ANALYSIS OF THE MONTANA CORPORATION INCOME TAX STRUCTURE

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INTRODUCTION

Montana is 1 of 44 states and the District of Columbia that taxes the net income of corporations. Michigan, Nevada, South Dakota, Texas, Washington, and Wyoming do not tax corporations on the basis of net income. Michigan imposes a modified value-added tax, Texas imposes a franchise tax based on net equity, and Washington imposes a gross receipts tax. South Dakota taxes financial institutions on the basis of net income but does not tax other corporations.

Taxes on corporate net income differ significantly among the states in terms of tax rates, methods of apportionment, and definitions of the taxable unit and taxable income. This report analyzes the Montana corporation income tax structure. It reviews the rationale for taxing corporate net income, describes the level of corporate income tax collections, and compares the Montana tax structure with that of other states.

RATIONALE FOR TAXING THE INCOME OF CORPORATIONS[1]

There are two major rationales for taxing the net income of corporations. The first is to protect the individual income tax base by including certain corporate source income, such as retained earnings, in the corporation tax base. If corporate income were not taxed, shareholders could hide income within the corporation. The corporate income tax is, however, an imperfect means of getting at this source of income. The tax on retained earnings could cause vertical inequities among shareholders because the rate structure faced by the corporation may be unrelated to the circumstances of the potential taxpayer. Horizontal inequities arise because corporate source income is taxed differently than other sources of income. In addition, shareholders would be subject to double taxation when

dividends are paid. Finally, if the corporation tax is not paid by shareholders but is shifted to workers (through lower wages) or consumers (through higher prices), both horizontal and vertical inequities may arise.

The second rationale for taxation of corporations is the benefits-received principle. Corporations receive many services from state and local governments. Net income, however, is a poor measure of the value of services provided. Obviously, corporations with no net income are not taxed (or taxed minimally) for services. To the extent that a benefit tax is appropriate for corporations, other tax bases may better reflect the value of services received. For example, real and personal property would reflect the value of such services as police and fire protection and improvements to infrastructure. Other taxes, such as a value-added tax or a gross receipts tax, would be better proxies for benefits received. Under value-added taxes or gross receipts taxes, businesses, whether profitable or unprofitable, would be required to pay for services.

MONTANA CORPORATION INCOME TAXES AS A SOURCE OF STATE REVENUE

Montana first levied a tax on the earnings of corporations in 1917. Montana was one of only six states (Connecticut, Missouri, Montana, New York, Virginia, and Wisconsin) and the Territory of Hawaii to impose a corporation income tax by 1917. The initial rate imposed on corporations doing business in the state was 1 percent of net income. The Montana Legislature has increased the tax rate six times since 1917. During the Second Extraordinary Session of the 42nd Legislature, the tax rate was increased from 6.25 percent to 6.75 percent (Ch. 7, 2nd Ex. L. 1971). That rate was made permanent during the 43rd Session of the Legislature (Ch. 5, L. 1974). The current rate is 6.75 percent of net income. (Multistate corporations electing water's-edge are taxed at 7 percent of net income. See below.) Multistate corporations whose only activity in the state consists of making sales and that do not own or rent real or personal property in the state and whose gross receipts do not exceed $100,000 may elect to pay a gross receipts tax of 1/2 of 1 percent (15-31-122, MCA).

In the past 20 years, two distinct trends in Montana corporation income tax collections may be observed (see Table 1). Between 1970 and 1981, total corporation income taxes increased steadily from $9.5 million to $52.9 million, or by an annual rate of about 17 percent. At the same time, corporation income taxes as a percentage of personal income also increased in an almost continuous upward trend, reaching a peak of 0.75 percent in 1981. Although not

as consistent, corporation income tax collections as a share of total tax collections generally increased during the period. The percent of total state tax collections derived from the tax averaged slightly over 8 percent between 1970 and 1981. Much of the consistent growth pattern in all three measures of corporation income taxes may be attributable to a relatively robust economy in the state that included energy and mineral development as well as growth in the wood products industry.

Corporate profits, and hence corporate income taxes, are very sensitive to economic fluctuations. Between 1982 and 1990, corporation income tax collections have exhibited the volatility normally associated with this tax. The back-to-back economic recessions of 1980 and 1982, the ups and downs of the natural resource industries, and changes in federal corporate income tax law all contributed to the swings in Montana corporation income tax collections, both in absolute and relative terms.

Table 1. Montana Corporate Net Income Tax Revenue, as a Share of Total State Tax Collections and as a Share of Total Personal Income

Fiscal Year	Corp. Tax Revenue (Thousands of Dollars)	Corp. Tax Revenue as a Share of Total Tax Revenue	Corp. Tax Revenue as a Share of Total Personal Income
1990	$80,316	9.36%	0.70%
1989	56,140	7.71%	0.54%
1988	46,200	6.46%	0.46%
1987	34,566	5.85%	0.36%
1986	58,585	9.49%	0.64%
1985	62,671	9.77%	0.70%
1984	35,396	6.07%	0.42%
1983	35,831	6.98%	0.44%
1982	44,630	8.43%	0.57%
1981	52,901	11.38%	0.75%
1980	45,623	10.47%	0.71%
1979	36,092	9.01%	0.62%
1978	29,239	8.64%	0.59%
1977	24,957	7.99%	0.55%
1976	23,020	8.29%	0.55%
1975	22,079	9.49%	0.57%
1974	15,736	7.15%	0.44%
1973	12,057	6.44%	0.40%
1972	11,523	6.30%	0.44%
1971	9,606	7.07%	0.39%
1970	9,536	7.40%	0.43%

Source: U.S. Bureau of the Census, State Government Finance, various years.
U.S. Department of Commerce, Regional Economic Information System.

Following 1981, corporation income taxes fell for 3 successive years. Corporation income tax collections fell dramatically in 1987 before increasing in each of the next 3 years. Corporation income taxes reached an all-time high of $80 million in 1990. A portion of the large increase between 1989 and 1990 is due to the payment of estimated taxes required by House Bill No. 56 of the June 1989 Special Session (Ch. 9, Sp. L. June 1989).* Corporation income taxes fell to $70.8 million in 1991. Corporation tax collections as a share of total state taxes averaged slightly less than 8 percent from 1982 to 1990.

Table 2 compares the percentage distribution of corporation income taxes with other taxes levied by the state and with the United State as a whole. Corporation income taxes account for less than 10 percent of total tax collections both in Montana and in the nation as a whole. In 1989, corporation taxes were slightly less important in Montana than in the United States. In 1990, they were more important in Montana.**

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* House Bill No. 56 was enacted, in part, to deal with the unfunded liability in the workers' compensation fund. Accelerated corporation income taxes (estimated taxes) provided the cash to help reduce the unfunded liability.

** Using 1990 as a comparison year may be somewhat misleading. In that year, the U.S. Bureau of the Census included for the first time property tax revenue from the countywide

Table 2. Percentage Distribution of State Tax Revenue, FY 1989 and FY 1990, Montana and U.S. Average

	Montana		U.S. Average	
	1989	1990	1989	1990
Individual Income Tax	36.5%	32.6%	31.2%	32.0%
Corporate Income Tax	7.7%	9.4%	8.4%	7.2%
Sales Taxes	24.6%	21.3%	48.7%	48.9%
General Sales	-0-	-0-	32.9%	33.2%
Selective Sales	24.6%	21.3%	15.8%	15.8%
License Taxes	11.0%	10.7%	6.2%	6.3%
Severance Taxes	11.7%	11.2%	1.5%	1.6%
Other Taxes	8.5%	14.8%	4.0%	4.0%

Source: U.S. Bureau of the Census, State Government Tax Collections, 1989 and 1990.

levies for schools as state tax revenue (and may have counted it as local tax revenue as well). In addition, the corporation estimated tax payments represent one-time revenue.

MONTANA CORPORATION INCOME TAX STRUCTURE

Like most states that impose a corporation income tax, Montana is tied to the federal system. In 1961, the Montana Legislature adopted the federal definition of gross income to include the income from all sources within the state that is recognized in the determination of the corporation's federal income tax liability (Ch. 235, L. 1961). Federal taxable income is the starting point for determining a corporation's Montana tax liability. Several items are added to and subtracted from the federal base. Additions to taxable income include federal, state, or foreign income taxes paid, federal exempt interest, federal capital loss carryovers, and federal net operating losses. Subtractions include federal jobs tax credit, state income tax refunds, computer donations, energy conservation investments, and capital gains and dividends received from a small business investment company.

Corporations can further reduce their tax liability by taking advantage of a wide range of tax credits presumably designed to encourage certain kinds of business activity. These include credits for new or expanding manufacturing industries, investment in wind-generated electricity, investment in a Montana small business company, the provision of employee dependent care, the provision of disability insurance for employees, and contributions to Montana higher education endowment funds. These credits may not be available to all corporations.

Apportionment

Most state corporate income taxes are paid by multistate firms.*[2] In order to allocate net income in a manner reflecting a multistate corporation's activity within a state, most states employ some form of unitary taxation based on formula apportionment. The apportionment formula is applied to the nationwide (or worldwide) income of the firm and its affiliates. A three-factor formula, which considers property, income, and sales, is the most common method of apportionment. This method of allocating income to a state eliminates the possible manipulation of transactions between divisions of the same corporation that would occur under separate accounting. Under separate accounting, the corporation determines, for each state, gross sales, the cost of goods sold, and

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* In Montana, the percentage of corporate income taxes paid by multistate firms varies from year to year. Typically, 100 corporations pay about 50 percent of the corporation income tax. Of those corporations, 70 to 80 percent are multistate firms.

the cost of all factors of production in order to arrive at the total net income in each state.[3] As a result, income can be allocated to a low-tax state through transfer prices set between divisions of the corporation. It is very difficult to determine whether transfer prices represent arm's-length transactions.

Montana requires worldwide unitary combination for tax purposes unless a corporation elects water's-edge combination. Under worldwide combination, affiliates operating anywhere in the world are included in a combined report if they are engaged in a unitary business with the firm operating in Montana. A multistate firm is part of a unitary group if the activity of the business is "dependent upon or contributory to" business activity outside the state (other states or foreign countries). If a domestic corporation operates worldwide, its worldwide net income would be apportioned to Montana under the formula. Similarly, a foreign parent corporation operating in the state would also be subject to worldwide unitary taxation. On the other hand, the income of the foreign parent would not be subject to worldwide apportionment if its only presence in the state is through a United States subsidiary corporation. Several states employ a domestic unitary apportionment; that is, only corporations created or organized in the United States are included in the unitary group.

Although the U.S. Supreme Court has liberalized state use of the worldwide unitary concept, pressure from foreign countries as well as multinational corporations headquartered in the United States has caused a number of states to modify the application of the worldwide principle.[4] In 1984, 12 states employed some version of the worldwide unitary concept.[5] By 1991, only Alaska required worldwide unitary combination. Several states, including California, Idaho, Indiana, Montana, North Dakota, and Utah, provide for a water's-edge election.[6] Under this election, foreign firms not operating in the United States are excluded from the combined report; that is, combination stops at "water's-edge".

In 1987, the Montana Legislature allowed corporations to make a water's-edge election (Ch. 616, L. 1987). According to the Montana Department of Revenue, 25 corporations have elected water's-edge for Montana tax purposes.[7] Although a water's-edge election may result in a significant reduction in tax liability, it may also result in a more complicated tax return filing procedure.

Net income of a multistate firm doing business in Montana is allocated by a three-factor, simple-average apportionment formula. That is, the proportion of total net income that is allocated to Montana is the average of the fraction of total property of the business in the state, the fraction of total payroll paid in the state,

and the percentage of total sales occurring within the state. Suppose, for example, that one quarter of a multistate firm's property is in Montana, one quarter of its payroll is paid in Montana, and one half of its sales occur in Montana. By formula apportionment, one third of the multistate firm's net income would be subject to taxation in Montana: [(1/4 + 1/4 + 1/2)/3] = 1/3.

Interstate Tax Comparisons

Forty-four states and the District of Columbia impose a tax on corporate income. Nevada, Texas, Washington, and Wyoming do not tax corporate income. Michigan uses a single-business tax (modified value-added tax). South Dakota taxes only the net income of financial institutions. A few states that tax corporate income impose different rates on financial institutions. Montana imposes the same tax rate on financial institutions as on other corporations but distributes the tax revenue from financial institutions in a different manner. Beginning in 1979, the Montana Legislature imposed the corporation income tax on financial institutions to replace lost local property tax revenue from the repeal of the tax on moneyed capital and bank shares (Ch. 634, L. 1979). Eighty percent of the tax collected from financial institutions is allocated to the county in which the institution is located, and 20 percent is allocated to the state.

Fifteen states use a graduated rate structure. Alaska has the most steeply graduated structure (10 brackets), ranging from 1 percent on the first $10,000 of net income to 9.4 percent on net income over $90,000. Iowa has the highest maximum statutory tax rate of the states employing a graduated rate structure (6 percent on the first $25,000 of net income to 12 percent on net income over $250,000).

Table 3 compares the corporate income tax rates and apportionment formulas for Montana and eight surrounding states.* Six of the comparison states impose a flat tax rate on corporate income, while Colorado, New Mexico, and North Dakota have graduated structures. Arizona abandoned its seven-tier rate structure beginning tax year 1990, while Minnesota abandoned its two-tier rate structure beginning tax year 1987. Colorado will impose a flat rate beginning July 1, 1993. Both Arizona and Minnesota weight the apportionment formula more heavily to

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* These states served as the initial comparison states for the examination of Montana state employee compensation issues under the study directed by House Bill No. 786 (Ch. 660, L. 1989). Nevada, South Dakota, Washington, and Wyoming were part of that study, but they do not tax the income of corporations.

sales. The purpose of weighting sales in the apportionment formula is to increase the taxable income in the state of those (usually out-of-state) firms with limited physical presence in the state but with significant sales activity. The remaining states use a three-factor, simple-average formula. Only North Dakota allows a deduction for federal income taxes paid.

Table 3. Corporation Income Tax Characteristics of Montana and Surrounding States for 1991

	Range of Rates	Minimum Taxable Income for Top Bracket	Unitary	Apportionment Formula
Arizona	9.3%	All	Domestic	Property (25%), Payroll (25%), Sales (50%)
Colorado	5.0-5.5% (2)	$50,001	Water's-edge required	3-factor, simple average or average of sales & property only (UDITPA)*
Idaho	8.0%	All	Water's-edge election	3-factor, simple average (UDITPA)
Minnesota	9.8%	All	Domestic	3-factor with 70% weighted sales
Montana	6.75%	All	Worldwide unless water's-edge	3-factor, simple average (UDITPA)
New Mexico	4.8-7.6% (3)	$1,000,001+	Optional- domestic	3-factor, simple average (UDITPA)
North Dakota	3.0-10.5% (6)	$50,001+	Worldwide unless water's-edge	3-factor, simple average (UDITPA)
Oregon	6.6%	All	Domestic consolidated	3-factor, simple average (UDITPA)
Utah	5.0%	All	Water's-edge or option for worldwide	3-factor, simple average (UDITPA)

Notes:

Arizona Minimum tax is $50.
Colorado Beginning after June 30, 1993, all net income will be taxed at 5%.
Idaho Minimum tax is $20. There is an additional tax of $10 on each corporation filing a return and having gross income during the tax year.
Minnesota An alternative minimum tax is imposed equal to 5.8% of Minnesota alternative taxable income. A franchise fee is also imposed ($0-$5,000 based on Minnesota property, payroll, and sales).
Montana Minimum tax is $50, except $10 for small business corporations. The tax rate for water's-edge election is 7%.
North Dakota Minimum tax is $50.
Oregon Minimum tax is $10.
Utah Minimum tax is $100.

* **UDITPA** means Uniform Division of Income for Tax Purposes Act of the Multistate Tax Compact.

Source: Significant Features of Fiscal Federalism, U.S Advisory Commission on Intergovernmental Relations, 1992 Edition, Vol. 1.

Table 4 shows the relative share of corporation income taxes to total state tax collections for Montana and the comparison states. In 1990, the corporation income tax contributed 9.4 percent of total state tax revenue collections in Montana. This share was above the U.S. average of 7.2 percent. Montana also relied more heavily on the corporation income tax than did any of the comparison states in 1990.

Between 1980 and 1990, Montana's reliance on the corporation income tax fell from 10.5 percent to 9.4 percent, while the U.S. average fell from 9.7 percent to 7.2 percent. With the exception of Utah, the reliance on this tax in the comparison states also declined, in some case dramatically (e.g., Minnesota and Oregon). Montana has typically been more reliant on the corporation income tax than have the comparison states.

Table 4: Corporation Net Income Tax as a Share of Total State Tax Revenue and as a Share of State Personal Income

	FY 1980		FY 1985		FY 1990	
State	Percent of Total Tax Revenue	Percent of Personal Income	Percent of Total Tax Revenue	Percent of Personal Income	Percent of Total Tax Revenue	Percent of Personal Income
Arizona	7.0%	0.54%	6.9%	0.55%	4.1%	0.32%
Colorado	7.4%	0.91%	4.4%	0.23%	4.2%	0.21%
Idaho	8.7%	0.58%	5.8%	0.41%	6.4%	0.51%
Minnesota	11.9%	1.75%	7.3%	0.69%	7.1%	0.62%
Montana	**10.5%**	**0.71%**	**9.8%**	**0.70%**	**9.4%**	**0.71%**
New Mexico	5.0%	0.48%	4.4%	0.43%	3.1%	0.31%
North Dakota	9.8%	0.67%	12.2%	1.06%	6.9%	0.52%
Oregon	12.2%	0.75%	7.8%	0.48%	5.3%	0.33%
Utah	5.1%	0.38%	3.9%	0.66%	5.3%	0.42%
United States	9.7%	0.66%	8.2%	0.57%	7.2%	0.55%

Source: For state tax revenue, U.S. Bureau of the Census, State Government Finance, various years. For personal income, U.S. Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1989 Edition, Vol. 1, and U.S. Department of Commerce, Survey of Current Business, August 1991.

Table 4 also shows corporation income tax revenue as a percentage of total state personal income. A similar pattern is evident for this measure. Corporation income taxes as a share of personal income typically have been higher in Montana than the U.S average as well as higher than the comparison states. The range for the comparison states over the 11-year period ranged from 1.75 percent (Minnesota, 1980) to 0.21 percent (Colorado, 1990).

Although Montana appears to be slightly more reliant on the corporation income tax as a source of tax revenue, interstate differences in the corporate income tax base, tax rates, credits, and the inherent instability of corporation income tax collections account, at least in part, for the differences shown in Table 4. Information contained in Table 4 would indicate that corporation income taxes in

Montana are fairly stable. However, as Table 1 (page 4) shows, since 1982, stability has not been the case. In addition, the share of personal income in the state devoted to corporation taxes is not so reliable a measure of tax burden experienced by residents of the state as it is for the personal income tax. One reason is that it is difficult to determine the final incidence of the corporation income tax and how much of the tax is exported.

SUMMARY AND CONCLUSIONS

The corporation net income tax is a relatively minor component of Montana's tax revenue structure. However, the imposition of the tax protects the personal income tax base by including income that would otherwise escape taxation. The corporation income tax appears to be relatively more important in Montana than in other states, and it takes a slightly higher share of state personal income than it does in the nation as a whole. The statutory tax rate is not high compared to other states, although the net income base may be greater because Montana uses the worldwide unitary combination.

It is difficult to evaluate the equity of the corporation income tax because the final incidence of the tax is not known. Regardless of who pays the tax, whether shareholders, workers, or consumers, vertical and horizontal inequities may arise. The tax is also justified on the benefits-received principle, but net income is a poor measure of benefit taxes.

The corporation income tax is a convenient revenue-raising source, but it is inherently unstable because of the cyclical nature of the tax. The instability of the tax is compounded by net operating loss carrybacks and carryforwards. Because of these factors, it is difficult to accurately forecast tax revenue from this source.

Despite its weaknesses, the corporation income tax is a familiar and generally accepted form of taxation. Changes to the existing corporation income tax structure, however, could be accomplished in a variety of ways. A graduated rate schedule, for example, could be imposed. Depending on its structure, a graduated system could increase revenue, but it could exacerbate the inherent inequities of the tax. The imposition of an alternative minimum tax or the elimination of carryover provisions for net operating losses could reduce some of the revenue instability. The worldwide unitary combination could be replaced with domestic unitary combination. Some economists argue that domestic unitary

combination enhances simplicity, fairness, and competitiveness.[8]

A more radical alternative would be to eliminate the current structure and adopt a new method of taxation, such as a value-added tax. There are several advantages to a value-added tax. First, the tax would be imposed on all business activity regardless of the legal form of organization (sole proprietorship, partnership, or corporation). As such, the imposition of a value-added tax would reflect more closely theconcept of a benefits tax. Because the tax base is so much broader under a value-added tax, the tax rate may be much lower than under a net income tax. As a tax on business activity rather than on profits, the value-added tax is a relatively stable revenue source. A significant disadvantage of the tax is that it does not resolve the vertical and horizontal equity problems inherent in the corporation net income tax.

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ENDNOTES

1. Suggested by analysis contained in the Final Report of the Minnesota Tax Study Commission: Findings and Recommendations, Vol. 1 (St. Paul: Butterworth Legal Publishers, 1986), pp. 199-200.

2. Michael Vlaisavljevich, "State Business Taxes: The Policy and Research Agendas", in The Unfinished Agenda for State Tax Reform, Ed. by Steven D. Gold (Denver: National Conference of State Legislatures, 1988), p. 187.

3. Therese J. McGuire, "The Corporation Income Tax", in State and Local Finance for the 1990s: A Case Study of Arizona, Ed. by Therese J. McGuire and Dana Wolfe Naimark (Tempe, Arizona: School of Public Affairs, Arizona State University, 1986), p. 81.

4. Ibid., p. 232.

5. Ibid., p. 255.

6. Significant Features of Fiscal Federalism, Vol. 1 (Washington, D.C.: U.S. Advisory Commission on Intergovernmental Relations, February 1992), Table 26, pp. 79-85.

7. Telephone conversation with Lynn Chenoweth, Corporation Tax Bureau Chief, Natural Resource and Corporation Tax Division, Montana Department of Revenue, June 4, 1992.

8. See, for example, the Final Report of the Minnesota Tax Study Commission, p. 217.