

## **The Proposed Business Tax A Heavy Burden By Any Name?**

March 1999

On February 8, 1999, in his State of the State address, Governor Don Sundquist proposed what he characterized as "The most sweeping business tax changes in three-quarters of a century."

### **The broad parameters of the Governor's proposal were:**

First, the elimination of the Tennessee sales tax on groceries. Relief from sales tax on groceries for the poor has been an objective that many of both parties have desired for a long time. However, the repeal of the sales tax on groceries for everyone carries a very high revenue loss - approximately \$400 million for the state and \$150 million for local government.

Second, the replacement of the corporate franchise and excise tax with a radical new business tax structure that is fundamentally different than the taxing structure of any state surrounding Tennessee (or for that matter, any other state). This proposed structure of taxation would apply to corporations, partnerships, limited liability companies and sole proprietorships, i.e., single individuals doing business themselves without a business form. The new tax structure is a combination of a 2.5% excise tax (income tax) and a 2.5% payroll tax. Under the Governor's proposal, the first \$50,000 of business profits would be excluded and the first \$50,000 of compensation would be excluded from this tax.

### **First Impressions**

1. The repeal of the sales tax on groceries would be popular and expensive.
2. The repeal of the franchise tax would favor companies with heavy capital investments in Tennessee as the franchise tax was a tax on capital used in business.
3. The excise (income) tax element for corporations was cut from 6% to 2.5%.
4. All forms of businesses and individuals would be subject to the tax, despite the fact that many of these forms of businesses were not subject to tax in any of the surrounding states and have never been subject to tax in Tennessee.
5. The 2.5% tax on compensation would represent a massive tax increase to businesses utilizing significant labor.

### **Reflections**

In the month following the State of the State address the proposed legislation has been released, revenue estimates have been obtained, and some of the ramifications of the Governor's proposal are beginning to be understood.

### **High Tax - Corporations**

Surprisingly the proposed legislation placed a cap on compensation included in the tax base at \$300 million. This is a height only the largest corporations can scale. More surprisingly, the proposal is a massive tax increase to all forms of businesses, including corporations. The proposal calls for \$750 million dollars more than the amount needed to fund the repeal of both the state and local sales tax on groceries. The corporate tax burden almost doubles. Partnerships, limited liability companies and proprietorships are called upon to make up for the removal of the franchise tax. Partnerships would pay

\$178 million, proprietorships would pay \$102 million and limited liability companies would pay \$28 million. In January 1999, The Tennessee Advisory Commission on Intergovernmental Relations released a report entitled "Financing Tennessee Government in the 21st Century" (The "Report"). When looking at Tennessee business tax reform the Report on page 49 states:

*"Business tax reform does not appear to offer additional revenue potential...Tennessee business taxes are at a reasonably competitive level with those in other states. Given the current environment of intense interstate tax competition, it would be politically difficult to raise Tennessee business taxes above their current levels after several years of business tax cuts designed to make Tennessee more attractive for business expansion and relocation."*

Obviously, through the use of a payroll tax, an almost doubling of the tax cost to corporations is a stunning development that will have adverse economic consequences on corporations headquartered and/or having extensive payroll in Tennessee. Perhaps even more disturbing, the impact of the tax increase is focused on service businesses which have relatively low capital deployed to payroll. These are the very companies that Tennessee's projected job growth was heretofore dependent on. See "Tennessee Job Outlook in Brief to 2005" located on the web at [www.state.tn.us/empsec/outlooks/tbrief.htm](http://www.state.tn.us/empsec/outlooks/tbrief.htm). Only Michigan imposes a significant tax on compensation. In response to the burden Michigan placed on new employment, Michigan has various credits to encourage job growth and a reduced rate for high tech industries. Other states seem to have recognized that job growth is good and that discouraging through taxation job growth is not good.

### **High Tax - Pass Through Entities and Proprietorships**

Suddenly imposing a tax on businesses that have historically not been taxed and which are not taxed by the surrounding states is also a very dramatic development. While the \$50,000 exclusions will reduce the pain for the smaller businesses that do not have many employees, businesses with more than 5 employees at minimum wage will be paying some payroll tax. The competitive ramifications of this aspect need to be looked at closely. Will partnerships, limited liability companies and proprietorships along our state's lines seek the shelter of the adjoining states where no tax is imposed on such entities and, at most, there will only be the state income tax on the individual owners' net income? What audit enforcement will be necessary to see that businesses located across state lines but doing business in Tennessee actually file Tennessee tax returns and pay Tennessee taxes? Non-compliance likely will be a major issue? Will businesses restructure to have independent contractors vs. employees leading to endless controversy over "job status"? Whether an employee is considered a "Tennessee employee" for purposes of the tax will also generate much controversy.

The administration repeatedly states that the reason that partnerships, limited liability companies and proprietorships are not taxed by the surrounding states is that those states have a personal income tax. Is that saying the problem with these unincorporated businesses is the lack of a state income tax? The Governor states that he does not want to have a personal income tax - as he stated in his State of the State address "All an income tax does is raise the tax burden on Tennesseans and create a way to finance the easy and endless expansion of government." Is a tax on the self-employed a rational way to raise revenue and foster economic and job growth?

Partnerships and proprietorships predate the corporate excise tax. The corporate franchise and excise tax was the exception; the exception was not the failure to tax proprietorships and partnerships.

The limited liability company is a relatively new entity. Tennessee, just as almost all other states, made the conscious decisions to tax limited liability companies as a corporation or a partnership, depending on federal classification. Florida originally taxed LLCs as corporations but reversed that position in the middle of 1998 citing economic competitive pressures - the adjacent states treated them as partnerships and the different tax consequences was placing Florida at a disadvantage. It is now argued that, in the name of "fairness," limited liability companies - the small business entity of choice which, according to the Tennessee Department of Revenue's Report entitled "The Impact of LLCs on Tennessee Revenues" has created 4,100 full-time and 950 part-time jobs that would otherwise have not been in Tennessee should be taxed. The same report concluded that LLCs only "cost" Tennessee between \$5.4 and \$10.1 million in direct revenue loss, a portion of which is offset by indirect revenue gains such as sales tax by the increased economic activity. Should a form of business that is efficiently creating jobs be burdened with a tax not charged by surrounding states?

The indirect ramifications of the proposed business taxes need to be considered. Tennessee, just as Florida, is not an island. Tennessee's economy is tied to the economy of the surrounding states, the nation and to some extent the world. If investment capital is taxed heavier or differently in Tennessee than in surrounding states, the investment capital will flow elsewhere. Investors outside of Tennessee are not going to pay significantly greater taxes to have business operations in Tennessee than having operations outside of Tennessee. In particular, individual investors who are residents of any of the states surrounding Tennessee who invest in Tennessee partnerships and limited liability companies would see the entity paying taxes and then would have to pay their own state's income tax. If those investors invested in the same kind of pass-through entity doing business in another state, the entity would not be taxed and if the investors were individually taxed by the entity's state, they would receive a credit for such tax against the income tax of their home state. With the business tax, there is no credit against the other state's income tax, simply a small deduction - the result is double taxation. The cost may or may not be high enough to move existing businesses out of Tennessee, but it will certainly cause businesses seeking to relocate or expand to consider other states than Tennessee.

### **Start-Up Business**

Small businesses getting started will find it more difficult to blossom in Tennessee. Typically, a growing businesses has operating losses as the costs of growth exceeds the income. Under the current taxing structure of Tennessee and the surrounding states, corporate businesses only pay the franchise tax during the loss years and pass-through entities pay no tax. When corporations become profitable, they are able to utilize the prior losses against current excise taxes. Under the proposed tax, there will be no franchise tax and the operating loss will be able to be used with respect to the excise tax component, but not with respect to payroll component. If the business is hiring people to work in Tennessee, it will pay tax in these growing years even when it is unprofitable. If it is a Tennessee businesses, investors will have to fund that tax in addition to the losses. If the business were located in another state, this extra funding would not be necessary.

### **Different Tax Structure**

The imposition of a different structure of business taxation that is not used by most other states is not likely to enhance Tennessee's reputation as a desirable state in which to locate a business. Because of the uniqueness of the tax, multi-state businesses will have additional compliance problems and expenses.

### **Loopholes**

The Governor has correctly identified a structural mechanism where corporations could utilize partnerships to avoid the Tennessee Franchise and Excise taxes. This mechanism has cost Tennessee tens of millions of dollars if not more. One estimate currently floating about is that, if unchecked, the mechanism would cost Tennessee \$150 million or more this year. The Tennessee Department of Revenue has been aware of the technique for some time and has given many rulings permitting its use. This loophole should be closed. It does not take a different tax structure, but merely a correction to the statute. Most of the other states use a similar tax structure and do not have this problem - Tennessee can easily solve it and be compatible with the surrounding states. Other "loopholes" that the administration has identified can be solved with the existing enforcement powers of the Commissioner and, if believed necessary, those powers can be strengthened.

**Tax Burden**

In reviewing the big picture numbers, the magnitude of the business tax burden comes home. In 1998, the six percent excise tax raised \$607 million dollars. Rounded, that equated to \$100 million per percentage point. The franchise tax which is based on capital and not profits raised \$310 million or the equivalent of three percentage points of excise tax. The total corporate business tax burden was approximately 9% of net income. If the equivalent of a 1% excise tax is \$100 million dollars, then the Governor proposes raising the corporate tax burden to approximately 17% as his proposed tax would cost corporations \$1.7 billion. Because the other non-corporate forms of businesses are generally smaller, it is probably not accurate to say they will be taxed at an effective average rate of 17%, but I expect it will be a high percentage. Obviously, the variable is the payroll. A business that hires Tennesseans to work in Tennessee will pay higher taxes than a company that hires Tennesseans or others to work outside of Tennessee. Is this good for Tennessee job growth and economic development? What labor intensive business will find Tennessee the preferential location to establish operations as opposed to any of the surrounding states?

Fairness has many aspects - overall competitiveness of Tennessee business with the businesses of surrounding states; the competitiveness of Tennessee's economic and job growth businesses with similar businesses in surrounding states; the double taxation of corporate income if all Tennessee business is to be taxed the same; the compatibility of Tennessee's tax structure with those of the rest of the country; the impact of the tax on existing employee compensation and benefits. If the threshold question of competitiveness cannot be answered, then the other issues are secondary as Tennessee's economic development slows and job opportunities vanish.

**Individual Business Tax**

The following chart shows the approximate effective tax rate for a Tennessee business at various levels of profitability and payroll after the first \$50,000, and through this chart you can determine the approximate "effective tax rate" for your business. The instructions for understanding the chart are set forth below the chart. This analysis indicates that relatively few businesses of any form that have a substantial number of employees will find Tennessee attractive from a tax standpoint.

**Proposed Tax Impact Analysis**

Payroll Less \$50,000 as a Percentage of Revenue	80.00%	70.00%	60.00%	50.00%	40.00%	30.00%	20.00%	10.00%
Net Income Less \$50,000								

as a Percentage of Revenue								
1.00%	202.50%	177.50%	152.50%	127.50%	102.50%	77.50%	52.50%	27.50%
2.00%	102.50%	90.00%	77.50%	65.00%	52.50%	40.00%	27.50%	15.00%
3.00%	69.17%	60.83%	52.50%	44.17%	35.83%	27.50%	19.17%	10.83%
4.00%	52.50%	46.25%	40.00%	33.75%	27.50%	21.25%	15.00%	8.75%
5.00%	42.50%	37.50%	32.50%	27.50%	22.50%	17.50%	12.50%	7.50%
6.00%	35.83%	31.67%	27.50%	23.33%	19.17%	15.00%	10.83%	6.67%
7.00%	31.07%	27.50%	23.93%	20.36%	16.79%	13.21%	9.64%	6.07%
8.00%	27.50%	24.38%	21.25%	18.13%	15.00%	11.88%	8.75%	5.63%
9.00%	24.72%	21.94%	19.17%	16.39%	13.61%	10.83%	8.06%	5.28%
10.00%	22.50%	20.00%	17.50%	15.00%	12.50%	10.00%	7.50%	5.00%
11.00%	20.68%	18.41%	16.14%	13.86%	11.59%	9.32%	7.05%	4.77%
12.00%	19.17%	17.08%	15.00%	12.92%	10.83%	8.75%	6.67%	4.58%
13.00%	17.88%	15.96%	14.04%	12.12%	10.19%	8.27%	6.35%	4.42%
14.00%	16.79%	15.00%	13.21%	11.43%	9.64%	7.86%	6.07%	4.29%
15.00%	15.83%	14.17%	12.50%	10.83%	9.17%	7.50%	5.83%	4.17%

**Instructions for Chart**

1. Determine what percent of your business' gross revenues is represented by compensation. For example, if sales are \$100X and compensation expense is \$40X, the compensation percentage is 40%.
2. Determine what percent of your business' gross revenues represents pre-tax net profits. For example, if pre-tax net profits are \$10X and sales are \$100X, the net profit percentage is 10%.
3. Utilizing the illustration above, you would locate the term "Payroll as a Percent of Revenue" and go across the table until 40% appears.
4. You should then go down the column labeled 40% until reaching the line labeled 10% (the net profit percentage). At that point of intersection will be the figure 12.5% - the "effective rate."

In this illustration, the business will pay 12.5% of its pre-tax net income to Tennessee. For the range of compensation to net income presented on this table, the "effective rate" will vary between 4.17% to 202.5%. Under the proposed tax, a profitable business can have a tax liability greater than its net income and become a loss business. In addition, under the proposed tax, a loss business can also incur a substantial tax liability. The effective aggregate business tax rates on corporations for each of the surrounding statutes follow. Surrounding state data for corporations was derived from franchise and excise tax collections as reported by each state's department of revenue. The value of each percentage point of excise tax was determined and the total collections for franchise and excise tax were divided by such value to determine the effective corporate excise tax rate. The effective franchise and excise corporate tax rate (expressed as a percentage of corporate net income) for each of the surrounding states is approximately:

<b>Corporate Combined Franchise &amp; Excise Tax Rate</b>		
	Estimated	Estimated Tennessee

	Effective Rate	Tennessee Current Effective Rate	Proposed Effective Rate
Alabama	7.27	9%	17%
Mississippi	6.40	9%	17%
Arkansas	6.74	9%	17%
Missouri	7.86	9%	17%
Kentucky	11.40	9%	17%
Virginia	6.34	9%	17%
North Carolina	11.04	9%	17%
Georgia	6.24	9%	17%

For pass-through entities such as partnerships and limited liability companies and for proprietorships, the surrounding states do not tax the businesses.

Note: For Tennessee computational purposes, data is not available to compute an "aggregate average" tax burden on pass-through entities and proprietorships whose employment compensation exceeded \$50,000 or whose profits exceeded \$50,000 to make a valid comparison. Therefore, no comparison is made.

### **Conclusion**

The above analysis demonstrates that a payroll tax is counterproductive as relatively few business in any form that have a substantial number of employees will find Tennessee attractive or competitive from a tax standpoint. Indeed, it is hard to imagine an \$800 million to \$1.2 billion tax increase as not being detrimental to Tennessee's economy. *As the legislature goes into special session, whatever taxing mechanism is developed to fund a growing state government must be compatible with the taxing structures of surrounding states and not be of a magnitude that will put Tennessee's economy and job growth in peril.*