Taxing Simply

District of Columbia Tax Revision Commission

Taxing Fairly

Full Report

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CHAPTER J

Business Franchise and Insurance Taxes in the D.C. Tax System

Joseph J. Cordes and Harry S. Watson

Introduction

Although all taxes are ultimately paid by people in their capacities as consumers, workers, or savers, it is sometimes convenient to group taxes on the basis of whether they are collected from individuals or businesses. As Figure J-1 shows, in fiscal year 1996, almost a third of the District's revenues came from taxes collected from businesses — not counting sales and use taxes that are collected from sellers. The most important business tax is the commercial property tax, which accounts for almost 16 cents of every tax dollar, and which is discussed in more detail in Chapter E. Selective gross receipt taxes imposed on telecommunications and public utilities, also discussed in more detail in Chapters K and L, brought in an additional 9 cents of every dollar collected.

This chapter focuses mainly on the District's franchise tax, which accounts for over 6 cents of every tax dollar collected, and which is imposed on the net income of businesses that are either located in the District, or that are deemed to have a District business "nexus." We also consider the tax on insurance premiums, which brought in $33 million in fiscal year 1996.

The business franchise tax is not as important a revenue source as taxes on property, sales, or personal income. But it merits attention in examining the overall structure of the District's finances. Along with the public utilities gross receipts tax, the franchise tax ranks after the commercial property tax as the second-most important tax collected from business. Also, even if total franchise tax collections comprise a modest share of District revenues, the tax liability that an *individual* entrepreneur or business can expect to face under the tax — along with the expected commercial property tax bill — is seen as defining the District's "tax climate," which is widely perceived to influence business location decisions in the Washington metropolitan area.

Unless otherwise noted, charts and graphs are based on the author's calculations and D.C. tax data.

Figure J-1

Sources of D.C. Tax Revenue

Type of Tax	Tax Revenue Raised ($ Millions)	Share of Tax Revenue (Percent)
Taxes Collected From Individuals	**$1,036.6**	**43.2%**
Personal Income	689.4	28.2
Residential Property	249.8	11.0
Personal Property	65.2	2.8
Inheritance	32.2	0.7
Taxes Collected From Business	**$763.6**	**31.8%**
Commercial Property	374.6	15.6
Franchise Tax		
Corporate	123.1	5.1
Unincorporated	31.0	1.3
Business Gross Receipts		
Public Utilities	144.8	6.2
Communications	45.5	1.9
Insurance	33.1	1.4
Health Care Providers	11.5	0.6
Sales and Use Taxes	**$530.4**	**22.1%**
Other Taxes	**$71.8**	**3.0%**
Total	**$2,402.2**	**100.0%**

Note: The breakdown of property tax revenue into residential and commercial components is based on data presented in O'Cleireacain (1997), p. 69.

Source: D.C. Comprehensive Annual Financial Report.

Why tax businesses?

As noted in the 1978 D.C. Tax Revision Commission report, the business firm is best seen as an organizational vehicle through which *individuals* derive the benefits of economic activity in their economic roles as consumers, workers, or shareholders. Thus, even though taxes may be collected from business entities, this should not obscure the fact that the economic burden of these taxes is ultimately borne by people in their role as:

- owners and shareholders, if business taxes lower equity returns;
- employees, if business taxes result in lower wages; or
- customers, if business taxes raise prices.

Under this view, the reason for taxing business enterprises is not because businesses are assumed to have a taxpaying capacity that is economically distinct from their owners, employees, and customers. Rather, in some cases, business taxes may be an *administratively convenient* way of making sure that the tax burden is properly apportioned among people.

Role of business taxes in a closed economy

When the economy of a taxing jurisdiction is closed, all of the income generated within its boundaries is received as income by its residents, and the sales of businesses are exactly matched by residents' purchases. Under these conditions, the equivalent fiscal outcome that results from taxing businesses and individuals separately could be achieved by a sufficiently comprehensive set of income and sales taxes collected only from individuals. In principle, there would be no need to tax businesses in addition to taxing people.

Even in a closed economy, however, practical considerations might nonetheless require taxing businesses as well as individuals. For example, a tax on *corporate* (as distinct from unincorporated) income might be needed when retention of corporate earnings creates unrealized capital gains that escape immediate taxation under the individual income tax. Sales taxes might also be collected from businesses instead of their customers, because it is simpler to collect sales taxes from sellers — even though it is widely believed that sales taxes are ultimately paid by buyers in the form of higher prices.

Role of business taxes in an open economy

The open character of most state and local economies provides an additional impetus for taxing business, in addition to practical considerations of the sort just mentioned. When the economy of a taxing jurisdiction is open, a portion of the sales and income that originate within its boundaries represents sales to nonresident customers and income paid to nonresident owners and shareholders who cannot be taxed directly. In this case, taxing businesses may not only be administratively convenient, it may be the only workable option that a state or local government has to tax all those who benefit from the business activity taking place within its boundaries.

The unique legal circumstances of the District reinforce the argument for taxing business entities. Since the inception of the *Home Rule Act,* taxation of nonresident income has been proscribed, which also limits the District's ability to directly tax nonresident individuals. Thus, taxing business entities may present the only legally viable means of ensuring that nonresidents who benefit from business activities in the District bear an "appropriate" share of the tax burden. (As is discussed below, however, the use by the District of business taxes as an indirect "handle" to tax nonresidents has also been limited by court decisions.)

Why tax business income?

The open nature of state and local economies provides a case for state and local business taxes in some form, but does not by itself justify taxing business income. If an important reason for imposing such taxes is to ensure that nonresidents bear a share of the tax burden along with residents, there are several ways of accomplishing this result:

1) **Gross Receipts** *(Base = Gross Receipts From Sales of Goods and Services)*
2) **Net Income** *(Base = Net Receipts From Sales of Goods and Services minus Payroll minus Interest Expense minus Rent Paid minus Depreciation)*
3) **Value Added** *(Base = Net Receipts From Sales of Goods and Services minus Purchases of Goods and Services From Other Businesses)*

Two issues arise in choosing among these alternative business tax bases: 1) What constitutes a "fair share" of the state or local tax burden that nonresidents should be required to bear? and 2) Which business tax base is most likely to distribute nonresident tax burden "fairly"?

ABILITY TO PAY

One widely used principle of tax fairness is the ability-to-pay principle, which holds that tax burden should be distributed among taxpayers in line with their ability to pay taxes, as typically measured by their income. The ability to pay of individual taxpayers and that of businesses is sometimes used to justify state corporate taxes (e.g., net income taxes). Under this view, a corporation's ability to pay taxes is assumed to depend on its profitability, just as an individual's ability to pay is presumed to be related to his or her personal income. A problem with such reasoning, however, is that although corporations have a legal status as "individuals," they do not economically have a taxpaying capacity distinct from that of their owners and shareholders.

SOURCE-BASED ENTITLEMENT TO TAX

Alternatively, one might argue that it is fair for a jurisdiction to tax the value-added from all economic activity that takes place within its borders. A portion of this value-added is received by resident factors of production, but a portion is earned by nonresidents. Under this view, it is appropriate to tax income originating in the jurisdiction that is received by nonresidents.

As noted by Musgrave, this "source-based entitlement, by its very nature, relates to the taxation of income originating in the jurisdiction, *not* of the particular individuals who receive it … (emphasis added)."[1] Thus, an appropriate vehicle for taxing such income would be an impersonal flat-rate tax levied on businesses. The broadest form of such a levy would be a tax on net value-added collected at the source. A next-best alter-

native might be to tax corporate net income — which in many jurisdictions accounts for much of the value-added that is ultimately received by nonresidents — perhaps coupled with a tax on business payroll, another major component of value-added.

The benefit principle

Another common rationale for state taxation of business is the benefit principle, which holds that burdens should be distributed according to the benefits that taxpayers receive from the public goods and services provided by government. One way of seeing to it that those who benefit from specific public services also pay for them is to assess fees and other beneficiary charges for the use of specific public services. Because the ability to conduct business directly or indirectly depends on a range of tax-financed goods and services such as a judicial system, policy and fire protection, roads, and schools, business taxes can also serve as a form of payment for public services.

Although there is fairly wide support among public finance scholars for some form of business taxation based on the benefit principle, there is also general agreement that a tax on business net income is a rather imperfect benefit tax. The main reason is that the benefit a business derives from public services is more apt to depend on factors such as the nature and scale of production than the amount of profit that is earned. Thus, both profitable and unprofitable businesses in the same industry are likely to derive similar benefits from public services; yet only the profitable businesses would be taxable under a net income tax. In such cases, business taxation based on more direct measures of the scale of productive activity, such as gross receipts, or value-added, would be more likely to match tax payments with benefits received.

Conformity with existing state and federal practice

In the final analysis, the main appeal of taxing net income for many states may be more practical than conceptual. As may be seen from Figure J-2, 45 of the 50 states have a corporate income tax, so that individual states are likely to feel comfortable imposing a business tax that is broadly similar to that imposed by other states. The existence of a federal tax on corporate net income also allows a measure of coordination between state and federal tax systems. For example, it is a common practice among the states to use income and deductions reported on federal tax returns as the starting point for computing state corporate net income subject to tax.[2]

Structure of the District franchise tax

The District corporate franchise tax is quite similar to the corporate income (or franchise) taxes found in many states, including Maryland and Virginia. In each state with a corporate income tax, a corporation with business nexus in the jurisdic-

Figure J-2

States With Corporate Income Taxes
by Maximum Tax Rate

State	Maximum Tax Rate	Minimum Tax
Iowa	12.0	No
Connecticut	10.5	$250
North Dakota	10.5	6% AMT
District of Columbia	9.975	$100
Minnesota	9.8	No
Massachusetts	9.5	$456
Pennsylvania	9.50	No
Alaska	9.4	No
Arizona	9.0	$50
New Jersey	9.0	$200
New York	9.0	No
Rhode Island	9.0	No
West Virginia	9.0	No
Maine	8.93	27% tax on federal AMT
Ohio	8.9	5.82 times the value of stock or $50
California	8.84	$800
Delaware	8.7	No
Kentucky	8.25	No
Vermont	8.25	$150
Idaho	8.0	$20
Louisiana	8.0	No
Indiana	7.9	No
Wisconsin	7.9	No
Nebraska	7.81	No
New Mexico	7.6	No
North Carolina	7.5	No
Illinois	7.3	No
Maryland	7.0	No
New Hampshire	7.0	No
Montana	6.75	$50
Oregon	6.6	$1
Arkansas	6.5	No

State	Maximum Tax Rate	Minimum Tax
Hawaii	6.4	No
Missouri	6.25	No
Georgia	6.0	No
Oklahoma	6.0	No
Tennessee	6.0	No
Virginia	6.0	No
Florida	5.5	3.3%
Alabama	5.0	No
Colorado	5.0	No
Mississippi	5.0	No
South Carolina	5.0	No
Utah	5.0	$100
Kansas	4.0	No

tion can expect to pay a tax equal to the legal tax rate multiplied by the enterprise's apportioned profit. Profits apportioned to the taxing jurisdiction, in turn, are determined by multiplying the entity's total profit by an apportionment factor that is intended to measure the fraction of profits that can be reasonably deemed to have originated in the taxing jurisdiction. Thus, in general terms, liability under a typical state corporate income or franchise tax is determined by: $Tax = T \times A \times P$, where T is the statutory corporate or franchise tax rate, A is the apportionment factor, and P is the base of taxable profits. Given the tax rate, the corporate tax burden thus depends on the definition of taxable profits P, and the apportionment factor A, which together define the base of what is to be taxed.

DEFINING TAXABLE PROFITS

The D.C. Code, summarized in Figure J-3, begins with a definition of the taxable unit. With a few exceptions, any corporation carrying on business in the District is required to file a return. The return is based on the activities of the corporation, exclusive of the activities of any affiliated firms; if affiliated firms do business in the District, each must file a separate return.[3]

As is the case in other jurisdictions, the determination of a corporation's District taxable income begins with the firm's gross income under federal rules. Some items in gross income are then excluded, such as income from U.S. government obligations, while other items are added, such as income from state obligations. There is no exclusion for dividends received. The adjusted income figure is then reduced by

Figure J-3

Main Features of Corporate Franchise Taxes in the D.C. Area

	D.C. Corporate Franchise Tax*	Maryland Corporate Income Tax	Virginia Corporate Franchise Tax
Taxable Entity	Individual firm (consolidated returns are not permitted)	Individual firm (consolidated returns are not permitted)	Individual firm or affiliated firms
Tax Rate	9.975%	7%	6%
Tax Base	Federal gross income, with exclusions including income from U.S. obligations, state income tax refunds, dividend received deduction, distributions from unincorporated businesses	Federal taxable income after net operating losses	Federal taxable income after net operating losses
Additions to Tax Base	Income from state/ local obligations	State/local income taxes, income on obligations of other states/localities, income from U.S. and foreign obligations, net operating loss modification, enterprise zone credits	State/local income taxes, interest on obligations of states other than Virginia, ESOP credit carryover from federal return, IRS Section 512 income

	D.C. Corporate Franchise Tax*	Maryland Corporate Income Tax	Virginia Corporate Franchise Tax
Subtractions From Base	Most deductions under the federal corporate income tax, including taxes paid, interest expense, labor compensation, depreciation, charitable contributions, net operating losses (to the extent these are not used by affiliated firms in filing at the federal level)	Interest earned on U.S. obligations, state/local income tax refunds, income from state of Maryland obligations, dividends from related foreign corporations or related DISCs	Income from obligations of the U.S. or state of Virginia, state/local income tax refunds, ACRS depreciation adjustments, Subpart F income, ESOP contributions, foreign source income, dividends received from a DISC
Apportionment Formula	Generally a three-factor formula (sales, property, payroll) with equal weights	Generally three-factor formula (sales, property, payroll), with sales double weighted (for corporations providing services, a single-factor formula using sales is required)	Generally a three-factor formula (sales, property, payroll) with equal-weights (for financial institutions a single factor formula — based on cost of performance — is required)
Credits	Economic development zone and worker's compensation insurance premium credits available	Enterprise zone, environmental, and job credits are available	Enterprise zone, environmental, low-income housing credits available

* *There is also a schedular gross receipts tax (Arena Fee) with a maximum rate of 0.06%.*

most of the deductions available under the federal corporate tax, including depreciation, interest expenses, and the net operating loss deduction. (For affiliated firms, any net operating loss deduction from the District entity that is used up in the federal return is not available as a deduction for the District entity.) The resulting taxable income base is quite similar to the base that would be found in many states, including Maryland and Virginia, which rely directly on the federal definition of taxable income (Figures J-4 and J-5).

Entity vs. unitary definition of taxable profits

One matter that states must confront in defining taxable profits is whether to tax corporations that operate in their jurisdictions on an *entity* or a *unitary* basis. The issue arises whenever a "single company" has affiliated subsidiaries that operate in more than one jurisdiction. Taxation on an entity basis involves treating such affiliates as separate companies for purposes of determining their taxable profits. Thus, for example, if company A owned affiliated, though legally independent, companies B and C, these companies would be taxed separately in any state in which they had a business nexus that defined taxable income on an entity rather than on a unitary basis.

Taxation on a unitary basis involves recognizing that affiliated entities are often part of an integrated business whole. For example, companies B and C might be the defense and government contracting subsidiaries of a larger business services firm, with business B obtaining its computer services from company C. In this case, even if affiliates B and C were legally separate companies, their profits would be combined and B and C would be taxed together as what is termed a unitary combination. The distinction matters in the case of state taxation because, as is discussed in more detail below, whenever a corporation operates in more than one jurisdiction, it has an incentive to use (perfectly legal) ways of allocating its profits between its affiliates — so as to shift taxable profits to states with lower rates of taxation.

The District of Columbia, Maryland, and Virginia use the entity rather than the unitary method of taxation. In this respect, they follow the practice of thirty other states that also tax corporations on an entity rather than a unitary basis.

Apportioning taxable profits

Because many corporations carry on business in jurisdictions other than the District, the taxable income figure determined above will include income originating from business activities undertaken elsewhere. Consequently, it is necessary to determine what portion of taxable income can be attributed to business activity in the District. To make this attribution, the District, like many states, uses a formula apportionment rule. The fraction of taxable income attributable to the District, A, is given by the formula: $A = (1/3)[\textit{Sales Factor} + \textit{Payroll Factor} + \textit{Property Factor}]$.

The *sales factor* is the ratio of sales made in the District to total sales of the firm, while the *payroll factor* is the ratio of labor costs in the District relative to the firm's total labor costs. The *property factor* is the value of the firm's real and tangible personal property used in the District relative to the total value of such property. This formula, which gives equal weight to all three factors, is used in many states, including Virginia. In some states, such as Maryland, factors are given different weights; usually, the weight accorded to sales is greater while the weights for payroll and property are less. In Maryland, for example, the sales weight is one-half while the payroll and property weights are one-fourth each.

It should be noted that firms may petition the mayor if this formula "... does not fairly represent the extent of the taxpayer's business activity in the District [47-1810.2 (h)]." Firms may request that any one of these factors be excluded, that one or more additional factors be included, or that an entirely different formula be used. If these variants are frequently granted, then the formula above may be a poor indicator of the actual apportionment of taxable income to the District.

Taxable income attributable to the District, the product of taxable income and the formula above, is subject to a rate of 9.975 percent. The resulting tax liability can be offset with economic development zones and worker's compensation insurance premium credits. The minimum corporate tax is $100.

Depending on the type of business, some corporations may be subject to other taxation; for example, insurance companies face premium taxes. In addition, all corporations are subject to a schedular gross receipts tax (the Arena Fee) that has a maximum rate of about 0.06 percent.

Regional treatment of corporations

As can be seen from Figure J-3 (page 388), corporate tax codes in the Washington area are quite similar, with only three substantive differences: the treatment of net operating loss deductions, the formula apportionment rule, and the tax rate.[4] The extent to which these variations in tax codes produce substantive differences in effective, as opposed to statutory, rates of taxation in the region is discussed in more detail below.

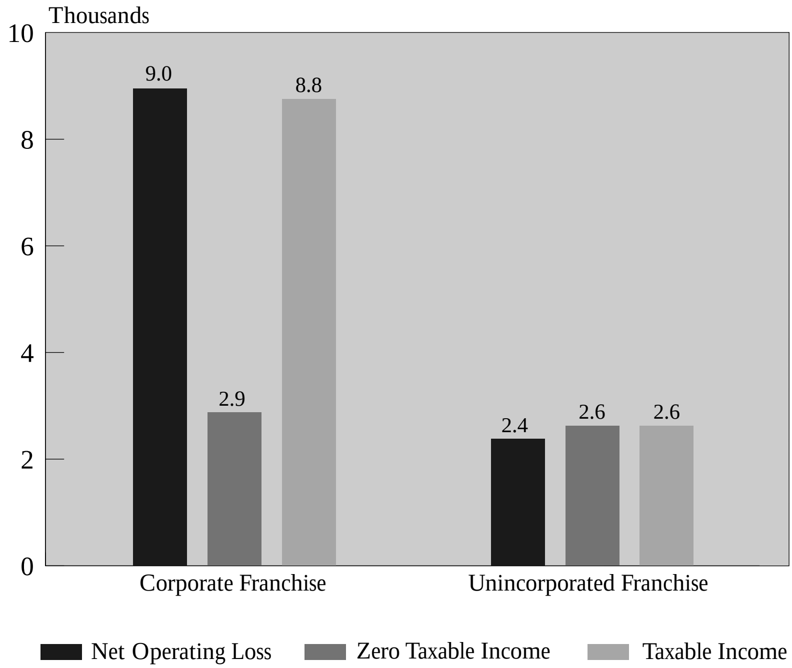
Tax treatment of unincorporated businesses

Most jurisdictions follow the pattern set by the federal government and do not impose a separate tax on unincorporated businesses. Instead, although unincorporated businesses' taxable income is determined using the rules that apply to corporations, the income is passed through to owners and is taxed at the individual level.

The tax treatment of unincorporated businesses in the District, however, departs from this norm. The District levies a tax on unincorporated businesses with gross receipts over $12,000 and, to avoid double taxation, allows its residents to exclude

Figure J-4

Number of Returns Filed by D.C. Businesses
1996



such income (at least that portion originating in the District) from income at the personal level. The unincorporated business tax provides a 30 percent salary allowance for owners along with a $5,000 exemption in determining unincorporated net business income. Aside from these provisions, the tax rules governing the determination of taxable income as well as those governing the apportionment of taxable income to the District are the same as those for the corporate franchise tax.

The decision to create a separate tax for unincorporated businesses appears to have been prompted by a desire to maintain neutrality in the taxation of different forms of business. These efforts to maintain neutrality have not been wholly successful for several reasons. First, because the individual income and corporate franchise taxes are not integrated, the effective tax rate faced by the shareholder of a corporation is not the same as that faced by an owner were the firm organized as an unincorporated business. Second, the prohibition of the taxation of commuter income led the courts to

rule in *Bishop v. District of Columbia* that the income from unincorporated businesses owned by nonresidents providing professional services could not be taxable under the unincorporated business tax. In response to this ruling, the District has foregone collecting the unincorporated business tax from any unincorporated business providing professional services, regardless of the owner's jurisdiction of residence. Finally, not all other jurisdictions provide tax relief for the unincorporated business tax, so that the effective tax rate facing owners of unincorporated businesses will vary by their jurisdiction of residence, as is discussed more fully below.

PARTNERSHIPS AND SUB-CHAPTER S CORPORATIONS

The tax treatment of business organized as unincorporated partnerships parallels that of other unincorporated businesses. Many such partnerships are likely to be found in industries providing professional services; in such cases, the effective tax rate of the individual partners depends on where they live and not on the physical location of the partnerships.

Sub-Chapter S corporations are a hybrid form of business organization, with features of both corporations and unincorporated partnerships. Like other corporations, S corporations enjoy the legal benefits of incorporation, such as limited legal liability of the partners. Like unincorporated partnerships, the income of the S corporation is passed through to individual partners, and thus is taxed only once at the individual level. To be treated as an S corporation under federal rules, the business cannot have more than 35 partners.

Most states follow the federal practice of treating S corporations like partnerships, which means that S corporation income, less deductions, is passed through to shareholders and taxed only at the shareholder level. As in the case of the unincorporated business franchise tax, the District departs from federal tax treatment by treating S corporations like any other corporation and subjecting them to the corporate franchise tax. Partnerships organized as sub-Chapter S corporations are subject to the District's corporate franchise tax without regard to whether the partnership is engaged in providing professional services.

The tax treatment facing a shareholder in an S corporation located in the Washington region depends on the shareholder's residence. For a District resident, the income passed through from the S corporation is excluded from individual-level taxation, but any deduction passed through cannot be taken at the individual level. Essentially, the gross income attributable to a District shareholder is taxed at the corporate franchise tax rate and deductions attributable to the shareholder are taxed at a rate that is equal to the difference between the corporate franchise tax rate and the shareholder's District tax rate. For an S corporation shareholder who resides in Maryland, a credit is available for the corporate franchise tax paid in the District. Since the highest individual marginal tax rate in Maryland falls below the corporate franchise tax rate,

Figure J-5

Distribution of Corporate Franchise Tax Payments by Industry

Industry	1994 Tax Payment ($ thousands)	1994 Percent of Total	1995 Tax Payment ($ thousands)	1995 Percent of Total	1996 Tax Payment ($ thousands)	1996 Percent of Total
Invalid code	$39	0.04%	$69	0.07%	$74	0.07%
Unknown	11	0.01	32	0.03	3	0.00
Building construction	1,290	1.35	1,426	1.35	1,317	1.08
Construction other than building	377	0.40	183	0.17	214	0.15
Food and kindred	92	0.10	134	0.13	53	0.05
Furniture and fixtures	178	0.19	143	0.14	104	0.10
Printing and publishing	3,727	3.91	2,196	2.08	2,023	1.77
Chemicals and allied	33	0.04	3,095	2.93	90	0.06
Stone, clay, glass	0.6	0.00	0.6	0.00	8	0.01
Machinery, nonelectrical	210	0.22	25	0.02	20	0.02
Electrical and electronic	786	0.83	665	0.63	898	0.76
Measure, analyze, control	110	0.12	43	0.04	83	0.08
Miscellaneous manufacturing	780	0.82	353	0.33	244	0.19
Local and suburban transit	157	0.16	203	0.19	85	0.07
Motor freight transport	547	0.57	234	0.22	143	0.08
Water transport	29	0.03	19	0.02	0.8	0.00

Industry	1994 Tax Payment ($ thousands)	1994 Percent of Total	1995 Tax Payment ($ thousands)	1995 Percent of Total	1996 Tax Payment ($ thousands)	1996 Percent of Total
Air transport	187	0.20	166	0.16	124	0.11
Transport services	871	0.91	1,044	0.99	1,153	1.07
Communications	12,116	12.72	15,131	14.32	15,665	14.60
Electric, gas, and sanitary	1,314	1.38	708	0.67	10,073	9.01
Wholesale trade — durables	1,505	1.58	1,587	1.50	1,832	1.66
Wholesale trade — nondurable	1,583	1.66	2,540	2.40	2,177	1.97
Building materials, hardware, etc.	722	0.76	275	0.26	256	0.22
General merchandise stores	862	0.90	156	0.15	1,055	0.98
Food stores	1,266	1.33	1,261	1.19	1,098	0.91
Auto dealers and gas stations	639	0.67	382	0.36	475	0.39
Apparel and accessory stores	1,474	1.55	1,799	1.70	684	0.46
Furniture and equipment stores	270	0.28	379	0.36	376	0.13
Eating and drinking places	2,258	2.37	2,809	2.66	1,784	1.45
Miscellaneous retail	6,650	6.98	4,659	4.41	9,102	8.27
Banking	1,986	2.08	3,642	3.45	5,195	4.19
Credit agencies	693	0.73	375	0.35	917	0.50
Security and commodity	2,030	2.13	1,434	1.36	1,343	1.21
Insurance	6	0.01	14	0.01	20	0.01
Insurance services	1,467	1.54	1,336	1.26	1,574	1.35
Real estate	4,601	4.83	3,872	3.66	3,970	3.25
Commercial real estate, insurance	25	0.03	20	0.02	21	0.02
Investment offices	2,541	2.67	4,840	4.58	2,592	2.15

Figure J-5, cont.

Distribution of Corporate Franchise Tax Payments
by Industry

Industry	1994		1995		1996	
	Tax Payment ($ thousands)	Percent of Total	Tax Payment ($ thousands)	Percent of Total	Tax Payment ($ thousands)	Percent of Total
Hotels, rooming houses, etc.	588	0.62	461	0.44	453	0.31
Personal services	510	0.54	732	0.69	622	0.52
Business services	17,628	18.50	19,433	18.39	17,130	14.55
Auto repair and garages	912	0.96	467	0.44	473	0.36
Miscellaneous repair services	61	0.06	52	0.05	45	0.04
Motion pictures	650	0.68	2,415	2.29	745	0.66
Amusement and recreation	427	0.45	436	0.41	274	0.22
Health services	1,354	1.42	1,281	1.21	1,253	1.02
Legal services	623	0.65	815	0.77	926	0.81
Educational services	875	0.92	1,115	1.06	381	0.25
Social services	270	0.28	334	0.32	273	0.21
Membership organizations	453	0.48	537	0.51	552	0.34
Miscellaneous services	8,536	8.96	10,509	9.94	8,924	7.47
Unclassified	5,747	6.03	5,916	5.60	4,599	3.31
Other	3,208	3.37	3,925	3.71	2,795	2.44
Total	**$95,273**	**100.00**	**$105,676**	**100.00**	**$106,291**	**100.00**

the effective tax rate facing a Maryland shareholder is the District corporate franchise tax rate. Finally, for an S corporation shareholder who resides in Virginia, there is no credit or deduction for taxes paid in the District, so that the Virginia S corporation shareholder faces an effective tax rate equal to the sum of the District corporate franchise tax rate and the appropriate Virginia individual income tax rate.

Patterns and trends in franchise tax revenues

Figure J-4 shows that in 1996, almost 28,000 businesses filed either corporate or unincorporated franchise tax returns. Of the returns filed, however, almost three out of every five corporations, and two out of every three unincorporated businesses reported either zero or no taxable income, and thus were subject only to the District's minimum tax of $100.

Figures J-5 through J-12 provide information about patterns and trends in both corporate and unincorporated franchise tax payments. A number of broad conclusions can be drawn from these data.

PATTERNS IN FRANCHISE TAX PAYMENTS

Figures J-5, J-6, and J-7 present tabulations based on data provided from corporate franchise tax returns by the D.C. Office of Tax and Revenue. It should be noted that the figures in these tables reflect *tax payments* made by corporations in a given year, rather than their actual *tax liability*. These numbers often will not be the same. For example, a corporation that owes additional tax based on an audit of prior years' tax returns would make total tax payments in the current year for an amount greater than its current-year tax liability. Conversely, a corporation that was found to have overpaid taxes in a prior year would make actual payments in the current year at a level lower than its current-year liability. Despite these differences, data from a three-year period reveal a relatively stable distribution of tax payments among industries, providing a reasonably good picture of how corporate franchise tax burdens are distributed among different kinds of businesses.

The detailed data presented in Figure J-5 are summarized in Figures J-6 and J-7. Figure J-6 groups the individual industries from Figure J-5 into broad industrial sectors, and Figure J-7 shows the share of payments made by industries ranked among the top 10 in terms of their contribution to corporate franchise tax collections in 1994, 1995, and 1996.

The broad patterns in the these tables, depicted graphically in Figures J-8 and J-9, show not too surprisingly that the D.C. corporate franchise tax base is made up mainly of businesses in: 1) transportation, communication and utilities; 2) wholesale and retail trade; 3) banking, finance, and real estate; and 4) services.

Figure J-6

Distribution of Corporate Franchise Tax Payments
by Broad Sector

Industry	1994 Tax Payment ($ thousands)	1994 Percent of Total	1995 Tax Payment ($ thousands)	1995 Percent of Total	1996 Tax Payment ($ thousands)	1996 Percent of Total
Building and construction	**$1,663**	**0.5%**	**$1,609**	**1.5%**	**$1,531**	**1.2%**
Manufacturing	**5,917**	**6.2**	**6,655**	**6.3**	**3,523**	**3.0**
Printing and publishing	3,727	3.9	2,196	2.1	2,022	1.8
Other	2,190	2.3	4,459	4.2	1,500	1.2
Transportation, communications, and utility	**15,220**	**16.0**	**17,504**	**16.6**	**27,244**	**24.9**
Communications	12,117	12.7	15,131	14.3	15,665	14.6
Electric, gas, and sanitary	1,314	1.4	708	0.7	10,073	9.0
Other	1,790	1.9	1,665	1.6	1,505	1.3
Wholesale and retail trade	**17,229**	**18.1**	**15,847**	**15.0**	**18,838**	**16.4**
Miscellaneous	6,650	7.0	4,659	4.4	9,102	8.3
Eating and drinking establishments	2,258	2.4	2,809	2.7	1,784	1.5
Other	8,320	8.7	8,379	7.9	7,953	6.7

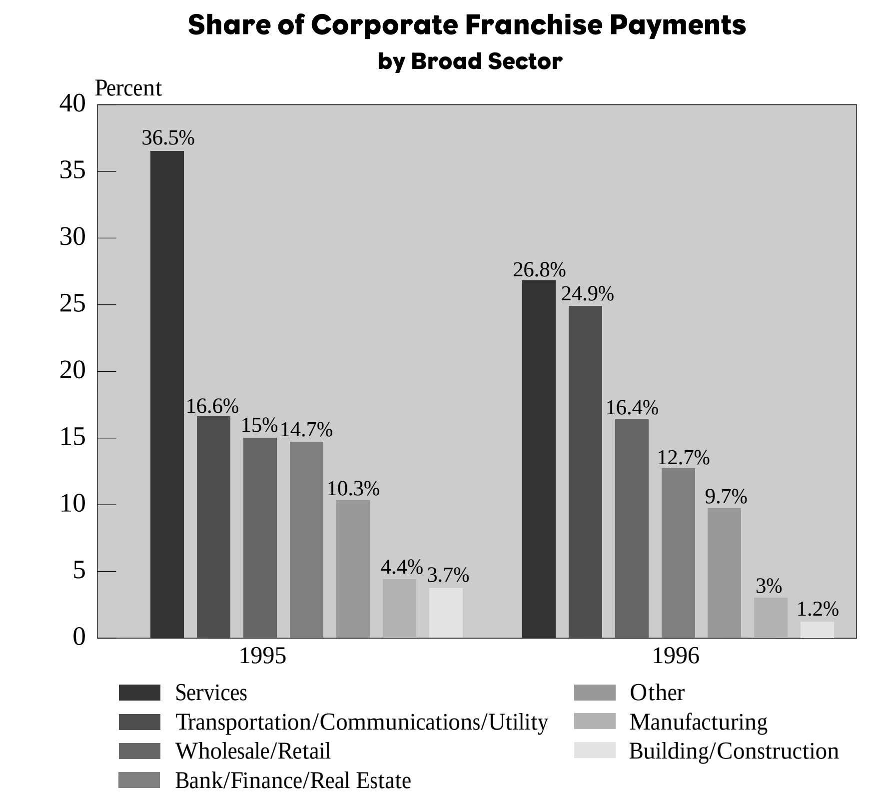
Industry	1994 Tax Payment ($ thousands)	1994 Percent of Total	1995 Tax Payment ($ thousands)	1995 Percent of Total	1996 Tax Payment ($ thousands)	1996 Percent of Total
Banking, finance, and real estate	**13,349**	**14.0**	**15,532**	**14.7**	**15,633**	**12.7**
Banking	1,986	2.1	3,642	3.5	5,195	4.2
Real estate	4,601	4.8	3,872	3.7	3,970	3.3
Investment offices	2,541	2.7	4,839	4.6	2,592	2.2
Other	4,221	4.4	3,178	3.0	3,875	3.1
Services	**32,888**	**34.5**	**38,586**	**36.5**	**32,051**	**26.8**
Business services	17,628	18.5	19,433	18.4	17,130	14.6
Miscellaneous services	8,537	9.0	10,509	9.9	8,924	7.5
Other	6,723	7.1	8,644	8.2	600	4.8
Unclassified	**5,747**	**6.0**	**5,916**	**5.3**	**4,599**	**3.3**
Other	**3,209**	**3.4**	**3,925**	**0.4**	**2,795**	**2.4**
Invalid code	**39,084**	**0.4**	**69**	**0.7**	**74**	**0.7**
Unknown	**11**	**0.1**	**32**	**0.3**	**3**	**0.0**
Total	**$95,273**	**100.0%**	**$105,676**	**100.0%**	**$106,291**	**100.0%**

Figure J-7

Industries With the Largest Share of Corporate Franchise Tax Payments

	1994			1995			1996		
Industry	**Tax Payment ($ thousands)**	**Share of Total**	**Rank**	**Tax Payment ($ thousands)**	**Share of Total**	**Rank**	**Tax Payment ($ thousands)**	**Share of Total**	**Rank**
Business services	$17,628	18.5%	1	$19,433	18.4%	1	$17,130	16.1%	1
Communications	12,116	12.7	2	15,131	14.3	2	15,666	14.6	2
Miscellaneous retail	6,650	7.0	4	4,659	4.4	6	9,102	8.3	3
Miscellaneous services	8,536	9.0	3	10,509	9.9	3	8,294	7.5	4
Banking	1,986	2.1	9	3,642	3.5	9	5,195	4.2	5
Unclassified	5,747	6.0	5	5,916	5.6	4	4,599	3.3	6
Real estate	4,601	4.8	6	3,872	3.7	8	3,970	3.3	7
Other	3,208	3.4	7	3,925	3.7	7	2,795	2.4	8
Investment offices	2,541	2.7	8	4,839	4.6	5	2,592	2.2	9
Subtotal	**63,014**	**66.1**		**71,927**	**68.1**		**69,342**	**65.2**	
Total payments, all industries	**$95,273**			**$105,676**			**$106,291**		

Figure J-8



Within these broad categories, in 1994, 1995, and 1996, about 50 cents of every tax dollar collected came from six industries: communications and business services (which together accounted for about one-third of all corporate franchise tax revenues); and miscellaneous retail, miscellaneous services, banking, and real estate, which together represented an additional 20 cents of every corporate franchise tax dollar.

Figures J-10 and J-11 provide some additional information on the distribution of corporate franchise tax returns. Some industries bear a share of total corporate franchise tax payments that is out of proportion with the number of returns filed by businesses in those industries. This pattern is a common feature of taxes on corporate income. The relative importance of different types of business as a source of corporate tax revenue depends on their profits more than on their numbers. For example, the communications industry accounts for about 16 percent of corporate franchise tax payments, but only 2 percent of total returns filed.

Figure J-9

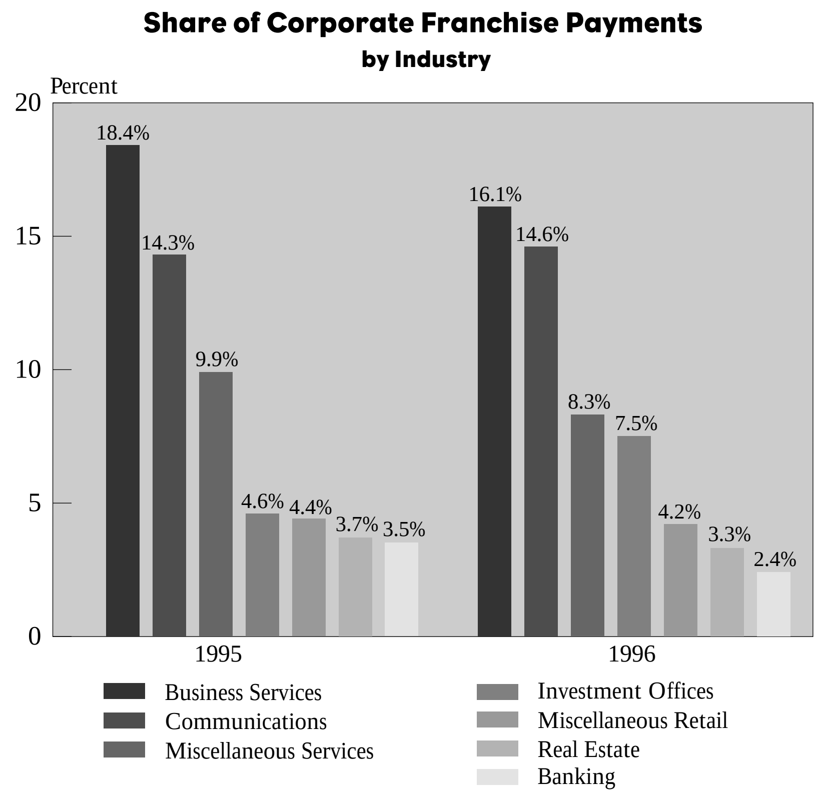


Figure J-10 provides additional information about the proportion of corporations having positive 1996 taxable incomes in each of the industry groups listed in Figure J-7 (page 400). These data are then used in Figure J-11 to estimate both the average tax payment per return and the share of total franchise tax payments made by businesses with positive taxable incomes in each of the industries that together account for the largest share of corporate franchise tax collections. The data indicate that overall, only four out of 10 businesses in these industries reported positive taxable incomes on their returns in 1996, while an equal number reported negative taxable income. In addition, the last two columns of Figure J-11 show that one-fourth of the corporate filers accounted for just under two-thirds of all payments.

The relatively large number of corporate returns that pay the minimum tax of $100 might be seen as a source of concern. Yet, the fact that many corporate filers pay little or no corporate tax is not a feature unique to the District's franchise tax. For example,

Figure J-10

Distribution of Corporate Franchise Tax Returns
by Taxable Income Status ("Top 9" Industry Categories)

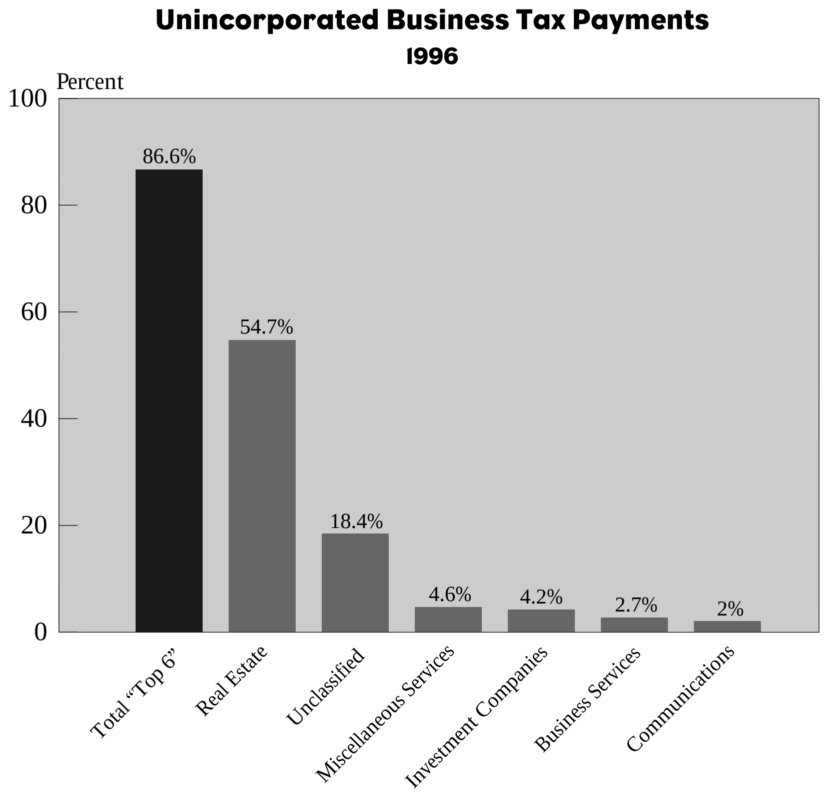
Industry	Total Returns		Returns With Taxable Income		Returns With Zero Taxable Income		Returns With Negative Taxable Income	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Business services	3,384	16.4%	1,606	47.5%	365	10.8%	1,413	41.8%
Communications	205	1.0	80	39.0	30	14.6	95	46.3
Miscellaneous retail	1,049	5.1	455	43.4	88	8.4	506	48.2
Miscellaneous services	3,475	16.8	1,425	41.0	615	17.7	1,435	41.3
Banking	55	0.3	19	34.5	14	25.5	22	40.0
Unclassified	2,484	12.0	858	34.5	534	21.5	1,092	44.0
Real estate	1,096	5.3	437	39.9	142	13.0	517	47.2
Other	1,076	5.2	526	48.9	145	13.5	405	37.6
Investment offices	263	1.3	68	25.9	46	17.5	149	56.7
Subtotal	**13,087**	**63.3**	**5,474**	**41.8**	**1,979**	**15.1**	**5,634**	**43.1**
Total returns, all industries	**20,673**	**100.0%**	**8,772**	**42.4%**	**2,884**	**14.0%**	**9,017**	**43.6%**

Figure J-11

Distribution of Corporate Franchise Tax Payments Among Businesses With Taxable Income
("Top 9" Industry Categories)

	All Returns	Returns With Taxable Income			
Industry	**Tax Payments**	**Tax Payments**	**Average Payment**	**Percent of Total Payments**	**Percent of Total Returns**
Business services	$17,129,729	$16,591,929	$10,331	15.70%	7.8%
Communications	15,665,433	15,652,933	195,662	14.81	0.4
Miscellaneous retail	9,101,901	9,042,501	19,874	8.56	2.2
Miscellaneous services	8,293,805	8,088,805	5,676	7.65	6.9
Banking	5,194,919	5,191,319	273,227	4.91	0.1
Unclassified	4,598,721	4,436,121	5,170	4.20	4.2
Real estate	3,970,491	3,904,591	8,935	3.69	2.1
Other	2,794,883	2,739,883	5,209	2.59	2.5
Investment offices	2,592,104	2,572,604	37,832	2.43	0.3
Subtotal	**69,341,986**	**68,220,686**	**12,463**	**64.56**	**26.5**
Total, all categories	**$105,675,875**		**$5,112**		

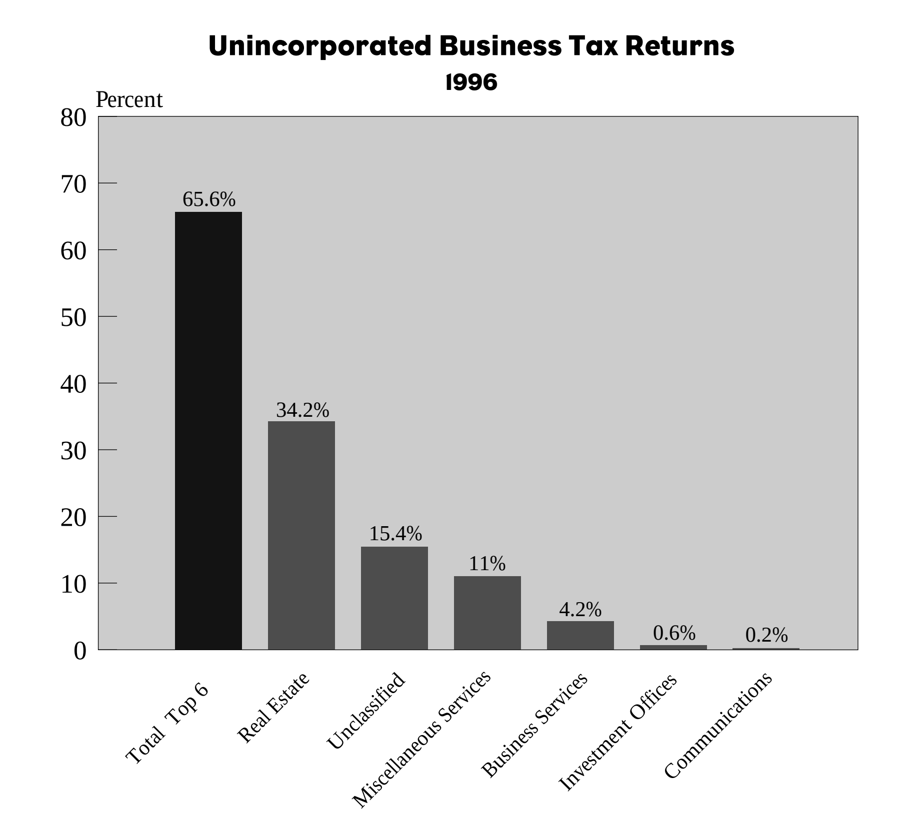
Figure J-12



in 1996, 53 percent of all corporate tax returns in Maryland were classified as nontaxable, and an additional 20 percent of all corporate returns reported taxable income of less than $10,000; in Virginia, over 90 percent of all returns were filed by corporations with taxable incomes of less than $24,000 and with average corporate tax liabilities of $55; and in California, 45 percent of all returns reported zero or negative taxable income and 33 percent reported taxable incomes between $0 and $25,000.

Figures J-12 and J-13 provide similar information about the relative importance of different businesses as a source of unincorporated franchise tax revenue. The broad implications of these figures is the same as those in Figures J-8 and J-9 (pages 401 and 402). Namely, among unincorporated businesses, revenues are highly concentrated, with over 50 percent of tax payments coming from real estate.

Figure J-13



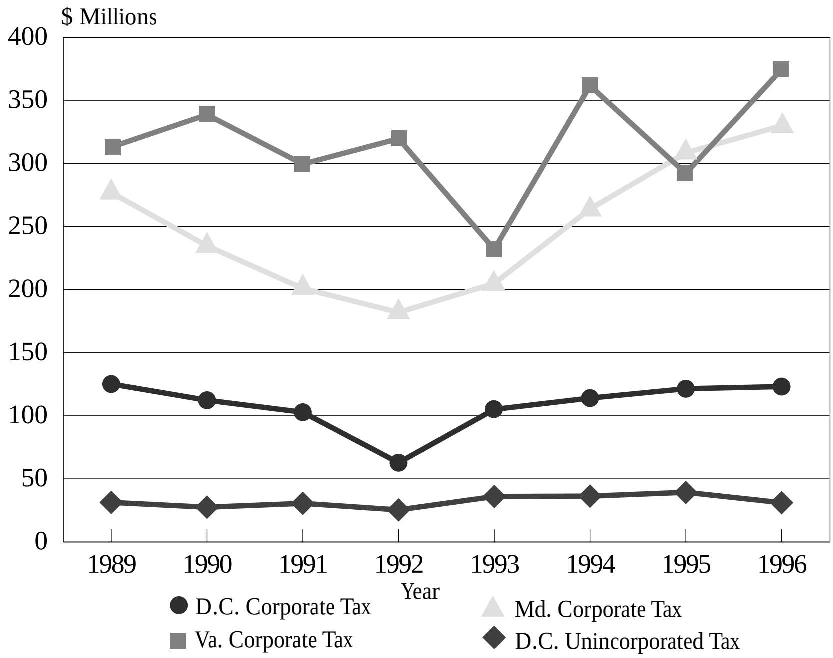
TRENDS IN CORPORATE AND UNINCORPORATED BUSINESS FRANCHISE TAX REVENUE

Figures J-14 and J-15 show trends in corporate and unincorporated business franchise revenues. Between 1989 and 1996, both corporate and unincorporated franchise tax receipts remained essentially "flat." This contrasts somewhat with trends in corporate tax collections in Maryland and Virginia, which increased over the same period.[5]

As with both the Maryland and Virginia corporate franchise taxes, receipts from the District's corporate franchise tax have fluctuated over the business cycle. The general pattern of cyclical fluctuations in District corporate franchise tax receipts exactly matches that observed in Maryland. In both the District and Maryland, corporate tax receipts declined each year between 1989 and 1992, and then increased each year between 1993 and 1996. But the cumulative 50 percent decline in

Figure J-14

Stability of Business Tax Revenue
Tax Receipts: 1989–1996



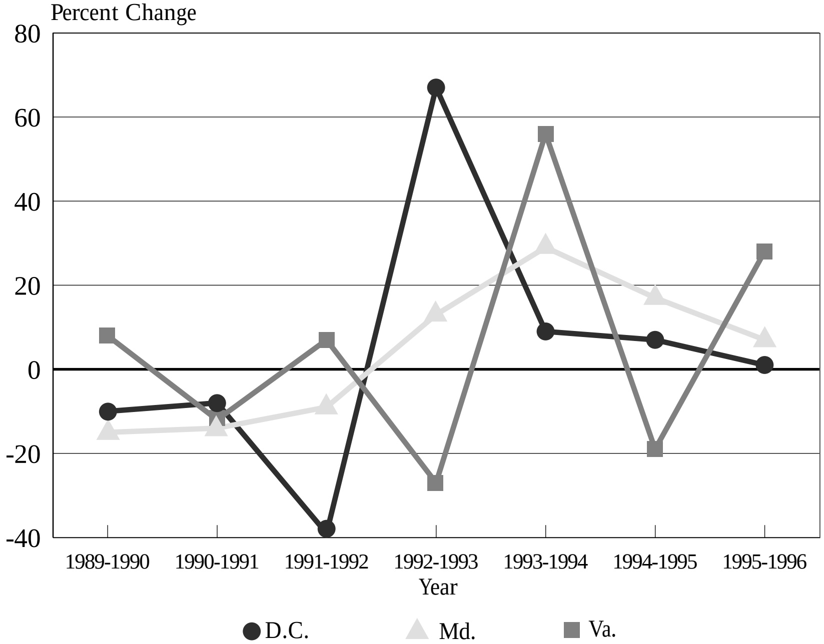
District corporate tax receipts between 1989 and 1992 was somewhat greater than the 42 percent decline in Maryland; and the cumulative 50 percent recovery in District corporate franchise receipts between 1993 and 1996 was weaker than the 80 percent increase in corporate tax receipts in Maryland.

Regional differences in business tax burdens

To the extent that taxes are a consideration, business location decisions should be based on effective tax rates, which depend not just on statutory tax rates, but also on how the tax base is measured. As noted above, however, the base of the District's franchise tax appears to be quite similar in major respects to the base of corporate income taxes in Maryland and Virginia. Thus, one might expect that regional tax burdens will vary mainly as a result of differences in apportionment formulas and/or the tax rate.

Figure J-15

Annual Percent Change in Corporate Franchise Tax Receipts
1990–1996



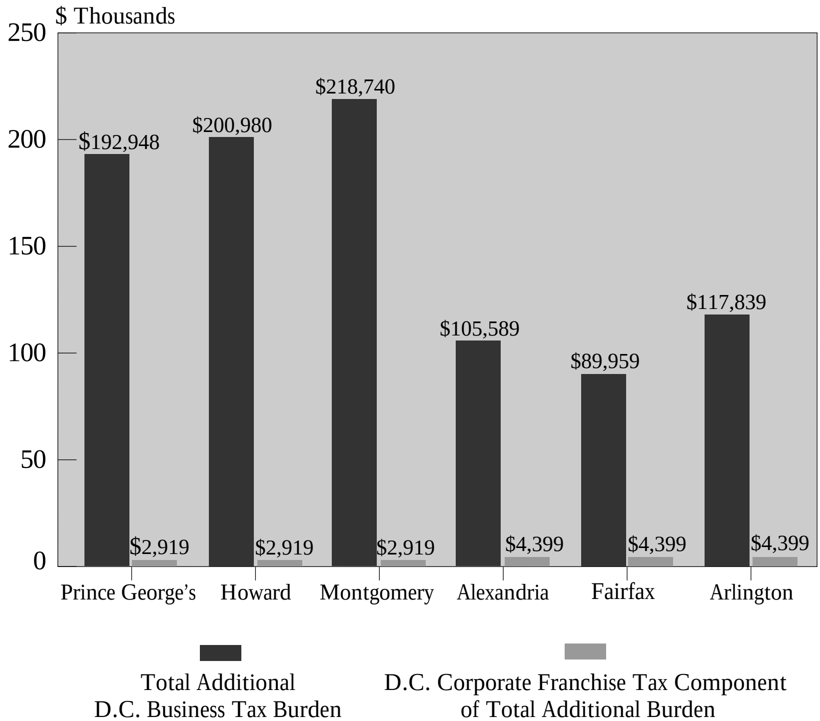
REGIONAL VARIATION IN CORPORATE TAX BURDENS

Consider first a regional corporation that makes one-third of its sales in the District, Maryland, and Virginia but can choose to locate its actual business operations in any of the three jurisdictions. If the firm were to locate entirely in the District, seven-ninths of its profits would be apportioned to the District and taxed at a rate of 9.975 percent; one-sixth of its profits would be apportioned to Maryland and taxed at a rate of 7 percent; and one-ninth of its profits would be apportioned to Virginia, and taxed at a rate of 6 percent. Thus, the combined effective tax rate of the District-based firm would be 9.58 percent (= 9.975% (7/9) + 7% (1/6) + 6% (1/9)). If instead, the business were to locate in Maryland, its effective tax rate would be 6.44 percent (= 9.975% (1/9) + 7% (2/3) + 6% (1/9)) and, were it to locate in Virginia, it would be 6.93 percent (= 9.975% (1/9) + 6% (7/9) + 7% (1/6)).[6]

Calculated effective tax rates would differ if the firm in question were a national corporation assumed to have, for example, 75 percent of its payroll and property in

Figure J-16

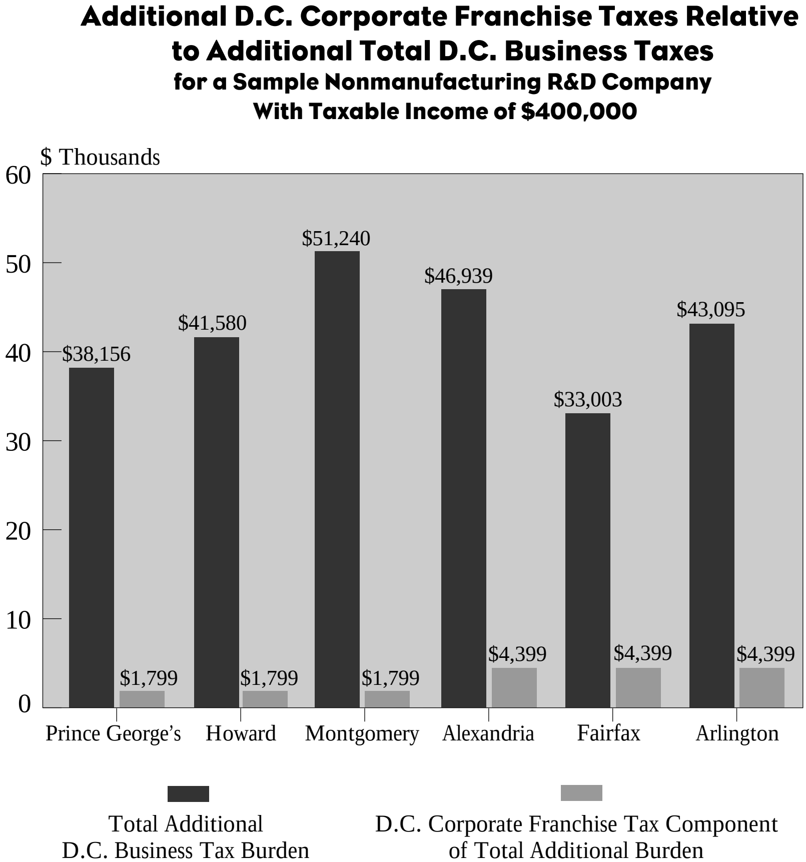
Additional D.C. Corporate Franchise Taxes Relative to Additional Total D.C. Business Taxes
for a Sample Biotechnology Manufacturing Company With Taxable Income of $400,000



the region, but with negligible sales (so that the sales factor would effectively be 0 percent). In this case, if the corporation were located in D.C., its effective tax rate would be 4.99 percent (= 9.975% (1/2)).[7] In Virginia, the effective tax rate would be 3 percent (= 6% (1/2)); while in Maryland, it would be 2.63 percent (= 7% (3/8)).

In each of these calculations, even though Maryland's statutory tax rate is 7 percent and Virginia's is 6 percent, the fact that Maryland's apportionment formula weights sales more heavily than Virginia's leads to a lower effective tax rate for the firm if it locates in Maryland. In either case, however, the higher statutory tax rate that applies in the District means that the profits of either a regional or a national firm would be more heavily taxed if the firm located in the District rather than in Maryland or Virginia.

Figure J-17



A very rough indication of how important these differences might be is provided in the Coopers & Lybrand study referenced above. This study compared the District, Maryland, and Virginia corporate franchise tax burdens on several different types of "prototypical" businesses: an information services company; a biotechnology manufacturing company; a nonmanufacturing research and development company; and a business services company. In each case, the hypothetical company was assigned illustrative values for property and income, with total tax business tax liabilities calculated under the assumption that the sales, payroll, and property factors in each jurisdiction would be, respectively: one-third, one-fourth, and one-fourth.

Figures J-16 and J-17 show the additional tax burden imposed by all District business taxes, as well as the component of this added burden that is attributable to the District's franchise tax. The District's franchise tax clearly contributes to creating an "adverse" tax climate in the District. But, on the whole, the added burden of this tax is small compared with that of other business taxes, most notably the commercial property tax.

ENTITY VS. UNITARY DEFINITION OF TAXABLE PROFITS

Another factor that makes it difficult to say much about effective tax rates is the ability of affiliated firms to engage in transfer pricing schemes that allow them to shift taxable income to low-tax jurisdictions. Consider two businesses that are affiliated, but that are considered to be independent entities for tax purposes. Assume that one affiliate operates entirely within the District and the other entirely within Virginia. The affiliate operating in the District could purchase unfinished products from the affiliated firm in Virginia at prices that are sufficiently above the cost of production to eliminate any taxable profit in the District — so that the profits that would have been reported in the District and taxed at 9.975 percent are now reported in Virginia and taxed at 6 percent. Alternatively, the District firm could pay its Virginia affiliate for managerial advice and set up the fees so that all District-taxable profits would be shifted to the Virginia affiliate. In either case, the effective tax rate faced by the affiliate located in the District is the Virginia tax rate.

These transfer pricing schemes are successful because affiliated firms are not required to combine their profits for purposes of defining their taxable profits. If all affiliated firms were required to file as a group, any pattern of taxable profits allocated across affiliates in different jurisdictions would still produce the same combined profits, so that transfer pricing would not alter aggregate tax liability. The District limitation on the use of the net operating loss deduction represents a consolidation with respect to losses; however, as there is no consolidation with respect to other income and cost items, the ability of affiliates to shift taxable income is little affected.

COMPARATIVE TAX BURDENS OF UNINCORPORATED BUSINESSES

In order to examine the effect of business location on the effective tax burden faced by owners of unincorporated businesses, it is useful to distinguish between those District businesses that provide professional services and those that do not. Consider first an unincorporated business that does not provide professional services, so that all owners, regardless of their jurisdiction of residence, are subject to the District's unincorporated business tax. The state of Maryland provides a credit against Maryland individual taxes for District unincorporated franchise taxes, equal to the amount of the District's unincorporated business income multiplied by the owner's

Figure J-18

Effective Tax Rates of Unincorporated Businesses
by Owner's State of Residence

Business Activity	District	Maryland	Virginia
Nonprofessional Services	$sT_{UBT} + (1 - s)T_{DC}$	$sT_{UBT} + (1 - s)T_{MD}$	$sT_{UBT} + T_{VA}$
Professional Services	T_{DC}	T_{MD}	T_{VA}

Maryland individual tax rate. Because the District's unincorporated business income tax rate exceeds the highest Maryland personal income tax rate, the effect of the Maryland credit is to ensure that a Maryland owner of a District unincorporated business is taxed only once, though in many cases, the last dollar of profit earned is effectively taxed at the District's unincorporated business tax rate instead of the Maryland personal income tax rate. Virginia provides no deduction or credit for the unincorporated business tax, so that a Virginia owner of a District unincorporated business pays the District's unincorporated business income tax, and then is taxed again under the Virginia personal income tax. Finally, owners of unincorporated enterprises who live in the District are subject to the unincorporated business tax for that portion of income originating in the District, while profits not apportioned to the District are taxed at the taxpayer's District personal tax rate.

With these rules, the effective tax rate for owners, by their jurisdiction of residence, are given in the first row of Figure J-18, where $\mathbf{T_{DC}}$, $\mathbf{T_{MD}}$, $\mathbf{T_{VA}}$ are the appropriate income tax rates (taking county-level income taxation into account), $\mathbf{T_{UBT}}$, is the District unincorporated business tax tax rate, and s is the portion of income apportioned to the District. In the case of unincorporated businesses, the effective tax rate is affected both by whether the business is located in the District, Maryland, or Virginia, and by the residence of the owner.

Because the unincorporated business tax rate exceeds all other tax rates (including the top District personal tax rate), the first row of Figure J-18 shows that the effective tax rate faced by the owner of an unincorporated business that does not provide professional services declines with the share of income (represented in the table as "s") that is apportioned to the District.

The results show that there is a tax penalty associated with owning an unincorporated business in the District while also residing in Maryland or Virginia. No jurisdictions in Maryland levy special taxes or fees on unincorporated businesses, and while several counties in Northern Virginia levy taxes on the gross receipts of

professionals, the rates associated with these taxes are quite low. Thus, if tax considerations are critical in decisions on where to live, and/or locate businesses, the current tax treatment of unincorporated businesses may affect such choices. Figure J-18 implies, however, that the current tax treatment of unincorporated business is a two-edged sword with regard to location decisions of regional entrepreneurs. On the one hand, owners of small businesses who live in Maryland or Virginia, and who own a business in the District have some tax incentive to move into the District to avoid being double-taxed. Similarly, small-business owners who currently live in the District have a tax incentive to remain District residents.

On the other hand, an entrepreneur who lives in Maryland or Virginia can reduce, or perhaps even eliminate, the double tax in several ways without changing place of residence. In some cases, there will be a financial incentive to shift the business's payroll, sales, and/or property out of the District. In other instances, one can move small business earnings out of the District by incorporating, and then increasing the amount of compensation and bonuses paid to the owner, which has the effect of shifting taxable income from the District to either Maryland or Virginia. Lastly, entrepreneurs who currently reside in Maryland or Virginia, and who otherwise might consider locating business activities in the District, may be discouraged from doing so.

The results in the first row of Figure J-18 show that these tax incentives are stronger when the owner of a taxable unincorporated business resides in Virginia instead of Maryland. Because Maryland provides a credit against its individual income tax for District unincorporated franchise taxes, it can be shown that each percentage point of taxable income that is shifted out of the District saves an owner who lives in Maryland the *difference* between the District's unincorporated franchise tax rate (9.975 percent) and the owner's Maryland individual tax rate. Virginia, however, provides no credit for District taxes paid, so that a Virginia resident owner can realize tax savings equal to the absolute amount of the District's unincorporated franchise tax by shifting business activities out of the District and into either Maryland or Virginia.

For example, if locating in the District would result in apportioning 75 percent of the business's profits to the District, an owner residing in Maryland would face an effective tax rate equal to 9.23 percent (0.75 x 9.975 + 0.25 x 7), while an owner residing in Virginia would face an effective tax rate of 13.23 percent (0.75 x 9.975 + 5.75). Shifting the business out of the District — and thereby reducing the share of income apportioned to the District from 75 percent to, say, 10 percent — would cut the Maryland owner's tax rate by roughly one-fifth, from 9.23 percent to 7.3 percent (0.10 x 9.975 + 0.9 x 7.0). In contrast, if the same business were owned by a Virginia resident, the effective tax rate would be cut almost in half from 13.23 percent to 6.7 percent (0.10 x 9.975 + 5.75).

Similar conclusions apply to the choice of place of residence. Living in Maryland costs the owner an extra tax equal to the difference between District and Maryland taxes, while living in Virginia costs the owner an extra tax equal to the District's franchise tax.

In contrast, one consequence of the *Bishop* decision, although probably unintended, is that the choice of where to locate an unincorporated business that provides professional services is not affected by the taxation of business income. Similarly, owners of exempt unincorporated businesses have no tax incentive to reside in the District. This can be seen in the second row of Figure J-18, where the effective tax rate is simply the individual tax rate of the owner's place of residence. Thus, the effective tax depends on where the owner lives, but not on where the business is located. At current income tax rates, owners of unincorporated businesses providing professional services face lower effective tax rates if they live in Virginia or Maryland, rather than in the District.

PARTNERSHIPS

Many partnerships are found in industries that provide professional services. If these partnerships are unincorporated, the District is proscribed from taxing their income, so that, as in the case of proprietorships that provide professional services, the effective tax rate faced by the individual partners does not depend on where the partnership is located, but only on the partner's place of residence.

Partnerships organized as sub-Chapter S corporations, however, are subject to the District's corporate franchise tax. Partners of S corporations who reside in the District are allowed to exclude partnership income apportioned to the District when determining their personal income tax liabilities, but partners who reside in Maryland or Virginia are, in effect, treated in the same way as owners of unincorporated nonprofessional proprietorships. Thus, sub-Chapter S corporations with significant numbers of partners who reside outside the District have a tax incentive to reduce the amount of taxable partnership income that is apportioned to the District; and, as in the case of unincorporated proprietors, the incentive is stronger among partners who reside in Virginia than in Maryland.

Assessing possible changes

Before examining possible changes that might be made in the structure of the District's general business taxes, it is useful to distinguish between two broad premises for recommending change. One is to address problems that are specific to the way in which franchise taxes are administered in the District. Another is to

address problems that are not unique to the District, but that are generally common to business net income taxes.

On one hand, the results presented above suggest that the franchise tax is less than ideal in several respects. It cannot be counted on to provide a stable flow of revenue from year to year. To the extent that the tax is intended to charge businesses for the benefits they derive from public services, it does so in an extremely uneven manner. For example, based on average tax payments, to literally interpret the franchise tax as a benefit tax, one would have to believe that businesses in the communications industry derive benefits from District public services that are almost 40 times greater than those received by the average business. The tax is also complex to administer and monitor.

On the other hand, it is worth noting that these problems are common to business net income taxes generally, and are not unique to the District's franchise tax. Receipts from corporate net income taxes fluctuate widely in other states where it is levied; it is widely regarded as a hard tax to collect and to monitor, with a disproportionately large share of the revenue collected from a small number of business taxpayers.

With this in mind, two broad strategies can be considered. One is to consider fairly modest incremental changes that retain the basic features of the existing taxes, while improving some aspects of their performance. The other is to consider fundamental changes, which would involve replacing the existing taxes, in whole or in part, with alternative revenue sources.

In considering either strategy, the main purpose of reform should not be seen as increasing the total amount of revenue that is collected from general business taxes. Instead, it seems more appropriate to judge proposed changes on the basis of the following criteria:

Fairness. Will the proposed change spread the overall burden of business taxation more evenly among taxpayers?
Tax climate. Will the proposed change make it more attractive for businesses to consider locating their activities in the District instead of in surrounding areas?
Revenue stability. Will the proposed change make annual revenue flows more stable?

Incremental Option 1: Retain the franchise tax and increase the corporate minimum tax from $100 to $500

As noted above, business income taxes generally get poor marks as benefit taxes because taxation on the basis of net income can result in rather uneven treatment of otherwise "equally situated" users of local public services. Our analysis of corporate franchise tax payments shows that there is indeed fairly wide variation in District franchise tax payments that probably bears little relation to the benefits received by enterprises from District public services.

A small step toward somewhat more uniform taxation would be to raise the District's minimum corporate tax from its current level of $100 to $500, thereby ensuring that all corporations pay at least this amount for the public goods and services provided by the District. This change would bring in added revenues of roughly $5 million.[8]

An increase in the minimum corporate tax payment might also be accompanied by a smaller increase in the minimum unincorporated income tax, from $100 to $250. The net effect of raising the minimum franchise payment on owners of unincorporated businesses residing in the District would be negligible, because these owners would be able to deduct any higher minimum tax payment against their District individual income tax. A higher unincorporated minimum franchise tax would, however, increase the minimum tax payment from nonresident owners of proprietorships who are not exempt from the District's unincorporated tax; and would put these owners on the same footing as nonresident owners of proprietorships that are presently exempt from the unincorporated business tax, but who must nonetheless pay a $250 business licensing fee. The added amount of revenue raised from this group, however, would be rather small, perhaps on the order of $300,000.

As mentioned, an increase in the minimum tax should be seen as an administratively simple way of spreading the burdens of general business taxes somewhat more broadly, rather than to raise additional revenue per se. Thus, any additional revenue raised from a higher minimum franchise tax should be used to reduce other business tax liabilities. Possible uses of the additional revenue might include: abolishing the corporate franchise surtax, which would lower the District's corporate franchise tax rate from 9.975 percent to 9.5 percent; using the added revenue to lower other fees collected from businesses; or using the additional revenue to help defray the revenue cost of other changes in business taxes discussed below.

Incremental Option 2: Retain the franchise tax and change the apportionment formula to double-weight sales

Jurisdictions that use an equally weighted apportionment formula, like that used in the District, have found it attractive to consider using a formula that gives greater weight to sales. Presently, 20 states that have a corporate net income use an equally weighted three-factor apportionment factor, 20 give double-weight to sales, and five other states give even more weight to sales.

As noted in the 1978 D.C. Tax Revision Commission report, the appeal of giving more weight to sales in apportioning income is twofold. First, if the jurisdiction serves mainly as a "sales outlet" rather than a producer of goods and services, weighing sales more heavily than payroll and property holds the promise of raising more revenue. For example, consider a corporation with no physical presence in the

District (e.g., no payroll or property) that makes 10 percent of its sales in the city. Under the current equally weighted apportionment formula, the effective D.C. apportionment rate for this business would be 3.33 percent (1/3 (0.10 + 0 + 0)). If instead sales were double-weighted (as is the case in Maryland), the apportionment factor would increase to 6.67 percent.

A second attraction of weighting sales more heavily is that it reduces the effective tax rate on corporations that have a significant physical presence in a jurisdiction by giving less weight to payroll and property when apportioning income. Weighting sales more heavily in the apportionment formula is thus seen as providing a tax break that encourages businesses to invest and provide jobs in the taxing jurisdiction.

Figure J-19 provides estimates of the apportionment factors that result from applying the current equally weighted three-factor formula and from applying a three-factor formula that gave double-weight to sales, using data on sales, payroll, and property reported on District franchise tax returns. The following broad conclusions can be drawn from these calculations.

First — although one might expect because of its size and economic make-up that the District serves mainly as a sales outlet, and that, as a result, double-weighting sales would increase the overall percentage of net income apportioned to the District — 27 of the 51 "industries" (including categories such as "invalid code," "nonclassifiable," and "other") would experience decreases in the fraction of income apportioned to the District if sales were double-weighted. Thus, although the median apportionment fraction would increase slightly from 1.33 percent to 1.34 percent, the average apportionment fraction (weighted by property in the District) would go down slightly from 5.36 percent to 5.33 percent. Moreover, apportionment factors among eight of the "top nine" categories of taxpayers that together account for more than 60 percent of corporate franchise tax revenues would fall under double-weighting.

A precise estimate of the revenue effects of moving to double-weighting of sales would require more detailed calculations based on data from individual franchise taxpayers. Nonetheless, the overall pattern of results in Figure J-19 suggests that double-weighting of sales would not be a significant revenue raiser and could actually cost the District franchise tax revenue.

Whatever the overall effects on revenue of double-weighting sales, the results in Figure J-19 also indicate that the formula used to apportion income to the District is likely to be of little importance in the location decisions of most firms. A large firm that operates across many states will have only a small fraction of its profits apportioned to any single jurisdiction, regardless of how the three factors are weighted. With the use of transfer pricing, such a business may also find it relatively easy to shift profits from states with disadvantageous apportionment schemes to states with more attractive apportionment schemes. For these reasons, the choice of an appor-

Figure J-19

Effects of Changing Apportionment Formulas

Industry	Equal-Weight Sales	Double-Weight Sales	Percent Change	Rank by Apportionment Fraction	
				Equal-Weight	Double-Weight
Legal services	0.4028	0.4114	2.14%	1	1
Stone, clay, glass	0.2504	0.3218	28.48	2	2
Membership organizations	0.1166	0.0978	-16.17	3	5
Commercial real estate, insurance loans, law	0.0880	0.1305	48.26	4	3
Social services	0.0809	0.1021	26.12	5	4
Water transport	0.0645	0.0643	-0.37	6	6
Real estate	0.0588	0.0541	-8.06	7	9
Hotels, etc.	0.0567	0.0576	1.45	8	7
Building construction	0.0539	0.0562	4.35	9	8
Insurance services	0.0499	0.0525	5.14	10	10
Banking	0.0428	0.0427	-0.36	11	11
Educational services	0.0384	0.0385	0.22	12	12
Communications	0.0354	0.0344	-2.89	13	13
Local and suburban transit	0.0299	0.0310	3.59	14	14
Electrical, gas, and sanitary	0.0282	0.0259	-8.24	15	17
Amusement and recreation	0.0272	0.0294	8.01	16	15

Industry	Equal-Weight Sales	Double-Weight Sales	Percent Change	Rank by Apportionment Fraction	
				Equal-Weight	Double-Weight
Invalid code	0.0226	0.0286	26.61	17	16
Eating and drinking places	0.0203	0.0202	-0.58	18	18
Measure/analysis/control	0.0201	0.0188	-6.30	19	20
Motion pictures	0.0191	0.0184	-3.59	20	21
Health services	0.0186	0.0190	2.22	21	19
Construction not building	0.0152	0.0163	6.89	22	23
Miscellaneous repair services	0.0139	0.0166	18.80	23	22
Business services	0.0136	0.0134	-0.79	24	25
Personal services	0.0133	0.0135	1.48	25	24
Miscellaneous services	0.0123	0.0118	-4.11	26	26
Food stores	0.0111	0.0109	-1.92	27	27
Printing and publishing	0.0099	0.0090	-8.76	28	28
Miscellaneous retail	0.0091	0.0082	-10.01	29	29
Apparel and accessory stores	0.0079	0.0078	-0.53	30	30
Nonclassifiable	0.0075	0.0072	-3.77	31	31
Miscellaneous manufacturing	0.0070	0.0072	2.36	32	32
Investment offices	0.0067	0.0055	-16.77	33	35

Figure J-19, cont.

Industry	Equal-Weight Sales	Double-Weight Sales	Percent Change	Rank by Apportionment Fraction: Equal-Weight	Rank by Apportionment Fraction: Double-Weight
Motor freight transportation	0.0040	0.0056	37.23	38	34
Furniture and equipment stores	0.0032	0.0030	-5.56	39	35
Insurance	0.0029	0.0029	1.06	40	36
Building materials and hardware	0.0024	0.0026	7.19	41	41
Credit agencies	0.0022	0.0018	-17.84	42	43
Transport services	0.0018	0.0017	-4.64	43	46
Furniture and fixtures	0.0017	0.0020	14.98	44	42
Wholesale trade — nondurable	0.0017	0.0018	6.41	45	45
Electrical/electronic	0.0016	0.0018	14.25	46	44
Wholesale trade — durable	0.0014	0.0015	9.17	47	47
Food and kindred	0.0007	0.0009	28.76	48	48
Auto dealers/gas stations	0.0007	0.0006	-11.77	49	49
Oil and gas	0.0007	0.0006	-18.58	50	50
Machinery — nonelectrical	0.0007	0.0006	-3.43	51	51
Air transport	0.0006	0.0005	-12.07	52	52
Chemicals and allied products	0.0004	0.0004	-14.79	53	53

tionment scheme for a small jurisdiction is likely to be of little consequence to a firm that is considering doing business in the jurisdiction.

The absolute magnitude of the apportionment factors shown in Figure J-19 illustrates the relative unimportance of apportionment schemes for small jurisdictions like the District. For most industries, the fraction of profits apportioned to the District is quite small; the median value is slightly more than 1 percent and the average (based on property in the District) fraction is about 5 percent. Thus, for the median industry, less than 2 percent of profits face the District tax rate of 9.975 percent, which suggests that District taxation may play a limited role in the locational decisions of most firms. As may be seen, double-weighting of sales would generally result in small absolute decreases or increases in the apportionment factor. For example, in communications and business services, which together account for one-third of corporate franchise tax revenues, double-weighting of sales would reduce corporate franchise tax liabilities in the District by less than 3 percent in both cases.

Incremental Option 3: Retain the franchise tax and conform the D.C. tax to that of Maryland or Virginia

An administrative change that would make it easier for businesses with a regional presence to comply with District taxes would be to conform the definition of the District's corporate franchise tax base to that used by Maryland and/or Virginia. Because there already are many similarities between the net income tax bases of the District, Maryland, and Virginia, the main substantive effect of conforming the District's base to that of Maryland or Virginia would be to change the treatment of net operating losses in a way that would benefit "start-up" corporate affiliates in the District.

Under current rules, a start-up company that is an affiliate of a multicorporate whole may not use a net operating loss to offset its taxable District income in the future, if a deduction for that net operating loss is taken on the federal return filed by the affiliate's corporate parent. This has the effect of raising the effective rate at which start-up affiliates are taxed if they choose to locate in the District, instead of in surrounding areas.

Conforming the District's tax base to that of either Maryland or Virginia would allow the affiliate to claim its own net operating losses as deductions when determining taxable income, which would lower the taxes collected over a number of years from affiliated corporate start-ups. Such a change would cost some revenue, though how much cannot be determined without more extensive analysis of individual corporate returns. The amount, however, seems unlikely to be large, since the proposed change in the base would apply mainly to start-up affiliates.

To the extent that net operating losses are often incurred during economic downturns, it is also possible that broadening the ability of corporate affiliates to claim net operating loss deductions would reduce the "rebound" in tax revenues

that might occur in the period after an economic downturn that had generated substantial operating losses. The comparative performance of the D.C. and Maryland corporate franchise tax collections in the 1990s, however, suggests that this effect also might be rather small.

LOWERING THE FRANCHISE TAX RATE

In addition to conforming the base of the District's franchise tax to that of either Maryland or Virginia, consideration might also be given to lowering the District's franchise tax rate to that of either the Maryland or the Virginia corporate tax rate. As noted above, reducing or eliminating the income tax rate differential between the District and surrounding jurisdictions may have only a modest effect on the total tax-differential tax burden. Nonetheless, cutting the rate — along with other changes — could be seen as a positive signal of improvement in the District's tax climate.

Several issues would need to be addressed if the rate were lowered. The most obvious is that lowering the rate would result in a revenue loss. If one assumes that the initial loss in revenue would be roughly proportional to the change in the tax rate, cutting the District's tax rate from 9.975 percent to Maryland's rate of 7 percent would lower revenue from both the corporate and unincorporated franchise tax by about 30 percent, or just over $45 million. That revenue would need to be matched either by reduced spending or other tax increases. (A possibility might be to use receipts garnered from a new, low, broad-based gross receipts tax to finance such a change. See the discussion below.)

Cutting the franchise tax rate would also raise some issues about the treatment of unincorporated businesses. If, as is assumed above, the unincorporated franchise tax rate were cut to 7 percent, retaining the current exemption for unincorporated business income under the individual tax effectively would tax business income at a lower maximum rate (7 percent) than the current District maximum income tax rate of 9.5 percent. One way of addressing this anomaly, while retaining the separate unincorporated income tax, would be to replace the current exemption of business income with a credit for business taxes paid. The practical effect of the change would be to ensure that businessowners, who would otherwise be subject to a personal income tax rate of more than 7 percent, would continue to be taxed at that higher rate.

Incremental Option 4: Retain the franchise tax and replace entity-based taxation with unitary taxation

As noted above, taxing corporations on an entity basis rather than a unitary basis makes it easy for corporate taxpayers to allocate costs among their affiliates, so as to shift income from high- to low-tax jurisdictions. This has the effect of eroding the base of business taxation in high-tax jurisdictions like the District. For this reason, 14 states have elected to tax businesses as unitary combinations — under which the

profits from legally independent businesses that form part of a multicorporate whole are combined for purposes of determining the amount of income that is to be apportioned.

Current rules effectively prohibit the District from taxing entities on a unitary basis, unless the taxpayer requests such treatment. Not too surprisingly, when such requests are made, they generally involve circumstances under which treatment as a multicorporate whole for purposes of computing District franchise tax liability is to the advantage of the taxpayer. This will happen when the multicorporate whole, though not the District affiliate, has net losses. In the past, such requests have generally been denied, but one analyst of the District's tax system has suggested that in recent years, corporations have increased their efforts to negotiate unitary tax treatment that allows them to move net operating losses into the District.[9]

Tax scholars generally agree that taxing corporations that operate in multiple jurisdictions on a unitary basis makes good sense conceptually. Also, although taxing corporations on a unitary rather than entity basis would allow some businesses to reduce their tax liabilities if the unitary combination, but not the District affiliate, has net losses, it is likely to increase the overall amount of positive profits that would be apportioned to the District because it would remove the incentive for businesses to shift profits from District affiliates to other affiliates in the unitary combination through transfer pricing. Thus, for both of these reasons, adopting a unitary approach to defining District-taxable net income merits serious consideration.

The advantages of moving toward a unitary basis of taxation would, however, need to be weighed against some potential costs. Although taxation on a unitary basis ultimately makes it easier to determine the taxable income of corporations with multiple affiliates, there are numerous and complex administrative issues that arise in deciding which parts of a multicorporate whole to treat as a unitary combination for tax purposes.

In addition, as long as Maryland and Virginia tax corporations on an entity instead of a unitary basis, moving the District tax toward a unitary basis would mean moving away from greater conformity with corporate taxation in surrounding jurisdictions. Moreover, to the extent that businesses (rightly or wrongly) perceive unitary taxation as increasing corporate tax burdens, a move by the District toward adopting a unitary base, especially if Maryland and Virginia continued to tax on an entity basis, might further reinforce the common perception of the District as a high-tax jurisdiction.

Incremental Option 5: Retain the corporate franchise tax and abolish the unincorporated franchise tax

Serious consideration might also be given to repealing the District's unincorporated business franchise tax. Although this change seems far-reaching, it would actually

result in only a modest change in net business tax revenues, while providing a number of benefits in the form of tax simplification and improved incentives for business location. It also can be seen as an incremental change because the corporate franchise tax would be retained.

There are several arguments for abolishing the District's unincorporated business tax. As currently administered, the unincorporated business tax does not satisfactorily meet the revenue objectives it was intended to serve. The unincorporated business tax does not result in the uniform treatment of corporate and unincorporated businesses; and because of the *Bishop* decision, it is a very poor vehicle for taxing nonresident owners.

In essence, the current unincorporated business tax accomplishes two things: 1) it serves as the administrative vehicle for taxing most of the business income earned by District residents; and 2) it is a very crude benefit tax on nonresident owners who are engaged in business activities that are not exempt from tax. These two objectives could be served almost as well and with minimal revenue loss by abolishing the unincorporated business tax, by making business income received by District residents taxable under the District's individual income tax, and by charging nonresident business owners who are currently not exempt from the unincorporated business tax the same $250 business licensing fee charged to nonresident owners of unincorporated businesses that have been exempted by *Bishop*.

If one assumes that half of the net income taxed under the unincorporated business tax is received by District residents, then approximately half of the revenue that would be lost by abolishing the unincorporated business tax would be recouped in the form of higher individual income tax payments. Requiring District resident owners of unincorporated businesses to pay a licensing fee of $250 would bring in an additional $2 million. Under these assumptions, the net-revenue cost of abolishing the unincorporated business tax would be more on the order of $14 million rather than the entire $31 million that is presently collected under the unincorporated business tax.

Eliminating the separate tax on unincorporated business would offer several advantages. It would simplify compliance with District taxes among resident owners of unincorporated businesses, who would be subject only to individual income taxes. It also probably would free up some resources that are currently devoted to monitoring compliance with the unincorporated business tax and allow them to be used to monitor compliance with the corporate franchise tax.[10]

Finally, eliminating the unincorporated franchise tax would remove tax considerations as a factor in the decision of where to locate unincorporated business enterprises, because entrepreneurs who reside in Maryland and, especially, Virginia would no longer have a tax-motivated reason to locate their businesses outside of

the District. This benefit, however, would need to be weighed against the consequences of removing current tax incentives for some owners of small businesses to reside in the District.

Fundamental Option 1: Abolish the franchise tax and replace part of the lost revenue with an expanded gross receipts tax

A study of D.C. revenues by Carol O'Cleireacain for the Brookings Institution (hereafter the Brookings proposal) recently proposed that both the corporate and the unincorporated franchise taxes be eliminated and partially replaced with an expanded version of the general receipts tax that is presently collected at very low rates and earmarked for the MCI Arena. O'Cleireacain estimates that current gross receipts tax rates could be increased fivefold and still remain below gross receipts tax rates found in surrounding Virginia jurisdictions and, in the process, yield about $50 million in additional gross receipts tax revenue to partially offset the revenue lost from eliminating the franchise tax. If one assumes that half of the revenue collected from the unincorporated franchise tax would be recouped on individual tax returns, the proposed change would result in a net-revenue cost of roughly $90 million.

ADVANTAGES AND DISADVANTAGES OF A GROSS RECEIPTS TAX

Aside from its revenue effects, the Brookings proposal would receive reasonably good marks — according to the above criteria — for assessing changes.

Administration. Eliminating the franchise tax would make the District's revenue system simpler and easier to administer because business net income taxes are among the more difficult taxes to collect, especially at the state and local level. The change would improve the tax climate in the District by easing the compliance burden on businesses, as well as by removing what is now perceived to be a relatively high tax on net income.

Fairness. It is also at least arguable that taxing businesses on the basis of gross receipts is as at least as fair, according the benefit principle, as is taxing business net income. For example, under a gross receipts tax, a business would make tax payments that depend on its scale of operations, which is related to the size of the benefits it derives from tax-financed goods and services.

Revenue stability. Gross receipts are also much less likely to fluctuate from year to year, as is sometimes the case with business net income. Thus, a gross receipts tax is likely to be a more stable and predictable source of revenue than the franchise tax.

Revenue neutrality. Unfortunately, however, the revenue implications of the Brookings proposal make it unfeasible, given the current budgetary circumstances of the District. The original Brookings proposal assumed that other revenues — notably some form of federal payment, and payments in lieu of taxes (PILOT) from nonprofit organizations — would be able to fill the revenue gap left from the

elimination of the franchise tax. Such revenue sources seem extremely unlikely to materialize in the near future.

This raises the question of whether a broad-based gross receipts tax could be seen as a full, rather than a partial, replacement for existing franchise taxes. Some of the benefits cited above in connection with a smaller, low-rate gross receipts tax would remain under a "large" gross receipts tax. For example, a large, broad-based gross receipts tax would still be easier to collect than a net income tax, and the revenues from such a tax would be more stable from year to year.

But, in order to raise the required revenue, current gross receipts taxes would have to be increased by at least 10- to 15-fold, which would have several potentially adverse consequences. As long as the District were the only jurisdiction in the area with a large tax on gross receipts, businesses — especially start-ups — would have a tax incentive to locate either in Maryland or Virginia because in these jurisdictions, losses incurred in the start-up phase would be deductible against future taxable income under the net income tax. (This incentive would also be present under a more "modest" gross receipts tax, but so long as rates were low, the incentive would not be as strong.) For similar reasons, businesses with a net income that fluctuates over the business cycle would prefer locating in a jurisdiction with a net income tax instead of a gross receipts tax.

In addition, although a gross receipts tax may be at least as fair a way of charging businesses for some of the benefits they derive from public services as a net income tax, it is perceived as unfair on grounds of ability to pay because all businesses are taxed without regard to their profitability. Moreover, a gross receipts tax tends to impose relatively heavier tax burdens on "sales-intensive" industries, such as wholesale and retail trade, which may not correspond to share of public benefits derived by businesses in these industries. These shortcomings of gross receipts taxes may be relatively insignificant as long as gross receipts are taxed at low rates; however, they matter more as rates increase.

Financing a franchise tax rate cut

A less far-reaching change would be to use the added revenue raised from an expanded low-rate gross receipts tax to finance a cut in the franchise tax rate. Such a change seems likely to spread the aggregate business tax burden more evenly among business taxpayers, and thus is worth considering. (Roughly speaking, the combined burden of a new low-rate gross receipts tax and a lower franchise tax would be higher for businesses that presently pay little or no franchise tax, and lower for businesses that presently pay significant amounts of franchise tax.) Determining the exact effects of such a change in the distribution of tax liabilities would, however, require more detailed analysis of individual business franchise tax returns.

Fundamental Option 2: Replace the franchise tax with a Michigan-style value-added tax

An alternative to either a net income or a gross receipts tax is to tax all businesses, without regard to organizational form or residence of the owner, on the basis of value added. Many countries rely on the value-added tax (VAT) as a major revenue source, but this form of tax has not yet attracted much interest in the United States. The only jurisdiction that uses a value-added tax is Michigan, which in 1976, replaced a panoply of business taxes with what is now termed the Single Business Tax. Michigan's success with this tax, however, suggests that in spite of the novelty of this form of taxation, it merits serious consideration as a revenue source for the District.[11]

HOW A VAT WOULD WORK

To understand the implications of replacing the net income tax with a VAT, it is helpful to consider some simple accounting relationships. The value-added of a firm is, literally, the value the firm adds to the unfinished materials it purchases, so that value-added may be determined simply by taking the difference between a firm's sales and its purchases of intermediate goods (including raw materials). Thus at the most basic level: *Value-Added = [Sales - Purchases of Intermediate Goods].* This approach to determining value-added is referred to as the subtraction method.[12] In principle, a VAT could be collected using the subtraction method. In practice, however, countries that have a VAT have found it administratively more convenient to rely on an approach known as the "credit-invoice method," which is not discussed here because it is not the approach that has been used to implement Michigan's VAT.

Addition method. The starting point for defining the base of the Michigan single business tax is the fact that value added by a business in production must ultimately be paid out to the various factors of production. Thus, value-added can be determined by adding up all the different forms of income generated within the firm. This approach to determining value-added is called the addition method. Thus, *Value-Added = [Sales - Purchases of Intermediate Goods] = [Profits + Interest Payments + Rental Payments + Royalties + Labor Compensation].* The equivalence of using the subtraction and the addition methods to determine value-added follows from the accounting identity that *Profits = Sales - [Purchases of Intermediate Goods + Interest Payments + Rental Payments + Royalty Payments + Labor Compensation].*

The VATs in other countries as well as the Michigan VAT adjust the basic definition of value-added in determining the actual tax base. The most common adjustment, as well as the most significant, is a deduction for the cost of investments in capital. With this deduction, the VAT is termed a "consumption type VAT"; and the VAT tax base becomes *[Profits + Labor Compensation + Interest Payments + Rental Payments + Royalties - Cost of Capital Goods].*

Figure J-20

Corporate Value-Added Tax (VAT) Base

Industry Group	VAT Base	Percent of Total
Construction	$101,097,248	2.1%
Manufacturing	134,263,362	2.8
Utilities and transportation	521,430,322	11.0
Trade	511,406,494	10.8
Financial services	246,583,829	5.2
Other services	2,942,647,973	62.1
Other	284,709,419	6.0
Total	**$4,742,138,647**	**100.0%**

After adjustments are made in value-added, a flat rate is usually applied to determine tax liability. In most systems, some allowances are made for small firms; often these are exempted in the interest of administrative simplicity.

Administering a VAT

As the Michigan experience shows, administering a VAT at the state level is relatively straightforward, because a business's VAT tax base can be determined from information contained on its federal corporate tax return. Using information provided on that return, the VAT base would be defined as follows: *VAT Tax Base = [Federal Taxable Income + Net Interest Payments + Net Capital Gains + Net Dividend Payments + Net Royalty Payments + Depreciation + Labor Compensation (including that of officers and directors) + Net Operating Loss Deduction - Investments in Capital Goods]*.

Note that in defining the VAT base, net-operating loss deductions would be added in because operating losses in one year will directly reduce VAT liability in that same year, so there is no need to carry them forward.

Apportioning value-added. The next step is to apportion a company's value-added to the taxing jurisdiction. This process is conceptually no different than the current process of apportioning net income under the franchise tax. There are several ways in which this might be done. For example, Michigan currently uses a weighting scheme in which sales receive a weight of 80 percent, while property and payroll each receive a weight of 10 percent.

Issues of whether to define value-added on an entity or a unitary basis would also remain. Michigan, for example, has elected to determine taxable value-added on an entity rather than a unitary basis.

Implementation issues. Several issues would need to be addressed in implementing a District VAT. First, because a VAT permits the deduction of the cost of investment goods, some firms, such as start-ups, may have a negative VAT base. The simplest way of dealing with this problem is to allow the firm to treat such a figure as a deduction from its VAT base in future years, as is the practice in Michigan.

Second, most business tax systems provide tax relief for small firms, either in the belief that market failures are more consequential for small firms or that the administrative cost of dealing with such firms outweighs the revenue collected. The District might choose to exempt firms with a VAT base below a certain level. (Currently, firms whose VAT base falls below $45,000 are exempt in Michigan.)

Some choice of rules for nexus must be established. Such rules would be no different than those that would be used with any corporate income tax, so that the District's current standards would suffice.

Coordination with other taxes. Although the sort of VAT described above does not have to be tailored to fit specific firms or industries — the same rules could be applied to manufacturing, trade, construction, and the financial services industry — tax coordination within the District might require firm- or industry-specific changes in other tax laws. For example, because the VAT is a better measure than gross receipts of benefits received, the Arena Fee, which is a benefits tax based on gross receipts, might be folded into the VAT for the for-profit sector.

There is also a broader issue of how to coordinate a VAT collected from unincorporated businesses, with the taxation of business income under the individual income tax. A fairly simple approach is to allow owners of unincorporated businesses to take a credit against their VAT liability in recognition of the fact that income is taxed at the personal level. Such credits are provided as part of the Michigan single business tax, which allows unincorporated businesses and S corporations a credit against their computed VAT liability, depending on their business income. If business income is less than $20,000, then the credit equals 20 percent of the Michigan single-business-tax liability; if business income is between $20,000 and $40,000, then the credit equals 15 percent of single-business-tax liability. Businesses with incomes greater than $40,000 receive a credit of 10 percent.[13]

INCIDENCE OF A VAT

Before discussing the pluses and minuses of substituting a VAT for the D.C. franchise tax, it is useful to consider who would bear the economic burden of a Michigan-style VAT. One commonly held notion is that such VAT would "just be a sales tax in disguise," because the European-style VAT that is collected in most countries is perceived as a tax on consumption.

The conception of the VAT as another form of sales tax, however, is incorrect. The accounting relationships that hold at the national level between the base of a "consumption-type" VAT and consumption do not apply when the same base is taxed at the subnational level. Moreover, although a European-style VAT is essentially the same as a retail sales tax in its final incidence, this is so because the credit-invoice method that is used to collect this tax is expressly designed to tax sales at the destination. But the addition method that is used to collect a Michigan-style VAT is designed instead to tax value-added at its source.[14]

The definition of the VAT base given above suggests that, at least in statutory terms, the incidence of such a source-based tax will be borne by the suppliers of capital to the firm and its workers. However, the statutory incidence of the tax is a poor indicator of how the tax will ultimately affect incomes once the economy adjusts to the tax. The ultimate effect of the tax on incomes, what economists term the economic burden of the tax, is a complicated matter.

In the case of a Michigan-style VAT, a useful starting point for understanding its incidence is to note that the economic effect of allowing capital spending to be immediately deducted (or "expensed") is to exempt what economists call the "normal" or "competitive return" to capital from taxation. Thus, for example, if the competitive return to investing in a business is set by market at 8 percent, the owner of a business that earned a return of 8 percent on invested capital would effectively be exempt from tax under a Michigan-style VAT. What economists call "economic profit," however, would be taxed. Economic profits would be earned whenever a business paid a profit that was more than enough to provide the owner with a competitive return on capital.[15]

Thus a Michigan-style VAT could be described (at least initially) as taxing economic profits plus labor compensation. Whether this would describe the final incidence depends in a complicated manner on how both owners of capital and workers would react to the presence of a VAT in the District — under the assumption that Maryland, Virginia, and other states continued to rely on business net income tax. The details of the analysis are beyond the scope of this chapter, but it seems plausible that in the end, the burden of a Michigan-style VAT would be shared by: 1) employees of businesses located in the District, in the form of lower take-home pay; 2) owners of these businesses, in the form of lower after-tax (economic) profits; and 3) consumers of goods and services produced by District businesses (such as restaurants and entertainment) that provided goods and services not having close substitutes in the regional or national market.

Although the likely incidence of a Michigan-style VAT might appear to be quite different from that of a business net income tax — which at the national level is widely believed to fall on the owners of capital — such is not the case. This is because the incidence of state corporate income taxes has been shown to be eco-

nomically equivalent to the incidence of separate taxes on each of the factors that are used to apportion profits.[16] Thus, under a three-factor formula, the economic incidence of a net income tax would be equivalent to the incidence of separate taxes levied on sales, payroll, and property. Thus, if the VAT raised about as much revenue as the corporate franchise tax, it is plausible to assume that it would not produce any dramatic change in the distribution of economic burden that already exists with the corporate franchise tax.

ADVANTAGES OF A VAT

Replacing the franchise tax with a VAT would offer a number of advantages:

Revenue stability. One clear benefit is that the revenue from a VAT will be less volatile than the revenue generated from the franchise tax. A VAT base will include most of the franchise tax base as well as labor compensation; labor compensation is far larger than the franchise tax base and tends to vary little. In addition, the VAT tax rate required to raise the same amount of revenue as a franchise tax is considerably smaller than the franchise tax rate. The combination of a low rate with a tax base that is dominated by a component that has little variance means that VAT tax revenue will vary less than franchise tax revenue.

Fairness. A second advantage is that value-added is much more likely to be related to the benefits that a business derives from public services than is net income or gross receipts. One of the main justifications for taxing business at the subnational level is that such taxation may be a substitute for user fees on services that the subnational unit may provide firms. When taxation plays this role, there should be some link between the value of service provided and taxes paid if firms are to allocate their activities across jurisdictions in an efficient fashion. Unfortunately, the franchise tax base provides a poor measure of economic activity. For example, large firms that place significant demands on the services of a jurisdiction may, as a result of transfer pricing policies, pay little in franchise taxes. Similarly, a gross receipts tax may provide a poor measure of economic activity; a firm with significant sales but few employees or property within a jurisdiction would face a relatively high tax burden while using few services within the taxing jurisdiction.

Because of the breadth of its base, VAT liability is more closely correlated with the demands a firm may place on a jurisdiction's services. Firms that employ a large number of workers or that rent significant commercial space will place demands on the jurisdiction's fire and police services, as well as on the jurisdiction's transportation system. At the same time, the VAT base of such firms will be concomitantly larger because it will include labor compensation and rental payments.

Administrative ease. A VAT is also easy to collect and has low compliance costs because of its broad base and relatively low rates. Given the complicated nature of

the current franchise tax, it seems likely that a move to a VAT would lower the administrative costs faced by the District as well as the compliance costs to taxpayers. A VAT that relied on federal taxable income as a starting point, with the addition of items that appear as deductions at the federal level (primarily depreciation, net interest, dividends, capital gains, royalties, and labor compensation) would have a number of desirable characteristics. First, the calculations required to determine tax liability are straightforward and transparent. Second, most of the information needed to ensure compliance is provided by the federal return, which should lower audit costs. Finally, unlike the franchise tax base, the VAT base is relatively insensitive to changes in federal corporate income tax rules, so that the District would not have to be as concerned with modifying the VAT structure in response to the changes in federal rules.

Economic neutrality. A VAT would also be fairly neutral with respect to decisions made by businesses. Absent other taxes, a firm that operated only in the District and faced a VAT would find little tax advantage in altering its mix of inputs. The firm's choices of different forms of capital inputs would mirror those found in a world with no taxes. While the firm would find that the cost of labor would rise, the increase in labor costs would be quite small because the VAT rate is quite small. For example, a VAT rate of 2.75 percent would only raise labor costs by slightly more than 2.8 percent. Finally, a firm would find that its choice of financing — debt or equity — would not be affected by a VAT. In contrast, the franchise tax likely biases all real and financial decisions of most firms operating in the District. For firms that operate across jurisdictions, a switch to a VAT would also lessen the opportunity to alter tax liability through a transfer pricing arrangement.

Source-based taxation. Lastly, a Michigan-style VAT could, in principle, provide a legally acceptable means of source-based taxation of nonresidents by the District. The tax would be collected from business enterprises rather than persons and, as indicated by the above discussion, a consumption VAT could not simply be characterized as an income tax. Thus, a VAT stands a good chance of legally complying with the current prohibition on taxing the incomes of nonresidents.

Obstacles in implementing a VAT

Although moving toward a VAT would seem to offer many advantages, there also are some hurdles that would have to be overcome.

Coordination with other jurisdictions. Whenever one jurisdiction levies a tax that it is not imposed in others, there are likely to be some coordination problems with the other jurisdictions. For instance, it seems likely that other jurisdictions would not recognize a Michigan-style VAT as an income tax — meaning that for firms operating across multiple jurisdictions, deductions and credits that they might previously have applied to their District franchise tax payments no

longer would be available. Even if the VAT eventually is accorded the same treatment as the corporate franchise tax, the uncertainty and inconvenience that firms will face during the period in which other jurisdictions adjust to the use of a VAT by the District should not be ignored.

While evidence of tax coordination problems is limited, the experience of Michigan suggests that tax coordination with other states has not been a significant problem. However, Michigan's economic and political relationships with neighboring states are not similar to those of the District, so that inferences from the Michigan experience may not be warranted.

Transitional administrative and compliance costs. Any significant substitution of a new tax for an existing tax also will create costs for both the District and its taxpayers. On the administrative side, it will be necessary to provide training for District government employees, promulgate the new code, identify firms that might be subject to the VAT (if the VAT code defines nexus differently from the corporate franchise tax), and create new accounting and audit systems. While all the functions of tax administration with a VAT may be less expensive, these one-time costs cannot be ignored. Taxpayers also will face some transition costs in the form of employee training and the creation of accounting systems. Additionally, taxpayers will have to make some effort to learn how to comply with a new tax code.

An additional transitional issue that normally would arise in replacing a net-income tax with a consumption-type VAT at the national level is that the change has the effect of reducing the value of existing or "old" capital. This happens because the value of capital assets that already are in place implicitly include the tax value of depreciation deductions allowed on such capital, which would be eliminated by the capital expensing provision of the VAT.

It would seem, however, that some of these effects would be attenuated because the value of existing assets is likely to depend at least as much on tax treatment at the federal level, where the net income would be retained. In principle, arrangements could also be devised to offset the effects of switching to expensing of capital assets, but such transition rules are likely to be quite complicated.

Source-based taxation of unincorporated business. A consequence of taxing the value-added of all businesses without regard to owners' residence is that many unincorporated businesses that have hitherto been exempt from District taxes would become taxable. It seems reasonable to assume that administrative convenience would induce the District to exempt smaller firms from the VAT, provided their VAT base falls below some threshold, as has been done in Michigan; but many businesses would have a VAT base above this threshold. The effects of imposing a VAT on these enterprises would depend on how the District and/or surrounding jurisdictions decided to coordinate a District VAT with the personal income tax.

As noted above, because a Michigan-style VAT is not an income tax in the usual sense, it is quite possible that Maryland would not continue to provide a tax credit based on the District's VAT, and it seems even more unlikely that Virginia, which has steadfastly refused to grant a credit for the District's unincorporated income tax, would do so for a VAT.[17] Thus, unincorporated businesses owned by nonresidents would appear to be double-taxed, first under the District's VAT, and then again under the personal income tax of their state of residence.

To some extent, such double-taxation would be more apparent than real because, as noted above, the economic effect of allowing businesses to take an immediate deduction for capital spending has the effect of exempting the normal return-to-capital from taxation. Thus, nonresident owners actually would be double-taxed only on the component of profit that represented an above-normal return. Any perception of double taxation also could be somewhat ameliorated if the District allowed all unincorporated businesses and S corporations to claim a tax credit, like that provided in Michigan, without regard to the owners' place of residence. In effect, the District would forego collecting some amount of tax on value-added from nonresident owners in order to reduce any double taxation faced by such owners.

Perceived unfairness. Another issue that has arisen in the case of the Michigan unincorporated business tax is that unprofitable businesses have complained that the VAT is unfair because it obligates them to pay tax, even though they are incurring losses. On the one hand, one can argue that this complaint has little conceptual basis if the primary intent of business taxation is to collect a payment for benefits provided to business in the form of public infrastructure. Under this view, benefits are received whether or not a business is profitable, and it is appropriate for even unprofitable businesses to make VAT payments for the same reason that it is generally not considered unfair to require businesses to pay property taxes without regard to their profitability.

On the other hand, the perception that it is unfair to make unprofitable businesses pay tax is an abiding one, and political pressures arising from this perception have led the Michigan single business tax to be modified so that businesses can elect to pay an alternative tax that essentially reduces single business tax liability for these firms by converting the VAT into a tax on income.[18] This change has reduced opposition to the VAT from small businesses, but at a cost of some added complexity.

Revenue- and industry-specific burdens

Although data limitations make it difficult to provide a measure of the VAT base for various industry groups in the District, a rough approximation of the scope of the VAT base can, however, be made for corporations, based on the information provided by the D.C. Office of Tax and Revenue. In particular, summing the fran-

chise tax base and labor compensation and applying a sales factor provides a rough estimate for most industry groups. Although this measure ignores interest, rental, and royalty payments and the cost of investment, the bias introduced may not be too significant because labor compensation alone accounts for about three-fourths of all value-added on an economy-wide basis.

The VAT base that results from making these calculations is defined by:

$$VAT\ Base = \left[\frac{D.C.\ Sales}{Total\ Sales}\right][Corporate\ Franchise\ Tax\ Base + Labor\ Compensation]$$

For two industry groups — financial services and "other" — even this approximation could not be used because of data limitations; and only labor compensation was used in the formula above. The VAT base approximations are given in Figure J-20. Using these figures, a VAT rate of 2.75 percent would raise about $130 million, which is roughly the level of revenue raised from the corporate franchise tax in 1996.[19]

A significant portion of the estimated corporate VAT base is in "other services," a category that includes legal and business services. While much of the VAT base resides in this category, it does not follow that this sector would face a significantly higher tax burden with a VAT. It must be kept in mind that while the VAT base is larger, the VAT rate needed to raise as much revenue as the current corporate franchise tax is quite small. In addition, many of the firms in this sector are apt to be S corporations, the owners of which might be expected to receive tax relief at the individual level if they reside in the District.

Replacing other business taxes and the franchise tax with a VAT

As mentioned above, the Michigan single business tax replaced not only its corporate income tax, but also Michigan taxes levied on financial institutions; a corporate franchise fee; a savings and loan association fee; a domestic insurance company privilege fee; local government taxes on inventories; and an intangibles tax on business. This raises the question of whether other District business taxes and fees — in particular, the selective gross receipts taxes currently collected from public utilities, communications, insurance companies, and health providers — might be replaced by a Michigan-style VAT.

A complete analysis of the implications of replacing these as well as the franchise tax with a VAT is beyond the scope of this chapter. Such a proposal might, however, be worth considering, if moving toward a broad, low-rate, single tax on all business activities could be shown to simplify the administration of District taxes.

Taxation of insurance

Like many states, instead of levying the corporate franchise tax on insurance companies, the District has opted to rely on what is effectively a gross receipts tax. The tax is a flat 2.25 percent of net premium income, where net premium income is defined to be the difference between gross premium income and the sum of dividends paid to insureds, payments made on canceled policies, and premiums received for reinsurance assumed. In addition, each issuer must pay a licensing fee ($100) and a filing fee ($50) each year. All mutual and for-profit insurers are subject to these rules; nonprofit relief organizations that sell insurance exclusively to members are exempt. Insurers are not subject to the corporate franchise tax. In recent years, the tax has produced a steady stream of revenue equal to roughly $30 million per year.

The simple tax treatment accorded insurance firms has at least two benefits. One is simplicity, both for tax administrators and for taxpayers. If these firms were subject to the corporate franchise tax, it would be necessary to develop complex rules for measuring insurance company profits, which has proved to be notoriously difficult (and, politically, rather contentious) at the federal level.

A second benefit is that net-premium income is fairly stable, making it a stable tax revenue source. If insurance companies were subject to the corporate franchise tax, tax revenue would vary substantially because insurer costs, and therefore insurer profits, are quite variable.

The benefits of a simple premium tax, however, need to be weighed against some distortions that are created by taxing premiums instead of profits. The distortions can arise in two ways.

Because insurance companies are taxed at the state level differently from almost any other form of business, there is the possibility that the tax burden faced by investments in the insurance industry are not similar to the burden faced by other forms of investment. The tax-induced differences in rates of return will lead to misallocation of financial capital between the insurance industry and the rest of the corporate sector. For example, if the current tax treatment is less generous than that faced with the corporate franchise tax, the level of insurance services would be inefficiently low.

For some forms of risk, firms may find that, as a result of moral hazard or adverse selection problems, the cost of insurance is sufficiently high that self-insurance is optimal. Firms, for example, may find that offering employee health coverage through an HMO is preferable to purchasing standard health insurance contracts; or they may find that providing compensation for the spouses of employees is preferable to buying life insurance contracts for these employees. In these cases there is no premium tax on the amount spent for self-insurance; indeed, in many cases, such

expenditures are deductible under the corporate franchise tax. This tax advantage leads to a misallocation of resources toward self-insurance activities.

Although the current tax treatment of insurance could be improved, in principle, there is a deterrent to any significant change undertaken by a single jurisdiction. The taxation of insurance is unique in that the courts as well as Congress (*McCarren-Ferguson Act*) have allowed states to retaliate if their insurance companies face differential taxation in other states. For example, consider a District insurer operating in another state, and suppose that the state finds that if the same District firm were instead located in the state, and sold insurance in the District, that its District taxes would be higher. Then the state has the right to retaliate by imposing an additional levy on the District firm that offsets the differential tax treatment.

The prospect of retaliation has led to significant uniformity across state insurance tax codes. Almost all states rely on taxation of net premium income, supplemented by licensing fees, and do not attempt to tax insurer profits. The tax rates on premium income often vary by the type of insurance (health, property and casualty, and life) and range between 1 percent and 5 percent.

The average premium tax rate across all types of insurance is about 2.5 percent, suggesting that the tax treatment of insurance in the District is fairly comparable to that found in other jurisdictions. For this reason, and because it seems quite likely that raising premium taxes would likely be met with retaliation on the part of states in which District firms operated, there seems little basis for considering raising these rates.

However, concerns that the District's premium tax rate is too high and should be reduced recently have been communicated to the District's Financial Responsibility and Management Assistance Authority. This matter is receiving further study. The issue is whether the immediate revenue loss from lowering premium taxes would be balanced by appreciable increases in the volume of insurance policies that are written in the District.

Implications of replacing franchise taxes with a VAT

If a decision were made to replace the District's franchise tax with a VAT, it would also make sense to include insurance in the base of a VAT, as has been done in Michigan. Although taxation of financial institutions creates some administrative complexity when modeled after "European-style" value-added taxes, this does not appear to be the case with the Michigan single business tax: Finance, insurance, and real estate businesses together account for about 10 percent of the tax liability under the Michigan single business tax.

Conclusions

The franchise tax accounts for a little more than 5 percent of District tax revenues, making it, after the commercial property tax, the most important business tax (along with the selective gross receipts tax on utilities). It is a somewhat unstable source of revenue from year to year: It is not especially broad-based, with a disproportionate share of franchise tax revenues collected from a small number of businesses in a small number of industries. These features of the District's franchise tax are not unique. State corporate income taxes generally tend to be unstable sources of revenue that are not especially broad-based.

As in the case of other state corporate taxes, measures can be considered that would improve the performance of the District's franchise tax, including: 1) increasing the minimum tax that must be paid by a business entity; 2) changing the apportionment formula; and 3) adoption of a unitary definition of the tax base.

Of these incremental changes, both the first and the third have merit. The benefits to be gained by changing the apportionment formula to double-weighting of sales are unclear. There is a chance that such a change could cause a loss of revenue, while creating nonexistent or small incentives at the margin for businesses to locate their operations in the District. If there is interest in double-weighting sales, more research — using data from individual franchise tax returns — is needed, at a minimum, to assess the potential revenue effect.

The unique circumstances of the District also provide a rationale for considering the elimination of its tax on unincorporated business, leaving only the corporate franchise tax.

More fundamental changes would include either replacing the franchise tax with a tax on gross receipts or a Michigan-style value-added tax. Although the disadvantage of completely replacing the franchise tax with a gross receipts tax would seem to outweigh the advantages, there is merit in using a low-rate gross receipts tax as a partial replacement for franchise tax revenue, coupled with a reduction in the franchise tax rate.

Replacing the franchise tax with a VAT offers several potential advantages, especially if the VAT were enacted as an across-the-board replacement for all District business taxes. Among these would be greater revenue stability, greater fairness from spreading the business tax burden more broadly among all businesses, ease of administration, and economic neutrality. Potential disadvantages from replacing the franchise tax with a VAT include issues arising from coordination with other jurisdictions, and transitional administrative and compliance costs.

In some cases, making incremental changes in the current franchise taxes would not seem to foreclose more fundamental reform in the future, such as enacting a VAT. This certainly would seem to be true in the case of increasing the current minimum tax, moving toward a unitary definition of income, and changing the appor-

tionment formula. It would also be true of a reform package that involved using additional revenue from an expanded gross receipts tax to cut the franchise tax rate.

A decision to eliminate the unincorporated franchise tax, however, is likely to affect what could be done in the future. For example, one might expect that small businesses would be less vocal in their opposition to a new tax that *replaced* an old tax, than to a new tax. Thus, a decision to eliminate the unincorporated franchise tax could limit, even rule out, the possibility for some fundamental reforms. On the other hand, if fundamental reform does not seem to be likely, this change is worth considering.

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Endnotes

[1] Musgrave, 1984.
[2] The administrative convenience of using information reported on federal returns is, however, not limited to the corporate net income tax. As discussed elsewhere in this report, alternative tax bases, such as the value-added tax, can also be administered using the federal corporate tax return as a starting point.
[3] However, with permission of the mayor, affiliated firms may file consolidated returns. D.C. Code 47-1805.2.5(B).
[4] Figure J-3 is based on information taken from *Greater Washington 1996 Comparative Tax Report*, prepared by Coopers & Lybrand for the Greater Washington Initiative and the Area Business Development Officials Committee, July 1996.
[5] A small part of this difference is due to the fact that the franchise tax rate was cut from 10.5 percent to 10.25 percent in 1993, and to 9.975 percent in 1994.
[6] The rates were calculated as follows: If the business had one-third of sales in the District, and was located entirely in the District, its District sales factor would be one-third, and its District payroll and property factors would be 100 percent. The D.C. three-factor formula would thus result in 1/3 x [1/3 + 1.0 + 1.0] = 0.777 of the firm's taxable profits being assigned to the District. The property and payroll factors of the firm would each be 0 percent in Maryland, while the sales factor would be one-third. Because Maryland double-weights the sales factor, one-sixth (1/2 x 1/3) of profits would be apportioned to Maryland. The Virginia property and payroll factors of this business would also be 0 percent, and the sales factor would be one-third. Using Virginia's equal-weighting formula, one-ninth (1/3 x 1/3) of the profits would be apportioned to Virginia. Similar logic and calculations lie behind the calculation of the effective tax rates, under the assumption that the firm locates its operations in Maryland and in Virginia.
[7] If the business had no sales in the District, but 75 percent of its property and payroll were in the District, its District payroll and property factors would be 75 percent and the sales factor would be 0 percent. Using the District's three-factor formula would result in one-half (1/3 x [0% + 75% + 75%]) of the firm's taxable profits subject to District taxation. The same result would hold if the firm were located in Virginia, which uses the same apportionment formula as the District. In Maryland, the sales factor would be 0 percent, while the property and payroll factors would each be 75 percent. Thus, three-eighths (1/2 x 0% + 1/4 x 75% + 1/4 x 75%) of the firm's taxable profits would be apportioned to Maryland.
[8] Figure J-4 shows that in 1996, more than 11,000 firms reported either zero or negative taxable income. Increasing the corporate minimum tax due on these returns by $400, from $100 to $500, would raise approximately $4.7 million in additional revenue. It also is likely that a large portion of the returns with positive

taxable income would face additional taxes if the minimum were increased to $500. If half of these returns became liable for an average additional tax payment of $200 as a result of an increase in the minimum, an additional $870,000 would be raised, for a total of $5.5 million.

[9] O'Cleireacain (1997), p. 116.

[10] Some of these resources, however, would still be needed to monitor compliance with the proper reporting of business income under the District's individual income tax.

[11] A very complete and readable discussion covering the history of the Michigan VAT and how the tax is implemented may be found in Michigan Department of the Treasury, Office of Revenue and Tax Analysis, *The Michigan Single Business Tax: 1992–1993*, 1996.

[12] For a discussion of the different ways of calculating value-added, see Congressional Budget Office, *Effects of Adopting a Value Added Tax*, 1992.

[13] Office of Revenue and Tax Analysis, op. cit.

[14] Ebel (1985), pp. 193–206 and Congressional Budget Office, op. cit.

[15] An implication of this result is that an administrative decision to exempt business income from District personal taxes would be tantamount to exempting the normal return to capital earned by District-resident owners of unincorporated businesses from taxation; only the component of profit that represented a return to capital over and above the competitive return would be taxed.

[16] McLure (1980).

[17] This would be reinforced by a kind of logical consistency. It would be difficult for the District (correctly) to argue that a Michigan-style VAT is not an income tax, and yet at the same time expect states that have traditionally limited credits to income taxes paid to grant a credit against state taxes for a District VAT.

[18] Office of Revenue and Tax Analysis, op. cit.

[19] Subsequent estimates of the base of a District VAT made by D.C. Tax Revision Commission staff include the value-added of businesses located in the District that currently are exempt from the corporate franchise tax that would become taxable under the VAT. Broadening the base of the VAT by including these currently untaxed enterprises has the effect of reducing the tax rate needed to raise the same amount of revenue raised by existing business taxes below the estimate of 2.75 percent.