporations and limited liability companies). This amount is apportioned based on the percentage of a firm's Minnesota sales to total sales. Unlike the BAT, there is no standard exemption or a capital expenditure deduction. A BET would likely have a low rate because the tax base is very broad.

Proponents of a BET believe one of its virtues is that all businesses would pay the tax. They argue that this is appropriate because all businesses benefit from government services. In other words, a BET is based on a benefits test. In addition, a BET would not be subject to the same nexus standards as Minnesota's corporate income tax. This expands the reach of the state by allowing it to tax companies that sell into Minnesota but have no physical presence in the state.

Gross Receipts Tax. A gross receipts tax operates by taxing all receipts of a business, occurring every time a product changes ownership during all stages of production through final distribution. Gross receipts taxes violate the tax policy principles of transparency, fairness, economic neutrality and competitiveness. These taxes lack transparency and affect: business sellers by making products less competitive; purchasers by making products more expensive; and workers by lowering wages and employment opportunities. Gross receipt taxes are unfair because they do not treat similarly situated taxpayers similarly. These taxes unduly impact start-up businesses, low-margin enterprises and unprofitable firms. Businesses that also have purchases from in-state suppliers are also further punished by adding another layer of tax on their business inputs. Gross receipts taxes are not economically neutral because they influence business decisions and discriminate against businesses that do not have vertical integration capacity. Gross receipts taxes make businesses less competitive, particularly when these businesses compete against other national and international businesses that are not subject to these

pyramiding taxes. When gross receipts are built into a business' production process, the effective tax rate can be more than three times the statutory effective rate.

Business taxation study. The 1997 Legislature directed the Legislative Coordinating Commission (LCC) to conduct a study of business taxation. The original charge of the study was to analyze the corporate franchise tax, the sales tax on capital or other business inputs and the business property tax, and look at alternative methods of taxing business such as a business activity tax. The study ended up analyzing the impact of eliminating the corporate income tax and minimum fee and implementing a BAT in a revenue neutral manner. The results of the study show that, for tax year 1999, a BAT of 0.71 percent would be needed to eliminate the corporate income tax. If a $100,000 small business exemption is included, the rate would have to be 0.86 percent. The following are some general conclusions of the study:

- The study estimates that the revenue neutral rate of 0.71 percent would reduce the tax liability of almost 20,000 C-corporations, 5,000 S-corporations and 8,000 partnerships. However, about 26,500 C-corporation tax returns, 53,000 S-corporation returns, 23,500 returns with partnership income, 420,000 returns with sole proprietor income, 84,000 returns with farm income and 169,500 returns with rental income would pay the same or have a tax increase.
- The study analyzed the impact of a BAT that would be assessed on C-corporations only. The revenue neutral tax rate would have been 1.58 percent. Under this analysis, industries with aggregate tax reductions were: management of companies, finance and insurance, utilities, manufacturing, information, and real estate. Industries with aggregate tax increases were health care, professional and technical services, mining, retail trade, construction, food services, transportation, other services, agriculture, educational services, administrative and waste services, arts and entertainment, and wholesale trade.
- If a $100,000 small business exemption is included, the study estimates that 588,393 out of 831,639 businesses would be exempt from the BAT. Most of the exempt businesses (92 percent) represent farmers, sole proprietors and rent earners. Even with a $100,000 exemption, the study predicts that 37,530 C-corporations would pay the same or have a tax increase.

Other potential tax swaps. The following is a brief comparison of two other potential tax swaps:

- **BAT vs. business sales tax.** The business sales tax discourages or makes it more difficult for firms to upgrade their capital equipment. By allowing direct expensing of capital purchases, a BAT would encourage investment in capital goods. All of the businesses that could potentially have a BAT liability would benefit from eliminating the business sales tax; however, some manufacturers could see an increase in tax burden because their purchases of capital equipment already are exempt from the sales tax.
- **BAT vs. commercial/industrial property tax.** Revenue from a BAT could be used to eliminate the new statewide property tax. However, doing so might link the BAT to education because the growth of the statewide property tax was initially dedicated to K-12 and higher education.

Michigan's experience. In 1953, Michigan adopted a business activity tax at a rate of 0.4 percent. In 1959, the rate increased to 0.775 percent. During the 1960s, organized labor lobbied to repeal the BAT and replace it with a corporate income tax because they saw it as a tax on labor. The BAT was never repealed; however, in 1967, Michigan adopted a personal and corporate income tax. Finally, in 1975, the Single Business Tax (SBT) was enacted at a rate of 2 percent. It replaced the corporate income tax, financial institutions income tax, corporate franchise fee and four other business taxes and fees. As enacted, the only exemption to the SBT was for small businesses. In 1998, more than 20 exemptions and credits existed and the tax rate was 2.3 percent. In 1999, Michigan began phasing-out the SBT. The tax rate was scheduled to decrease 0.1 percent per year until the tax was eliminated. Due to budget deficits, Michigan suspended the phase-out of the SBT. In 2006, Michigan eliminated the SBT. In mid-2007, Michigan expanded its tax base to include 58 new services, which would generate $614 million/year in revenue. Seventy-four percent of the new revenue generated would have been business-to-business service transactions. On December 1, 2007, however, this law was repealed and replaced by a 21.99-percent Michigan Business Tax. This 21.99-percent surcharge is imposed after allocation or

apportionment of Michigan income, but before the tax liability reduction due to credits available. The surcharge is capped at $6 million per taxpayer for any single tax year

Growth and Justice Study: In 2004, the Growth and Justice think tank studied Minnesota's tax system and made recommendations to improve its progressivity and competitiveness. Its recommendations consisted of two restructuring proposals, one of which includes a business activity tax. That proposal had the following components:

- Use federal adjusted gross income as the starting point for the Minnesota return rather than federal taxable income.
- Increase the top marginal rate to 9.5 percent.
- Eliminate the corporate income tax.
- Eliminate the sales tax on most business purchases.
- Create a business activity tax with a rate of 2.5 percent.
- Broaden the sales tax to consumer services, untaxed goods and clothing and reduce the rate to 4.2 percent.

Growth and Justice argues that a business activity tax would be a much simpler method of taxing business. A similar tax in New Hampshire has a form that is one-half page in length. It also argues that the tax would favor firms that expand Minnesota's economy and will help state revenues keep up with economic growth. However, it also recognizes that this proposal would be a net tax increase for many businesses and the tax's simplicity could erode over time like the experience in Michigan.