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Business Taxes
The Center for Local, State, and Urban Policy (CLOSUP), housed at the University of Michigan’s Gerald R. Ford School of Public Policy, conducts and supports applied policy research designed to inform state, local, and urban policy issues. Through integrated research, teaching, and outreach involving academic researchers, students, policymakers and practitioners, CLOSUP seeks to foster understanding of today’s state and local policy problems, and to find effective solutions to those problems.
Business Taxes

EXECUTIVE SUMMARY

Business taxes have resurfaced as a major policy issue in Michigan in recent years. The Single Business Tax (SBT), in place since 1976, was replaced by the Michigan Business Tax (MBT) in 2007. The MBT, enacted during the summer 2007 legislative session, went into effect January 1, 2008. Although the new tax was originally designed to raise the same amount of revenue as the SBT, the late addition of a 21.99 percent MBT surcharge (to replace a short-lived expansion of the sales tax to new services) increased the tax’s revenue. This surcharge is unpopular and has been criticized by many businesses and is now a focal point for further tax reform discussions.

Numerous plans to reform the Michigan Business Tax have been proposed since its enactment. It is reasonable to expect that business taxes will continue to be a high priority topic in Michigan public policy debates for the foreseeable future. Revenue generated via business taxes are crucial to maintaining the state’s expenditures. Given Michigan’s budget deficit, revenue must increase, perhaps through the maintenance of the MBT, or spending must decrease.

Other states have also reformed their business taxes in response to declining revenues in recent years. Many states have enacted gross receipts taxation, legislation requiring combined reporting, and legislation facilitating the formation of limited liability companies, among other reforms.

This brief describes characteristics of a good tax system, examines the MBT and other tax options in terms of those characteristics, and reviews the public debate in Michigan regarding business taxation.

OVERVIEW OF BUSINESS TAXES

In order to raise revenue, states tax a variety of different individuals, organizations, and activities within their borders. For example, 43 states have an individual income tax and 46 states have a sales tax. Most states have some set of taxes focused on firms that are located in and/or do business in the state. The corporate income tax is the primary business tax in most states that taxes business income. Three states do not tax business income: Nevada, South Dakota, and Wyoming.

It is important to note that while business taxes are generally levied on businesses themselves, the burden of these taxes is ultimately borne by consumers, workers, and owners of capital. A main concern from critics of the MBT is that owners of capital may relocate to low tax states to escape the tax burden. Consumers also pay business taxes through higher prices, and this
is particularly true for taxes of businesses with significant market power. Finally, workers bear the burden of business taxes in the form of lower wages and fewer jobs. The extent to which workers, consumers or owners of capital share the burden of business taxes depends on a number of economic factors as well as the details of the tax itself.

**What Would a Good Tax System Look Like?**

According to many economists, a good tax system should exhibit three characteristics: reliability, equity, and efficiency. Ideally, a tax system should be simple and transparent and not limit economic growth. A good business tax should be assessed on all types of businesses to minimize market distortions. Market distortions occur when taxes affect businesses' decisions on how to allocate resources such as hiring labor versus investing in capital. Distortions, in effect, drive up costs for consumers and businesses. A good tax should have a broad base and a low rate and have few special exemptions, deductions, or credits. While there is no perfect tax or tax system, a system that has several taxes that balance each other can achieve these three characteristics.\(^1\)

A reliable tax system is stable and raises sufficient revenue to pay for government spending. An equitable tax system treats taxpayers the same and minimizes the extent to which the proportion of income paid in taxes decreases as income increases (i.e., minimizes regressivity).\(^2\) There are two types of equity that a tax system should possess: horizontal equity and vertical equity.\(^3\) A tax system exhibiting horizontal equity taxes similar businesses similar amounts, while one that is vertically equitable distributes the tax burden fairly among different types and sizes of businesses. An efficient tax system is simple, minimizing administrative and compliance costs. By making sure that businesses understand the true costs of the tax system, an efficient system minimizes the effect of taxes on businesses’ economic decisions, allowing the market to operate with the least amount of government intervention.\(^4\) An efficient tax also treats the resources utilized to produce goods and services (such as labor, tools, machinery, facilities) neutrally, limiting the impact on the allocation of resources in the economy.\(^5\)

**Advantages and Disadvantages of Different Types of Business Taxes**\(^6\)

States use a variety of taxes to raise revenue through businesses. Of the 47 states that tax business income, most have a corporate income tax. The corporate income tax as well as other business taxes is described below.

**Corporate Income Tax (CIT)**

Corporate income is usually defined as gross receipts minus expenses, adding in interest, dividends, and other income, and subtracting out wages, depreciation, and other business expenses. A CIT is essentially a tax on profit. The advantages of a corporate income tax include that it is widely used, thus minimizing compliance costs for multistate firms, and that it only taxes businesses that make a profit.\(^7\) However, the tax also has several disad-
vantages. CITs tend to be volatile in terms of the revenue raised because profit can rise and fall and thus tax revenues change with business cycles. In addition, CITs are not neutral (they only tax corporate capital), and they often do not apply to businesses that are not organized as corporations.

**Business Income Tax (BIT)**

A business income tax is similar to a corporate income tax. The major difference is that it also taxes businesses that are not corporations, such as partnerships, S corporations, and limited liability companies. Thus, a BIT has a broader tax base and is more equitable and stable than a corporate income tax. However, it is still relatively volatile, based on economic conditions and the business cycle, and usually only taxes capital.

**Gross Receipts Tax (GRT)**

A gross receipts tax is a tax on total receipts from goods and services sold. A key advantage of this tax is that it has a very broad base, allowing it to raise a lot of revenue even with low tax rates. In addition, the GRT is stable and has low administrative costs. Disadvantages include tax pyramiding and vertical integration,8 the fact that businesses pay the GRT even if they suffer losses,9 and the fact that GRTs are not used in many states (although more states, including Michigan, have enacted GRTs in recent years).

**Business License Tax**

A business license tax is a fee of a flat dollar amount per taxpayer. It could have several tax brackets based on sales or income, with each bracket having a fixed fee amount. This tax is very simple, and therefore has low administrative and compliance costs. It is also very stable. The disadvantages of a business license tax are that it raises limited revenue and has little growth potential since it is a fixed-dollar amount per business, although it could be indexed to inflation to provide future growth. If all businesses are taxed the same amount, the tax is inequitable since it would represent a larger burden to businesses with little revenue compared to those with larger revenue. In addition, businesses are taxed even if they do not make a profit.

**Franchise Tax**

A franchise tax is a tax based on net worth (assets minus liabilities), equity, or assets. It could be a flat amount, like the business license tax, or a percentage of the tax base. Many states have a franchise tax in addition to a corporate income tax. Some states levy a franchise tax only on certain businesses, such as financial institutions. The positive aspects of a franchise tax include that it is stable, can be applied to all types of businesses, and minimizes compliance costs by taxing financial measures that businesses are familiar with. The negative aspects are that a franchise tax must be paid even if businesses do not make a profit, annual growth may be weak, and it is biased against capital if assets are used as the base.

**Value Added Tax (VAT)**

A value added tax is a tax on the difference between the amount of revenue businesses receive from selling goods and services and the cost of inputs to produce or provide those goods and services.10 A VAT is different from a GRT because a VAT allows businesses to deduct the cost of production inputs such as purchases from other firms and taxes included in the cost of those purchases. A VAT has a broad base, can be levied on all types of businesses, and treats all businesses the same. It is more stable than an income tax and is neutral with respect to labor and capital. However, it must be paid even when businesses do not make a profit and it is not widely used in the United States (although it is widely used in other countries).

**Business Tax Rankings**

Organizations have attempted to rank state business tax systems according to how much they promote or discourage economic activity. These rankings are controversial. Two such rankings, from the Tax Foundation and Ernst and Young/Council on State Taxation, are discussed below.

According to one index, the Tax Foundation’s *State Business Tax Climate Index of 2009*, Michigan ranks 20th in overall business tax climate out of the 50 states.11 The most competitive tax systems, and the ones that score best on this index, are the systems that create the fewest economic distortions by having broad bases and low rates and by treating...
all taxpayers the same. Each of the top 10 states in this ranking does not levy at least one of the five major taxes included in the index. These 10 states are able to raise sufficient revenue from property taxes, unemployment insurance taxes and some combination of sales taxes, individual income taxes, or corporate taxes.

The Center on Budget and Policy Priorities has cautioned that the Tax Foundation’s rankings are unreliable.\textsuperscript{12} They note that the rankings differ substantially from year to year, and argue that the differences are too large to represent actual changes in state tax policy. They question the Tax Foundation’s methodology, criticizing their use of a mix of actual data and projections derived from years-old data, and conclude that the Tax Foundation’s estimates may turn out to be incorrect and should not be relied upon. However, the CBPP is not an unbiased organization; as a liberal policy organization the CBPP advocates for increased business taxes.

Another ranking system developed by Ernst and Young and the Council on State Taxation examines state business tax burdens.\textsuperscript{13} They develop three measures of business tax burdens; using data from 2007, before the start of the MBT, Michigan is close to the national average on all three measures. The first looks at the business share of total state and local taxes. Businesses remit 44 percent of state and local taxes in Michigan, which is the same as the national average. This measure ranges from a low of 32 percent in Maryland to a high of 81 percent in Alaska. The second measure, or the total effective tax rate imposed on business activity, is the ratio of state and local business taxes to private sector gross state product (the total value of the state’s annual production of goods and services by the private sector). This measure ranges from 3.5 percent in Delaware to 11.6 percent in Alaska. At 5.1 percent, Michigan is again very close to the national average of 5.0 percent. A third measure used in this report is the ratio of business taxes to government expenditures for services used by businesses. This measure ranges from 1.38 in Oregon to 3.73 in Wyoming. Michigan is at 1.60, slightly below the national ratio of 1.78. The report notes that these rankings are useful in comparing tax burdens across states, but provide only limited information regarding a state’s competitiveness.

Michigan Future, Inc., a non-profit organization whose mission is to provide Michigan residents and businesses with the tools to succeed in today’s economy, argues that factors other than a state’s business tax climate affect its economic prosperity. In \textit{A New Agenda for a New Michigan}, they argue that there is no evidence that lowering taxes is an effective economic growth strategy to create a high-prosperity economy.\textsuperscript{14} The report notes that the states with the lowest taxes lag behind the national average in per capita income, share of employment earnings from high-pay, knowledge-based industries, and proportion of adults with at least a college degree. The report argues that most successful states are not characterized by low taxes. However, it is difficult to interpret such simple comparisons between tax burdens and economic prosperity since there are many intervening factors that affect tax burden and measures of economic prosperity and these factors vary by state. For example, a state may decide to repeal taxes exactly \textit{because} of poor economic growth in the state.

\textbf{DO BUSINESS TAXES INFLUENCE BUSINESS LOCATION DECISIONS?}

The extent to which a state’s business tax policy significantly affects where businesses decide to locate and, therefore, create jobs, is an unresolved question. In \textit{Michigan at the Millennium}, University of Michigan economist James Hines reviews academic studies that found little effect of tax policy on business location decisions as well as others that found significant effects, settling eventually on the side that tax policy does indeed affect business investment decisions.\textsuperscript{15} In \textit{Michigan’s Economic Future}, Charles Ballard, a Michigan State University economist, also reviews the contradictory literature and concludes that business taxes likely have a modest impact on business location decisions and business activity.\textsuperscript{16} But, Ballard also notes that high business taxes may not harm economic growth if the revenues are used to finance services valued by businesses and that taxes are just one of many components that influence business location decisions. The Tax Foundation’s 2009 State Business Tax Climate Index argues strongly that the economic
literature has finally resolved itself around the idea that taxes do indeed impact business location decisions.\textsuperscript{17} That report argues that states compete for business with their tax systems and that taxes have a significant effect on business activity and growth.

In addition to the empirical evidence on the effectiveness of business taxes to attract and retain businesses, many analysts hold theoretical beliefs about the role of taxes and a state’s economic strategy. Many analysts across the political spectrum think that the government should not pick winners and losers through incentives. Tax breaks for one industry mean higher taxes for others, if tax revenue is to remain constant. While this may be desirable in the short run, permanently subsidizing one industry at the expense of others may be less so.

In Michigan, there are several tax incentives aimed at attracting business to the state. A variety of analysts argue that these credits have had mixed results. A recent paper found that the film credit enacted as part of the MBT (discussed later in more detail) has benefited Michigan’s economy.\textsuperscript{18} The authors found that film production created 1,102 year-round jobs in Michigan in 2008, with total wage and salary income of $53.8 million. They estimate that benefits from the tax credit will increase over time based on economic theory and the experiences of Louisiana and New Mexico, which passed similar credits in 2002 and continue to experience growth in film production expenditures. Although the film credit appears to have led to new jobs, other credits may have been less successful, according to other analysts. The Michigan Economic Growth Authority (MEGA) Act, which was established in 1995, provides tax credits to select high-technology businesses and businesses that will create and maintain significant job opportunities, particularly in rural areas. A 2005 study by the free-market think tank Mackinac Policy Center argued that MEGA did not improve Michigan’s per-capita personal income, employment, or unemployment rate and concluded that the credits were ineffective.\textsuperscript{19}

**BUSINESS TAXES IN MICHIGAN**

In recent years, business taxes have been one of Michigan’s highest priority policy issues. The Michigan Business Tax (MBT), signed into law on July 12, 2007, replaced the Single Business Tax (SBT) effective January 1, 2008 (businesses paid the SBT for the 2007 year). The SBT became very controversial over time. Its replacement, the MBT, has also been controversial.

**The Single Business Tax (SBT)**

The Single Business Tax (SBT) was intended to impose a form of value added taxation that would allow firms to deduct investment expenditures from taxable income and thus encourage business investment.\textsuperscript{20} The original SBT rate was 2.35 percent, reduced to 2.3 percent in 1994. In 1999, legislation was passed to reduce the rate by 0.1 percent each year until the tax was eliminated as long as the state’s Budget Stabilization Fund (i.e. “rainy day fund”) did not fall below $250 million. In 2002, legislation was passed that allowed the fund to fall below $250 million, while the rate was maintained at 1.9 percent until 2009, when the tax would be eliminated.

The SBT was a modified value added tax on the value a business adds to its product during production. The main components of added value were the cost of labor, capital, and profit, with deductions allowed for capital investment and an exemption for small businesses. The small business exemption and other deductions, credits, and exemptions added over the years made the SBT more complicated and less like a traditional VAT.

Originally, the SBT was simple and transparent, making it efficient, and the revenue stream did not fluctuate significantly with the business cycle relative to other business taxes. New investment was untaxed under the SBT. However, the SBT imposed substantial taxes on firms that lost money, and concerns about the constitutionality of the capital acquisition deduction, prompted by the increasing multistate nature of many of Michigan’s businesses, eventually contributed to the phased elimination of the SBT.\textsuperscript{21} Over time the SBT became increasingly complex and unpopular in the business community and then also in the political arena. For more information on the SBT, see Hines’s chapter in *Michigan at the Millennium*.

**The Michigan Business Tax (MBT)**

Along with a 21.99 percent surcharge, the new tax has two components: a business income tax and
The business income tax is a tax on the business income of all eligible taxpayers with business activity in Michigan. The modified gross receipts tax (GRT) is a tax on the dollar value of the receipts from the sale of goods and services minus the cost of purchases of tangible goods from other firms. Business income is taxed at a rate of 4.95 percent and gross receipts at 0.80 percent.

Insurance companies, financial institutions, and some small businesses pay a different tax rate than other entities. Banks pay an alternate capital tax, a tax on net worth at a rate of 0.235 percent. The insurance tax rate on premiums was increased to 1.25 percent from 1.07 percent under the SBT, and credits were retained. There is also a small business alternate tax and a small business tax credit.

The MBT retained many credits from the SBT as well as adding new credits. The tax includes substantial credits for compensation paid in Michigan, research and development, and capital investment in Michigan. In addition to these and other credits, there is a film-making subsidy designed to attract out-of-state moviemakers to Michigan.

Most businesses must pay the state an additional surcharge of 21.99 percent on top of their total tax bill under the MBT. This surcharge was added in December of 2007 to help reduce the state budget deficit after a plan to expand the use tax to include more services was abandoned, and it is scheduled to expire in 2017. The surcharge is capped at $6 million for most businesses. For financial institutions, the surcharge was 27.7 percent in 2008 and 23.4 percent for 2009 and after; the surcharge is not capped for financial institutions. Insurance companies and some small businesses are not subject to the surcharge.

The MBT was intended to shift the tax burden to entities outside of Michigan. The tax has a low nexus standard (the standard for determining the presence of a business in Michigan): businesses are subject to the gross receipts tax if they have a physical presence in Michigan for more than one day annually or if they actively solicit business in Michigan and have $350,000 or more in Michigan-sourced gross receipts. The low nexus standard was intended to result in higher tax burdens for businesses based in other states that sell in Michigan markets.

The SBT raised $1.786 billion in FY 2007, the last year the SBT was in place. This represented 7.3 percent of state tax revenue. In FY 2008, revenue from the MBT was $2.454 billion, which represented 9.5 percent of state tax revenue.

**IS THE MBT A GOOD BUSINESS TAX?**

Evaluated using the principles of a good tax system described above, is the MBT a good business tax? An economist at the Michigan Senate Fiscal Agency assesses the MBT according to these criteria. He argues that the MBT will be less reliable than the SBT, likely generating inconsistent revenue streams from year to year. It will probably not keep up with economic growth or inflation, and is unlikely to raise sufficient revenue over time. While it exhibits vertical equity, the tax does not possess horizontal equity due to the many credits and the gross receipts portion. The gross receipts tax is inequitable due to tax pyramiding, as described in detail below. The analyst also notes that because the MBT is a unique and complicated tax, it will lead to high administrative and compliance costs, rendering it inefficient. In addition, the business income portion of the tax is biased against capital.

The MBT and especially the surcharge are widely criticized in the business community, although some analysts argue that the MBT is not yet well understood. While the tax benefits some firms in comparison to their previous burden under the SBT, it hurts others. The surcharge is described as burdensome for many firms and is almost universally disliked. The business income portion of the tax is straightforward, but the gross receipts tax is criticized for introducing tax pyramiding (described below), being overly complicated, and for having many exceptions. After its many years of modifications, the SBT was also heavily criticized for its complexity and the resulting burdens placed on businesses for compliance and reporting.

The MBT has shifted tax burdens among different kinds of firms. It has helped manufacturers via personal property tax credits, but has hurt commercial real estate companies and service-based businesses by changing the way their tax liability is calculated. The tax has also benefited small businesses in that

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more small businesses are eligible for tax breaks under the MBT than were eligible under the SBT.

A recent Michigan Chamber of Commerce Survey of 700 chamber members found that 80 percent of respondents feel that they are worse off under the new business tax. More than 30 percent of those respondents said that their tax burden under the MBT represented a 100 percent or more increase over their SBT burden. The Michigan Chamber is critical of the new tax, although it acknowledges some benefits, including expanded relief for small businesses and manufacturing companies and rewards for putting employees and property in Michigan.

The Michigan Business Tax Assessment Subcommittee of the Michigan State Senate held four meetings in May of 2008 during which they heard testimony from businesses on the impact of the MBT. The subcommittee found that the tax burden of the MBT is much higher for firms in many industries than was the case under the SBT. It also found that the 22 percent surcharge is universally disliked and imposes heavy burdens on many firms. Firms complained of high compliance costs and many were unaware that they qualified for credits and deductions. Although the tax has expanded relief for small businesses, many were not aware that they were eligible for the small business credits.

Some firms testified that they are unable to hire additional workers or offer wage and salary increases due to the burdens imposed by the MBT. Some indicated that they are at a disadvantage compared to non-Michigan based competitors and a few even noted that they may leave the state. While manufacturers benefit from personal property tax credits, they remain critical of the surcharge. Real estate developers have experienced especially large increases in liability under the MBT, as have service-based businesses.

An economist at the Michigan Senate Fiscal Agency found little evidence that the MBT has exported the tax burden to other states. He estimates that in 2009 Michigan-only firms will experience a $572.4 million tax increase compared to the SBT, while multistate firms will experience only a $122.9 million increase. Thus, 82.3 percent of the tax increase is borne by Michigan-only businesses. Among multistate businesses, those based in Michigan will experience a decrease in tax burden from the SBT of $223.4 million, while those based out-of-state will experience an increase of $286.1 million. In other words, under the MBT, the tax burden will be redistributed among multistate firms, with the increase in tax burden for those based in other states paying for the decrease in burden for those based in Michigan. Tax revenue from firms located only in Michigan will increase under the MBT.

**PROPOSALS TO MODIFY THE MBT**

Due to the unpopularity of the MBT and its surcharge, there have been many proposals to modify the new tax. The Senate passed SB 1 on January 29, 2009. This bill would decrease the MBT surcharge by 50 percent in 2009, making the surcharge 11 percent. It would then eliminate the surcharge for businesses other than financial institutions in 2010. The Senate Fiscal Agency estimates that this bill would reduce revenue from the MBT by $166.1 million in FY 2008–2009, by $457.5 million in FY 2009–2010, and by $593.4 million in FY 2010–2011.

In addition, SB 1038 was passed by the House and the Senate in 2008 and became law on January 9, 2009. This act removes some taxes and fees from inclusion in the gross receipts tax portion of the MBT. Currently, some taxes and fees are included in the calculation of gross receipts, and many businesses have complained that this amounts to a tax on a tax. This act solves that problem. The Senate Fiscal Agency estimates that this act will reduce revenue an unknown and potentially significant amount.

Other policy makers have also weighed in on the MBT. Governor Jennifer M. Granholm is willing to discuss changes to the MBT, but with conditions such as reducing the cost of the state prison system to offset reduced revenue. Increasing costs of Michigan’s corrections system has made it a target for reform and some have suggested that savings from corrections reform could be used to pay for reductions in the MBT. A proposal by the Detroit Regional Chamber and others would overhaul the prison system, saving $800 million a year, and use the cost savings to phase out the MBT surcharge. Other reform proposals include the West Michi-
gan Regional Policy Conference’s call to eliminate the MBT outright without replacement, accompanied by cuts in state spending. However, given that spending has decreased drastically over the past two decades largely due to previous tax cuts, many analysts argue that further deep spending cuts would be irresponsible. Finally, some policy makers have suggested eliminating the film industry subsidy, a tax break designed to attract out-of-state moviemakers to Michigan, in an effort to diversify the state economy.

OPTIONS FOR FURTHER BUSINESS TAX REFORM

If the MBT surcharge is repealed, Michigan will need to either cut spending or replace the lost revenue with new taxes or changes to existing taxes. As noted above, some policy makers have proposed cuts to the state prison system to finance repeal of the surcharge or eliminating the film credit to raise more revenue. Others, including Michigan State University economist Charles Ballard, have suggested several other ways to raise revenue. Ballard has recently raised the idea of eliminating the MBT entirely and replacing the revenue through other sources such as making the currently flat individual income tax a graduated tax. Michigan is one of the few states that has only one individual income tax rate which increases the regressivity of Michigan’s tax system. Most other state income taxes and the federal income tax have graduated marginal tax rates, meaning that individuals with higher incomes face higher tax rates. Ballard’s call for a graduated income tax would require an amendment to Michigan’s Constitution and might therefore be politically difficult.

Another option proposed by Ballard and others is including more services in the sales tax. Like in many states, most services are exempt from the sales tax in Michigan. As recounted by Ballard in Michigan’s Economic Future, a recent report by the Federation of Tax Administrators listed 168 categories of business services that can be taxed. Ballard reports that the median state taxes 55 categories while Michigan taxes only 26.

The potential revenue lost from not including services in the sales tax is large and growing as services become a more important part of the economy. One argument against expanding the sales tax to cover more services is that this will lead to employment losses in the service sector of the economy. While this may occur, economic theory argues there will be employment gains in the sectors of the economy that were previously harmed by being taxed while other sectors went untaxed. Ballard argues that overall employment will not decrease substantially and may even increase because including more services in the sales tax would lead to a more efficient allocation of resources in the economy. As mentioned above, a law that would expand the use tax to include many services was enacted in 2007, but was repealed under intense lobbying pressure before implementation.

STATE TAX POLICY CHANGES AND PROPOSALS AROUND THE NATION

Many states have adopted new corporate tax policies in response to declining revenues, especially during the 2000–2003 cyclical economic downturn. However, the downturn was not the only cause of the declining revenues. Corporate tax revenues have been declining since the early 1990s largely because of reductions in the federal corporate tax base, state policy decisions that lowered corporate tax burdens, such as legislation enabling the formation of LLCs, and more aggressive corporate tax planning.

Gross Receipts Taxation

One major change in tax policy in recent years is the movement to replace corporate income taxes with gross receipts taxes. In Michigan, the gross receipts tax (GRT) portion of the MBT is a tax on the dollar value of receipts from the sale of goods and services, minus the cost of business purchases from other firms. In 2002, only three states had significant GRTs; since then five more states (including Michigan) have enacted GRTs either to replace existing taxes or as a source of additional revenue, and GRT proposals have also been considered in three other states. In addition to Michigan, Delaware, New Hampshire, and Ohio all levy both a business income tax and a gross receipts tax. Among states
that levy GRTs, Michigan’s rate is the second highest after Texas.

GRTs differ from corporate income taxes in that they often apply to all forms of business organizations and thus have a broader base, covering more economic activity. GRTs are applied on each business transaction, meaning goods and services can be taxed one or more times during the production process and again at the final sale to consumers. For example, the GRT would apply not only when a car company sells a car, but also when tire manufacturers sell tires or when steel manufacturers sell steel to the car company. This aspect of the GRT is called tax pyramiding and is one of the main criticisms of GRTs. Tax pyramiding means that GRTs violate the principle of horizontal equity, as similar firms may have different tax burdens due to pyramiding. The GRT portion of the MBT partially addresses this concern by allowing the deduction of capital purchases from other companies from gross receipts.

GRTs are also criticized for distorting economic decisions by favoring vertical integration. Firms have an incentive to integrate with their suppliers to avoid being taxed at intermediate stages of the production process. In the example above, the car company could integrate with the tire and steel manufacturers to avoid the taxes applied at each stage of the process. This artificial incentive for integration distorts economic decisions and means that firms that are not vertically integrated may face higher tax burdens than those who do integrate vertically.

Some analysts believe that GRTs are a second-best option and that value added taxes are a better approach. A value added tax (VAT) is a general sales tax on all goods and services that is levied on a business at each stage of the production and distribution process. A VAT differs from a GRT in that purchases from other firms and taxes included in the cost of those purchases are deducted in the VAT but usually not in the GRT. By allowing deductions of the cost of certain purchases from other firms, the gross receipts portion of the MBT is similar to a VAT. It is worth noting that the SBT was a VAT, although the many modifications to it over the years made it less and less like a traditional VAT.

Scholars argue that a VAT accurately reflects the economic presence and activity of a firm in the state and is more closely aligned with business services consumed by the firm. A VAT is also unbiased towards either capital-intensive or labor-intensive firms, whereas other business taxes often tax capital more heavily than labor. Some researchers argue that while a VAT is superior, a GRT is better than a corporate income tax because it is levied on all businesses, is easier to administer and comply with than a business income tax, and has a broad base and low rate.

**Limited Liability Companies**

An important reason why state corporate tax revenues have declined nationally is the advent of limited liability companies (LLCs). A limited liability company is a business structure that combines elements of a corporation and a partnership. Like a corporation, owners have limited liability for the debts of their company, but owners of LLCs also retain the flexibility of a partnership. There are tax advantages to LLCs because they avoid the double taxation of profits once as business income and once as personal income through salary or dividends. By 1996, all states and the District of Columbia enacted LLC statutes, and many corporations became LLCs.

LLCs facilitate state tax avoidance and, consequently, have had a negative impact on state corporate tax revenues. LLCs can increase tax avoidance because they can allow multistate businesses to shift income to states that do not tax LLCs. Some states have made an effort to offset the losses from LLCs by increasing annual fees on LLCs and taking other steps. Yet, the prevalence of LLCs presents an obstacle to both maintaining and increasing state revenue streams.

In 2006, Michigan ranked 10th in the number of LLCs created. LLCs are subject to the MBT and do not receive tax preferences, so LLCs are less of an issue for Michigan’s tax revenue compared to some other states.

**Combined Reporting**

Another cause of declining state corporate tax revenue across the nation is the failure to require combined reporting. Combined reporting treats parent corporations and their subsidiaries as a single corporation. This increases tax revenue because companies can no longer move profits into subsidiaries located in states with low or no business
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taxes. This is one example of a tax planning strategy or tax shelter that companies use to lower their tax burdens. Michigan adopted combined reporting as part of the legislation enacting the MBT. About half of the states with corporate income taxes currently require combined reporting.

Some scholars have found that, in practice, combined reporting does little to combat aggressive tax planning, while others have found that it has been effective at fighting tax shelters. One group of researchers finds that combined reporting has limited effectiveness in practice because state laws differ regarding which companies need to file a combined tax return and in several states combined reporting is voluntary. On the other hand, another researcher finds that combined reporting is effective in combating tax shelter strategies by allowing the state to tax profit shifted into out-of-state subsidiaries.

CONCLUSION

Business taxes have been an important issue in Michigan in recent years, and it appears likely that they will continue to be a major concern in the future. Like its predecessor, the SBT, the MBT has generated much controversy and has led to many proposals for reform. Policy makers, businesses, scholars, and others have come up with various ideas for modifying or replacing the MBT.

Other states have also adopted new business tax policies in recent years to address the problem of declining revenues. These policies, such as gross receipts taxation, limited liability legislation, and requiring combined reporting, have had mixed results. As described above, there are a wide variety of business taxes in use by states, and all of these have advantages and disadvantages when evaluated in terms of the three principles of a good tax system: reliability, equity, and efficiency. The MBT does not appear to score well on these three principles, and therefore seems likely to face continuing calls for reform or elimination.

Notes
3. Although vertical equity is more often thought of in terms of the tax burden on individuals, it can still be useful for analyzing business taxes.
7. The argument that a business tax should only tax businesses that make a profit is not a strong one. Businesses must still pay suppliers and workers regardless of whether they make a profit, and this argument is not used in the context of other taxes.
8. Tax pyramiding, vertical integration, and gross receipts taxes will be discussed in greater detail later in this brief.
9. Although, some economists note that businesses must pay their workers and suppliers and remit income tax withholding and payroll tax withholding even if they suffer losses and, consequently, GRTs should not necessarily be different.
10. Labor and capital inputs are excluded in the calculation of a VAT.
11. Barro, 2008. This index compares states on five aspects of the overall business tax climate: corporate taxes, property taxes, individual income taxes, sales taxes, and unemployment insurance taxes. The results for these components are added to determine the overall ranking. The individual income tax is a component because some businesses, such as partnerships, report their income through the individual income tax code.


22. Capital expenditures are subtracted from gross receipts, but not service expenditures.

23. The plan to expand the use tax to include a broad array of services was enacted in October of 2007, but was repealed immediately before implementation in December of 2007.


26. This was an on-line poll of Michigan Chamber of Commerce members conducted from March 8 to April 28, 2008. Respondents included company presidents, CEOs, senior executives, and business owners from across the state.


42. Testa & Mattoon, 2007.

43. Testa & Mattoon, 2007.

44. Pogue, 2007.


47. Fox & Luna, 2005.


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