



**Testimony before the
Governor's Committee for Simple, Fair, and Low Taxes
Jefferson City, Missouri
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**by
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Chairman Walters and Members of the Committee, thank you for inviting me to provide the Council On State Taxation's views on Missouri's tax system to aid your deliberations. My testimony will focus on the Committee's goals of achieving a best-in-class tax system, well integrated with the State's overall business climate, and supported by sound economic analysis. Assessment and evaluation of Missouri's tax credit programs should be viewed in light of those goals. With a view towards achieving a best-in-class tax system, I plan to address three fundamental questions regarding the State's *business* taxation: 1) Are businesses paying their fair share of Missouri's taxes? 2) What is the compelling economic justification for taxing businesses at all? and 3) What steps can Missouri take to implement a fair, efficient, and competitive state business tax system?

About COST

COST is a nonprofit trade association consisting of approximately 600 multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Are Businesses Paying Their Fair Share of Missouri Taxes?

EY, in conjunction with COST, annually estimates the total state and local tax burden imposed on businesses in each state. Our fourteenth annual report "*Total State and Local Business Taxes*" was released in December 2016.

This "State Tax Burden" study provides estimates of the total taxes paid by businesses in each state, an important first step in any evaluation of business taxes or tax reform. The total tax burden paid by businesses includes corporate income taxes, franchise taxes, property taxes, sales taxes on business inputs, excise taxes, business taxes paid through the personal income tax by pass-through entities, unemployment taxes, and license taxes. To enable comparisons across states, the study also measures benefits received by businesses due to government spending and calculates a tax-benefit ratio to estimate the extent businesses are "getting what they paid for" through their tax dollars.

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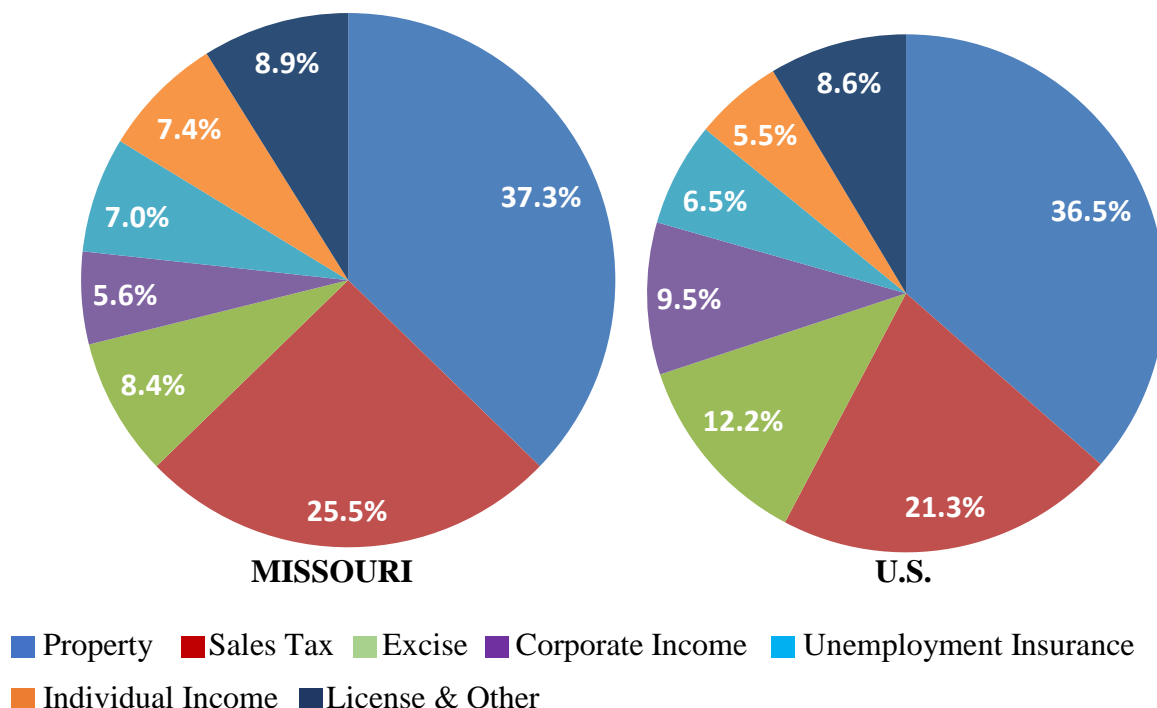
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The annual study was developed to answer questions from legislators asking, “Are businesses paying their fair share of taxes?” Increasing economic competition among states and around the globe has transformed the initial question into a more fundamental query: “What is the basis or rationale for business taxation at the state or local level?” The basic rationale for business taxes, recognizing that the economic burden of business taxes is ultimately borne by consumers or owners of factors of production (including workers), is to pay for government services that directly benefit businesses.

If state and local business taxes are equal to the value of the benefits business received from state and local public services, they would be considered a payment for services, and taxes would not influence business location decisions or impact competitiveness. However, if state and local business taxes exceed the value of the benefits received from government services, the difference represents an excess cost to business that will reduce profitability in the absence of shifting the tax through higher prices or lower payments to labor. When such excess costs exist, they can affect a company’s choice of locations.

In FY 2015, the study¹ estimates that Missouri businesses paid \$9.1 billion in state and local taxes, or 40.3% of all taxes collected in Missouri. Neighboring states generally compare unfavorably in the business share of their respective tax burdens: Arkansas – 40.6%; Illinois – 44.7%; Iowa – 45%; Kansas – 47.5%; Nebraska – 46.2%; Oklahoma – 49.1%; and Tennessee 53%. Nationwide, businesses contributed \$707.5 billion, or 44.1% of all state and local taxes.



¹ Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2015, December 2016, available at: <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=94697>.

Missouri also fares generally well against its surrounding states when evaluating the amount of taxes paid by businesses as compared with the value of benefits received by businesses through government spending. Using the Study's mid-range for education spending deemed to benefit business, Missouri's tax benefit ratio is 1.5; that is, for every \$1.50 paid in state and local taxes, Missouri businesses receive only \$1.00 in government benefits. Tax benefit ratios for surrounding states are as follows: Arkansas - 1.5; Illinois - 1.5; Iowa - 1.6; Kansas - 1.8; Kentucky - 1.3; Oklahoma - 2.1; and Tennessee - 2.1. The national average tax benefit ratio for all states is 1.64.

Evaluating State Corporate Income Taxes

State corporate income taxes seem to garner an inordinate amount of attention from policymakers, commentators, and interest groups – perhaps because the tax is often perceived by the uninformed to be the primary source of business taxation levied by states. In fact, state corporate income taxes contribute relatively small amounts to state coffers. Nationally, in FY 2015, state corporate income taxes generated only 9.5% of total state and local business taxes. In Missouri, it comprises approximately 5.6% of all business taxes. Yet because the tax is inherently unstable (it only operates when a corporation earns income) and because the myriad of bases, rates, and rules among states allow tax planning opportunities, it is widely vilified as rife with “loopholes” that need “closing.” State corporate income taxes are also tremendously complex, creating costs of compliance and tax administration that are far out of proportion to other significant taxes paid by businesses, such as property or sales taxes. Indeed, many public finance economists “find little justification for the state corporate income tax” in the first instance.² Professor Charles McLure of the Hoover Institution says:

It is hard to think of a good reason to tax corporate income.... The case against state corporate income taxes is even stronger. It is common among economists to acknowledge that a small open economy (one that cannot affect the world price of capital) should not tax the return required to elicit investment within its boundaries.... The difficulty of actually taxing corporate income where it originates is a further reason for not trying to tax it.³

Despite the economic consensus that the state corporate income tax is a poor tax, it exists. And, because of the erroneous public perception that the corporate income tax is the primary business tax, it is often the focus of “corrective” legislation in efforts to “save” the tax. In many cases, however, attempts to fix the tax can have greater repercussions from a competitiveness and economic development perspective than the tax itself. Because the corporate income tax is inherently volatile and difficult to administer, policymakers should not rely on the tax as a consistent and stable source of revenue. Instead, programs and legislation that ease the burdens of the tax can be a significant economic development tool and a means of improving the State's business climate.

² Fox, William F., Matthew N. Murray and LeAnn Luna, “How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?” *National Tax Journal*, March 2005.

³ McLure, Charles, “How to Improve California's Tax System: The Good (But Infeasible), the Bad, and the Ugly,” California Commission on the 21st Century Economy, February 2009

Steps to Improve Missouri’s Business Tax Climate

Avoid Mandatory Unitary Combined Reporting:

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and corporate taxpayers is how a state should determine the corporate income tax base for multistate corporations with multiple businesses and entities. One method -- mandatory unitary combined reporting -- is touted by proponents as a “loophole closer” and as a way to stop “income shifting” to low tax jurisdictions. In actuality, however, mandatory unitary combined reporting carries severe economic consequences: it arbitrarily assigns income to a state, negatively impacts the real economy, and imposes significant administrative burdens on both the taxpayer and state.⁴

The administrative and compliance burdens of mandatory unitary combined reporting can be severe, particularly if the state revenue department expects to achieve what are often “aspirational” fiscal estimates. The concept of a “unitary business” is uniquely factual and universally poorly defined. It is a constitutional (Due Process) concept that looks at the business as a whole rather than individual separate entities or separate geographic locations. In order to evaluate a taxpayer’s determination of a unitary relationship, state auditors must look beyond accounting and tax return information. Auditors must annually determine how a taxpayer and its affiliates operate at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation’s operational and tax staff to gather this operational information. In practice, however, auditors routinely refuse to make a determination regarding a unitary relationship based on operational information and instead wait to determine unitary relationships until after they have performed tax computations. In other words, the tax result of the finding that a unitary relationship exists (or does not exist) often significantly influences, or in fact controls, the auditor’s finding. Determining the scope of the unitary group is a complicated, subjective, and costly process that is not required in separate filing states and often results in expensive, time-consuming litigation.

Avoid “Alternative Base” Business Taxes:⁵

In part because of the flaws associated with the corporate income tax, a handful of states have considered or enacted new business taxes that are based on some alternative base. These alternative base taxes are generally derived from—or linked to—gross receipts. Gross receipts taxes are widely acknowledged to violate numerous tax policy principles.

Gross receipts taxes had largely disappeared as an important revenue source for state governments by the later years of the twentieth century, usually after considerable effort by state business groups to eliminate them. Analysts and scholars presumed that these taxes—also known

⁴ A thorough discussion of the problems associated with MUCR can be found in the study prepared for COST by Ernst & Young LLP, “Understanding the Revenue and Competitive Effects of Mandatory Unitary Combined Reporting” (<http://www.cost.org/WorkArea/DownloadAsset.aspx?id=70000>).

⁵ This section is excerpted from a joint COST/Tax Foundation Study: “*Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance*” (January 2007) by John Mikesell, professor of public finance and policy analysis and director of the Master of Public Affairs program at the Indiana University School of Public and Environmental Affairs. Link: <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=67458>.

as “turnover taxes”—had forever been replaced with options that made more sense as ways of distributing the cost of government and had less undesirable impact on the taxpaying public, including businesses, and generally lost interest in them. In recent years, however, such broad base, low-rate taxes have again entered state tax policy discussions. With this re-emergence comes a need for a new analysis of gross receipts taxes to aid policymakers who are unfamiliar with their structure and drawbacks. This examination of American and European experience with gross receipts taxation has identified several significant conclusions about the tax. These may be summarized:

- *Broad Base:* The gross receipts tax base can be broad, broader than the total value production of the economy, but it lacks any link either to capacity to bear the cost of government services or to the amount of government services used—the normal standards for assigning tax burdens.
- *Low rate:* Whether a gross receipts tax has a low rate depends on how much revenue the government intends to raise from it. Unlike most taxes, the effective rate of a gross receipts tax is higher than the statutory (or advertised) rate. A broad-based, low-rate gross receipts tax is unlikely to contribute a major share of tax revenue to a modern state government.
- *Stable revenue:* A gross receipts tax appears to be roughly as stable as a retail sales tax. Its variations do not contribute to the overall stability of total state revenue because its fluctuations follow generally the same pattern as other major taxes.
- *Economic neutrality:* A gross receipts tax interferes with private market decisions. Its pyramiding creates a haphazard pattern of incentives and disincentives for business operations. Most significantly, it establishes artificial incentive for vertical integration and discriminates against contracting work with independent suppliers and the advantages of scale and specialization that production by independent firms can bring.
- *Competitiveness:* A gross receipts tax interferes with the capacity of individuals and businesses to compete with those in other states and other parts of the world. The tax embedded in prices grows as the share of a production chain within the state increases, so there is incentive to purchase business inputs from outside the state. It discourages capital investment by adding to the cost of factories, machinery, and equipment, and the disincentive increases as more of those capital goods are produced in the taxing state. This tax structure does not promote the growth and development of the state.
- *Fairness:* A gross receipts tax does not treat equally situated businesses the same. Firms with the same net income will face radically different effective tax rates on that income, depending on their profit margins. Low-margin firms will be at great disadvantage relative to higher-margin firms, regardless of their overall profitability. Many new and expanding firms have low margins (or even are initially unprofitable) and the gross receipts tax reduces the chance that these firms will survive. This also is not consistent with a climate for growth and development.

- *Transparency:* A gross receipts tax is a stealth tax with its true burden hidden from taxpayers. Hiding the cost of government is inconsistent with efficient and responsive provision of government services and contrary to the fundamentals of democratic government.

There is no sensible case for gross receipts taxation. The old turnover taxes—typically adopted as desperation measures in fiscal crisis—were replaced with taxes that created fewer economic problems. They do not belong in any program of tax reform.

Improve State Tax Appeals and Procedural Requirements:

COST regularly evaluates states' statutes, rules, and practices that impact taxpayer access to an independent appeals system and that impact fairness and efficiency. In the latest COST administrative scorecard (December 2016),⁶ Missouri received a B grade. Below are our findings that contributed to that grade, including any updates to our prior research.

- *Independent appeals forum:* While Missouri's Administrative Hearings Commission is an independent agency, its commissioners are not required to have tax expertise (and appear generally not to possess such expertise). Further, the Commission hears all types of executive agency appeals. To ensure the requisite expertise to handle complex tax appeals, COST recommends that independent tax tribunal judges have significant state tax experience, and the tribunal should dedicate those tax tribunal judges to deciding tax appeals.
- *Timing of appeals:* Taxpayers have 60 days after mailing date to protest a notice of deficiency however, they only have 30 days from the mailing date to appeal a final income tax decision of the Department of Revenue to the Administrative Hearing Commission. As with protests of assessments, taxpayers should have at least 60 days from the actual receipt of a determination to appeal an adverse final decision of the Department of Revenue to an independent tribunal.
- *Interest rate differential:* While Missouri's interest rates on tax refunds and underpayments previously were the same, since 2004 there has been a differential in the interest rate applied to refunds versus tax deficiencies. The statutory rate of interest applied to refunds is the annualized average rate on funds invested by the Treasurer's Office, whereas the rate applied to underpayments is the prime rate. For 2017, the resulting interest rate applied to refunds is less than one percent per quarter, while the rate on tax deficiencies is 4%. In addition to this disparity, interest on refund claims begins from the date a claim is filed and not the date the tax was overpaid. In contrast, interest on tax deficiencies starts from the original payment due date. For business taxes, no interest is paid if the refund is issued within 120 days of filing the return or the claim. Interest rates are meant to compensate for the time-value of money, and the rate (and its application) should be equal for both refunds and tax deficiencies.
- *Reporting of federal changes:* COST supports clear and consistent rules for determining when a "final determination" of a federal income tax audit triggers a reporting requirement to a

⁶ COST Scorecard on Tax Appeals & Procedural Requirements, December 2016, available at: <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=94726>.

state.⁷ The reporting requirement should only require a taxpayer to file one return after the audit is truly final (*i.e.*, all appeals exhausted). A taxpayer should also be able to make estimated payments to address a potential tax deficiency, while preserving the taxpayer's right to a refund. COST urges a review of Missouri's regulatory definition of "final determination" against these standards. COST also supports providing at least six months (or 180 days) to file an amended return or worksheet to the state to notify it of the changes. Missouri currently requires reporting a final determination within 90 days.

- *Additional issues impacting fair and efficient tax administration:*
 - New issues to support claims for refund may not be raised at the Administrative Hearing Commission. Because the Commission is the first level of review by an independent tax tribunal, taxpayers should be allowed to raise new issues to the Commission.
 - Constitutional issues must be raised at the Commission level, even though the Commission may not decide those issues. COST recommends allowing taxpayers to raise constitutional issues on appeals of Commission decisions, even if those issues were not raised by the taxpayer before the Commission.

Improve Property Tax Administration:

COST also evaluates both U.S. and international property tax systems to provide an international scope for tax policymakers with best practices and a comparative measure of the fairness and efficiency of their property tax administration practices.⁸ Missouri received a C+ grade in this most recent scorecard (September 2014). While some of the categories may be beyond this Committee's purview, there are several issues this Committee should review. These include:

- Providing a *de minimis* exclusion;
- Excluding intangible property;
- Equalizing interest rates on overpayments and underpayments of tax;
- Providing at least 60 days to appeal; and
- Allowing the taxpayer to defer payment on the disputed tax rather than prepay (although the collector escrows the disputed amount).

Participate in National Sales Tax Simplification Efforts:

COST has regularly participated in the Streamlined Sales Tax project since its inception, representing the business community in working cooperatively with state tax administrators and legislators in seeking to simplify and harmonize state sales tax and use tax systems. COST encourages Missouri to consider conformity with and becoming a full member of the Streamlined Sales and Use Tax Agreement (SSUTA). While we understand that approval of

⁷ For COST's policy position and a recommended definition of "final determination," see [http://www.cost.org/uploadedFiles/About_COST/Policy_Statement/COST%20Federal%20Tax%20Changes%20\(RAR\)%20POLICY%20%20FINAL%204.%2016.15.pdf](http://www.cost.org/uploadedFiles/About_COST/Policy_Statement/COST%20Federal%20Tax%20Changes%20(RAR)%20POLICY%20%20FINAL%204.%2016.15.pdf).

⁸ COST's most recent property tax scorecard is available at <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=88125>. The addendum to the study is available at: <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=88127>.

ballot Amendment 4 prohibits the State from expanding its sales tax base to services or to any transactions not subject to the sales tax as of January 1, 2015, the SSUTA provides multiple “toggles” designed to allow states to maintain current exemptions and exclusions while providing clarity and ease of administration. Further, the SSUTA has numerous benefits beyond the definitional categories, including uniform exemption administration provisions that would be a major benefit for Missouri businesses, regardless of whether the state seeks SSUTA membership.

COST is currently researching a new scorecard on sales tax issues. Many of the categories examined in this scorecard are addressed through the SSUTA. Another major category is taxation of business inputs. A well-designed sales tax exempts business-to-business (B2B) transactions. While Amendment 4 will prevent new taxes on B2B services, Missouri already imposes approximately 46% of its sales taxes on business purchases. These costs are borne directly by businesses and not billed through to customers. Our research shows that companies subject to high sales taxes on their purchases of goods and services are put at a competitive disadvantage to many of their competitors in other states and in foreign markets. Further, B2B sales taxation violates fundamental principles of a well-designed retail sales tax, resulting in tax pyramiding and multiple other harmful effects.⁹ We urge the Committee to examine ways to reduce Missouri’s reliance on sales taxes on B2B transactions.

Repeal the “Throwback” Rule in the Corporate Income Tax:

Missouri’s “throwback” rule provides that receipts from sales are included in the numerator of a taxpayer’s Missouri sales factor if the sales originate in Missouri, but the purchasers are in other states and the taxpayer is not subject to tax in those states.¹⁰ Simply stated, throwback and related “throwout” rules tax the wrong income at the wrong rate by the wrong state. COST encourages the Committee to consider recommending the repeal of Missouri’s throwback rule for all corporate income taxpayers.¹¹

Conclusion

Missouri, like most states, is grappling with fiscal problems. Those problems result from the significant downturn in the real economy that began in 2008 and low economic growth in subsequent years. Most economic indicators suggest that the economy is slowly but steadily improving. Missouri’s business taxation currently relies on a balanced “three-legged stool” of income, property, and sales taxes, with rates and compliance burdens that are relatively competitive with neighboring states. Business taxes can either help drive or hinder State economic growth. Accordingly, in making recommendations regarding tax reform, this Committee should seek opportunities to minimize obstacles to investment and job creation. Please feel free to contact me with any questions or comments at dlindholm@cost.org.

⁹ For COST’s study on the taxation of business inputs, see <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=83841>.

¹⁰ Source: Bloomberg BNA Corporate Income Tax Navigator. The throwback rule does not apply to elective single sales factor apportionment. The impact of the throwback rule is also mitigated by the states’ aggressive assertion of economic nexus. See *Lorillard Licensing Co. v. Director, Div. of Taxation*, 29 N.J. Tax 275, N.J. Super. A.D., Dec. 4, 2015, *cert. den.*, 226 N.J. 212, N.J., June 17, 2016.

¹¹ See COST’s policy statement on throwback and throwout rules, available at: http://www.cost.org/uploadedFiles/About_COST/Policy_Statement/Throwback-Throwout.pdf.