A QUESTION OF BALANCE

Taxing Business in the 21st Century

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Foreword

The convergence of scandals that diminished the awe in which business is sometimes held and a deep shortfall in the state budget brought about a political moment that New Jersey seized by overhauling its Corporate Business Tax system. As the report that follows describes in detail, the changes were hard fought and are by no means assured of being permanent.

But if the debate over how to tax businesses came about almost by happenstance, it is an important debate nonetheless. And it was fitting that it should take place in New Jersey because this is a state where there are so many difficult questions to be asked about how taxes should be structured. They are, as the title of this report suggests, in large measure questions of balance. What is the right mix of taxes on businesses as opposed to people? To what extent should taxes be based on the value of someone's house or a business's property? Does it make sense for less affluent people to pay a higher percentage of their yearly income in state and local taxes than more affluent people pay?

Not all of those questions came up in the debate on business taxes, nor are they dealt with in this report. But understanding the rationale behind taxing businesses and why the system for doing so fell into such disrepair is an important part of the overall picture. If ours is to be a society where everyone pays their fair share, we need to come to some public judgment over what "fair" means. There might never be total agreement, but neither should there be denial of the problems to be faced. What happened in New Jersey in 2002—whatever the reasons—was a healthy, vibrant process. This report explains what took place, what it means and what else should be done. It is part of New Jersey Policy Perspective's ongoing effort to promote and inform discussion about how this state raises money so that an equitable, efficient system evolves to meet the needs of its people.

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— Jon Shure

Introduction

In the spring of 2002, the Governor of New Jersey proposed and won enactment of significant, controversial changes in the way the state taxes corporations. Whether characterized as loophole closing—usually by supporters—or tax hikes—usually by opponents—the new rules are expected to bring the state substantially more money. And these changes are being watched closely across the United States as the shaky economy erodes state revenues and forces consideration of previously off-limit topics.

Ask most people about the subject of corporate taxation and their responses will be the same: general support for the concept, some desire to make sure businesses cannot avoid paying their fair share—and a glazing over of the eyes and rush for the nearest exit when the complicated details of business taxation are mentioned.

For the most part, corporate executives take a different perspective. They argue that business taxes are so high already that they inhibit growth and new investment. They often contend that businesses should not be taxed at all, on grounds that the taxes are just passed on to other people in the form of higher prices to consumers and lower pay and benefits for employees. The complexity and detail of business taxation is not in the least daunting to the accountants, lawyers and lobbyists who are well compensated for setting up intricate methods of making the system work for their clients.

But corporate taxation is too important to the well being of average people—whether they realize it or not—to be left to accountants, lawyers and lobbyists. There are important public policy questions to answer, involving issues like fairness and the adequacy of resources for government to provide the services people need and want. Indeed, for honest debate about the appropriate levels of taxation to take place, information must be available and there must be a way to measure how fair and effective the tax system is.

The *idea* behind corporate taxation is simple. Corporations exist because the law allows them to; they are created as ways to amass more capital, attract more investment and make higher profits than might be feasible for an individual to accomplish, and with less risk. But, just like people, corporations thrive in part because a public infrastructure exists to support them. Good schools, a legal system to protect property and enforce contracts, reliable services, efficient transportation networks and stable markets all are part of the formula for success. So the basic principle behind corporate taxes is that businesses, like people, should pay for benefits they receive. If good schools, good transportation and stability are essential to the product, then corporations, just like people, should help to secure them.

But in some respects corporations are *not* like people. For one thing, they have shareholders who stand to profit from the corporation's activities when they receive dividends and sell their stock for a profit. In a sense, the shareholders—owners—are the true beneficiaries of the public services provided to corporations. These people often live in a state other than where much of the company's business is conducted. If their state of residence has an income tax, they will pay some tax on their dividends and capital gains. But the ultimate success of a shareholder's investment is determined at least in part by the skills of the company's employees and the infrastructure where the company is located. It is, therefore, appropriate for shareholders to somehow help support the educational system and roads, for example, where their money is invested. The only way this happens is through corporate business taxes.

And there is one other key difference between a corporation and a person. Over the years, lawmakers have fashioned a widening array of exemptions, incentives, credits and other devices that make possible far more opportunities to *avoid* paying taxes than are available to people.

Sound Tax Policy

Experts say that tax policy is sound if it[1]:

- Is understandable
- Is predictable
- Treats all those in similar circumstances in a similar way
- Is relatively cheap and easy to administer

Across the United States, the corporate tax system is none of the above.

Few people understand it; even fewer people have any idea how much corporations pay in taxes. As recently as 2000, 77 percent of New Jersey's corporations paid only $200 a piece in state corporate income taxes even though the stated rate was 9 percent of the net income they made in New Jersey. This fact would seem to suggest that most corporations in New Jersey were not profitable that year. But while some of these corporations lost money, most did not. Indeed, multinational firms that report a very profitable year to shareholders often end up owing virtually no tax in New Jersey and other states because of accounting techniques they employ or because of the way they are allowed to apportion their income among various states where they do business. Understanding how this happens is complicated—but essential to having a fair debate about reasonable levels of taxation.

The tax is not very predictable. Each fiscal year's corporate tax revenue stream is affected by as many as four calendar years of economic activity as the result of delayed tax refunds or amended returns filed after settling federal tax issues. In general, a small number of corporations pay a disproportionate share of the tax. The amount the state collects fluctuates because it's possible—and far more likely than in the case of a person— for a corporation to pay $200,000 in taxes one year and $200 the next.

Research shows that similar sized corporations in similar industries often pay vastly different amounts of tax in the same state—and that smaller, less profitable businesses in the same field pay much higher taxes than giant corporations. Indeed, in New Jersey it has been possible for a small independent grocery store to pay more than 30 times the amount of tax paid by a multinational grocery chain.

And, dollar for dollar, the corporate tax system consumes more resources to administer than other taxes because of its complexity.

This report will explain how corporate taxation works in New Jersey, analyze the attempts to reform the system in 2002 and suggest further improvements.

Overview

Today, 47 states—all but Nevada, Washington and Wyoming—levy what could be considered a corporate income tax. Such taxes take various forms, making comparisons across state lines difficult. Some states tax net corporate worth and others tax net income. Still others tax gross receipts, gross sales or gross profits—and even the definitions of those terms vary from state to state. In addition, every state allows its own set of deductions, exemptions and tax credits. To make matters more mysterious, it is virtually impossible for the public to determine how much a corporation pays in state taxes because the information is confidential. Although corporations must disclose their *federal* taxes paid in Securities and Exchange Commission reports, individual *state* tax information is not required. This makes analyzing proposals for changing state tax rules nearly impossible for anyone who does not work for the Internal Revenue Service or a state tax department.

Corporate Tax Rates

Two concepts elementary to understanding the implications of any tax system are the "rate" and the "base." Rate refers to what percent tax is levied on the taxable base. Base refers to what is being taxed: income, for example, or that share of income that is considered by law to be taxable.

Among states charging a single corporate tax rate, those rates as of January 2002 varied from as low as 4 percent in Kansas to 9.99 percent in Pennsylvania. In the 13 states using a graduated rate structure, rates ranged from 1 percent to 9.4 percent in Alaska to 6 percent to 12 percent in Iowa.

Since 1996, more states have reduced rates than raised them. From 1996 to 2000, eight states—Arizona, Colorado, Connecticut, Michigan, New York, North Carolina, Ohio and Pennsylvania—cut corporate income tax rates. Only New Hampshire and Vermont raised rates.

But those are the *statutory* rates—what is paid if no deductions, exemptions or tax credits are permitted. Although Iowa has the highest statutory rate, it allows corporations to deduct 50 percent of their federal corporate income tax. So, for businesses that pay federal income tax—and not all do—this lowers the amount of tax an Iowa corporation must pay to the state and as a result lowers the *actual* tax rate.

Table 1 provides insight into the complexity of state corporate income tax structures. Flat tax rate states are listed first; graduated rate states are listed next. Five states are not included: Michigan, Texas, Nevada, Washington and Wyoming. The Federation of Tax Administrators chose not to include Michigan and Texas in the table because their corporate taxes are substantially different; Nevada, Washington and Wyoming are not included because they levy no corporate income tax. More than half of the states require footnoted explanations because rates, tax bases and special provisions individualize every state tax code.

Corporate Tax Bases

Tax bases matter. If a company computes its state income tax using the same rate but a different base, it can end up paying vastly different amounts of tax. For example, a company that can demonstrate that it

TABLE 1

State Corporate Income Tax Rates

For tax year 2002, as of January 1, 2002

SINGLE BRACKET STATES

State	Rate	Federal Tax Deductible
Alabama	6.5%	Yes
Arizona (a)	6.968	No
California (a)	8.84	No
Colorado	4.63	No
Connecticut (a)	7.5	No
Delaware	8.7	No
Florida (a)	5.5	No
Georgia	6.0	No
Idaho (a)	7.6	No
Illinois (c)	7.3	No
Indiana (d)	7.9	No
Kansas (f)	4.0	No
Maryland	7.0	No
Massachusetts (a) (g)	9.5	No
Minnesota (a)	9.8	No
Missouri (e)	6.25	Yes
Montana (a) (h)	6.75	No
New Hampshire (i)	8.5	No
New Jersey (a) (j)	9.0	No
New York (a) (k)	7.5	No
North Carolina	6.9	No
Oklahoma	6.0	No
Oregon (a)	6.6	No
Pennsylvania	9.99	No
Rhode Island (a)	9.0	No
South Carolina	5.0	No
Tennessee	6.0	No
Utah (a)	5.0	No
Virginia	6.0	No
West Virginia	9.0	No
Wisconsin	7.9	No
Dist of Columbia (a) (m)	9.975	No

Source: Federation of Tax Administrators from various sources, January 2002.

TABLE 1, continued

MULTIPLE BRACKET STATES

State	Rates	Lowest to Highest Bracket	Number of Brackets	Federal Tax Deductible
Alaska (a)	1.0 to 9.4%	$10,000 - $90,000	10	No
Arkansas	1.0 to 6.5	$3,000 to $100,000	6	No
Hawaii (b)	4.4 to 6.4	$25,000 to $100,000	3	No
Iowa (a) (e)	6.0 to 12.0	$25,000 to $250,000	4	Yes
Kentucky	4.0 to 8.25	$25,000 to $250,000	5	No
Louisiana	4.0 to 8.0	$25,000 to $200,000	5	Yes
Maine (a)	3.5 to 8.93	$25,000 to $250,000	4	No
Mississippi	3.0 to 5.0	$5,000 to $10,000	3	No
Nebraska	5.58 to 7.81	$50,000	2	No
New Mexico	4.8 to 7.6	$500,000 to $1 mil.	3	No
North Dakota	3.0 to 10.5	$3,000 to $50,000	6	No
Ohio (a) (l)	5.1 to 8.5	$50,000	2	No
Vermont (a)	7.0 to 9.75	$10,000 to $250,000	4	No

Notes: Michigan imposes a single business tax which is sometimes described as a business activities tax or value added tax of 1.9 % on the sum of federal taxable income of the business, compensation paid to employees, dividends, interest, royalties paid and other items. Texas imposes a franchise tax of 4.5% of earned surplus. Nevada, Washington, and Wyoming do not have state corporate income taxes.

(a) An alternative minimum tax applies in Alaska, Arizona, California, Connecticut, Florida, Idaho, Iowa, Maine, Massachusetts, Minnesota, Montana, New Jersey, New York, Ohio, Oregon, Rhode Island, Utah, Vermont and the District of Columbia.
(b) In Hawaii, capital gains are taxed at 4%. There is also an alternative tax of 0.5% of gross annual sales.
(c) In Illinois this includes a 2.5% personal property replacement tax.
(d) In Indiana this consists of 3.4% on income from sources within the state plus a 4.5% supplemental income tax.
(e) In Iowa and Missouri 50% of the federal income tax is deductible.
(f) In Kansas this includes an additional surtax of 3.35% taxable income in excess of $50,000.
(g) In Massachusetts the rate includes a 14% surtax.
(h) In Montana this includes a 7% tax on taxpayers using water's edge combination.
(i) In New Hampshire this includes an additional 0.5% tax on the enterprise base (total compensation, interest and dividends paid). Business profits tax imposed on both corporations and unincorporated associations.
(j) In New Jersey the corporation business tax is a franchise tax measured by net income. Effective 1/1/02 there are three rates: 6.5% for corporations with net income below $50,000, 7.5% for those between $50,000 and $100,000 and 9% for corporations with net income over $100,000.
(k) In New York, or 1.78 mills per dollar of capital up to $350,000; or 3.0% of the minimum taxable income; or a minimum of $100 to $1,500 depending on payroll size; if any of these is greater than the tax computed on net income. Small corporations with income under $200,000 pay a 7.5% tax on all income.
(l) In Ohio, or 4.0 mills times the value of the taxpayer's issued and outstanding share of stock with a maximum payment of $150,000. An additional litter tax is imposed equal to 0.11% on the first $50,000 of taxable income, 0.22% on income over $50,000; or 0.14 mills on net worth.
(m) In District of Columbia, effective Jan. 1, 2003, the tax rate decreases to 9.45%.

had no net income would pay no corporate tax in states that base their taxes on net income. However, that same company might owe a significant amount of corporate tax based on its gross receipts or net worth.

As with rates, considerable variation in tax bases exists among states. For example, 46 states—including New Jersey—use net income and 24 use capital stock or net worth. Only two states use gross receipts.

Defining these terms can be a challenge. Gross receipts correspond roughly to a business's gross sales. Capital stock refers to the value of all shares of common and preferred stock issued by a corporation as of a certain date. The net worth of a company is its assets minus its liabilities. And net income is the total gross income of a company less expenses, tax credits and other allowable costs. Comparing corporate net income across states is particularly difficult because of the wide range of deductions, exemptions and credits allowed corporations in different states.

As Table 2 shows, many states use both net income *and* net worth. Some states actually levy separate taxes on each of these bases. Other states require corporations to calculate their taxes under two different methods—one based on net income, the other on capital stock or net worth. The method yielding the most tax is what the corporations pay.

TABLE 2

State Corporate Tax Bases

State	Gross Receipts	Net Income	Capital Stock or Net Worth
Alabama (a)		X	X
Alaska		X	
Arizona		X	
Arkansas		X	X
California		X	
Colorado		X	
Connecticut (b)		X	
Delaware (c)		X	X
Florida		X	
Georgia		X	X
Hawaii		X	
Idaho		X	
Illinois		X	X
Indiana		X	
Iowa (d)		X	X
Kansas		X	X
Kentucky		X	X
Louisiana		X	X
Maine		X	
Maryland		X	
Massachusetts (e)		X	X
Michigan (f)			
Minnesota		X	
Mississippi		X	X
Missouri		X	X
Montana		X	
Nebraska		X	X
New Hampshire (g)		X	
New Jersey		X	
New Mexico		X	
New York (h)		X	X
North Carolina		X	X
North Dakota		X	
Ohio		X	X
Oklahoma		X	X
Oregon		X	
Pennsylvania		X	X
Rhode Island		X	X
South Carolina		X	X
South Dakota (i)			
Tennessee (j)		X	X
Texas			X
Utah		X	
Vermont		X	
Virginia		X	
Washington	X		
West Virginia		X	X
Wisconsin		X	
Wyoming			X
Dist of Columbia		X	
Totals	1	46	24

Sources: U. S. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1991, Washington, D.C. Multistate Tax Commission update, November 2002.

An important question for corporate taxes is whether to levy them only on net income or to use a gross receipts, capital stock or net worth component as the tax base. Firms that are taxed only on net income are not required to pay corporation taxes in years when they are not profitable while firms that are taxed on other bases have a tax liability even when they lose money. The "benefit principle" favors gross receipts, capital stock and net worth tax bases over net income because firms benefit from public services regardless of their profitability.

Amount of Tax Collected

Not surprisingly, the amount of corporate income taxes that various states actually collect varies dramatically since tax rates and bases vary. This is especially clear when the amount of tax a state collects is expressed by dividing the amount of money raised by the number of people who live in the state. Thirty years ago, only 12 of the 45 states that levied a corporate income tax collected more than $25 per capita, and no state collected more than $50. Back then, New York and Connecticut were among states collecting the most tax per capita; West Virginia and Nebraska were among the least.[2]

Times have changed. Data from the 2000 Census show that Alaska, Delaware and New Hampshire collected the most corporate business taxes per capita; Missouri and Louisiana the least. As Table 3 shows, collections

Notes: Gross receipts include only general business taxes based on business gross receipts. Does not include various special business taxes that may be based on gross receipts, such as insurance gross premiums or utility taxes. Some corporate income tax bases have a capital stock component. Net worth is the assets of a business minus its liabilities.

(a) Two separate corporation franchise taxes.
(b) Tax is on the highest of two bases, or minimum tax. The income and capital bases are not combined.
(c) Two separate corporation taxes: income and franchise, which is based on capital stock outstanding. The corporate franchise tax is levied for the privilege of being incorporated in the state.
(d) Annual filing fee with secretary of state no longer based on value of capital stock; $30 fee for all corporations.
(e) Also has non-income measure of the tax based on tangible personal property or net worth allocable to the state.
(f) Single business tax, which is a modified value-added tax.
(g) Modified value-added tax.
(h) Net income base pertains primarily to taxation of general business corporations. Transportation and transmission companies (i.e. utilities) pay tax on gross receipts base.
(i) Limited income tax on certain banks and financial institutions.
(j) Two distinct corporate taxes: excise (income) tax and franchise tax imposed on higher of either apportioned capital stock or value of property owned and leased in the state.

ranged from nearly $700 per capita in Alaska to $47 in Missouri. At $160 per capita, New Jersey was surpassed by seven other states: Alaska, Delaware, New Hampshire, Massachusetts, California, Illinois and Minnesota.

Corporate Income Taxes as a Proportion of Total Tax Revenues

Another way to compare state tax systems is to look at the entire mix of taxes levied by states and determine what percentage of total tax collections comes from corporate income taxes. Nationwide, in 2001 corporate income tax collections were less than 6 percent of total state tax collections. But the variation was considerable.

As Table 4 shows, Alaska and New Hampshire relied most heavily on corporate business taxes in 2001, collecting 28 percent and just under 20 percent of their state revenues from corporations. New Jersey collected just under 7 percent of its revenues from the corporate business tax in 2001. Eleven states—Alaska, New Hampshire, Illinois, Delaware, Michigan, Tennessee, Indiana, California, New York, Massachusetts and Montana—collect a higher percentage of their state taxes from corporations than New Jersey does.

One thing that is clear is that no two states are alike, a fact that raises the costs of compliance for everyone. States collect less revenue because of this complexity; they cannot collaborate easily with one another; and they use scarce public resources in their enforcement efforts that might be used more profitably. This complexity also forces multi-state corporations to devote resources to compliance efforts that could be put to more profitable use. The variations across states in the scope, rates and structure of corporate business taxes create numerous opportunities for tax avoidance at the expense of other state taxpayers. Finally, the disparities between states in their approach to this tax and the confidentiality of corporate tax returns make it very difficult for the public to understand proposals for changing state tax rules.

TABLE 3

Per Capita Corporate Income Tax Collections

State	Total State Corporate Income Taxes FY 2000 ($000)	Population 2000	Per Capita Collections 2000
Alabama	$ 243,099	4,447,100	$ 55
Alaska	438,438	626,932	699
Arizona	523,182	5,130,632	102
Arkansas	236,969	2,673,400	89
California	6,638,762	33,871,648	196
Colorado	334,980	4,301,261	78
Connecticut	426,617	3,405,565	125
Delaware	240,319	783,600	307
Florida	1,182,796	15,982,378	74
Georgia	712,421	8,186,453	87
Hawaii	75,271	1,211,537	62
Idaho	125,860	1,293,953	97
Illinois	2,261,293	12,419,293	182
Indiana	924,823	6,080,485	152
Iowa	214,605	2,926,324	73
Kansas	272,432	2,688,418	101
Kentucky	306,450	4,041,769	76
Louisiana	222,008	4,468,976	50
Maine	150,046	1,274,923	118
Maryland	431,109	5,296,486	81
Massachusetts	1,306,353	6,349,097	206
Minnesota	803,357	4,919,479	163
Mississippi	227,716	2,844,658	80
Missouri	265,467	5,595,211	47
Montana	99,772	902,195	111
Nebraska	140,022	1,711,263	82
New Hampshire	312,176	1,235,786	253
New Jersey	1,347,336	8,414,350	160
New Mexico	159,338	1,819,046	88
New York	2,771,556	18,976,457	146
North Carolina	989,280	8,049,313	123
North Dakota	78,221	642,200	122
Ohio	630,607	11,353,140	56
Oklahoma	194,145	3,450,654	56
Oregon	407,084	3,421,399	119
Pennsylvania	1,696,845	12,281,054	138
Rhode Island	74,825	1,048,319	71
South Carolina	227,161	4,012,012	57
South Dakota	45,123	754,844	60
Tennessee	613,924	5,689,283	108
Utah	173,799	2,233,169	78
Vermont	44,430	608,827	73
Virginia	565,909	7,078,515	80
West Virginia	217,793	1,808,344	120
Wisconsin	587,733	5,363,675	110
U.S. Total	$32,038,362	280,849,847	$114

Source: U.S. Bureau of the Census, January 2002.

Note: Michigan, Nevada, Texas, Washington and Wyoming are not included in the table because they do not levy a corporate income tax.

TABLE 4

2001 State Tax Collection by Source

Percentage of Total Taxes Collected

State	Property	Sales	Selective Sales	Individual Income	Corporate Income	Other
Alabama	2.9%	26.7%	24.9%	33.0%	2.7%	9.8%
Alaska	3.2	–	9.4	–	28.0	59.4
Arizona	3.7	46.4	12.3	27.2	6.4	4.0
Arkansas	8.8	36.1	13.6	31.9	3.8	5.8
California	3.7	26.9	7.1	49.3	7.6	5.4
Colorado	–	26.0	12.1	51.5	4.5	5.9
Connecticut	–	32.8	14.3	42.2	3.9	6.8
Delaware	–	-	13.6	33.1	9.5	43.8
Florida	2.0	59.0	17.2	–	6.4	15.4
Georgia	0.4	34.1	7.9	48.2	4.8	4.6
Hawaii	–	46.8	15.9	31.5	1.7	4.1
Idaho	–	30.6	12.1	40.3	5.6	11.5
Illinois	0.3	27.3	20.0	33.1	9.6	9.7
Indiana	0.0	35.3	14.8	37.0	8.1	4.7
Iowa	–	34.0	14.6	36.6	3.2	11.5
Kansas	1.0	34.9	11.8	39.8	4.7	7.7
Kentucky	5.3	28.8	17.2	33.8	4.6	10.4
Louisiana	0.3	33.4	23.7	24.3	4.1	14.2
Maine	1.8	30.6	13.4	43.5	3.6	7.0
Maryland	2.4	24.5	18.0	43.8	4.6	6.6
Massachusetts	0.0	21.8	8.7	57.5	7.0	4.9
Michigan	8.0	34.7	9.7	30.5	9.4	7.6
Minnesota	0.1	27.9	15.5	43.6	5.4	7.6
Mississippi	0.0	49.0	17.1	21.8	4.4	7.7
Missouri	0.2	31.7	13.8	43.2	2.7	8.4
Montana	13.7	–	23.6	37.2	6.9	18.7
Nebraska	0.2	33.8	13.7	40.5	4.6	7.2
Nevada	2.6	53.5	32.3	–	–	11.6
New Hampshire	25.8	–	33.5	4.3	19.7	16.7
New Jersey	0.0	29.9	14.3	41.5	6.8	7.6
New Mexico	1.0	40.5	11.6	20.7	4.8	21.4
New York	–	19.6	9.6	59.0	7.1	4.7
North Carolina	0.0	22.1	17.8	48.2	4.6	7.3
North Dakota	0.2	27.6	28.2	17.3	5.1	21.4
Ohio	0.1	32.1	13.7	42.3	3.4	8.5
Oklahoma	–	24.2	11.6	35.9	2.6	25.6
Oregon	–	–	11.3	74.4	5.5	8.8
Pennsylvania	0.3	32.1	15.2	31.7	6.2	14.6
Rhode Island	0.0	31.0	18.9	41.4	3.5	5.2
South Carolina	0.2	40.5	13.8	34.6	3.1	7.7
South Dakota	–	52.7	24.8	–	4.4	18.1
Tennessee	–	57.3	17.4	2.5	8.6	14.2
Texas	–	50.0	29.2	–	–	20.8
Utah	–	36.4	12.1	41.9	4.0	5.5
Vermont	23.7	13.8	20.3	31.1	2.9	8.2
Virginia	0.2	20.2	14.8	55.2	2.8	6.8
Washington	11.0	63.6	15.7	-	-	9.7
West Virginia	0.1	27.1	26.6	29.8	6.3	10.1
Wisconsin	0.7	30.7	13.6	43.8	4.2	7.1
Wyoming	9.8	36.1	7.8	–	–	46.3
U.S. Total	1.9	32.1	14.1	37.1	5.7	9.2

Source: U.S. Bureau of the Census, 2001

Note: Selective sales taxes include taxes such as cigarette, alcoholic beverage and motor fuel taxes. The "Other" tax category is largely severance taxes.

Evolution of Corporate Business Tax in New Jersey

Long before it imposed a sales or income tax, New Jersey obtained revenue from businesses. By the time of the American Revolution, legislatures were creating corporations by granting them charters to perform specific public functions. As such, corporations provided some of the first resources available to governments. Among the first chartered businesses were commercial banks, insurance companies, canals and railroad corporations and a few telegraph companies.[3]

Bank charters provided the first substantial funds for the state treasury. When it chartered New Jersey's first bank, the Newark Banking and Insurance Company, in 1804, the state reserved the right to buy $25,000 of the capital stock within a limited period. The governor was authorized to sell the stock to individuals and use the proceeds for state purposes.

In 1810 New Jersey passed a law levying a general annual tax on all banks. Opponents of the tax attacked it as a plan to raise revenue from "aristocrats" and "foreigners." Supporters claimed that most capital stock of New Jersey banks was owned by residents of New York and Philadelphia who should pay New Jersey for the protection they received from the state. After 1828, this tax supported schools in New Jersey.

Insurance companies were also regarded as taxable entities. Two fire insurance companies incorporated in the 1820s were required to pay annual taxes to the state based on their capital stock after they had been in business for three years.

New Jersey lawmakers also taxed companies that built transportation facilities in the state. The Delaware and Raritan Canal Company and the Camden and Amboy Rail Road and Transportation Company, builders of the major transportation arteries between New York and Philadelphia, were chartered in 1830. Both charters reserved the state's right to buy one-fourth of the companies' capital stock and required them to pay transit duties on the weight of merchandise and the number of passengers transported. Shortly after the two companies were chartered they gave the state additional shares of stock in return for a guaranteed monopoly on the New York-to-Philadelphia route.

By the mid 19th Century most of New Jersey's state revenue came from a handful of railroad companies. Most railroads avoided taxation, though, because their charters exempted them unless they declared dividends or had a certain level of net income, which they seldom attained. The state comptroller at the time noted that the charters of many companies failed to specify how earnings were to be computed or what property was taxable. In some instances charters also were interpreted to preclude payment of taxes to local governments.

When New Jersey needed additional revenue in 1884, it extended the railroad tax to other corporations. This became a franchise tax based on the entire authorized capital stock of a firm regardless of where the firm was located. As a concession to New Jersey manufacturing and mining firms, a deduction based on the amount of capital invested in the state was permitted. About the same time as New Jersey extended the franchise tax, it also changed its incorporation laws to give in-state corporations more freedom to acquire other firms and merge them into a single new legal entity.

By 1900, the state was known as the charter-mongering champ because more than 90 percent of the nation's major corporations were chartered in New Jersey. This somewhat derogatory term describes the state's reputation as a dealer in corporate charters at a time when other states were refusing to grant charters to monopolies. New Jersey had no such qualms; nor did it actually require the companies to establish a physical presence in the state or contribute to its economic life other than to pay a tax. The large number of incorporation certificates filed in Trenton meant that a large share of New Jersey's public revenue was from fees and franchise taxes paid by companies incorporated in the state. Although the absolute levels of these receipts were not large, they came to dominate state finances in New Jersey.

New Jersey's success in attracting such large corporations as duPont, General Motors and Standard Oil induced Delaware to follow its lead. Delaware passed corporate laws that were substantially the same as New Jersey's but offered lower tax rates. When New Jersey in 1913 adopted stricter corporate laws, a number of large corporations, including duPont and GM, reincorporated in Delaware.

Between 1884 and 1946, New Jersey based its corporate business tax on the total amount of capital stock issued by the firm that was outstanding on January 1 of each year. On January 1, 1946, the tax became a tax on net worth. This was paid by corporations located both in and out of state and measured by the share of total net worth that was attributed to New Jersey. In 1958, the Corporate Business Tax Act was amended to add a second tax measured by net income. For almost 30 years—from 1958 until 1986—New Jersey taxed corporations on two bases: net income and net worth. A specific tax rate was applied to each base and the corporate business tax was the sum of the two amounts. The net worth portion was phased out starting in 1982 and totally eliminated by June 30, 1986. Over the years, the corporate tax was extended to cover different types of businesses: banking corporations and incorporated financial businesses in 1975 and later electric and telephone companies in 1999.

New Jersey corporate business tax rates have steadily increased as follows:

Year	Rate
1959	1.75%
1967	3.25
1968	4.25
1972	5.5
1975	7.5
1980	9.0

The Corporation Business Tax Act today imposes a franchise tax, or license fee, on corporations based in New Jersey or elsewhere for the privilege of doing business, employing or owning capital or property or maintaining an office in New Jersey. The tax applies to every corporation with a taxable status unless it is specifically exempt. Exemptions include certain agricultural cooperative associations; building and loan associations and savings and loan associations; certain federal corporations; corporations created under the Limited-Dividend Housing Corporation law; nonprofit cemetery corporations; nonprofit corporations without capital stock; non-stock Mutual Housing Corporations; railroad and canal corporations; sewerage and water corporations; insurance companies subject to premiums tax; and certain municipal electric corporations.

Prior to enactment of the New Jersey Business Tax Reform Act in 2002, the tax rate levied on that portion of a corporation's net income attributable to New Jersey was 7.5 percent if the corporation's net income was $100,000 or less and 9 percent otherwise. Starting in January 2002, the tax is levied at rates of 6.5 percent for corporations with net incomes of less than $50,000, 7.5 percent for corporations with net income between $50,000 and $100,000, and 9 percent for corporations with net income over $100,000.

Since 1994, New Jersey corporations have been required to pay an alternative minimum tax even if they made no profit. Since 1997 this tax has been a flat $200 per corporation. Beginning in 2002, the minimum tax would have increased to approximately $210; instead the Business Tax Reform Act set a new minimum rate of $500.

Revenues collected from most corporations are deposited in the State Treasury for general use, except for the 4 percent that are constitutionally dedicated to fund hazardous discharge cleanup, underground storage tank improvements and surface water quality projects. Tax revenue from banking and financial corporations is by law supposed to be distributed as follows: 25 percent to counties, 25 percent to municipalities and 50 percent to the state. But each year language has been put into the state budget that retains all of the money for state use.

Table 5 presents data from New Jersey's three major state-level taxes—the corporate business tax, personal income tax and sales tax. From 1990 to 2002, total collections from these three taxes roughly doubled, from $7.4 billion to $14.1 billion. But during that time, income tax and sales tax revenues grew 131 percent and 88 percent respectively, while corporate business tax revenues grew by only 4 percent.

Although the corporate business tax has long been the state's third largest tax revenue source and the rate has been 9 percent for more than 20 years, its relative share of total taxes collected has declined significantly: from just under 16 percent of the total collected from these three taxes in 1990 to less than 8 percent in 2002. As a percentage of the total, the sales tax has declined slightly: from about 44 percent to 43 percent. But the absolute amount of sales taxes collected has actually increased from $3.2 billion to $6 billion. In contrast, the relative share of the personal income tax has gone from over 40 percent to almost 49 percent and actual collections have increased from approximately $3 billion to $6.8 billion.

TABLE 5

Receipts From Three Major Taxes in New Jersey

Fiscal Years 1990–2002

	Corporate Business Tax (billions)	Personal Income Tax (billions)	Sales Tax (billions)	Big Three Total Tax Revenue (billions)	Corporate Business Tax as % of Total	Personal Income Tax as % of Total	Sales Tax as % of Total
1990	$1.13	$2.96	$3.20	$7.29	15.5%	40.6%	43.9%
1992	0.91	4.10	4.04	9.05	10.1	45.3	44.6
1994	1.06	4.49	3.78	9.33	11.4	48.1	40.5
1996	1.17	4.73	4.32	10.22	11.4	46.3	42.3
1998	1.23	5.59	4.77	11.59	10.6	48.2	41.2
2000	1.45	7.21	5.51	14.17	10.2	50.9	38.9
2002	1.17	6.84	6.00	14.01	8.4	48.8	42.8

Source: New Jersey Comprehensive Annual Financial Report, various years

Why Corporate Business Tax Revenue Stagnated

The six years from 1993 to 1999 were a time of extraordinary economic growth. Combined gross domestic product of all states grew 40 percent; total state revenue grew 41 percent; and corporate profits grew 68 percent.[4]

Information included in the Governor's Fiscal Year 2003 budget shows that corporate profits in New Jersey grew from $15.6 billion in 1990 to $31.2 billion in 2000. According to the New Jersey Commerce & Economic Growth Commission, the 24 Fortune 500 firms with their corporate headquarters in New Jersey in 2000 had combined revenues of $285.2 billion. In that year, these companies were among the most successful computer, pharmaceutical, utility, food, insurance, retail, chemical, engineering, metal product and scientific equipment companies in the world.

With more than its share of highly successful companies, why did corporate business tax revenues in New Jersey grow by a mere 4 percent during the 1990s? Were businesses in New Jersey losing money? Were they less productive than businesses in other states?

It is difficult to be specific but it is clear that certain factors have played an important role in this stagnation. Multistate corporations have become more aggressive in their state tax planning, playing states off against each other to get the best deals and vigorously taking advantage of tax-law provisions that could save them money. Four strategies have been especially popular:

- Lobbying for changes in state tax laws
- Using a variety of corporate organizational structures
- Shifting income to lower-tax states
- Profiting from the increasing array of deductions, exemptions and other incentives provided by state governments to attract and retain businesses

Changing Tax Laws

An important business strategy to reduce tax burden has been to lobby for changes in state tax laws. For example, as a result of an effective lobbying effort, since 1985 New Jersey has permitted corporations to deduct

TABLE 6

Fortune 500 Companies Headquartered in New Jersey

Fortune Rank	Company	Location	County	Revenues	Industry
22	Lucent	Murray Hill	Union	$38,303,000,000	Network Communications
34	Merck	Whitehouse Station	Hunterdon	32,714,000,000	Pharmaceuticals
43	Johnson & Johnson	New Brunswick	Middlesex	27,471,000,000	Pharmaceuticals
48	Prudential	Newark	Essex	26,618,000,000	Insurance: Life & Health
65	Honeywell International	Morristown	Morris	23,735,000,000	Aerospace
129	American Home Products	Madison	Morris	13,550,200,000	Pharmaceuticals
139	Warner-Lambert	Morris Plains	Morris	12,928,900,000	Pharmaceuticals
148	Toys "R" Us	Paramus	Bergen	11,862,000,000	Specialty Retailers
185	Schering-Plough	Madison	Morris	9,176,000,000	Pharmaceuticals
207	Bestfoods	Englewood Cliffs	Bergen	8,637,000,000	Food
210	Ingersoll-Rand	Woodcliff Lakes	Bergen	8,504,600,000	Industrial & Farm Equipment
219	Nabisco Group Holdings	Parsippany	Morris	8,268,000,000	Food
242	American Standard	Piscataway	Middlesex	7,287,200,000	Industrial & Farm Equipment
244	Pharmacia & Upjohn	Peapack	Somerset	7,252,600,000	Pharmaceuticals
257	Chubb	Warren	Somerset	6,729,600,000	Insurance: Property & Casualty
263	Public Service Enterprise	Newark	Essex	6,497,000,000	Utilities, Gas & Electric
269	Campbell Soup	Camden	Camden	6,424,000,000	Food
298	Automatic Data Processing	Roseland	Essex	5,540,100,000	Computer & Data Services
338	GPU	Morristown	Morris	4,757,100,000	Utilities, Gas & Electric
365	Engelhard	Iselin	Middlesex	4,404,900,000	Chemicals
407	Foster Wheeler	Clinton	Hunterdon	3,944,100,000	Engineering, Construction
433	Supermarkets General	Carteret	Middlesex	3,698,100,000	Food & Drug Sales
441	U.S. Industries	Iselin	Middlesex	3,506,100,000	Metal Products
451	Becton Dickinson	Franklin Lakes	Bergen	3,418,400,000	Scientific Equipment
Total Revenues				$285,226,900,000	

Source: New Jersey Business Resource Center Website, New Jersey Commerce and Economic Growth Commission and New Jersey Business & Industry Association, 2000.

net operating losses for seven years following the year of the actual loss. In 1993, New Jersey allowed corporations to use the federal modified accelerated cost recovery system for depreciation of property. Both of these tax law changes, provided corporations with larger deductions against their gross income.

Then in 1995 the state changed its allocation formula for multi-state corporations. Under prior law, multi-state corporation income was allocated to New Jersey based on equally weighted New Jersey property, payroll and sales. The new formula counts sales twice, so they account for half the allocation formula. The state estimates in 2002 it took in about $37 million less than it would have had it not changed from three-factor to double-weighting sales.

In 2001 and 2002, a group of multi-state corporations in New Jersey lobbied unsuccessfully for switching to a single sales factor allocation formula. It was estimated that this change would have cost the state up to $250 million in lost tax revenue annually, while benefiting a small number of large New Jersey-based corporations.

Differing Corporate Structures

There are many different ways under the law to set up a corporate structure, and they have important tax implications. Growth of certain types of corporations known as pass-through entities—limited liability partnerships, limited liability corporations and Subchapter S corporations—has shifted income away from the corporation and onto the individuals who created it so they can take advantage of the lower tax rates paid by individuals.

Before July 1993, New Jersey did not recognize Subchapter S corporations, usually small businesses that distribute profit to shareholders based on the shareholder's ownership percentage. Though net income from these businesses is classified as corporate profit, it is considered shareholder income for tax purposes. This means it is taxed as *personal* income, with a maximum rate of 6.37 percent, and not *corporate* income with a maximum rate of 9 percent. To the extent that this income accrues to non-residents or foreign residents, it increases the potential for non-compliance in filing a New Jersey income tax return and the chance that this income escapes New Jersey taxation altogether.

Until 2001, New Jersey subjected S corporations to both the corporate business tax and the personal income tax, with the corporation paying the 9 percent rate if its net income exceeded $100,000 and 7.5 percent if it was less. Distributions to shareholders were also taxed as personal income. New Jersey has exempted smaller S corporations with net income under $100,000 from the corporate business tax since July 2001. In the same year the state started to phase out the tax on larger S corporations, at a rate of one-third a year with a final phase-out slated for July 2003. The income of S corporations continues to be taxed as personal income in New Jersey.

A study by the Multistate Tax Commission[5] found that, nationally, the percentage of all corporate entities classified as Subchapter S corporations increased from 22.1 percent in 1985 to 49.8 percent in 1996. The percentage of net corporate income attributed to these entities more than tripled, from 3.2 percent in 1985 to 11.5 percent in 1996.[6] Some of the growth in New Jersey's personal income tax can be attributed to shifts in these tax structures as New Jersey residents receive distributions from S corporations located both in New Jersey and in other jurisdictions.

Income Shifts to Lower Tax States

One tactic that has proliferated is the establishment of companies in states, such as Delaware or Nevada, which tax corporate income at a lower rate or have special provisions under which intangible income is not taxed at all. For example, a parent company transfers its trade names or trademarks to another company in Delaware and then pays a fee to the Delaware company in return for use of the name or mark. This reduces the parent company's income in the state where it is doing business, lowering the corporate income tax it would pay there because the fee is a deductible business expense. The Delaware company may then loan the money back to the parent company or send it back in the form of dividends to achieve more tax advantages for the parent. The interest the parent pays on the loan is an expense that can be deducted from net income thus reducing taxes further. The dividends the parent receives back from the Delaware corporation do not have to be recognized by the parent as taxable income. In either case, the parent corporation has successfully transferred operating income earned in New Jersey into tax-free income that it can use without restriction.

Such a case received considerable attention during the overhaul of New Jersey's corporate tax system. Geoffrey, Inc., is incorporated in Delaware and is a wholly-owned subsidiary of Toys "R" Us, a New Jersey corporation. Geoffrey, Inc. owns several trademarks—including Geoffrey, the Toys "R" Us giraffe—and trade names—including Toys "R" Us. Toys "R" Us pays royalties to Delaware-based Geoffrey, Inc. to use the trademark and trade name. The tax impact of this is to reduce Toys "R" Us' taxable income in New Jersey, where royalty *payments* are deductible, and shift it to Delaware, which does not tax royalty *income*. Other variations of this exist, but the impact is always the same: taxable income is shifted from higher-tax states to lower- or no-tax states.

According to published reports,[7] state authorities have targeted the tax avoidance strategies of at least 50 well-known companies, including Toys "R" Us, Home Depot Inc., Limited Brands Inc., Kmart Corp., Gap Inc., Sherwin-Williams Inc., Tyson Foods Inc., Circuit City Stores Inc., Stanley Works, Staples Inc. and Burger King Corp. The subsidiaries of these companies do not produce anything tangible and generally do not employ anyone, but are big moneymakers because of the tax breaks they provide the

parent companies. At least 12 states have filed almost 70 cases involving use of these intellectual property holding companies. The proceedings have involved the company or one of its subsidiaries before a state tax agency, board or court. In every case, the companies contend they have not violated state tax laws or regulations. Although this may be true, it is also true that they have successfully avoided paying a substantial amount of state taxes. To the extent that other businesses or competitors either cannot or choose not to adopt such strategies, the tax burden becomes less equitably distributed and more concentrated on a shrinking number of taxpayers.

Business Incentives

A fourth reason for declining corporate tax collections is state-created business incentives. Between 1989 and 1998, tax credits offered to New Jersey businesses increased from $1.9 million to $87.7 million—growth of 4,600 percent. Business incentives enacted by one state are often mirrored in neighboring states that fear their prosperous businesses will be lured away. Every credit for equipment, research, jobs, health care or relocation costs reduces the amount of tax a business pays. Audits and information about those programs—who gets the subsidy, how much it gets, where the business is located, how many jobs were created and how much they pay—are not readily available.

What New Jersey Did in 2002

Governor James E. McGreevey took office in January 2002 amid faltering economic conditions. The state budget was out of balance for the current fiscal year and it was clear this situation would continue, if not worsen, into Fiscal Year 2003, which started July 1, 2002. The total shortfall was listed at about $9 billion.

In his budget address to a joint session of the Legislature on February 11, Governor McGreevey outlined steps the administration would take to balance the Fiscal Year 2002 budget, including spending freezes, across-the-board reductions, exhausting unspent balances and redirecting trust fund balances.

From the start, the McGreevey administration said it would consider every possible avenue to close the budget deficit—except raising state taxes on personal income and retail sales, the two taxes which generate almost $14 billion, or 65 percent, of the $21.4 billion in revenues collected in Fiscal Year 2001. The Governor did not rule out changes in the corporate business tax or increasing other taxes and fees.

In early March, before the Fiscal Year 2003 budget was introduced, the Governor's office released information that collections from the corporate business tax were $53 million below the $991 million the state had expected to collect for the first six months of Fiscal Year 2002, from July 1 to December 31, 2001.

Meanwhile, a *Star Ledger*/Eagleton-Rutgers Poll[8] taken in early March, just before the budget was introduced, found that most New Jerseyans believed budget problems were serious and resulted from excessive government spending rather than an economic downturn. Asked whether they supported the following proposals as ways to balance the budget, those polled responded affirmatively to various options as follows:

Option	Percent
Reducing governmental waste	84%
Increasing corporate taxes	65%
Laying off state personnel	49%
Decreasing/delaying property tax rebates	42%
Reducing state services	39%
Increasing gas tax	28%
Increasing income tax	21%

When the Governor introduced his first budget on March 26, 2002, it was immediately clear that the most significant debate over the next three months would center on his plan to increase business tax collections by $711 million. In his address, McGreevey said:

> "We're also making changes to the Corporate Business Tax which is neither fair nor equitable. It's broken. And we're going to fix it. The changes I am proposing today are designed to ensure corporations pay their fair share, just as every New Jersey family must do.
>
> We're going to restore the integrity of the corporate income tax by eliminating the loopholes and gimmicks that have allowed companies to shirk their responsibilities…."

McGreevey went on to say that of the 50 companies with the largest payrolls in New Jersey, 30 paid only the minimum corporate tax of $200 per year. He contended that restructuring the tax to provide for greater equity and fairness would achieve the $1.8 billion in revenue that the Legislature had intended a year earlier. He also pledged to take steps to protect small businesses from being adversely affected by changes. The text of the Governor's budget included information on the 262,341 corporations that filed tax returns in New Jersey in 1999. Of these, he said, only 23 percent—61,083 corporations—paid more than the $200 corporate business tax minimum. The remaining 77 percent—201,258 corporations—paid only the $200. And of those companies paying only the minimum, 70 percent—141,811 companies—were viable businesses, engaged in real economic activity, not shell corporations.

The 50 largest businesses in New Jersey, measured by number of employees, combined to pay $345 million in corporate income taxes in 1999.[9] But the burden was anything but evenly shared. Indeed, 10 companies paid $314 million, or 91 percent of the revenue, while 30 collectively paid a total of $6,000—only $200 per company.

Tables 7 and 8 in the appendix present information on the 50 largest employers in New Jersey. In some instances, information on these companies is not complete. Generally, however, these companies are recognized as large, successful businesses with significant standing in the state.

To bolster his argument that corporations were not paying their fair share, the Governor presented data in his Fiscal Year 2003 budget comparing corporate profits to corporate business tax collections from 1991 to 2001. Overall, corporate profits doubled during the 1990s, increasing from $15.6 billion in Fiscal Year 1991 to $31.2 billion in 2001. During the same period corporate business tax collections remained more or less flat—$1.1 billion in 1991 and $1.4 billion in 2001. Clearly, the rapid growth of corporate profits was not being reflected by corporate tax payments into state tax coffers.

The main reasons given for erosion of the corporate business tax were the use of tax loopholes and accounting gimmicks by multi-state and multinational companies. The primary loophole cited by State Treasurer John McCormac was the ability of these companies to transfer profits off their New Jersey books and into out-of-state companies. Another problem cited was the state's inability to tax companies with a sales force, but no physical presence, in New Jersey.

Perhaps the most ambitious and controversial aspect of McGreevey's tax overhaul proposal was establishment of a new Alternative Minimum Assessment (AMA) that many large New Jersey corporations would have to pay, especially if they had been paying minimal amounts under the existing law. This Alternative Minimum Assessment would be capped at a maximum tax per corporation of $5 million and would be based on either gross New Jersey receipts or gross New Jersey profits, depending on which method generated the lowest tax liability. Under this proposal a corporation would calculate its tax under the corporate business tax structure (revised by a number of specific loophole-closing measures and changes) as well as under the new AMA and would pay the greater of the two.

All corporations that have an economic presence in New Jersey —that generate gross receipts here—would be required to compute the Alternative Minimum Assessment and, where necessary, pay it. Pass-through entities like S corporations, partnerships and proprietorships are not subject to the AMA. To affect small and medium-sized corporations as little as possible, corporations with less than $2 million in gross receipts or $1 million in gross profits are not subject to the AMA. Corporations with between $2 million and $20 million in gross receipts or between $1 million and $10 million in gross profits can deduct up to $2 million in gross receipts or $1 million in gross profits when calculating the AMA base.

Business Reaction

On June 13 the New Jersey Chamber of Commerce, New Jersey Retail Merchants Association, New Jersey Food Council and New Jersey Small Business Federation launched a $300,000 "Save Sally's Job" media campaign to spearhead their opposition to the corporate tax changes. The premise of the campaign was that New Jersey's new corporate business tax would take money away from employees because businesses would no longer be able to afford salaries, raises, health coverage and retirement plans if they had to pay the increased taxes.

Business groups countered the Governor's tax plan with an alternative that differed little from the status quo. The details featured suspending net operating loss exclusions for two years, increasing the minimum tax to $500 from $200, accelerating the third and fourth estimated payment for businesses worth $1 million or more and changing the rules on copyright and trademark royalty deductions. These changes had an estimated monetary value of less than $500 million, far short of the $1 billion proposed by the Governor's plan.

Legislative hearings on these varying proposals were heated and prolonged. One of the most interesting parts of the debate occurred on June 17 when representatives of the Great Atlantic & Pacific Tea Co. (A&P), QuickChek and the owner of Pagano's IGA, a small supermarket in Bayonne, appeared before the Assembly Budget Committee. A&P is one of New Jersey's 50 largest employers, a publicly held company with its headquarters in Montvale. Testimony by A&P at the hearings indicated that the company had $1.5 billion in sales the previous year, operated 150 stores, had a major warehouse in Edison and employed 20,000 people. It expanded eight stores two years ago and five last year, with plans to expand another 10 or 11. The company said it had paid only $200 in tax for each of the previous two years, as compared with the $2 million a year it said it would have to pay under the McGreevey plan.

Contrast this with information provided by QuickChek, a privately held, mid-sized company based in Whitehouse, with no out-of-state stores. It had $275 million in gross sales, 137 stores and 1,700 employees. In 2001 the company paid $210,000 in taxes and said that under the Governor's plan it would pay $486,475.

The third grocer testimony came from the owner of a single supermarket in Bayonne, who told legislators that McGreevey's plan would raise his tax bill from $3,000 this year to $10,000 next, forcing him to lay off workers. The small grocer's testimony delivered a mixed message. On the one hand, his tax would rise dramatically. On the other he already was paying many times more than the giant A&P chain. Interestingly, he also noted that he was feeling competitive pressure from two supermarkets going up in Bayonne—one of which was an A&P, the development costs of which helped drive down the chain's state tax bill to $200.

The testimony from these three individuals disclosed the complex nature of the debate. An article in The *Star Ledger*[10] summed the situation up well.

> "Opponents of the plan say the recent drop in business tax collections reflects a decline in corporate profits. And, they say, it is not 'loopholes,' but valuable business investments in new buildings, more employees, better research and charitable endeavors that enable some companies to pay minimal taxes on the billions of dollars of business they do in New Jersey.
>
> State Treasurer John McCormac at an Assembly Budget Committee hearing said, 'I think you have to look at owners and bonuses and salaries paid to the owners and families, at any rents potentially paid by the company to the owners or family members. You have to look at expenses like meals and entertainment, you have to look at pensions and profit sharing plans taken by the owners.'"

The article went on to point out that in 2001, when A&P paid just $200 in New Jersey taxes because of losses, the company's chairman and CEO, Christian Haub, earned almost $1.2 million in salary and bonuses. Four other top A&P executives shared $828,260 in performance bonuses, got raises totaling $84,000 and were awarded stock options worth $1.4 million. In addition the company reported paying rent of about $300,000 a year for a Canadian property owned by a company Haub owns.

An amended version of McGreevey's plan passed both houses of the Legislature (41-38-1 in the Assembly; 21-17 in the Senate)[11] and was signed into law by Governor McGreevey on July 2.

The New Jersey Business Tax Reform Act

Though enacted in July, the New Jersey Business Tax Reform Act, P.L. 2002, Chapter 40, is retroactive to the tax year beginning January 1, 2002. Both the administration and the nonpartisan state Office of Legislative Services estimated that the restructuring brought about by the law will raise about $1 billion in Fiscal Year 2003. They project that new revenue, along with the original $800 revenue projection for the year, will allow the state to collect approximately $1.8 billion in 2003, the same as was budgeted but not raised in Fiscal Year 2002.

OLS, however, also predicts that the revenue gain will decrease by about 40 percent in Fiscal Year 2004 and more in Fiscal Year 2005. Revenues are expected to be lower in part because the law suspends corporate net operating loss deductions for tax years 2002 and 2003 and requires larger corporations to prepay taxes. These provisions temporarily will increase revenues in Fiscal Year 2003.

The key issues addressed by the 34-page Business Tax Reform Act include the following:

- Disallow Royalty, Dividend and Interest Payments to Related Entities
- Combined/Consolidated Reporting
- The Nexus Test of Public Law 86-272
- Throwout Rule
- New Alternative Minimum Assessment
- Minimum Corporate Business Tax
- Changes in How Pass-Through Entities are Treated
- Creation of a Corporation Business Tax Study Commission
- Creation of the Corporation Business Tax Excess Revenue Fund
- New Jobs Investment Tax Credit Act (P.L. 1993, c. 170)

Disallow Royalty, Dividend, Interest Payments to Related Entities

The Issue:

Corporations had been able to shelter taxable profit by sending it as royalty and dividend income to subsidiaries or affiliated companies in other states with lower tax rates or no corporate tax at all on that form of income. Royalty payments were tax-deductible in New Jersey. If the subsidiary then returned the royalty income to the New Jersey company as a dividend, that flow of income would also not be taxed under a provision saying that dividends paid to a New Jersey corporation by an 80 percent owned subsidiary were not taxable. And if the income were returned to the New Jersey company as interest, it would be a deductible expense from the net income reported to New Jersey under the corporate business tax.

The Change:

The law limits the ability of a taxpayer to deduct royalty payments and other intangible expenses, costs and related interest when paid to affiliates. It continues to allow such deductions in areas that are established as non-tax avoidance situations. The Director of the Division of Taxation can allow deductions on a case-by-case basis; but, since disallowance of the deduction is the general rule, the effect is that a company must secure prior approval for the deduction.

Royalty payments or other intangible expenses now must be added back to net income if they are made to a parent or an affiliated company. In addition, an affiliation between an out-of-state company that sells trademarks to related companies in New Jersey gives the out-of-state company a presence in New Jersey under the law which will require that it pay its fair share of taxes.

The law also restricts deductibility of inter-affiliate interest expenses but continues to allow such deductions in areas that are established as non-tax avoidance situations. And it disallows deduction of dividends received from a corporation in which the taxpayer has less than a 50 percent ownership interest.

The administration estimated New Jersey would collect between $100 million and $150 million from these changes: $25 million to $40 million for disallowing royalty payments; $50 million to $70 million by taxing dividends; and $25 million to $40 million by requiring that interest from an affiliated company be added back to New Jersey net income.

Combined/Consolidated Reporting

The Issue:
New Jersey treats each subsidiary or affiliate corporation in a related family of corporations as a separate entity, filing separate tax returns. The problem with this is that the state can lose a significant amount of tax revenue when corporations transfer income among related corporations or out of the state to a lower-tax state.

Combined tax reporting requires all related entities engaged in business both in and out of New Jersey to calculate their tax burden as a single unit under the apportionment formula. With combined reporting, corporations cannot structure transactions—such as transferring royalty and dividend income and interest expenses—between affiliates in various states to avoid tax. As Michael Mazerov of the Center on Budget and Policy Priorities writes, "If a state requires combined reporting, all related corporations that are operated as a single business enterprise, any part of which is being conducted in the state, are essentially treated as one taxpayer for apportionment purposes."[12]

Many economic experts believe that the most efficient, fairest way to tax corporate income at the state level is to combine the corporation's total income, apportion a fair amount of that income to the taxing district and apply the state's tax rate to the income apportioned to the taxing district. California-style combined unitary reporting requires a multi-state or multi-national firm with multiple subsidiaries to combine all those entities which are part of a unitary business in California.

Approximately 21,000, or 8 percent, of corporations that filed tax returns in New Jersey in 1999 had related places of business outside the state and would be affected by mandatory combined reporting. Most of these are large, profitable companies that have affiliated companies both in and out of state. These companies incur approximately 60 percent of the state's corporate business tax liabilities, according to the Division of Taxation. In addition, an unknown number of businesses operating completely within the state are made up of related corporations and also would be affected by combined reporting.

New Jersey initially proposed giving corporations the option of paying tax based on their federal consolidated return, which combines all of a corporation's entities—even those not part of the unitary business. Piggybacking on the federal consolidated return is less subject to disputes over what part of the business is unitary with the business in New Jersey. According to Treasurer McCormac, "Consolidated reporting would give firms the option to present a total pie of corporate income; identify the fair slice apportioned to New Jersey; and then pay tax on that New Jersey apportioned income."[13]

The Change:
New Jersey did not enact mandatory combined or consolidated reporting. Instead, the law allows the Director of the Division of Taxation to require disclosure of inter-affiliate transactions, including transactions with related businesses that are not themselves corporate business taxpayers, including management fees, rents and charges for other services. The taxpayer has 90 days to comply. Noncompliance is treated as a failure to file a complete return. If a taxpayer cannot demonstrate that it has accurately reported true earnings, the director may compel consolidated filing.

Currently in New Jersey only casinos are required to file consolidated returns. The Director of the Division of Taxation now has authority to require a consolidated return but cannot unilaterally force all corporations to file that way, and it is unlikely that many corporations will be compelled to.

The Nexus Test

The Issue:
A 1959 federal law restricts states' authority to impose taxes on interstate commerce. This law requires that a state have a sufficient "nexus," or contact, with a corporation before the state can subject the corporation to taxation on its business activities. This statute, along with the Interstate Commerce clause of the U.S. Constitution, created significant limits on state power to reach corporations and impose taxes on them for commercial activity occurring within the state.

One area where this limitation is important is in mail order sales. States have not been permitted to tax a corporation's income if the corporation's only activity in the state was to solicit orders and deliver goods, even though the company clearly is deriving income from its business in the state.

Traditionally, nexus has required an actual physical presence either by owning property or having employees located in the state. A more current view is that physical contact is unnecessary and that economic presence suf-

fices. Under this view all that is necessary is that the corporation regularly avail itself of the market presented by the state. A key challenge to the McGreevey administration was how to craft the new law so as to reach as much business activity by New Jersey corporations without running afoul of the nexus test under federal law.

Successful use of this economic activity standard can be seen in an example from New Mexico. That state sued Kmart Properties Inc. (KPI), a wholly owned Michigan subsidiary of Kmart, which owned and managed trademarks previously developed by Kmart Corp. KPI granted Kmart exclusive right to use the trademarks in exchange for royalty payments to KPI. The court decided that use of KPI's trademarks within New Mexico generated substantial income for KPI and thus justified imposing the state's income tax on Michigan-based Kmart Properties Inc.

The Change:
The law uses an "economic activity" standard for nexus instead of a physical presence standard. It revises the activities that would subject a corporation to the New Jersey franchise tax to include "the privilege of deriving receipts from sources within this State or the privilege of engaging in contacts within this state." This clarifies New Jersey's position that any corporation making money in the state is subject to the franchise tax. And the law extends the reach of the corporate business tax to any corporation deriving any income from New Jersey sources.

Throwout Rule

The Issue:
So-called "nowhere sales" occur when a company sells products in a state where that company is exempt from taxation. The company would be exempt if it had no nexus with the state, such as is the situation with mail order sales, or if the state had no corporate tax. Two ways states have of recovering nowhere sales are through "throwout" and "throwback" rules which cause more of the income of the corporation to be assigned to the state where the corporation actually has operations.

The throwout rule changes the calculations used to determine tax liability with regard to how much of a company's sales are apportioned to the state. It does this by reducing the sales factor denominator in the ratio used in the apportionment calculation. For example, if a firm sells $500 worth of goods in New Jersey and $500 worth of goods to other states throughout the United States where the $500 worth of non-New Jersey sales are all taxed, the sales factor is $500/$1,000 or one-half. If the firm sells $500 worth of goods in New Jersey, plus $300 worth in states where the units are taxed and $200 where they are not taxed, the sales factor is $500/$800 or five-eighths—the $200 worth of sales to states where the corporation is not taxable are "thrown out" of the denominator of the fraction which raises the sales factor from one-half to five-eights and increases the tax liability.

The Change:
New Jersey has adopted a throwout rule and is now one of 26 states[14] addressing the issue of "nowhere sales." To prevent this change from creating an exceptionally large tax burden on an affiliated group of companies, the additional liability for a group is limited to $5 million, and may be spread proportionately among the affiliates.

Alternative Minimum Assessment

The Issue:
In 2000, 77 percent, or over 201,000, of New Jersey's corporations paid only the $200 minimum corporate business tax. Included in this group were 30 of the 50 largest companies in New Jersey in terms of payroll. The $200 these corporations paid in no way reflected their economic presence in New Jersey.

The Change:
The law creates a new Alternative Minimum Assessment (AMA) to measure a company's economic activity in New Jersey in situations where the traditional taxable income formula is not a fair measure. Unlike the $200 minimum corporate business tax, the AMA is a computed amount, not a flat amount.

It is expected that most corporations will not be subject to the AMA, because either their gross receipts or their gross profits fall below the eligibility threshold or because the corporate business tax liability computed under the new rules will exceed the AMA liability.

The AMA is relatively simple. Only corporations that earn more than $2 million in gross receipts or $1 million in gross profits (gross receipts minus the cost of goods sold) will be subjected to the tax. The tax on gross receipts and gross profits is imposed at graduated rates, with maximum rates of 0.4 percent and 0.8 percent respectively.

Corporations can calculate their AMA based on either their New Jersey gross receipts or New Jersey gross profits, but whichever they choose must then be used as the tax base for five consecutive years. In computing its AMA, a corporation can exclude up to $2 million in gross receipts or up to $1 million in gross profits. No exemptions, deductions or credits can be taken. By allowing the use of gross profits to calculate the AMA, the bill protects high volume, low margin industries such as retailers and food stores. Originally it was thought that using gross profits would also protect car dealers; as it turns out 90 percent of car dealerships are S corporations which are not subject to the AMA.

The amount of AMA a corporation is required to pay is capped at $5 million. The combined AMA and corporate tax liabilities for a group of affiliated companies is capped at $20 million. The group can pay more than $20 million in combined corporate business tax liability but it would not have any AMA liability. The AMA is temporary, scheduled to expire in five years except for corporations protected by P.L. 86-272. Past AMA payments are available as credits to the corporate business tax in years when no AMA payment is made. The AMA is not imposed on S corporations, investment companies or professional corporations.

The Division of Taxation estimates that a corporation with $3 million in gross receipts has a potential maximum AMA tax liability of $1,389. Corporations with $10 million, $20 million and $200 million in gross receipts have potential AMAs of $11,111, $25,000 and $800,000 respectively. Each of these could potentially be lower if their gross profit margin is less than 50 percent. If the cost of goods sold is less than 50 percent, the corporation would choose to use gross receipts instead of gross profits; if the cost is greater than 50 percent, the corporation would choose to use gross profits. Auto dealerships, department stores, manufacturers and grocery stores would use gross profits because more than 50 percent of their gross receipts reflect the costs of the goods they sell.

The AMA expires December 31, 2006, except for businesses with significant economic presence in the state that currently pay no New Jersey corporate tax because they claim exemption under P.L. 86-272. The new law provides an incentive for corporations to agree to pay the regular corporate business tax. Under New Jersey's new law, if these businesses agree to pay the regular corporation business tax they will be exempt from the AMA after June 30, 2006.

It is difficult to measure the impact of the new AMA. Its aim is to reduce the number of profitable businesses that pay only the minimum tax in New Jersey. The administration and Office of Legislative Services estimate that the state might collect as much as $300 million in Fiscal Year 2003 from this provision. The administration's estimate is based on examining a sample of tax returns from multistate corporations and extrapolating to the universe of corporate taxpayers. Because the AMA is compared to the corporate business tax liability and only paid if it is greater, the new changes create substantial uncertainty about how much AMA will be paid and by whom. It will really become clear only after the tax year 2002 returns become available in 2004.

Minimum Corporate Business Tax

The Issue:
As was discussed earlier, 77 percent of New Jersey's corporations paid only the $200 minimum corporate business tax. Most of the corporations paying that tax were viable corporations with economic activity. Some corporations, however, had no economic activity but remained incorporated for a variety of legal and business reasons. Prior to January 1, 2002, these corporations annually paid the state the $200 to maintain their corporate status.

The Change:
The new law increases the $200 minimum tax to $500 for the tax period that started on January 1, 2002. The minimum tax on corporations affiliated with groups or parent companies that have payrolls of $5 million or more is $2,000.

Corporations most likely to pay the minimum tax are the 60,000 or so mostly inactive New Jersey corporations. The Division of Taxation estimates that another 100,000 New Jersey corporations will not be subject to the AMA because their gross receipts or gross profits are below the threshold. Some of these smaller corporations will end up paying the $500 minimum tax. The administration and the Office of Legislative Services estimate that the state could collect $45 million from the increase in the minimum corporate business tax from $200 to $500.

Pass-Through Entities

The Issue:
Pass-through entities—Subchapter S corporations, Limited Liability Companies (LLCs), Limited Liability Partnerships (LLPs) and Partnerships—have grown in popularity as owners take advantage of the fact that personal income is taxed at a lower rate than corporate income. The Department of the Treasury estimates that in New Jersey there are approximately 276,000 of these businesses, including 82,100 Subchapter S corporations, 110,700 LLCs, 1,400 LLPs and 81,700 partnerships.[15] New Jersey taxes the income of these owners if they actively participate in the business whether they live in the state or not.

Until now, the state has not been as successful as it could be at taxing the income of non-resident owners. In fact a consultant who used to work at the Internal Revenue Service estimates that New Jersey loses about $50 million a year because partners in pass-through entities who live out of state do not report all of their income earned in New Jersey.[16]

New Jersey has exempted smaller S corporations with net income under $100,000 from the corporate business tax since July 2001. In the same year the state started to phase out the corporate business tax on larger S corporations, at a rate of one-third a year with a final phase-out slated originally for July 2003.

The Change:
The law institutes a $150 per owner processing fee on owners of pass-through entities having more than two owners. In addition, in the case of business entities with out-of-state partners, New Jersey will withhold state income tax due at a top rate of 6.37 percent for individual partners and 9 percent for non-individual business entity partners. The payment is credited against the partners' respective tax liabilities.

The law also suspends the final phase-out of the corporate business tax on larger S corporations until after tax year 2005. The rate is frozen at 2001 levels through tax year 2005 and then resumes its phase-out. S corporations will pay corporate business taxes at a rate of 1.33 percent through 2005, at which point the tax will be eliminated.

The administration estimates that the state might collect up to $80 million from the new processing fee, though the actual number of pass-through entities with more than two owners is unknown.

Corporation Business Tax Study Commission

This commission was created as an amendment to the original bill changing the corporate tax system. It is comprised of nine members[17]: five appointed by the Governor, two by the Senate co-presidents; and two by the Assembly Speaker. Each member must be a New Jersey resident with knowledge and expertise in the area of corporate income tax. One of the gubernatorial appointees must be from the academic community, one a certified public accountant, one a member of the tax bar, one a representative of large businesses and one from small businesses.

The commission is to evaluate the new corporate tax law changes by empirical analysis and by feedback from public hearings. It also has the authority to hire an executive director. The commission is required to produce a report by December 30, 2003. If the report is not produced by June 30, 2004, the Alternative Minimum Assessment will be suspended two years early—after December 31, 2004 instead of 2006.

Among issues the Commission will consider are:

- Whether the corporation business tax burden is fairly and equitably borne and distributed among corporations subject to the tax;
- Whether profitable corporations doing business in New Jersey can still avoid paying their fair share of taxes by using tax minimization or avoidance strategies;
- Whether, without reducing anticipated revenues, the tax burden could be more fairly and equitably borne and distributed;
- Whether the revenue and distributional impacts of the tax law changes yield the recurring revenue goals that New Jersey must achieve to bring long-term structural balance to state finances;
- Whether New Jersey and its corporate business taxpayers would be better served by requiring parent and affiliated multi-state and multinational businesses to file a single combined tax return.

Corporation Business Tax Excess Revenue Fund

Also created by an amendment to the original bill, this stipulates that if the revised corporate business tax generates more tax revenue than the projected $1.823 billion, excess collections will be placed in a reserve account. Balances in the account will be available for use in Fiscal Years 2004 and 2005 to help cover shortfalls in the amounts certified for the General Fund. Then any remaining funds will be used to cover shortfalls in corporate business tax collections from the target amount. If a balance exists in the fund on December 30, 2005, the law requires the Director of the Division of Taxation to reduce the corporate business tax rates accordingly.

New Jobs Investment Tax Credit Act

The New Jobs Investment Tax Credit Act was created in 1993 as an incentive to create new jobs in New Jersey. According to the Division of Taxation, about 15 corporations a year have qualified for this credit, which has cost the state between $200,000 and $300,000 in lost revenues annually.

An amendment to the corporate tax legislation of 2002 doubles the value of the new jobs factor and raises eligibility caps to allow mid-sized businesses to qualify for the credit. No estimates were provided on how many new businesses may now qualify or on what the potential revenue loss to the state may be.

Recommendations

Supporters and opponents agree on one thing: the changes made to New Jersey's corporate tax structure were sweeping. In some cases New Jersey is moving ahead of other states in terms of how vigorously revenue will be pursued and loopholes closed. In others, New Jersey is catching up to where others already are.

But the corporate tax law changes New Jersey has made should not be viewed as a finished product. The issue is anything but static. The new law contains provisions under which parts of it could expire. It sets up a commission charged with reporting back on results and impacts of the changes, with an eye toward future expansions in the program or rollbacks. By no means is it expected that business advocates will stop seeking legislative actions or changes to their corporate structure that will reduce their tax burdens as time goes on.

Those involved in paying the taxes or collecting them, analyzing the impact of the changes or debating their future will have much to examine in the months ahead. The following recommendations aim at building on the recent changes in order to help create a fair, equitable corporate tax structure that would serve as an example of what states can and should do in this complex and crucial arena.

The state should mandate combined reporting.

Mandatory combined reporting is perhaps the single most important measure New Jersey can enact to simplify corporate tax administration and limit the tax strategies that companies use to minimize their tax liability in New Jersey. If New Jersey were to mandate combined reporting, it would join sixteen other states that require related companies to file a combined report.

According to Richard Pomp, a law professor and the former head of the New York Tax Study Commission, "A state that does not require related corporations conducting a unitary business to file a combined report is at the mercy of its corporate taxpayers. Transfer pricing, holding companies, and more subtle and less notorious strategies exist for exploiting separate entity states."[19]

Although the recent action giving the Director of the Division of Taxation authority to compel combined reporting is an improvement on the old system, few companies are likely to be required to do so. Because each individual case will have to be considered separately, it will be time-consuming to make that determination and will further stretch the Division of Taxation's limited resources.

The Alternative Minimum Assessment should not be suspended even if the Corporate Business Tax Study Commission does not produce a report by June 30, 2004.

The commission is required to produce a report by December 30, 2003. If that report is not produced by June 30, 2004, the AMA will be suspended two years early—after December 31, 2004 instead of 2006.

This should not be allowed to happen.

New Jersey's budget crisis has brought to light the relative unfairness of the corporate business tax in this state. The state's financial situation is mirrored in most other states and many are looking to New Jersey to provide a framework for what they might also do.

The Corporate Business Tax Study Commission has been asked to assess issues like fairness, predictability and stability—important, complex issues made more difficult by the inaccessibility of corporate tax data to the average citizen and the recent changes made to the corporate tax structure. Producing the required report by June 2004 may be problematic because the state will not know the actual impact of these tax law changes until January 2004 at the earliest. Although businesses were to start paying the AMA in December 2002, they do not have to file tax returns until October 2003. The Division of Taxation will then have to analyze approximately 260,000 corporate tax returns under a new system.

It is possible that the Commission will find the new AMA is a reasonable alternative to the regular corporate business tax and should not sunset even in 2006. This would require legislative action but certainly should be considered. Alternative minimum assessments or taxes currently are imposed by the federal government and 18 states.[19] The other states are: Alaska, Arizona, California, Connecticut, Florida, Idaho, Iowa, Maine, Massachusetts, Minnesota, Montana, New York, Ohio, Oregon, Rhode Island, Utah and Vermont, plus the District of Columbia. In assessing these taxes, particular attention should be paid to problems that exist in the federal program and in other states. One of the biggest problems cited with the federal alternative minimum tax, created in 1986, is the number of special adjustments, preferences, exemptions, write-offs and credits a firm can use to adjust current earnings. The new AMA in New Jersey does not suffer from these problems because its base is gross receipts or gross profits and it allows no adjustments, preferences, exemptions, write-offs or credits.

The Corporation Business Tax Excess Revenue Fund and provisions that established it should be eliminated.

This fund will be created if the revised corporate business tax generates more tax revenue than the projected $1.823 billion in Fiscal Year 2003. Excess revenues will be placed in this reserve account and the balances in the account will be available to help cover first General Fund then corporate business tax shortfalls in Fiscal Years 2004 and 2005. If a balance exists on December 30, 2005, the law authorizes the Director of the Division of Taxation to reduce the corporate business tax rates accordingly.

Although the current fiscal situation in New Jersey makes it difficult to believe this fund could have a balance in three years, stranger things have happened. And, if by some chance a balance exists, it is inappropriate for the Director of the Division of Taxation to be authorized to reduce corporate business tax rates. All such changes should be made only after extensive public debate with input from all interested parties, including the business community and all those who would suffer under a state revenue shortfall.

The state should require corporations to disclose their tax returns.

In 1984, a group of tax professionals focusing on the issue of worldwide income recommended using a spreadsheet to help ensure full accountability and disclosure of corporate income. The group called for a federal law requiring multi-jurisdictional taxpayers to file with the IRS data that would include the taxpayer's liability in each state where it operates, as well as disclosure of the method used to calculate the liability. New Jersey officials should support the creation of a nationwide accounting database that would show how corporate taxable income gets divided across state lines.

No such law was passed, though data on federal tax liability is available from 10K documents that firms must file with the Securities and Exchange Commission. Using this data, the nonprofit Institute on Taxation and Economic Policy (ITEP) examined the U.S. profits and federal income taxes of 250 of the country's largest and most profitable corporations from 1996 to 1998. It reported that many of these corporations paid little or no federal income taxes.[20]

Such research is impossible in New Jersey because busi-

ness tax returns, like those filed by individuals, are confidential. To help make his case for reform, Governor McGreevey could provide only the most basic information about taxes paid by New Jersey corporations. The only reason the public knows that the large A&P supermarket chain paid $200 in corporate taxes in 2000 is because a company representative was asked at a public hearing how much tax the company paid.

Since corporations are creations of the law and it is in the public interest for citizens to know whether the standards of law are being met, business returns should be treated differently from individual returns with respect to disclosure. In New Jersey, it is relatively easy to find out what your neighbor pays in property taxes; the same should be true for the taxes paid by corporations in this state. New Jersey should require that corporations provide the public with clear and detailed information on their taxes, including a straightforward statement of what they paid in state taxes and the reasons why those taxes differed from the statutory 9 percent, 7.5 percent or 6.5 percent corporate tax rates now in effect in New Jersey.

The state should report how much tax revenue is given up by providing incentives to businesses and should establish rigorous criteria for the future use of such credits.

Erosion of corporate business tax receipts in New Jersey is partly due to the proliferation of business tax credits. What started as $1.9 million in credits to business in 1989 had grown by more than 4,600 percent to $87.7 million by 1998.

Tax credits provided to business include: a jobs investment tax credit and a property tax credit for qualified investments in new or expanded business facilities resulting in new jobs; a credit for investment in qualified equipment; a credit for increased research activities; a tax benefit certificate transfer program to assist certain emerging companies; the carry forward of net operating losses under the corporate business tax for certain taxpayers; extension of the carry forward of research and development tax credit; the Neighborhood and Business Child Care Tax Incentive Program; Urban Enterprise Zone Credits; Research and Development Tax Credit; the Smart Moves for Business Programs Tax Credit and the Neighborhood and Business Child Care Tax Credit.

Awarding these incentives is perfectly legal. But New Jersey has no formal, easily accessible mechanism to account for the money the state chooses *not* to collect because of tax breaks and incentives. New Jersey should compile a tax expenditure report disclosing the value of all business incentives provided to corporations. Each program and the amount provided to each participant should be listed separately. This should be updated monthly and should be available on the Internet as well as included every year in the state budget.

States such as Minnesota, Maine, Texas, Connecticut and West Virginia have enacted disclosure laws that require companies to make public the value of subsidies they receive each year. Maine and Minnesota require that the companies disclose wages and benefits paid. Connecticut, Maine and Minnesota require the companies to disclose actual job creation and/or retention. Some of these states also have started to respond to subsidy abuse through "clawback" laws that reclaim taxes and subsidies if a company does not create all the jobs promised.

States should move toward greater uniformity in their corporate tax codes.

"Why do we have less uniformity in state tax laws than we did in the early 1980s?" Dan Bucks, Executive Director of the Multistate Tax Commission, asked. "Because businesses don't support it. They undermine uniformity whenever they see it because they have learned [that] the lack of uniformity creates opportunities for tax shelters."[21]

Cooperative auditing by states of returns filed by multistate businesses is desirable in the interests of efficient tax administration. But differences in state laws and tax forms prevent this from happening in many cases. This diversity is rooted in historical, constitutional and policy reasons. Greater uniformity among states with respect to formulas and other key features of their corporate tax laws would make interstate cooperation in this field more feasible and increase the efficiency and effectiveness of state tax administration. At present the level of compliance is poor when departures from the federal base are complex. Conformity means also that a state secures the benefits of federal enforcement with little or no state expense.

If states could find more ways to work together they would have a better chance of standing up to corporate attempts to force favorable treatment by threatening to leave a state

that does not do what a neighboring state does, or other similar actions. New Jersey officials should take every opportunity to be part of this effort.

New Jersey should strengthen the audit and research capacities of the Division of Taxation.

The new law, while it contains many provisions aimed at tougher standards and enforcing stricter compliance, does not in any way enhance the Division of Taxation's ability to achieve these ends. Requiring the Division to make a determination about combined reporting, or disallowing certain tax strategies up front, changes the timing but not the amount of work that has to be done. The reality is still that overworked, relatively low paid state employees are battling on a daily basis armies of corporate lawyers and accountants who provide their clients with increasingly sophisticated methods for avoiding taxes.

For New Jersey's new law to reach its potential and the expectations that its supporters have created among the public, more staff and money must be provided.

Conclusion

Corporate tax policy is often determined in the shadows, away from the glare of media attention and public scrutiny. Small changes in obscure passages in the law can mean millions of dollars in revenue lost to the state. Politicians relying, whether they like it or not, on corporate campaign contributions often are disinclined to anger big firms, especially when actions they take to help those firms are unlikely to be known by voters anyway.

Few public policy organizations have the resources, the staff or the expertise to counter the complicated arguments made by multi-national corporations, Chambers of Commerce and other business advocacy groups.

But the *public* interest demands that this situation not be tolerated.

Corporate tax policy is intimidating and complicated. The accountants, lawyers and lobbyists who work in the field seem to speak a different language. And they have at their disposal knowledge and information, much of it confidential, that average people cannot get.

But the average person *can* have an opinion and *should* be provided with the facts needed to make it an informed opinion. Governor McGreevey was correct, when he said at the beginning of this process that it is inappropriate for a large, profitable corporation in New Jersey to pay less in income taxes than a single parent earning $25,000 a year. It is inappropriate for a corporation to pay only $200 a year when it pays multi-million dollar salaries and bonuses to its CEO. It is inappropriate for a multi-national supermarket chain to pay less tax than a single small grocery store owner who competes in the same market.

The administration has taken a stand to right some wrongs of the corporate tax system but there are still important areas that need attention. In declaring his intention to eliminate loopholes, to ensure that companies pay their fair share—even if they reside out of state and only profit from an economic presence in New Jersey—and to lessen the burden on small businesses and level the playing field for all, Governor McGreevey declared that, "fairness and equity will be restored to our tax code."

New Jersey clearly is headed in that direction with the policy changes of 2002. The system we should have is now within reach.

TABLE 7

50 Largest Employers in New Jersey

		Location	NJ Employment	Total Employment	% of Employees in NJ	Revenues 1999 (Millions)
1	Wakefern Food Corporation	Elizabeth, NJ	34,500	54,500	63.3%	$5,500
2	AT&T	Basking Ridge, NJ	23,900	147,200	16.2%	64,100
3	Lucent Technologies	Murray Hill, NJ	20,000	153,000	13.1%	38,700
4	Verizon	NY	18,290	145,416	12.6%	NA
5	Pathmark Stores, Inc	Carteret, NJ	13,500	27,000	50.0%	3,700
6	United Parcel Service	Atlanta, GA	13,450	344,000	3.9%	27,100
7	Prudential Insurance/Financial Inc (a)	Newark, NJ	13,351	60,550	22.0%	26,618
8	Trump Hotel and Casino Resorts	Atlantic City, NJ	13,235	16,800	78.8%	NA
9	Park Place Entertainment	Las Vegas, NV	12,078	57,000	21.2%	NA
10	Johnson & Johnson	New Brunswick, NJ	12,000	97,800	12.3%	4,200
11	Federated Dept Stores	NY	11,500	130,000	8.8%	NA
12	Great Atlantic & Pacific Tea Co. (a)	Montvale, NJ	11,380	81,087	14.0%	10,151
13	Merrill Lynch & Co., Inc.	NY	11,300	69,000	16.4%	21,000
14	Public Service Enterprise Group Inc	Newark, NJ	11,200	12,000	93.3%	6,500
15	Continental Airlines	Houston, TX	11,000	50,500	21.8%	NA
16	Merck & Company, Inc	Whitehouse Sta., NJ	10,356	57,300	18.1%	32,700
17	J.C. Penny Co., Inc	Plano, TX	9,062	250,000	3.6%	NA
18	Sears, Roebuck & Co	Hoffman Estates, IL	8,519	300,000	2.8%	41,071
19	Bristol-Myers Squibb Co.	NY	8,000	54,000	14.8%	20,200
20	Home Depot	Atlanta, GA	8,000	150,000	5.3%	38,000
21	Summit BanCorp	Princeton, NJ	7,998	9,341	85.6%	397
22	Wal-Mart Stores, Inc	Bentonville, AR	7,900	1,000,000	0.8%	165,000
23	First Union Corp-Wachovia	North Carolina	6,573	70,000	9.4%	14,503
24	Harrahs Entertainment	Las Vegas, NV	6,435	38,000	16.9%	3,024
25	Federal Express	Memphis, TN	6,200	15,000	41.3%	NA
26	Schering-Plough Corp	Madison, NJ	6,000	26,500	22.6%	9,200
27	Toys "R" Us, Inc (a)	Montvale, NJ	6,000	23,000	26.1%	11,862
28	Telcordia	Morristown, NJ	5,800	6,000	96.7%	1,200
29	Kmart	Troy, MI	5,700	278,500	2.0%	NA
30	Acme Markets, Inc	Boise, ID	5,600	220,000	2.5%	35,000
31	Tropicana/Aztar	Atlantic City, NJ	5,300	10,800	49.1%	NA
32	Automatic Data Processing, Inc	Roseland, NJ	5,100	37,000	13.8%	5,540
33	Horizon BC & BS of NJ	Newark, NJ	4,735	4,735	100.0%	3,450
34	Paine Webber Group, Inc	NY	4,600	19,000	24.2%	NA
35	Foodarama Supermarkets, Inc	Freehold, NJ	4,550	4,550	100.0%	800
36	Novartis	Basel, Switzerland	4,400	82,400	5.3%	21,643
37	IBM	Armonk, NY	4,132	307,000	1.3%	87,500
38	Lookheed Martin	Bethesda, MD	4,100	147,000	2.8%	25,000
39	Chubb Corporation (a)	Warren, NJ	4,036	9,700	41.6%	6,730
40	Exxon-Mobile Corp	Irving TX	4,000	120,000	3.3%	NA
41	Pricewaterhouse Coopers LLP	NA	3,900	150,000	2.6%	NA
42	Grand Union Company	Wayne, NJ	3,866	13,000	29.7%	2,286
43	Marriott International Corp	Bethesda, MD	3,800	140,000	2.7%	NA
44	Nabisco Foods Group (a)	East Hanover, NJ	3,652	53,000	6.9%	8,268
45	General Motors Corp	Detroit MI	3,627	388,000	0.9%	NA
46	Commerce Bank	Cherry Hill NJ	3,582	4,260	84.1%	359
47	American Home Products	Madison, NJ	3,534	52,022	6.8%	13,550
48	PNC Bank	Pittsburgh, PA	3,500	25,000	14.0%	NA
49	Gannett Co., Inc	Arlington VA	3,400	39,000	8.7%	NA
50	Resorts Casino Hotel	Atlantic City, NJ	3,400	3,400	100.0%	270

Source: New Jersey Business Resource Center Website, New Jersey Commerce and Economic Growth Commission and New Jersey Business & Industry Association, 2000.

Note: (a) Revenue data are from 2000 not 1999.

TABLE 8

50 Largest Employers, 2002 vs. 2000

	2002	Employees	2000	Employees
1	Wakefern Food Corp.	31,000	Wakefern Food Corp.	34,500
2	Verizon	16,525	AT&T	23,900
3	Park Place Entertainment	16,261	Lucent Technologies	20,000
4	AT&T	16,159	Bell Atlantic Corp.	18,290
5	Pathmark Stores, Inc	13,000	Pathmark Stores, Inc	13,500
6	Merck & Company, Inc	12,846	United Parcel Service	13,450
7	Trump Hotel & Casino Resorts	12,846	The Prudential Insurance Co.	13,351
8	Public Service Enterprise Group, Inc.	12,000	Trump Hotel & Casino Resorts	13,235
9	Continental Airlines	11,600	Park Place Entertainment	12,078
10	The Prudential Insurance Co.	11,315	Johnson & Johnson	12,000
11	Home Depot	11,300	Federated Department Stores	11,500
12	Johnson & Johnson	11,000	Great Atlantic & Pacific Tea Co.	11,380
13	Merrill Lynch & Co., Inc.	11,000	Merrill Lynch & Co., Inc.	11,300
14	Great Atlantic & Pacific Tea Co.	10,908	Public Service Enterprise Group, Inc.	11,200
15	Lucent Technologies	9,600	Continental Airlines	11,000
16	Wal-Mart Stores, Inc.	9,300	Merck & Company, Inc	10,356
17	Federated Department Stores	9,200	J.C. Penney Co., Inc.	9,062
18	Bristol-Myers Squibb Co.	8,000	Sears, Roebuck & Co.	8,519
19	Cendant Corp.	7,012	Bristol-Myers Squibb Co.	8,000
20	Schering-Plough Corp.	6,800	Home Depot	8,000
21	Fleet Boston Financial	6,500	Summit Bancorp	7,998
22	Harrah's Entertainment, Inc	6,475	Wal-Mart Stores, Inc.	7,900
23	Automated Data Processing, Inc	6,202	First Union	6,573
24	Federal Express	6,100	Harrah's Entertainment, Inc	6,435
25	Acme Markets, Inc.	6,076	Federal Express	6,200
26	First Union/Wachovia	6,000	Schering-Plough Corp.	6,000
27	Foodarama Supermarkets, Inc.	5,700	Toys "R" Us, Inc.	6,000
28	UBS/Paine Webber	5,332	Telcordia	5,800
29	Telcordia	5,200	KMart	5,700
30	Tropicana/Aztar Corp.	4,918	Acme Markets, Inc.	5,600
31	Commerce Bank	4,826	Tropicana/Aztar Corp.	5,300
32	IBM	4,766	Automated Data Processing, Inc	5,100
33	Marriott International Corp.	4,720	Horizon BC & BS of NJ	4,735
34	Horizon BC & BS of NJ	4,600	UBS/Paine Webber	4,600
35	Novartis	4,000	Foodarama Supermarkets, Inc.	4,550
36	Pricewaterhouse Coopers, LLP	3,800	Novartis	4,400
37	Silver Line Bldg Products, Corp	3,600	IBM	4,132
38	J.C. Penney Co., Inc.	3,559	Lockheed Martin	4,100
39	Inserra Supermarkets	3,522	The Chubb Corporation	4,036
40	Lockheed Martin	3,500	Exxon-Mobil Corp.	4,000
41	Siemens Corp.	3,483	Pricewaterhouse Coopers, LLP	3,900
42	J.P. Morgan Chase & Co.	3,287	The Grand Union Co.	3,866
43	Gannett Co., Inc.	3,192	Marriott International Corp.	3,800
44	Professional Security Bureau Ltd.	3,110	Nabisco Holdings Group	3,652
45	L'Oreal USA, Inc.	3,024	General Motors Corp.	3,627
46	BASF Corporation	3,000	Commerce Bank	3,582
47	Hoffman-LaRoche	3,000	American Home Products	3,534
48	Pfizer	3,000	PNC Financial Services Group, Inc.	3,500
49	PNC Financial Services Group, Inc.	2,850	Gannett Co., Inc.	3,400
50	Foster Wheeler Corp.	2,828	Resorts Casino Hotel	3,400

Source: New Jersey Comprehensive Annual Financial Report, 2000 and 2002

End Notes

[1] John H. Bowman, professor of economics at Virginia Commonwealth University testified on the four basic principles of evaluating tax systems at a hearing before the Joint Subcommittee to Study and Revise Virginia's State Tax. See "Professor Offers Reform Panel Basics of Tax Evaluation," *State Tax Notes,* May 20, 2002.

[2] Maxwell, James A. and J. Richard Aronson, *Financing State and Local Governments.* The Brookings Institute, 1976, p 116.

[3] This history comes from two sources: John W. Cadman, Jr's book *The Corporation in New Jersey: Business and Politics 1791-1875* (Harvard University Press: 1949) and Christopher J. Grandy's PhD thesis, *The Economics of Multiple Governments: New Jersey Corporate Chartermongering, 1875-1929* (University of California, Berkeley: 1987).

[4] "Where Have All the Corporate Income Taxes Gone," in *State Budget and Tax News* Vol 19, No. 20, October 15, 2000, p. 2.

[5] The Multistate Tax Commission was created in 1967 as an agency of state governments to help make state tax systems fair, effective and efficient as they apply to interstate and international commerce and to protect state fiscal authority. It encourages states to adopt uniform tax laws and regulations, reduces state tax compliance burdens on businesses through a joint audit program, encourages voluntary disclosure through a National Nexus Program; participates in significant court cases and educates Congress about state tax authority and interests.

[6] "Where Have All the Corporate Income Taxes Gone," in *State Budget and Tax News* Vol 19, No. 20, October 15, 2000, p. 3.

[7] Glenn R. Simpson, "A Tax Maneuver in Delaware Puts Squeeze on Other States," *The Wall Street Journal*, August 9, 2002, p. A1.

[8] "New Jerseyans View Budget Problems as Serious But They're Not Willing to Pay Higher Taxes to Solve Them," *Star Ledger*/Eagelton-Rutgers Poll, March 17, 2002.

[9] State of New Jersey, Executive Budget, Fiscal Year 2003, p. C-5.

[10] Dunstan McNichol, "$200 Question for Legislature," *The Star Ledger*, June 24, 2002.

[11] The New Jersey Assembly currently is composed of 44 Democrats and 36 Republicans; the Senate is 20 Democrats and 20 Republicans. In the Assembly the vote on the New Jersey Business Tax Reform Act was along party lines except for three Democrats who voted no and one Republican who abstained. In the Senate the vote was also along party lines except for one Democrat who voted no, two Republicans who voted yes and two Republicans who did not vote.

[12] Michael Mazerov, "Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenues for Many States," Center on Budget and Policy Priorities, April 9, 2002.

[13] Testimony by State Treasurer John E. McCormac before the Senate Budget and Appropriations Committee on May 29, 2002.

[14] Twenty-four states use throwback rules; two—New Jersey and West Virginia—use throwout rules.

[15] Joe Donohue and Beth Fitzgerald, "Tax Plan Gets Bit of Economic Muscle," *Star Ledger*, April 11, 2002.

[16] Bob Ingle, "McGreevey Lauds Bryant's Tax Plan," *Courier Post*, May 1, 2002.

[17] Appointments to the Commission were announced on October 23, 2002. They are Eileen Appelbaum, Robert C. Krueger Jr., John J. Pydyszewski, James B. Evans, Tami Gaines, Kenneth K. Gershenfeld, Frank Huttle III, Michael N. Kasparian and David Shipley.

[18] Richard D. Pomp, "The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer," in David Brunori, ed., *The Future of State Taxation*, The Urban Institute Press, 1998, p. 62.

[19] A discussion of alternative minimum taxes can be found in "Corporate Income Taxes in the 1990s," Robert S. McIntyre and T.D. Coo Nguyen, *Institute on Taxation and Economic Policy,* October 2000.

[20] Ibid. p. 13).

[21] "State FTA Roundtable Debates Viability of Corporate Income Tax," *State Tax Notes*, June 10, 2002, p. 1008.