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Nevada May Consider New Business Taxes

By
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Introduction

Fewer states have been hit harder by the present recession than Nevada. A boom illustrated most prominently in the tourist and construction industry saw the state's population grow by a third since 2000, but that has now turned to bust.[1] Wagers in the state's casinos have fallen a third from their 2006 peak, tax revenues have dropped sharply, and the state has the highest foreclosure rate (about 1 percent) and the highest unemployment rate (about 13 percent) in the nation.[2]

Many experts believe that Nevada is well positioned for strong growth in the future, and glimpses of economic recovery can be seen now.[3] However, the lengthy period of high growth rates carried over into budgeting assumptions, making it difficult to adjust to the recession's period of revenue stagnation. This has created understandable concern about balancing the state's budget while maintaining necessary services and not undermining recovery and growth. While the state has a relatively good tax structure, its tax burdens and collections are about middle-of-the-pack among the states.[4]

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[1] Andrew Clinger, "Legislative Commission's Budget Subcommittee Executive Budget Overview," Department of Administration (Jan. 25, 2011), http://budget.state.nv.us/budget_2011_13/Budget%20Overview.pdf.
[2] *Id.*
[3] *See, e.g.*, Stephen P.A. Brown, Ph.D., *et al.*, "Nevada Economic Conditions and Outlook 2011," University of Nevada, Las Vegas Center for Business and Economic Research (Apr. 2011), http://cber.unlv.edu/publications/CBER-NVEconomicOutlook-Apr2011.pdf; Small Business & Entrepreneurship Council, "Small Business Survival Index 2010," (Dec. 2010); Jennifer Baumer, "Nevada's Workforce in Today's Economy," *Managed Pay* (Mar. 2010), http://www.managedpay.com/index.php?option=com_content&view=article&id=105:nevadas-workforce-in-todays-economy&catid=48:news&Itemid=85; "The Way We'll Work," TIME (May 25, 2009) ("Job Migration: Where the Jobs are Going"); Jonathan Williams *et al.*, RICH STATES, POOR STATES, American Legislative Exchange Council (3d Ed. 2010).
[4] *See 2011 Facts & Figures: How Does Your State Compare?*, Tax Foundation (2011), at http://www.taxfoundation.org/publications/show/2181.html (ranking Nevada as 34th in state and local tax burden per capita, 49th in state and local tax burden as a percentage of income, 34th in state tax collections per capita, 48th in state revenue per capita, and 38th in state and local revenue per capita).

In January 2011, Gov. Brian Sandoval (R) proposed a 2011-13 two-year budget of $16.71 billion in total spending, a $1.44 billion reduction over the previous biennium.[5] The state's General Fund, which represents just over a third of total expenditures, would drop from $6.09 billion to $5.8 billion between the two bienniums.[6] Explaining why he chose spending cuts instead of tax increases, Sandoval said that "Nevada families and businesses have made do with less through three long years of economic downturn, and it is my belief that state government must continue to do the same."[7]

In May, brighter revenue numbers and additional Medicaid funds enabled Sandoval to pledge an additional $440 million, including $270 million for state education.[8] However, members of the majority-Democratic legislature called for $650 million more in spending, financed by higher taxes.[9] (Nevada is one of seven states without a state corporate income tax, and one of only three states with no state-level business activity tax.) Also, a number of temporary tax increases enacted in 2009 are set to expire on June 30, 2011.[10]

Some of these ideas for new or expanded taxes have focused on business, including a corporate income tax, a gross receipts tax similar to Washington's or Ohio's, or a "margin" tax similar to Texas's.[11] Sandoval, however, has pledged not to raise taxes.

Proposed Taxes Would Drop Nevada's Rank on the *State Business Tax Climate Index*

Our [2011 *State Business Tax Climate Index*] ranked Nevada 4th in the country, the highest of its immediate neighbors.[12] The Silver State's lack of an individual or corporate income tax eliminates the compliance burdens and deadweight loss associated with an entire tax. Despite a relatively high sales tax, overall the state's tax system offers a simpler, more stable, and more competitive tax environment relative to other states. (See Table 1.)

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[5] "State of Nevada Priorities and Performance Budget 2011-13 Biennium," http://budget.state.nv.us/budget_2011_13/ppb/2011-2013%20Priorities%20and%20Performance%20Budget.pdf.

[6] *Ibid.* This is a combination of $5.34 billion in revenue collections combined with other reserves and other sources.

[7] Letter from Gov. Brian Sandoval to Members of the Senate and Assembly (Jan. 20, 2011), http://budget.state.nv.us/budget_2011_13/budget_book/2011-2013%20Executive%20Budget.pdf.

[8] Ed Vogel, "Governor reasserts raising taxes would hurt state's 'fragile economic recovery'," *Las Vegas Review-Journal* (May 3, 2011), http://www.lvrj.com/news/governor-sandoval-pledges-not-to-raise-taxes-in-televised-budget-speech-121218028.html.

[9] Nevada News Channel has posted the proposal PowerPoint at http://www.nevadanewschannel.com/userfiles/file/Reconstructing%20Nevada.pdf.

[10] Increase of the state's payroll tax from 0.63% to 1.1%, with a reduced 0.5% rate on the first $250,000 of a company's payroll; increase of state sales tax by 0.35%; increase of hotel tax from 10% to 13%; 10% increase in car registration taxes; and doubled annual business license fees. The net effect of these increases was projected to be $1.001 billion over two years.

[11] *See, e.g.*, Amy Hamilton, "Nevada Democrats Outline $1.5 Billion Tax Package," *State Tax Today* (May 6, 2011), http://services.taxanalysts.com/taxbase/tbnews.nsf/Go?OpenAgent&2011+STT+88-24; Geoffrey Lawrence, "One Sound State, Once Again," Nevada Policy Research Institute (Jun. 1, 2010), http://www.npri.org/publications/pub_detail.asp?id=667.

[12] *See* Kail Padgitt, "2011 State Business Tax Climate Index," *Tax Foundation Background Paper* No. 60, at 41 (Oct. 2010), http://www.taxfoundation.org/research/show/22658.html.

Table 1: Nevada and Neighbors' *State Business Tax Climate Index* Ranks

State	2011 *Index* Overall Rank	2011 Individual Income Tax Sub-Index Rank	2011 Corporate Income Tax Sub-Index Rank	2011 Sales Tax Sub-Index Rank	2011 Unemployment Insurance Tax Sub-Index Rank	2011 Property Tax Sub-Index Rank
Nevada	4th	1st	1st	43rd	40th	17th
California	49th	48th	33rd	49th	14th	16th
Oregon	14th	46th	45th	4th	37th	5th
Idaho	18th	29th	17th	12th	48th	2nd
Utah	9th	13th	6th	27th	24th	3rd
Arizona	34th	23rd	22nd	48th	2nd	6th

Source: Tax Foundation, *2011 State Business Tax Climate Index*

If a corporate income tax similar to California's had been in effect in Nevada on July 1, 2010, the snapshot date of the *2011 State Business Tax Climate Index*, Nevada's corporate tax sub-index score would have been 32nd instead of 1st. The state's overall *State Business Tax Climate Index* rank would have been 8th instead of 4th. (See Table 2.)

Table 2: Nevada's *Index* Rank with a Corporate Income Tax

	2011 *Index* Overall Rank	2011 Corporate Income Tax Sub-Index Rank
Nevada	4th	1st
Nevada with a California-style corporate income tax	8th	32nd

Source: Tax Foundation. Snapshot date of July 1, 2010.

If a gross receipts tax similar to Ohio's had been in effect in Nevada on July 1, 2011, Nevada's corporate tax sub-index score would have been 39th instead of 1st. The state's overall *State Business Tax Climate Index* rank would have been 8th instead of 4th. (See Table 3.)

Table 3: Nevada's *Index* Rank with a Gross Receipts Tax

	2011 *Index* Overall Rank	2011 Corporate Income Tax Sub-Index Rank
Nevada	4th	1st
Nevada with a Ohio-style gross receipts tax	8th	39th

Source: Tax Foundation. Snapshot date of July 1, 2010.

If a "margin" tax similar to Texas's had been in effect in Nevada on July 1, 2011, Nevada's corporate tax sub-index score would have been 45th instead of 1st. The state's overall *State Business Tax Climate Index* rank would have been 11th instead of 4th. (See Table 4.)

Table 4: Nevada's *Index* Rank with a "Margin" Tax

	2011 *Index* Overall Rank	2011 Corporate Income Tax Sub-Index Rank
Nevada	4th	1st
Nevada with a Texas-style "margin" tax	11th	45th

Source: Tax Foundation. Snapshot date of July 1, 2010.

Each of these three proposals (corporate income tax, gross receipts tax, and "margin" tax) has its dangers and would reduce the appeal of Nevada's tax system to investment and business activity. State corporate income taxes are in a long-term decline and have proven to be volatile. Gross receipts taxes are distortive and destructive. The Texas "margin" tax is really a badly designed corporate income tax, and should not be used as model due to its collection shortfalls, perceived unfairness for taxing unprofitable and small businesses, and confusing rules. Nevada should be careful about its options, as its ability to attract investment and capital depends greatly on its favorable tax climate.

State Corporate Income Taxes Are in a Long-Term Decline and Have Proven to Be Volatile

Nevada is one of seven states without a state corporate income tax, and one of only three states with no state-level business activity tax.[13] Nationwide in 2010, state corporate income taxes made up just 5 percent of state tax revenue, about the same as gasoline taxes, and much lower than individual income taxes (34% of state tax revenue) and sales taxes (32% of state tax revenue).[14] In the late 1970s, state corporate income tax made up nearly a tenth of state tax revenue; the decline has been steady and consistent.

In recent congressional testimony, we commented that the tax is "dying," "killed off by thousands of credits, deductions, abatements, and incentive packages."[15] By our most recent count, 29 states offer resident businesses credits from state corporate income tax if the resident business engages in research and development, new job creation, or new investment.[16] Many states also adopt a calculation to divide up interstate income that ignores in-state payroll and property.

These trends suggest that if Nevada were to adopt a corporate income tax, policymakers would immediately face enormous pressure to reduce its burdens with targeted tax incentives, pressure that in other states has led to a hollowing-out of the tax. Nevada would gain the administrative and compliance costs with a new major tax, the political wrangling over targeted tax incentives that plagues other state legislatures, and a tax notoriously volatile and subject to tax avoidance planning.

The volatility of corporate income taxes cannot be overstated. As the table below shows, corporate income taxes have proven to be the most volatile of the major taxes, as measured by year-over-year revenue changes (see Table 5).[17] Additionally, an important study released in 2008 by the Organization for Economic Cooperation and Development (OECD) found that of the various taxes a country can impose, "Corporate taxes are the most harmful tax for economic growth."[18]

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[13] The seven states are Michigan, Nevada, Ohio, South Dakota, Texas, Washington, and Wyoming; the three states are Nevada, South Dakota, and Wyoming.

[14] *See* U.S. Census Bureau, "Annual Survey of State Government Tax Collections," http://www.census.gov/govs/statetax/.

[15] Joseph Henchman, Testimony Before the U.S. House Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, Hearing on the Impact of Congressional Legislation on State and Local Government Revenues (Apr. 15, 2010), http://www.taxfoundation.org/research/show/26193.html.

[16] *See* Kail Padgitt, "2011 State Business Tax Climate Index," Tax Foundation Background Paper No. 60, at 41 (Oct. 2010), http://www.taxfoundation.org/research/show/22658.html.

[17] *See* U.S. Census Bureau, "Annual Survey of State Government Tax Collections," http://www.census.gov/govs/statetax/.

[18] Asa Johansson, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia, "Tax and Economic Growth," Economics Department Working Paper No. 620. ECO/WKP(2008)28, Organization for Economic Cooperation and Development, July 11, 2008.

Table 5: Year-to-Year Changes in State Tax Revenue in the U.S., As a Percentage of Previous Year, Fiscal Years 2000-10 (in real terms)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total Taxes	+ 4.3	+ 0.9	– 6.0	+ 0.3	+ 4.9	+ 6.1	+ 6.4	+ 2.8	– 0.7	– 8.5	– 2.0
Property Taxes	– 9.1	– 8.1	– 8.8	+ 5.4	+ 6.1	– 4.1	+ 4.8	– 0.1	– 3.3	+ 4.1	+ 9.1
General Sales Taxes	+ 2.6	0	– 1.4	+ 0.5	+ 4.3	+ 4.0	+ 4.4	+ 0.9	– 2.7	– 5.0	– 1.9
Excise Taxes	+ 0.2	– 1.5	+ 3.4	+ 5.3	+ 4.0	+ 1.1	+ 5.1	+ 2.7	– 1.2	– 2.3	+ 3.0
Individual Income Taxes	+ 8.6	+ 3.9	– 13.0	– 4.3	+ 5.3	+ 8.5	+ 7.1	+ 5.1	+ 0.9	– 12.1	– 5.0
Corporation Income Taxes	+ 2.2	– 5.4	– 24.7	+ 9.9	+ 3.7	+ 21.3	+ 17.2	+ 8.0	– 8.0	– 22.6	– 7.2

Source: Data from U.S. Census Bureau.

In 2009, we calculated the relative volatility of different types of state tax revenue over the period 2000 to 2009.[19] The standard deviation measures how spread out the percentage change numbers are or, in other words, whether the annual change percentages are always about the same (considerable stability in the rate of change) or whether there is considerable variability. We find that state corporate income taxes are the most volatile of the five major tax revenue sources. (See Table 6.)

Table 6: Volatility Measures of State Tax Revenue in the U.S., Fiscal Years 2000-09

	Standard Deviation (Volatility Measure)
Total Taxes	5.02
Property Taxes	6.17
General Sales Taxes	3.16
Excise Taxes	2.81
Individual Income Taxes	8.10
Corporation Income Taxes	15.43

Source: Tax Foundation calculations from U.S. Census Bureau and Bureau of Labor Statistics data.

This showing of extremely volatile corporate income tax receipts nationwide and a trend of decline is consistent with other scholarly work on the topic.[20] Such volatility can be problematic for state budgets, where predictability

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[19] Kail Padgitt, "State Revenue Changes from 2008 to 2009," *Tax Foundation Fiscal Fact No. 225* (May 2010), http://www.taxfoundation.org/news/show/26297.html.

[20] *See, e.g.*, David Brunori, "State Tax Policy" at 87 (Urban Institute 2005) ("The state corporate income tax has not been a particularly reliable or stable source of income for state governments."); William F. Fox, "The Ongoing Evolution of State Revenue Systems," 88 Marquette L. Rev 19, 28-42 (2004) ("Underlying Causes of Slow Sales and Corporate Income Tax Growth"); David Brunori, "Stop Taxing Corporate Income," *State Tax Notes* 47 (Jul. 1, 2002) ("We cannot fix the problems that plague the tax. So maybe it's time to throw in the towel and stop taxing corporate profits, at least at the state level."); Chris Edwards, "State Corporate Income Taxes Should Be Repealed," (Cato Institute Tax & Budget Bulletin) (Apr. 2004), http://www.cato.org/pubs/tbb/tbb-0404-19.pdf

and year-over-year revenue smoothness is preferred to maintain annual spending commitments. This is especially troubling for a state that has a biannual budgeting procedure, as Nevada does.

Increasingly, states are finding that corporate income taxes are hindrances to their economic development. The use of tax incentives, the abandonment of apportionment uniformity, the proliferation of tax planning opportunities, and the rise of pass-through entities like LLCs have led to a long-term decline in state corporate income tax revenues. Nevada (and people who invest in the state) are currently able to avoid much of the complexity and political wrangling (exemptions, abatements, credits, incentive programs apportionment games, and nexus rules) that accompany the corporate income tax. This advantage has been a key driver of the state's past economic growth and is a key advantage for future economic growth.

Gross Receipts Taxes Are Distortive and Destructive

At first glance, gross receipts taxes appear to satisfy economists' prescription for taxes that have a broad base and low rate. Such taxes are imposed on all transactions, at a very low rate. However, the base of the tax is often broader than the entire economy, resulting in high effective tax rates that vary dramatically between industries. States with gross receipts taxes include Delaware ("Merchants' License" Tax), Michigan ("MBT"), Ohio ("CAT"), Texas ("Margin" tax), Virginia ("Business/Professional/Occupational License Tax"), and Washington ("Business & Occupation" tax). Kentucky enacted a gross receipts tax in 2005 but repealed it within a year.

The chief economic problem with gross receipts taxes is the pyramiding nature of the tax.[21] That is, since the tax applies each time a business sells its goods or services, the tax "pyramids" on products as they move through the production process. The longer the production chain, the higher the effective tax rate on the final product. This produces major distortions in economic decision-making, with notably negative impacts on low-margin, high-volume businesses.

For example, the Washington State Business & Occupation (B&O) tax is the oldest gross receipts tax in the United States. First enacted in the 1930s, Washington has repeatedly amended it, resulting in an ever-changing blizzard of different rates and bases. Every business is assigned a B&O tax classification with different rates, exemptions and credits. (See Table 7.)

("As the mobility of corporate profits continues to rise, the corporate tax will become more inefficient and tougher for states to enforce. The solution is to repeal them, with the modest revenue losses to state governments made up with cuts to business subsidies."); Richard D. Pomp, "The Future of the State Corporate Income Tax" *in* "The Future of State Taxation" at 67 (Urban Institute 1998) ("If only we had known at the beginning of this century what we know now, perhaps the states would never have taken on the administration of a corporate income tax."); Charles E. McLure, Jr., "The State Corporate Income Tax: Lamb in Wolves' Clothing," in *The Economics of Taxation* (Henry J. Aaron & Michael J. Boskin, eds.) 327-48, Brookings Institution (1980) ("Since accurate state taxation of corporate income is often a logical impossibility, it seems best to abandon this tax as a source of state revenue.").

[21] *See* Andrew Chamberlain & Patrick Fleenor, "Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes," *Tax Foundation Special Report No. 147* (Dec. 2006), http://www.taxfoundation.org/publications/show/2061.html.

Table 7: Selected Washington Gross Receipts Tax Rates

Industry	B&O Tax Rate
Manufacturing (generally)	0.484%
Manufacturing (semiconductors)	0.275%
Manufacturing (flour, soybean oil, etc.)	0.138%
Manufacturing (airplane components)	0.2904%
Manufacturing (aerospace product development)	0.900%
Timber extraction, manufacturing, and processing	0.3424%
Retailing	0.471%
Real Estate	1.500 %
Horse Race Meets	0.130%
Travel Agents & Tour Operators	0.275%
Garbage Disposal	3.300%
Hospitals	1.500%
Crabbing	Exempt

Source: Commerce Clearing House summary of Washington revenue code.

Delaware faces similar complexity with its Merchants' License Tax (see Table 8).

Table 8: Selected Delaware Gross Receipts Tax Rates

Industry	Merchants' License Tax Rate
Wholesalers (generally)	0.384%
Food processors	0.192%
Commercial Feed dealers	0.096%
Manufacturers	0.180%
Retailers (generally)	*0.720%*
Restaurants	*0.624%*
Grocery Supermarkets	*0.315%*

Source: Commerce Clearing House summary of Delaware revenue code.

Virginia has a varied structure with its BPOL tax, varying by county. Below are some representative examples of Virginia jurisdictions near Washington, D.C.

Table 9: Selected Virginia BPOL Tax Rates

Industry	Alexandria City Business/ Professional/ Occupational License Tax Rate	Arlington County Business/ Professional/ Occupational License Tax Rate	Fairfax County Business/ Professional/ Occupational License Tax Rate	Loudoun County Business/ Professional/ Occupational License Tax Rate
Professional Services	0.58%	0.36%	0.31%	0.33%
Finance Services	0.35%	0.36%	0.31%	0.33%
Personal Services	0.35%	0.35%	0.19%	0.23%
Business Services	0.35%	0.35%	0.19%	0.17%
Repair Services	0.35%	0.35%	0.19%	0.16%
Retail	0.20%	0.20%	0.17%	0.17%
Contractors	0.16%	0.16%	0.11%	0.13%
Wholesale Merchants	0.05%	0.08%	0.04%	0.05%

Source: City of Alexandria, Virginia.

Michigan and Ohio have one uniform rate for their gross receipts taxes but retain their complexity. Michigan's MBT consists of a 4.95 percent tax on corporate profit, a 0.8% tax on all transactions, and a 21.99 percent surcharge on the collections from the first two taxes.[22] Governor Rick Snyder (R) has proposed switching from the MBT to a 6 percent corporate income tax. While there is debate on how best to replace the revenue, observers generally agree that the MBT is a badly designed tax that should not be used as a model.[23] Ohio's Commercial Activities Tax (CAT) was enacted as part of a tax package in 2005, phasing out the corporate franchise tax and phasing in the CAT over time through 2010. The rate currently stands at 0.26% and applies to businesses that:

(1) have $500,000 in gross receipts in Ohio;
(2) have $50,000 in property in Ohio;
(3) have $50,000 in payroll in Ohio;
(4) have 25% of their property, payroll, or gross receipts in Ohio;
(5) are domiciled in Ohio.

The compliance burden of tracking and calculating liability is not minimal, and the state has faced legal and political resistance from high-volume, low-margin businesses that are most harmed by gross receipts taxes, such as grocery stores and casinos.

Regardless of rate structure, all gross receipts taxes feature tax pyramiding, which distorts and interferes with business investment decisions. Sales, individual income and property taxes do not have the same tax pyramiding feature, making them more economically efficient. An increase in any of those taxes would cause far less economic harm than a gross receipts tax that raises the same amount of revenue.

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[22] *See* Alex Wood-Doughty & Kail Padgitt, "Michigan Gov. Snyder's Budget Improves Competitiveness But Costs Individuals," *Tax Foundation Fiscal Fact No. 262* (Mar. 2011), http://www.taxfoundation.org/publications/show/27102.html.

[23] *Id.*

There is no sensible case for gross receipts taxation, or modified gross receipts taxes such as a Texas-style margin tax. The old turnover taxes — typically adopted as desperation measures in fiscal crisis — were replaced with taxes that created fewer economic problems. Gross receipts taxes do not belong in any program of tax reform.

Texas Margin Tax Experiment Failing Due to Collection Shortfalls, Perceived Unfairness for Taxing Unprofitable and Small Businesses, and Confusing Rules

In 2006, Texas faced a court mandate to boost education spending from a source other than local property taxes.[24] Taking the opportunity to replace the corporate income tax (known in Texas as the franchise tax) with a tax that reached pass-through entities such as limited-liability corporations and partnerships, the state enacted a tax on business "margin," a modified gross receipts tax and corporate income tax defined with some complexity as follows:

- Business taxpayers can choose one of three options for a tax base:
    - Total revenue minus cost of goods sold; or
    - Total revenue minus wages (limited to $300,000 per person) and benefits; or
    - 70% of total revenue.
- "Cost of goods sold" is specially defined by statute: excludes services, selling costs, distribution costs, advertising, taxes, and compensation
- Tax is 1%, with a special rate of 0.5% for retailers and wholesalers. (The unequal rate, intended to reduce the negative effects of tax pyramiding, may be challenged in court.)
- Initially, the state had a discounted tax schedule for certain businesses:
    - Total revenue of less than $300,000: no tax liability.
    - Revenue between $300,000 and $400,000: pay 20% of tax liability.
    - Revenue between $400,000 and $500,000: pay 40% of tax liability.
    - Revenue between $500,000 and $700,000: pay 60% of tax liability.
    - Revenue between $700,000 and $900,000: pay 80% of tax liability.
- After an initial outcry from small business, all businesses with revenue of less than $1 million are exempt from the tax. Beginning in fiscal 2012, the exemption falls to $600,000, but extension of the existing exemption is likely.
- Taxable entities with less than $10 million can instead elect to pay 0.575% of total revenue multiplied by Texas's apportionment factors.
- No tax liability if tax due is less than $1,000.
- Tax owed on the Texas apportioned share of combined reported profits from all related business entities.

While it was enacted in 2006, officials proceeded cautiously with the untried tax. Large businesses were required to file informational returns as if they were paying the tax; the tax took effect in full beginning in 2008. Texas officials projected the tax would raise $5.9 billion per year (with some suggesting as much as $12 billion per year), but the 2006 information returns suggested it would raise barely $5 billion.[25] In 2008, the tax raised just $4.45 billion, and collections fell under $4 billion in 2009.[26] The eliminated corporate income tax raised $2.5 billion per year.[27]

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[24] *See* Chris Atkins, "Appropriation by Litigation: Estimating the Cost of Judicial Mandates for State and Local Education Spending," *Tax Foundation Background Paper No. 55* (Jul. 2007), at http://www.taxfoundation.org/files/bp55.pdf.

[25] *See* Billy Hamilton, "The Texas Margin Tax Falls Short of Projections," *State Tax Notes* (Dec. 22, 2008).

[26] Billy Hamilton, "The Tax That Fell to Earth: Lessons From the Texas Margin Tax's Launch," *State Tax Notes* (Sep. 6, 2010) at 671.

[27] *See* David Bowser, "New tax for businesses called 'taxpayer's nightmare,'" *Pampa News* (Oct. 17, 2006).

Far from solving the problems of the previous corporate franchise tax, the margin tax seems to have only aggravated them. The tax was designed to reach businesses not reached by the corporate income tax, including partnerships, unprofitable businesses, and small businesses. As the tax was enacted, however, legislators expanded exclusions in the face of arguments that hefty tax compliance costs on small businesses were disproportionate.[28] Calls for additional exclusions, such as on unprofitable businesses, continue, and the state may well end up with something resembling its old corporate franchise tax but with added complexity. At the same time, over 18,000 taxpayers that had paid franchise tax reported no liability under the new tax.[29] In 2009, the Texas House Ways and Means Committee struggled with over 100 proposals to modify the tax, greatly increasing legislative workloads for a session that lasts only five months every other year.[30] These ongoing changes result in taxpayer confusion and aggravate the margin tax's shortfall in collections.

Significant wrangling has occurred over the vague definition of "cost of goods sold." Associate Deputy Comptroller Mike Reissig points to this as the main reason for the tax's underperformance.[31] Texas permits numerous items as "cost of goods sold" that differ from federal tax rules, many of which were directly added when the legislation was enacted. Reissig reported that tens of thousands of taxpayers have taken "cost of goods sold" deductions they were not eligible for, under state law.[32]

Other issues have included taxpayer confusion, increased compliance costs, and a lack of guidance for the peculiar definitions and rules under what is essentially a brand new type of tax. Jon Hoke, of the Texas chapter of the National Federation of Independent Business (NFIB), seeks the margin tax's repeal because in the group's view it is "crippling the small and mid-sized businesses without bringing in what [legislators] thought."[33] The NFIB is also concerned that the 1 percent tax rate will rise due to the collections shortfall, as is the Texas Retail Association (whose members pay 0.5 percent).[34] Dale Craymer of the Texas Taxpayers and Research Association has said that "[f]rom a taxpayer standpoint, it isn't as simple as it was conceived, and from an economic standpoint, it's controversial."[35]

Noted tax academic John Mikesell has referred to the Texas margin tax as a "badly designed business profits tax…combin[ing] all the problems of minimum income taxation in general—excess compliance and administrative cost, penalization of the unsuccessful business, undesirable incentive impacts, doubtful equity basis—with those of taxation according to gross receipts."[36]

With the Texas margin tax collecting far less in revenue than expected, causing significant confusion and compliance costs, resulting in significant litigation and controversy over "cost of goods sold" definitions, and facing calls for substantial overhaul and even repeal, it should not be used as a model tax reform for Nevada or any other state.

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[28] Billy Hamilton, "Cosmetic Surgery for the Texas Margin Tax," *State Tax Notes* (Apr. 27, 2009), at 327.
[29] *See* Hamilton, "The Tax That Fell to Earth: Lessons From the Texas Margin Tax's Launch," *State Tax Notes*.
[30] Hamilton, "Cosmetic Surgery for the Texas Margin Tax," *State Tax Notes*, at 327.
[31] Hamilton, "The Tax That Fell to Earth: Lessons From the Texas Margin Tax's Launch," *State Tax Notes*, at 673.
[32] *Id.* at 674.
[33] Paul Wiseman, "NFIB Calls Texas' Business Margin Tax a 'Lose-Lose' Situation," *Midland Reporter-Telegram* (Apr. 6, 2011).
[34] Samantha Stone, "Word From Texas: Margin Tax is a Work in Progress, Not Meeting Projections, Likely Headed for Major Reform," Nevada News Channel (May 6, 2011).
[35] *Ibid.*
[36] John L. Mikesell, "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance," *Tax Foundation & Council on State Taxation Background Paper No. 53* (Jan. 2007), at 4 n.6, http://www.taxfoundation.org/research/show/2180.html.

Conclusion

As the economy improves, the state is well positioned for capital investment and job creation.

This is an advantage that Nevada should be careful not to jeopardize. A corporate income tax and, in particular, a gross receipts tax, would do significant harm to the state's tax climate. As Nevada policymakers consider fiscal options through 2011, they should keep this in mind.

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The Tax Foundation's Center for State Fiscal Policy produces timely, high-quality, and user-friendly data and analysis for elected officials, national groups, state-based groups, grassroots activists, the media, business groups, students, and the public, thereby shaping the state policy debate toward simple, neutral, transparent, stable, and pro-growth tax policies.