LOCATION MATTERS

THE STATE TAX COSTS OF DOING BUSINESS

TAX FOUNDATION Since 1937

KPMG

Location Matters was made possible through the generous support of a grant from the John Templeton Foundation. The opinions expressed in this publication are those of the authors and do not necessarily reflect the views of the John Templeton Foundation.

LOCATION MATTERS

THE STATE TAX COSTS OF DOING BUSINESS

ISBN: 978-1-942768-02-9

1325 G Street, NW, Suite 950
Washington, DC 20005
202.464.6200
taxfoundation.org

Table of Contents

Introduction

State and local taxes represent a significant business cost for corporations operating in the United States and can have a material impact on net operating margins. Consequently, business location decisions for new manufacturing facilities, corporate headquarter relocations, and the like are often influenced by assessments of relative tax burdens across multiple states.[1]

Widespread interest in corporate tax burdens has resulted in a range of studies produced by think tanks, media organizations, and research groups. None of these other studies, however, provide comparisons of actual state tax costs faced by real-world businesses.

Some studies compare total tax collections or business tax collections per capita or as a percent of total tax revenue. The shortcoming of this approach is that collections are not burdens: many business taxes are collected in one state but paid by companies in other states. Comparing state collections thus does not accurately portray the relative tax burden that real-world businesses would incur in each state.

Some studies assess the relative value of tax incentives available for different types of businesses, such as new job tax credits, new investment tax credits, sales tax exemptions, and property tax abatements. However, these studies can give the incorrect impression that all businesses in a state enjoy such incentives. They also do not typically account for increased tax rates for mature businesses that may be required to support such incentives.

Some studies, including the Tax Foundation's widely cited annual State Business Tax Climate Index, *define model tax structure principles and measure the state's tax code relative to those principles*. The *State Business Tax Climate Index* is a useful tool for lawmakers to understand how neutral and efficient their state's tax system is compared to other states and to identify areas where their system can be improved. However, this does not address the bottom line question asked by many business executives: "How much will our company pay in taxes?"

An individual firm considering expansion frequently calculates its tax bill in various states, but these calculations are not often released publicly and are usually confined to a small number of states.

To fill the void left by these studies, the Tax Foundation collaborated with U.S. audit, tax, and advisory firm KPMG LLP to develop and publish a landmark, apples-to-apples comparison of corporate tax costs in the 50 states. Tax Foundation economists designed seven model firms—a corporate headquarters, a research and development facility, an independent retail store, a capital-intensive manufacturer, a labor-intensive manufacturer, a call center, and a distribution center—and KPMG tax specialists calculated each firm's tax bill in each state. This study accounts for all business taxes: corporate income taxes, property taxes, sales taxes, unemployment insurance taxes, capital stock taxes, inventory taxes, and gross receipts taxes. Additionally, each firm was modeled twice in each state: once as a new firm eligible for tax incentives and once as a mature firm not eligible for such incentives.

1 *See, e.g.*, Sanja Gupta & Mary Ann Hoffman, *The Effect of State Income Tax Apportionment and Tax Incentives on New Capital Expenditures*, Journal of the American Taxation Association, Supplement 2003, pp. 1-25; Timothy Bartik, *Business Location Decisions in the United States: Estimates of the Effects of Unionization, Taxes, and Other Characteristics of States*, Journal of Business and Economics Statistics, Vol. 3, No. 1., Jan. 1985, pp. 14-28; James Papke and Lesie Papke, *Measuring Differential State-Local Tax Liabilities and Their Implications for Business Investment Location*, National Tax Journal, Vol. 39, No. 3, 1986, pp. 357-366.

Tax Foundation economists then used the raw model results to perform the ensuing industry and state comparisons. The result is a comprehensive calculation of real-world tax burdens, now in its second edition, that we designed as a valuable resource for a variety of stakeholders, to ensure that:

- Governors, legislators, and state officials can better understand and address their states' competitive positions among the 50 states;
- CEOs, CFOs, and other corporate stakeholders can better evaluate the relative competitiveness of states in which they operate or states in which they are contemplating business investments;
- Businesses and trade organizations can better identify policy improvements for each state;
- Site-selection experts can screen states more quickly and accurately for consideration by their clients; and
- National, state, and local media organizations can more effectively report on the tax competitiveness of the 50 states.

The *Location Matters* study, together with our annual *State Business Tax Climate Index*, provides the tools necessary to understand each state's business tax system and the burdens it imposes, offering a roadmap for improvement.

Study Overview and Key Findings

Chapter 1 outlines the objectives and scope of the study. This chapter describes the seven model firms that were analyzed, the specific taxes that were included in the study, the locations that were chosen in each state, and the other factors that could influence the results.

Chapter 2 presents an overview of the effective tax rates experienced by both new and mature operations for each of our seven model firm types and summarizes how various components and features of state tax systems contribute to the overall tax burdens these firms experience.

Chapter 3 summarizes the results for each state. The chapter is aimed at legislators and reporters seeking insight into states' business tax systems, as well as at business owners and location consultants investigating the effects of states' tax systems. The chapter outlines the major factors contributing to the effective tax rates experienced by our model firms in each state.

The Appendices provide further detail on the components comprising effective tax rates for each state and firm type and compare states' incentives for new businesses. They also detail the study's methodology and assumptions. The Appendices are valuable for conducting 50-state comparisons, understanding our modeling, and reviewing our source data.

For many readers, *Location Matters* will serve as a reference guide, not a book to read from cover to cover. As such, it may be valuable to summarize a few key findings:

- *Statutory tax rates only tell part of the story.* While topline rates are important and high rates may provide "sticker shock" for corporations considering locating within a given state, they are just one component of effective tax burdens. Tax incentives, apportionment, throwback rules, and other factors can have a dramatic impact on effective tax burdens. In some cases, states with low statutory tax rates can impose high effective tax burdens, and *vice versa*.

- *Corporate income taxes are just one part of the corporate tax burden.* Sales, property, and unemployment insurance taxes are highly significant components of a firm's overall tax burden. In fact, corporate income taxes are responsible for more than a third of the average corporate tax burden for only four of the fourteen new and mature iterations of the seven firm models.

- *Incentives chiefly benefit new firms, often to the disadvantage of established operations.* Because most tax incentives are developed to convince firms to relocate to, or increase hiring in, a given state, they tend to benefit new firms, which can shift costs to mature firms. Businesses with longer time horizons may have cause to be wary of states which too substantially prioritize attracting new industries over maintaining modest rates for established operations.

- *Incentive-heavy tax structures can reduce tax equity even among newly-established firms.* While incentives favor new firms over mature operations, they often differentiate among firm types as well, with some incentives that favor one operation but do little or nothing to help another. As such, they tend to pick winners and losers and, while potentially making the state highly attractive to specific industries or firm profiles, can limit the state's broader economic appeal across diversified business types.

- *Different firm types experience dramatically different effective tax rates.* Both because different firm types will vary in their exposure to major state and local taxes—distribution centers will be more sensitive to property tax burdens, for instance, while retail establishments may be more significantly impacted by the sales tax—and because of differential treatment of different firm types under the tax code, businesses can experience dramatically different effective tax rates. The median effective tax rate for new retail operations (which rarely receive tax incentives) is 31.0 percent, while the median rate for highly-favored new R&D centers is 11.4 percent. The median rate for a mature labor-intensive manufacturing firm is 9.2 percent; the median mature distribution center, by contrast, experiences a 26.7 percent tax burden.

- *The impact of corporate income and gross receipts taxes depends heavily on structure and firm type.* Although gross receipts taxes generally have much lower statutory rates than traditional corporate income taxes, they are assessed on firms' total receipts (sometimes less certain subtractions), not just net income. Some firm types benefit from this structure, while others do not. The relative impact of these two approaches to business taxation for any given firm type can also depend heavily on how nexus or, in the case of corporate income taxes, apportionment is treated.

Tax structure and ease of compliance are also important considerations for many firms but are not the subject of this study, which focuses exclusively on effective tax burdens. Our annual *State Business Tax Climate Index* takes tax structure into account and includes further analysis of the impact of tax structure on business decision-making and economic growth.