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Trend #3: Corporate Tax Reductions

Top 10 State Tax Trends in Recession and Recovery, 2008 to 2012

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Japan's corporate tax rate reduction on April 1, 2012 left America with the highest corporate income tax rate in the industrialized world.[1] Effective taxes are also high by international standards.[2] Because state corporate income taxes are levied in addition to this high federal tax, state tax systems are not competitive internationally even if the state system by itself is reasonable. Every state corporate income tax, when combined with the federal corporate income tax, is higher than France, Germany, the UK, and other countries.[3]

This high federal tax rate has led to businesses taking non-corporate forms (such as LLCs, LLPs, and S-corporations that usually pay tax under the individual tax code) and determination by states to lower the tax costs of corporations within their borders. These state efforts to lower corporate tax bills have taken two forms.

First, many states have reduced corporate tax rates, including eight since 2008 (Indiana, Kansas, Massachusetts, New Jersey, New York, North Dakota, Vermont, and West Virginia). The Indiana reform, for example, will reduce its current 8.5 percent tax rate in half-percentage steps from 2012 through 2015, until it reaches 6.5 percent.[4] (6.56 percent is the average top state corporate tax rate in 2011.) Michigan, as another example, replaced a complicated, burdensome gross receipts tax with a standard 6 percent corporate income tax.

Second, most states offer generous targeted incentive packages to new or expanding businesses. A comparison of the tax costs of seven "model firms" recently found that, for example, a pre-existing manufacturing plant in New Jersey pays an effective tax rate of 10.6% while an identical but new plant would pay only 5.9%, thanks to targeted tax incentives.[5] It remains disputed whether such targeted tax incentive packages are effective at long-term economic development, and some business types, such as retail, generally pay much higher effective tax rates than other types.

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[1] *See* Scott A. Hodge, *The Countdown is Over. We're #1*, TAX FOUNDATION FISCAL FACT NO. 294 (Apr. 1, 2012), http://www.taxfoundation.org/research/show/28081.html.

[2] *See* Philip Dittmer, *U.S. Corporations Suffer High Effective Tax Rates by International Standards*, AX FOUNDATION SPECIAL REPORT NO. 195 (Sep. 13, 2011), http://taxfoundation.org/publications/show/27609.html.

[3] *See* Tax Foundation, *National and State Corporate Income Tax Rates, U.S. States and OECD Countries, 2011* (Jan. 14, 2011), http://www.taxfoundation.org/taxdata/show/23034.html.

[4] Joseph Henchman, *Indiana Approves Tax Changes, Including a Corporate Tax Rate Reduction*, TAX FOUNDATION TAX POLICY BLOG (May 2, 2011), http://www.taxfoundation.org/blog/show/27252.html.

[5] TAX FOUNDATION, LOCATION MATTERS: A COMPARATIVE ANALYSIS OF STATE TAX COSTS ON BUSINESS x-xiii (2012), http://www.taxfoundation.org/publications/show/28006.html.

With these generous tax credits and the rise of non-corporate forms such as LLCs, LLPs, and S corporations, the state corporate income tax has been "hollowed out." In 1979, state corporate income taxes made up 4.9 percent of total state tax revenue; that number dropped to just 2.6 percent in 2007. Commentators have recommended, one on hand, that states abolish the state corporate income tax altogether and focus on other revenue sources, and on the other hand, adopt old-style gross receipts taxes that impact all business activity, including that by partnerships and sole proprietors. These gross receipts taxes, such as the Commercial Activity Tax (CAT) in Ohio, the Margin Tax in Texas, and the Business & Occupation (B&O) tax in Washington, have a simple structure but are among the most economically damaging of taxes.[6]

States should not follow the example of Illinois and Maryland, which recently raised tax rates while stepping up incentive packages. Illinois has seen an increase in business flight from the state since raising its corporate income tax from 7.3% to 9.5% in 2011.[7] Maryland in 2010 infamously lost a bidding war for Northrop Grumman's headquarters to Virginia, a fight that many thought it could not win in the first place due to its poor tax policy.[8]

Until federal tax reform reduces competitive pressures, states should instead focus on reducing rates and minimizing incentive packages that hollow out the base and pick winners and losers.

Table: State Corporate Income Tax Rate Changes, 2007-2012

States Increasing Corporate Income Tax Rates	States Reducing Corporate Income Tax Rates	Other
Connecticut **Illinois** **Maryland** **Oregon**	**Indiana** **Kansas** **Massachusetts** **New Jersey** **New York** **North Dakota** **Vermont** **West Virginia**	**Michigan** (replaced gross receipts tax with corporate income tax) **Ohio** (replaced corporate income tax with gross receipts tax)

Source: Tax Foundation.

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[6] *See generally* Andrew Chamberlain & Patrick Fleenor, *Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes*, TAX FOUNDATION SPECIAL REPORT NO. 147 (Dec. 4, 2006), http://taxfoundation.org/research/show/2061.html.

[7] *See* Joseph Henchman, *Illinois Legislators Hint that Tax Increases Are Driving Away Jobs*, TAX FOUNDATION TAX POLICY BLOG (Jun. 24, 2011), http://www.taxfoundation.org/blog/show/27398.html.

[8] *See* Joseph Henchman, *Reality Crashing on Maryland Post-Northrop Rejection*, TAX FOUNDATION TAX POLICY BLOG (Apr. 30, 2010), http://www.taxfoundation.org/blog/show/26267.html.