Special Report / Viewpoint

Top Ten Reasons Why New Hampshire's BET May Provide An Answer to State Tax Reform

by Stan Arnold and William F.J. Ardinger

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Introduction

Traditional state taxation systems face uncertain futures, with a variety of very threatening storm clouds on the horizon. Efforts to shore up these traditional tax systems are draining the energy of the nation's top state taxation experts from the public and private sectors. But fundamental changes in our economies, technologies, and public attitudes about taxation mean that these efforts may simply be prolonging the inevitable demise of these traditional systems.

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New Hampshire has one of the most unique tax systems in the nation. It has no individual earned income tax. It has no general retail sales tax. Over the last 30 years, many within and outside of the state have criticized New Hampshire's tax system as "behind the times" and "out of step."

The authors are now colleagues in the same private New Hampshire law firm, but before that, we worked for years on either side of the public/private divide — one as the 14-year commissioner of the New Hampshire Department of Revenue Administration, and the other as a leading practitioner representing business taxpayers. In those roles, we participated in the development, enactment, and implementation of New Hampshire's business enterprise tax (BET) in 1993.

As many states struggle to revise the scope and nature of traditional state tax systems, we have been impressed with the fact that the history and structure of the BET may provide relevant guidance to policymakers as they address various difficult questions concerning tax reform. We understand that any tax reform discussion necessarily involves "winners and losers." We do not advocate here for any particular tax policy. However, we believe that once New Hampshire's BET is contrasted with many of the changes currently under consideration (for example, expanding the traditional retail sales tax to services), the BET could prove to be a better choice in the long run.

Here are the top ten reasons why we believe New Hampshire's business enterprise tax may be a "good BET" for state tax reform deliberations.

***Number 10:* It is an economically neutral tax.** In its essence, the BET is a multistage consumption tax or value added tax (VAT) imposed and administered at the business level.[1] In its most comprehensive form, a VAT is a tax on consumption in the economic sense. The tax base is equal to the value of goods and services consumed by the economy. Tax policy experts have long held that one of the most important goals of a tax system is economic neutrality — the tax system should not alter economic choices that would otherwise be made. Economists have acknowledged that a comprehensive tax on consumption would be an economically neutral tax.[2] For example, unlike the corporate income tax, a tax on consumption would not prefer one form of capital over another (by providing a deduction for interest, but not for dividends as in the corporate income tax).

This economic neutrality is in stark contrast to the traditional general retail sales tax, which many refer to as a single-stage consumption tax (see below). In fact, traditional sales taxes deviate substantially from sound tax policy because they apply to purchases made by businesses.[3] True consumption taxes should seek to measure consumption of goods and services by households and should exclude "cascading" or "pyramiding"

[1] *See* Daphne A. Kenyon, "A New State VAT: Lessons from NH," 49 *Nat'l Tax J.* 381-399 (September 1996).

[2] *See for example*, David F. Bradford and U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform* (Tax Analysts, 2d Ed., 1984).

[3] *See* Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, section 12.01(1999).

taxation of inputs used by firms to add value.[4] As demonstrated below, the BET, with some compromises, is designed to avoid that problem.

So, in general, the BET, as a tax on consumption or value added, meets a basic requirement for good tax policy because it is economically neutral, certainly more so than the corporate income tax. But as indicated by our prioritization of this "good policy" point as reason No. 10, we believe that some of the practical benefits of the BET offer even more important reasons why it should be on the state tax reform agenda.

Number 9: **It is a simple tax to compute and administer.** Consumption in an economy can be measured in several ways. One measure is to value all sales of goods and services at retail, because this value reflects all value added through the process of production and distribution of goods and services in the economy.[5] Traditional state retail sales taxes reflect this type of single-stage consumption tax. A consumption tax can also be implemented on a multistage basis, requiring each firm in the production and distribution process to compute its value added, based on its employment of labor and capital in its business. The sum of the value added of all firms in an economy is equal to the economy's total value added.

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There are three ways to compute value added under a multistage VAT. European-style VATs utilize an invoice-credit method, in which each firm charges tax on each sale transaction, and is allowed a credit for all VAT it paid on its business inputs. A VAT can also be computed using a subtraction method (like the Michigan single business tax), in which each firm pays an annual tax on the difference between its gross receipts and its costs of purchased business inputs. Or the VAT can be computed using an addition method (like New Hampshire's BET), in which the tax base is equal to the value of labor and capital inputs employed by each firm as measured by the sum of amounts "paid" to compensate labor and capital employed in the business (for example, compensation paid to labor, dividends paid and earnings retained for the benefit of equity owners, interest paid to providers of debt capital, and other returns such as rent and royalties paid to providers of other assets employed in the business). From an accounting perspective, all of these methods are equivalent means of computing value added.

New Hampshire selected the addition method for its simplicity in computation and administration.[6] Indeed, the legislature accepted several deviations from pure consumption tax theory in favor of simplicity, such as eliminating from the tax base retained earnings, and other components reflecting the use of intellectual property (royalties) or real estate (rent). The New Hampshire BET system uses an annual accounting period based on three simple components (compensation paid to labor, dividends paid to equity capital providers, and interest paid to debt capital providers) that rely on accounting information commonly used by most business organizations. It can be audited using the methods traditionally applied by state corporate income tax auditors. The BET therefore avoids the transaction-based recordkeeping that has caused businesses to object so strongly to the traditional sales and use tax imposed by many states, not only on individual consumers, but also on firms.

We wonder how long it would take the business community to accept the BET as a replacement for the application of traditional single-stage retail sales and use taxes to businesses. Under the BET, there would no longer be a need to determine and prove whether the purchase was a sale for resale, whether the product was being consumed in the production of goods, or whether the seller had already collected sales tax. Moreover, under the BET, businesses would need to maintain only annual accounting records similar to those used under corporate income tax systems, rather than volumes of sale-for-resale certificates. State auditors would no longer need to undertake statistical samples of large volumes of transactions. The BET compares favorably on simplicity grounds.

Number 8: **It is a fair tax.** The BET is applied to all business enterprises, regardless of how they are organized. One of the reasons that *State Tax Notes* reports regular complaints about the continuing deterioration of the corporate income tax is that less and less business activity is carried on in traditional corporate form. More and more business activity in the United States is being conducted through S corporations, limited liability companies, joint ventures, partnerships, or sole proprietorships. For federal income tax purposes, these latter entities are generally not subject to entity-level taxation; rather, their owners are taxed on their respective shares of the entity's income. Most states follow this "passthrough" treatment.

By its very terms, a tax only on corporations that are treated as C corporations for federal income tax purposes is a narrow tax that fails to reach many of the growing parts of our economy, such as the service sector, which are often conducted through noncorporate forms. The BET was enacted specifically to "broaden the base" so that all business entities that use labor and capital in the state would be required to contribute to supporting the cost of government.[7] Prior to the enactment of the BET, New Hampshire's business tax burden was borne solely by a few larger enterprises that operated in corporate form.[8] After the BET, all business firms — capital-intensive manufacturers organized as corporations with many shareholders, closely held corporations that could reduce net income

[4] It has been estimated that roughly 40 percent of state sales tax revenues are attributable to business purchases. *Id.*, citing Raymond J. Ring, "Consumers' Share and Producers' Share of the General Sales Tax," 52 *Nat'l Tax J.* 79-90 (March 1999).

[5] *See* Charles E. McLure Jr., *The Value Added Tax* (AEI 1987).

[6] A detailed summary of the structure of the BET is set forth in Berghaus and Ardinger, "Policy and Structure of the BET," *N.H.B.J.* (December 1993).

[7] *See* Commissioner Arnold, "Report to the Governor — New Hampshire Business Organization Tax Reform Plan: Fairness, Simplicity and Economic Growth" (February 1993) (hereinafter, the "Commissioner's Report"). New Hampshire's Constitution has been construed to require strict uniformity and proportionality so that the legislature does not have the power to impose a tax on corporations and exclude other business enterprises that are "similarly circumstanced." *Opinion of the Justices*, 82 N.H. 561, 564 (1927); *see also Opinion of the Justices*, 106 N.H. 202, 206 (1965) ("We have said that a tax on corporations, while allowing individuals in like businesses or vocations to go free, is unconstitutional").

[8] "The [BET] proposals seek to address the actual and perceived inequity within the current [Business Profits Tax], which permits one-half of one percent of the nearly 70,000 businesses who file a return to pay over 70 percent of BPT revenues." "Commissioner's Report" at 1.

by paying compensation to owners, or law firms operating through partnerships — were required to pay tax on the factors of production employed in their operations.[9]

***Number 7:* It is a comprehensive tax.** Not only is the BET a fair tax because it applies to all forms of business organizations, it is a comprehensive tax because it applies to all types of economic activity. The BET applies to all firms and all economic activity, including the growing service sector, on an equal basis.

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The BET's comprehensive nature is distinguishable from traditional retail sales taxes, which generally apply only to tangible goods. Tax policy experts have long criticized the fact that traditional general retail sales taxes typically apply only to tangible goods and therefore do not apply to the full scope of goods and services consumed by households in our economy. One of the most compelling reasons why traditional retail sales taxes are dying on the vine is that they typically apply only to sales of tangible property and do not typically apply to sales of services. Could traditional retail sales taxes be expanded and applied to retail sales of services? Yes, but not without overcoming some very serious political and administrative challenges, such as determining where a service is performed when the business is located in more than one jurisdiction, creating disincentives for a service industry to locate in the state, and collecting tax from service businesses with no nexus to the state. And such an extension would only compound the cascading or pyramiding problems arising from including additional business inputs (the bulk of services are purchased by firms) within the retail sales tax system.[10]

The BET applies to all firms that employ labor and capital within New Hampshire, regardless of their form of organization or their type of business activity. It reaches the economic activity represented by the growing service sector so that all firms contribute to defray the cost of government. And it avoids the significant administrative difficulties that stymie efforts to stretch traditional retail sales taxes to sales of services. Again, if presented with a choice, we wonder whether businesses would select the BET as a method of broadening the scope of taxation to the service sector as opposed to torturing traditional retail sales tax formats to extend to services.

***Number 6:* It is deductible for federal income tax purposes.** This is an easy one. As noted above, the authors believe a number of practical realities recommend consideration of the BET for basic tax reform. One of these practical points is that the BET is deductible for federal income tax purposes. While Congress recently has seen fit to allow a very narrow window (through 2005) in which state taxpayers can deduct sales taxes (but only if they give up the state income tax deduction),[11] the traditional retail sales taxes paid by individual consumers are generally not eligible for any federal tax deduction. There is almost no justification for continuing to cling to a state tax system that is not eligible for a federal tax deduction that, in effect, transfers some of the burden of the tax from local taxpayers to the federal government.

***Number 5:* It was enacted as a revenue-neutral tax reform.** In today's political environment of "just say no" to new or increased taxes, we do not recommend that the BET be enacted simply as a new tax on top of already burdensome business taxes. In New Hampshire, the BET was enacted as part of a comprehensive restructuring of a number of aspects of New Hampshire taxation that was, in the aggregate, revenue-neutral.[12] As part of the legislative package that led to the BET's enactment, New Hampshire lowered the tax rate of its business profits tax (BPT, a tax on business net income), and repealed an outmoded bank franchise tax and corporate franchise fees.[13]

This approach represents a long-term approach to tax reform — substituting an economically neutral, simple, fair, and comprehensive tax for other less viable and outmoded taxes and fees, and allowing a reduction in the tax rate for the state's traditional BPT. Over the long term, this substitution has strengthened New Hampshire's overall revenue system. Given the New Hampshire electorate's uniquely strong opposition to expanded government and taxes, we are not confident that New Hampshire could have accomplished this important long-term improvement if the BET had been proposed as a new tax layered on top of old taxes.

***Number 4:* It avoided an "all at once" academic approach to tax reform.** The BET represents real tax reform (a shift from income taxation to consumption taxation), but its enactment did not purport to radically alter the landscape of taxation in New Hampshire. Indeed, New Hampshire retained its longtime business profits tax, and adopted the BET as an alternative tax that is allowed as a credit against BPT liability.[14]

This alternative tax approach offered several practical benefits. First, even though the reform included a reduction in the BPT rate (from 8 percent to 7 percent), it ensured that the legislature would not experience material unanticipated revenue losses or gains as a result of the change. This assurance made it easier for the legislature to consider tax reform. Second, the alternative tax approach allowed for the implementation of tax reform over a longer period of time in a manner that did not materially disrupt expectations of larger employers that typically would continue to pay the BPT amount. Indeed, the state was able to send a strong and positive competitive signal to these businesses by lowering the BPT rate just when New England was recovering from recession.

***Number 3:* It addresses the jurisdictional challenges to traditional tax systems resulting from changing economies and technologies.** As our economy becomes more electronic and more global, the ability of traditional state tax systems to

[9] Small businesses with gross receipts of less than $150,000 and a tax base of less than $75,000 are exempt and are not required to file a BET return. RSA 77-E:5, I.

[10] For example, in remarks to the 5th Annual COST/State Chambers of Commerce Tax Policy Conference on September 21, 2004, Dr. Robert Cline indicated that businesses would pay 75 percent of new taxes resulting from extending the sales tax to services.

[11] American Jobs Creation Act of 2004, H.R. 4520, 108th Cong. section 591 (2004).

[12] *See* "Commissioner's Report," Appendix I.

[13] 1993 N.H. Laws section 350.

[14] N.H. Rev. Stat. Ann. section 77-A:5 (2003). This credit may be carried forward for five years.

capture new forms of economic activity has been challenged.[15] Herculean efforts like the Streamlined Sales Tax Project have been mounted to prop up traditional retail sales taxes that struggle to subject out-of-state electronic commerce retailers to collection responsibilities. Other battles are under way in Congress to expand or contract jurisdictional reaches of state business taxes, again partly in response to continuing deteriorations in business tax revenues as multijurisdictional businesses adopt legal structures to reduce tax costs.

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We believe that the BET provides a practical answer to many of these important jurisdictional concerns. First, the BET uses well-established apportionment principles to allocate a firm's BET base among jurisdictions.[16] Second, because of the comprehensive nature of a multistage business-level consumption tax, the BET base is not susceptible to the income-shifting transactions that have reduced corporate income taxes. Third, because the BET is not an income tax, the limitations on state tax jurisdictions imposed by Public Law 86-272 do not apply. Indeed, because the BET has been implemented as part of a comprehensive business tax system including a business income tax, the reporting obligations of the BET have helped the New Hampshire Department of Revenue Administration identify taxpayers who should be filing tax returns.

Number 2: **It is a financially stable tax.** One of the greatest challenges to state tax systems is to build stable and diverse sources of revenue that will expand with the economy over time without being overly exposed to volatility with changes in the business cycle. State governments have generally proved to be unable to manage budgets well through "boom" and "bust" periods (for example, raising spending when personal income tax revenues are flush with capital gain income, rather than funding reserves to address the inevitable downturns in such volatile revenues). In today's competitive environment, volatile revenues, with the corresponding need for frequent and significant increases in tax rates, may be the greatest obstacle to attracting new businesses and jobs.

A major goal of the BET was to increase the stability of New Hampshire's overall revenue systems. Prior to the BET, New Hampshire regularly struggled to mitigate the effects of the BPT's volatility. For example, from 1988 until 1992, New Hampshire saw BPT revenue drop from a high of $146 million to a low of $98 million, a drop of 33 percent.[17] Given New Hampshire's proportionately greater reliance on this revenue source, such volatility greatly undermined the state's ability to project a certain and stable government infrastructure.

The BET has proved to be a much more stable tax than the BPT, which is based on business income. Our preliminary analysis suggests that as BPT revenues have declined significantly as a share of total state revenues during the most recent recession (2000-01), the BET's share has been stable or even increased. This result is not surprising given the differences in the tax bases. A 2001 study of revenue options available to address recent public education funding challenges concluded that an additive method VAT similar to the BET would generally grow with personal income, and it would be relatively more stable and less sensitive to the business cycle than any other tax, except for the property tax.[18]

And the Number 1 Reason: **It is a politically stable tax.** Our top reason why the BET should be considered as a candidate for state tax reform is that it may be better-suited than many traditional state tax systems to withstand one of the greatest threats to tax stability in the United States — the rise of direct voter power over tax law. Analysts have observed that voter opposition to taxes as reflected in their approval or disapproval of tax initiatives has grown over the last couple of decades.[19] The percentage of "antitax" initiatives that have passed has been increasing steadily.[20] Some have suggested that this increase in direct democracy reflects a pervasive sense of public frustration and alienation with political institutions that have failed to adopt reforms to meet the demands of the new technological information age.[21]

In 2002 voters in Massachusetts surprised many observers by defeating only narrowly a ballot initiative to repeal the state's personal income tax. *The Wall Street Journal* reported: "An amazing 46% of voters in the state formerly known as Taxachusetts voted to *abolish* the income tax . . . "[22] Just two years before, the same Massachusetts voters passed by a 59 percent majority a ballot measure to reduce the state's personal income tax rate to 5 percent. Other states have seen voters take direct action to reduce automobile taxes, inheritance taxes, and, of course, to limit property taxes. In contrast, initiatives to raise taxes, while becoming more frequent, have fared poorly.[23]

It is not our goal here to question whether the rise of direct voter power over tax law is "good" or "bad." However, there can be no question that one certain result of this trend will be increasing direct challenges to traditional state tax systems that are imposed directly on voters (for example, personal income taxes, retail sales taxes, and property taxes). We fear that these challenges may threaten the stability of state revenues and therefore the infrastructure that can support a positive and stable environment for business growth.

The BET can be viewed as a tax system that is somewhat insulated from the rise of direct voter power over tax law. While the tax base is generally household consumption, the multi-

[15] *See* Walter Hellerstein, "Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective," 38 *Ga. L. Rev.* 1 (2003).

[16] The BET uses special apportionment factors for each component of the tax base. These factors were designed to satisfy the principles set forth in *Trinova Corp. v. Michigan Department of Treasury*, 498 U.S. 358 (1990). *See* Berghaus and Ardinger, *supra* note 6, pp. 11-12.

[17] During this period the legislature increased the rate of the BPT to make up for the falling revenue, so the actual drop was 37 percent.

[18] Report of the New Hampshire Commission on Education Funding (Jan. 8, 2001).

[19] B. Piper, *A Brief Analysis of Voter Behavior Regarding Tax Initiatives From 1978 to March 2000* (Initiative and Referendum Institute).

[20] From 1978 to 1989, 43 percent of antitax initiatives across the United States passed; 53 percent passed between 1990 and March 2000; from 1996 to March 2000, 62 percent of antitax initiatives passed. *Id.*

[21] *See* Caroline Tolbert, *Direct Democracy as a Catalyst for 21st Century Political Reform*, located at http://www.iandrinstitute.org/Studies.htm.

[22] *The Wall Street Journal Online*, "Review and Outlook, Common Sense at the Polls," Nov. 7, 2002.

[23] For example, in September 2003, Alabama voters defeated a proposed $1.2 billion tax increase by a margin of 68 percent to 32 percent.

stage BET is imposed and administered at the business level. This business-level administration offers several practical benefits. First, businesses typically are in a better position than individuals to maintain accounting records, prepare tax returns, and manage any compliance issues. Second, and perhaps most importantly, it avoids putting individuals through an annual tax return preparation exercise that often produces high anxiety and antagonism toward government even though most individual returns produce refunds of tax that has already been withheld and paid over to government by employers.

Some might criticize this analysis on the grounds that the BET could become a "money machine" for government because the tax burden is not "transparent" to, or directly felt by, voters. We think such a criticism would be misplaced. In today's very global and mobile economy, governments simply no longer have the luxury to raise taxes indiscriminately on business. Capital and jobs quickly flow out of noncompetitive high-tax jurisdictions to places with stable and competitive economic attributes. Indeed, in New Hampshire, the BET has served the role of uniting the entire business community — larger capital-intensive businesses, smaller closely held businesses, manufacturing firms, and service-sector businesses — in a single political force to ensure that government remains responsive to the needs for a competitive, stable, and low-tax business environment.

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In our experience, the most important engine for improving the quality of life in New Hampshire is the business community and the jobs that it offers to residents. We have found that businesses desire both competitive and stable tax systems that promote long-term planning and investments. For the reasons stated in this article, we believe the BET could be an important component of states' response to changes in our economies and challenges to traditional tax systems. ✰