

## Interviewing Stan Arnold, Former New Hampshire Tax Commissioner

by Billy Hamilton



Stan Arnold has improbably broad shoulders for a certified public accountant, but then his background is a little improbable for a CPA and tax administrator, too. He spent 24 years in the U.S. Army, rising to command sergeant major of an artillery battalion. In retrospect, it may have been great training for the 19 years he spent with the New Hampshire Department of Revenue Administration, during which he rose meteorically from desk auditor to commissioner.

Arnold served as the state's chief tax collector for 14 years under four governors from both political parties. That's five years from entry-level auditor to commissioner. He should be advising people about career planning, but he's not. Even though he retired from state service in 2002, he's still talking about taxes, now as senior tax adviser with the Concord, N.H., law firm Rath, Young and Pignatelli.

One of the signal achievements of Arnold's tax career was his role as one of the chief architects of New Hampshire's business tax reform in 1993. The result of that reform was the business enterprise tax (BET), which has held up surprisingly well in the succeeding 16 years. While the tax has shown some strain in the last year, as most state taxes have, it's still relevant today because business tax reform has become a hot topic in many state legislatures. In recent years, Michigan, Ohio, and Texas have swapped their old business taxes for new, broad-based taxes. California is considering a similar reform. Other states have tinkered with the idea as well.

"One of the things I've enjoyed about my post-state career is talking to other states about the BET," Arnold told me recently. "It's a good tax, a sound approach to business tax reform. I think states should take a look at it." In recent months, Arnold has talked about the tax and its creation to lawmakers and others in Massachusetts, Pennsylvania, Rhode Island, Tennessee, and several other states. He believes the

BET offers a simpler alternative than some other new business taxes getting attention nationally. "A lot of the new taxes that are tied to gross receipts are very complex. You can get to the same place much easier with the BET," he said.

**Arnold was one of the chief architects of New Hampshire's business enterprise tax, which has held up surprisingly well.**

Arnold said that in all the years the BET has been in effect, it has never faced a legal challenge, and the tax has remained remarkably stable with few legislative changes. "The tax has done comparatively well the last couple of years," he said. "Its growth has been flat, but that doesn't look too bad compared to the taxes in other states in the New England region."

New Hampshire is perhaps better known for its oddball tax system than its innovations in tax reform. It has one of the most unusual tax systems in the nation, with no individual income tax and no general sales tax. State government is funded mainly by selective taxes on meals and rooms, beer, tobacco, lottery sales, liquor sales, interest and dividends, and real estate transactions. Among the state's taxes, business taxes play a particularly prominent role, accounting for better than a quarter of unrestricted revenue.

Until the reforms that created the BET, the state's major business tax was the business profits tax (BPT) enacted in 1970. Before 1970 the state based its state and local tax systems largely on capital-based taxes, which was a barrier to investment, and resulted, according to state tax lore, in a ring of warehouses around New Hampshire.<sup>1</sup> The BPT replaced 13 different taxes on capital, stock,

<sup>1</sup>Charles Arlinghaus, "Taxes and the Economy," The Josiah Bartlett Center for Public Policy, undated, available at <http://www.jbartlett.org/files/pdf/Taxes%20and%20the%20Economy.ppt>.

and investment, and returned a large portion of the revenue to towns to replace the local taxes that were eliminated. Charles Arlinghaus of the Josiah Bartlett Center for Public Policy in Concord argues that the change from taxing capital to profits dramatically changed the state economy for the better. The initial BPT rate was set at 6 percent. The rate steadily increased to a high of 8.56 percent in 1983, among the nation's highest corporate rates, which itself became an issue some years later.

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Although the BPT nominally taxed unincorporated businesses as well as corporations, in reality corporations paid most of the BPT. The reason for that had to do with the treatment of compensation under the tax. Both corporate and noncorporate businesses were allowed to deduct compensation to labor from gross business revenue in calculating business profits. Unincorporated businesses were able to reduce reported compensation so that profits were effectively zeroed out for many businesses. The result was to shrink BPT liability for noncorporate businesses. A 1992 study by KPMG Peat Marwick found that while partnerships, fiduciaries, and proprietorships accounted for two-thirds of BPT returns, they produced only about 11 percent of BPT payments. The consultants concluded that "application of the business profits tax to all business taxpayers has not prevented the tax from becoming in essence a corporate profits tax on a fairly small fraction of the corporations doing business in New Hampshire."<sup>2</sup>

Arnold said:

The major taxpayers under the old profits tax were becoming more and more concerned. About 1 percent of total New Hampshire business taxpayers were paying something like 70 percent of the tax. They were, as you might expect, very large corporations. In the early 1980s, the legislature had increased the tax rate to deal with revenue problems. The rate was brought back down under Gov. [John H.] Sununu, but we still had a very high tax rate paid by a very few taxpayers.

<sup>2</sup>KPMG Peat Marwick, Policy Economics Group, "A Study of the New Hampshire State and Local Revenue Structure," submitted to the New Hampshire General Court, Feb. 13, 1992.

Arnold said that by the late 1980s, despite a relatively strong economy, the major business taxpayers were asking the legislature to reconsider the tax because they were worried that the next time the economy fell into recession, lawmakers would raise the BPT rate again. With all of the lobbying, business tax reform became a matter of rising legislative concern. "The legislature made a couple of attempts at reform in this period, and the result was a couple of approaches that didn't meet state constitutional requirements," Arnold said.

Beyond the concerns of the taxpayer community, the BPT had other problems that were becoming obvious. For one thing, it was tied to federal tax statutes, and the state was affected by changes in federal policy that were made with no regard for their effect on state revenue. Moreover, the federal Tax Reform Act of 1986 encouraged many businesses to change their business form to noncorporate entities, which resulted in their paying less in New Hampshire BPT. As in most states, the base was further eroded by the shift in the state economy from capital-intensive industries like manufacturing to a larger concentration on services.

**With the BET, legislators didn't fall prey to the temptation to create special exemptions for various types of businesses to fix perceived inequities, Arnold said.**

It was then that Arnold, who had worked with the legislature closely even before becoming commissioner, was asked to work on an alternative business tax strategy. He worked with a small technical group that included Bill Ardinger, who now works with him at Rath, Young and Pignatelli. "Our approach was to create a base tax so that everyone — all businesses — would have to pay something. One of our attorneys — Bill Ardinger — suggested a value-added-type approach with a tax base tied to compensation and capital," Arnold said.

The result was the BET enacted in 1993. The new tax didn't replace the business profits tax. Instead, it supplemented the older tax. The BET is levied on the "business enterprise value tax base," which consists of wages and other compensation, and interest and dividends. The initial tax rate was 0.25 percent. Businesses with gross business receipts less than \$100,000 and with a business enterprise value tax base less than \$50,000 were exempted from the tax. BET tax payments are credited against BPT tax liability — the higher a business's BET, the lower its BPT liability. As part of the reform, the BPT rate was reduced from 8 percent to 7 percent.

One of the significant features of the BET is its inclusiveness. Not only corporations, but also partnerships, proprietorships, and nonprofit corporations other than 501(c)(3)s were made subject to the tax.

Arnold said:

Including all types of businesses had a couple of important advantages. First, it allowed a reduction in the business profits tax, so the taxpayers who were paying most of that tax worked hard to pass the BET. In addition, since all types of businesses were in the tax, it was clear that everyone was being treated more or less equally. Legislators didn't fall prey to the temptation to create special exemptions for various types of businesses to fix perceived inequities.

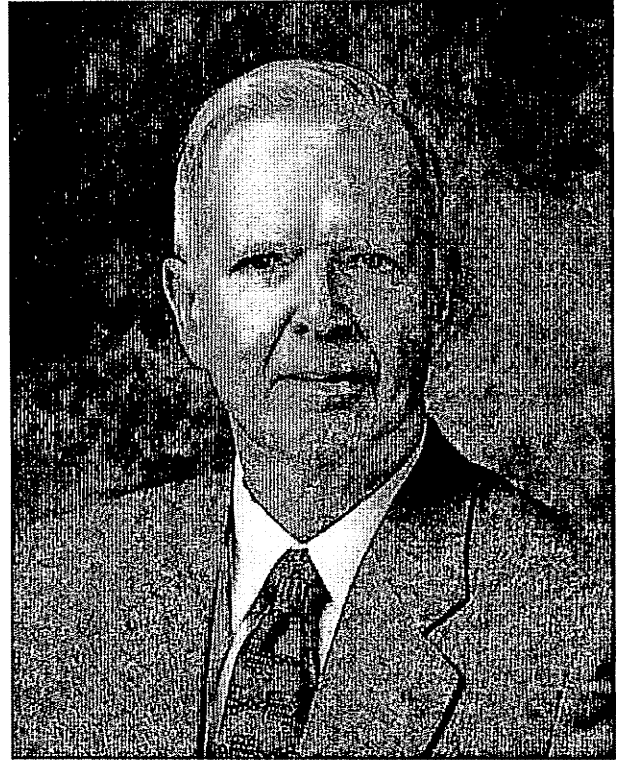
Arnold said a key to the tax's success is that it was designed in the most practical way possible. He admits the tax isn't theoretically pure, just workable. He said:

The tax was never intended to be pure. It was intended to solve a problem. We made the decision that rather than making wholesale changes in the business tax system, we would take the system everyone was familiar with and work from there. The information needed to compute the BET was exactly the same as you needed for the business profits tax. You calculate the BET, carry over that tax to the BPT return and calculate total tax due. A business's business enterprise tax liability is, effectively, a credit against BPT liability.

From an administrative standpoint, the tax calculations are comparatively straightforward. There aren't a lot of adjustments. That, I think, is one of the problems with the new business taxes that have developed in the last few years. They have so many adjustments, I'm not sure how anyone knows how much revenue they're going to produce, and if you look at what's happened with the taxes, that's just what's happened — no one is sure how much revenue the taxes brought in or what will happen in future years.

Arnold emphasized that one component of the BET's success was that all business entities with the exception of 501(c)(3)s had to pay tax. "The CPA Society has to pay tax if they meet the requirements of the minimum tax," he said. "We wanted to spread the base as far as we could — to everyone but purely charitable organizations."

Arnold said one of the hurdles that had to be overcome was, oddly enough, the low rate of the BET, which was originally set at 0.25 percent. "People were worried that if you had a low rate it would be easy to increase. It's been 15 years. They've raised it a couple of times — it's currently 0.75



*Stan Arnold, former commissioner of the New Hampshire Department of Revenue Administration*

percent — but not much. The reason for that is simple — all businesses had an interest in the tax. They're involved in it. They pay attention."

I asked Arnold if he saw the trend toward alternative business tax bases as a sign that the era of the traditional corporate profits tax was past, that changes in the economy and business practices were rendering it obsolete. He agreed that business forms have changed, and that has undercut corporate taxes to some extent. "There are many more flexible business arrangements now that didn't exist in the past, particularly those that flow income through to the income tax, like LLCs," he said.

However, Arnold believes, other factors may be moving states toward alternative business tax forms. "I think there are a couple of other explanations for the interest in alternatives to the traditional corporate taxes," he said. In some cases, there are problems with business tax policy that have nothing to do with business entity forms. Instead, the problems are the creations of the state's own policy choices. "Many states are giving more and more breaks like shifting to a single receipts factor for apportionment. They are giving the tax base away, so how can they not expect the business share of taxes to shrink?" he said.

A second factor, he said, isn't tied directly to the business tax, but to the overall environment in which tax policy is made. Some states, he said, have lost control of the tax policy agenda. Arnold said:

The other piece is more indirect. Many jurisdictions have referendum provisions. Citizens have taken control of taxation through that process. The result is that the states can't raise taxes on individuals. As a result of that, the states have to look for taxes that don't tax people directly, hence the interest in expanded business taxes. It's a response to a failure on the side of individual taxes.

Arnold said you don't have to look much further than one of New Hampshire's neighboring states to see the potentially destructive effect of referendum provisions. He said:

When a state does choose to raise personal taxes, they may wind up in a situation like in Massachusetts recently, where the citizens' response to a tax increase proposal was to seek a public vote on ending the tax entirely. In that case, it didn't work, but it could have been a fiscal disaster.

In the end, the question is how else are the states going to get the money they need for the services they've promised to deliver? They can't walk away from business taxes entirely. If the traditional taxes don't work for whatever reason, then they have to look for other approaches. In a sense, that's what led New Hampshire to the BET. The BPT wasn't working. The tax rate was too high and the base too narrow. We had to find a workable alternative, and time has shown that we did.

However well the BET did its job over almost two decades, the whole of the New Hampshire revenue system, including the BET, is under enormous pressure right now. In December 2007, when the national recession started, New Hampshire's revenue was growing at a rate of about 7 percent a year, but shortly thereafter tax growth started to slow. By October 2008 total New Hampshire state revenue was declining compared with the previous 12 months, and it has continued to fall. For the 12 months up to September 2009, New Hampshire revenue destined for the general fund and education trust fund was 6 percent less than the previous 12-month period. The decline in state revenue has been broad based, affecting all revenue sources, be it business, consumer spending, or gambling.

The business taxes have been particularly problematic, reflecting the general weakness of the state economy. In fiscal 2009, which ended June 30, collections from the two business taxes were 21 percent below prior-year levels and an even larger percentage below the state's revenue projections. In the first months of fiscal 2010, collections have continued to

decline even compared with the previous (lousy) fiscal year, although the decline has slowed considerably. The business taxes are not alone in their problems. Among major state revenue sources, the only ones that were growing in the first three months of the fiscal year were the tobacco taxes and liquor store sales.

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Large revenue declines cause large budget problems, and earlier this year, New Hampshire found itself in a major budget dilemma. After considerable wrangling, the legislature in late June finally passed a combined tax and spending bill for the two-year budget period starting July 1. The \$11.6 billion budget compromise package raises the cigarette tax 45 cents to \$1.78 per pack, increases the tax on restaurant meals and renting hotel rooms to 9 percent, and applies the state's 5 percent tax on dividends to limited liability companies.

In what proved to be one of the more unpopular parts of the plan, the rooms tax was extended to campers — what has come to be known as the "tent tax." Lawmakers also raised vehicle registration fees by \$30 for passenger vehicles and \$15 for vanity plates. Both increases are designed to shore up the highway fund used to maintain roads and bridges. Lawmakers also approved a 10 percent tax on gambling winnings.

Despite all the tax and fee increases, there were budget cuts and a little smoke and mirrors involved as well. State employee costs have to be cut by about \$25 million. Other cuts were also made. And the state dipped into its Joint Underwriting Association (JUA) surplus. The JUA is a state-founded organization that provides malpractice insurance to state doctors. That part of the budget plan remains up in the air. The JUA filed a lawsuit against the state to keep its funds, and the Belknap County Superior Court ruled against the state in July. New Hampshire appealed the decision in the state supreme court and is awaiting a verdict after an October hearing.

If the New Hampshire Supreme Court does not overturn the lower court's decision, the funds will be returned to the JUA, leaving a \$110 million gap in the budget plan. That potential pitfall has triggered widespread speculation about more tax increases or budget cuts to come. Republicans have also called for a rollback of the tax increases and more spending cuts. Adding to the problem, revenue for fiscal 2010 is already well short of the state's plan, and a recent analysis by the national Center on Budget and

Policy Priorities found that New Hampshire's shortfall for this fiscal year could wind up at \$250 million, with another \$250 million shortfall next year.<sup>3</sup>

Perhaps sensing more problems to come, the House and Senate Democratic leadership in late October announced plans for a two-day hearing intended to elicit information and recommendations about how to make state revenue match the state's spending needs. House Ways and Means Committee Chair Susan Almy (D) said the sessions, held on October 21 and 22, were important to educate lawmakers and update information on the revenue system for the first time in almost two decades — since the BET was put into effect. “We have a highly imperfect tax system,” Almy told reporters shortly before the hearings. “This will give us a better opportunity to understand the structure. We are accused by some of not doing our jobs well, so this is an opportunity to make us all more knowledgeable.”

Critics, though, suspected darker designs, labeling the seminar a “tax summit” and charging that it was intended to pave the way for a state income tax. In response, Republican legislative leaders held their own “summit” on state spending, concluding mainly that the budget needed further pruning.

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The outcome of the revenue meeting was less clear-cut. The committees heard from two dozen witnesses, including economists, demographers, business community representatives, community leaders, a couple of journalists, and what looks like a blogger or two. All in all, the testimony provided no unified theme about what the state should do or could do to “fix” its revenue system.

The committee members were told, among other things, that New Hampshire ranked seventh overall in the country in the 2010 State Business Tax Climate Index produced by the Washington-based Tax Foundation, a national policy research group that analyzes government tax and fiscal activities. When foundation researchers looked at New Hampshire's business taxes alone — the BPT and the BET — the picture was the complete opposite: The state had the worst ranking in the country.

<sup>3</sup>Elizabeth McNichol and Nicholas Johnson, “Recession Continues to Batter State Budgets; State Responses Could Slow Recovery,” Center on Budget and Policy Priorities, Oct. 20, 2009, available at <http://www.cbpp.org/cms/?fa=view&id=711>.

Some of the testimony favored an income tax, while other testimony favored a general sales tax coupled with a business tax rate reduction. Yet other testimony suggested that an income tax would be ruinous to the state, and another commentator said adopting any broad-based tax would destroy the state's key economic advantage over other New England states. “New Hampshire is to the Northeast what Switzerland is to Europe; that is, a refuge, if you will, [from] oppressively high taxes in neighboring areas,” Scott Hodges of the Tax Foundation told lawmakers.

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There is, perhaps, such as thing as too much knowledge to be had on the subject. “It’s as clear as mud, isn’t it?” Rep. Gary Richardson (D) asked a reporter at one point during the hearings.

Arnold didn’t testify at the hearings, but I asked him what he made of the proceedings. He said:

They really were just political theater at some level. Some of the tax changes made in the last legislative session were added at the last minute without hearings. They are going to be difficult to put into effect.

Arnold cited, for example, a provision applying the state’s 5 percent tax on dividends to LLCs, on top of the BET. Arnold said:

The whole thing turned into a horror show. It was not the way to adopt good tax policy and not well thought through. It likely will not bring in the dollars that were predicted. At some point, they’re going to have to do something about the problems caused by these last-minute changes. So for now, you hold a tax summit and hope the economy comes back.

The problems with New Hampshire’s businesses tax, Arnold believes, are largely a product of economic conditions, and economic conditions for most states have been so severe that there isn’t a way for any tax system to cope adequately. He still believes that the BET offers a beneficial approach to state business tax reform for states that are considering making changes to their current tax regime. He believes it’s an important issue.

“State taxation is such an interesting field,” Arnold said, sounding like an accountant, although a broad-shouldered one. “It’s a field that can have such an impact in ways that really affect the people of a state. It’s been a great field to be in.”

I asked if he has any plans to slow down anytime soon — to spend less time on taxes and more on skiing and golf, his two favorite outdoor activities in outdoor-activity-crazy New Hampshire. He doesn't plan to. He'll go on talking about taxes and particularly the BET to anyone who's interested. "It's really a passion," he said. "I enjoy talking to people about tax ideas. I'm available if anyone wants to talk. I'm here." Actually, when I last talked to him, he wasn't there. He was heading for Rhode Island — to talk about the BET. ☆

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where to find them.*

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