Business Franchise Taxes in the District of Columbia

Report to the District of Columbia Tax Revision Commission

FINAL

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Contents

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Executive Summary

The District of Columbia Tax Revision Commission ("Commission") asked the Tax Policy Center (TPC) to assess the District's business franchise taxes in the context of the District and regional tax systems. This report describes some of the challenges of taxing businesses in the District. It also examines the mechanics of the corporate franchise tax and the unincorporated business franchise tax, how the District compares to other jurisdictions, and options available to the Commission for reform.

As a result of unique limitations, the District relies heavily on taxes on business. The District cannot tax nonresident income and hosts many organizations and entities that are exempt from taxation. As a result, the District's taxes on business account for almost half of the local revenue needed in fiscal year 2012 to finance important government services. The commercial property tax accounts for most of this revenue while business franchise taxes, the subject of this brief, are a relatively small share, only 8 percent of local revenue.

DC has made major changes to its franchise taxes over the last three years, and the impact of these changes has not yet been fully assessed. Below are the recent changes with the effective dates:

- Mandatory combined reporting (2011): Beginning with tax year 2011, a multistate company will be required to combine all entities under its control when filing franchise tax returns rather than each entity filing a separate return.
- Double-weighted sale factor apportionment (2011): Beginning with tax year 2011, most multistate companies will have to apportion income using a formula that weighs sales in the District more heavily.
- Increased minimum tax (2012): The minimum franchise tax owed was increased from $100 regardless of receipts to $250 for companies with receipts less than $1 million, and $1,000 for all others.

If thought of as a reform package, this recently enacted legislation has met some of the Commission's goals: equitability, productivity, efficiency, and effect on economic growth.[1] For example, the requirement of combined reporting targets tax avoidance planning and broadens the base. Switching to double-weighted sales factor favors businesses with payroll and property located here.

Although data on the taxpayers affected by recent legislation is not yet available for analysis, data on the District's economy is available. The economic data offers little evidence that the recent legislation has hampered the District's recovery or long-term growth prospects. Small business growth is higher than the national average and comparable to neighboring states. Growth in employment, wages, and all establishments has outperformed many of the adjacent counties in Maryland and Virginia. The District has a larger share of the U.S. and regional economy than it did in 1997.

[1] More detail for the Commission can be found at http://www.dctaxrevisioncommission.org.

In our view, enacting additional measures is premature and would add uncertainty for businesses coping with the recent changes. For this reason, our main recommendation is for the District to evaluate the impacts of the recent legislative changes, as data becomes available. We also recommend some changes the Commission might consider to strengthen the District's tax base and discuss other options available to the Commission, but we are not recommending at this time.

Introduction

Taxes on business are necessary, but complicated. They are necessary because businesses are part of the community and ought to share the burden of financing government services that create the environment for them to prosper. However, how they meet that responsibility is where the complexity arises. Part of the complexity derives from the different business structures. “Business” includes corporations, both local and multinational, partnerships, and sole proprietorships. The ideal tax system would be able to equitably tax the activity of any of these structures. Imposing a tax on both a small business and a multinational requires flexible policies. As state economies have become more global and capital has become more mobile, state policymakers have struggled to maintain equitable taxation while attracting business investment.

The District shares these challenges. Over the last few years, in response to the Great Recession of 2007–09, the District acted to shore up leakages in the corporate franchise tax (CFT) and the unincorporated business franchise tax (UBFT). Most of these recent actions had been recommended for the District in the past (Cordes and Watson 1998) and also recommended by tax commissions in other states (New Mexico 2003; South Carolina 2010; Kentucky 2012).

This report examines business franchise taxes in the District, how they have evolved, and whether the current system disadvantages the District competitively. Because of the significance of the recent changes, the major finding is the District should systematically evaluate the major tax reforms that have already taken place.[2]

The District has one of the highest corporate franchise tax rates in the country, a statistic often cited to suggest that the District is uncompetitive. Tax rates, however, are not a good measure of a city’s ability to attract, retain, and expand business. Undermining the perception that the District is uncompetitive, the District lost fewer businesses in the recession than the national average, losing 2 percent of establishments versus 6 percent nationally. In most indicators of business performance, the District seems to be keeping up with other jurisdictions. Taxes are just one of the factors determining competitiveness, corporate income taxes are only a subset of these, and the tax rate tells you little about the overall tax environment.

[2] It is still too early for a complete evaluation. Many of the changes first applied in tax year 2011, and the returns for that tax year were filed in 2012 and are only now becoming available for the Office of Revenue Analysis (ORA) in the Office of the Chief Financial Officer (OCFO) to assess. These first returns will likely be amended as well, so the full examination is still at least one year away.

Types of Business Structure

Sole proprietorship: A single individual is responsible for the business and receives all of the profits. Sole proprietors file individual tax returns, including Schedule C for business income and SE for self-employment tax (FICA and Medicare), for the IRS. For the District, business income or loss is reported as an information item on the D-40 unless the taxpayer has gross business income greater than $12,000 and must file as an unincorporated business.

Partnership: At least two individuals or entities are responsible for the business and share the profit, and the business is not incorporated. A partnership set up as a limited liability corporation that has not elected to be taxed as a corporation for federal purposes is also treated as a partnership. (Referred to as "checking the box.") Partnerships qualified as unincorporated business with gross District income greater than $12,000 file the D-30, UBFT, and partnerships with $12,000 or less file D-65 and the District resident partners report the income on the individual income tax form, D-40. A subtraction of income reported and taxed under the UBFT is allowed for the pro-rata share of the District resident partner's income on the individual income tax form.

Corporation: A company that has incorporated in the District, including S Corporations (which are treated differently at the federal level). Corporations file D-20 and dividends paid to District resident shareholders are reported on the individual income tax return.

The District operates under a unique set of constraints, making it difficult to look to other states for help on designing the ideal tax system for the District. Like other cities, the District is the employment hub where much of the metropolitan population works but not necessarily where they live. Commuters coming into the city require government services including roads and police and fire protection. Most other central cities are supported by income tax revenue from those employees because they are taxed based on where they work. The federal government, however, prohibits the District from taxing the income of nonresidents, including consultants, lawyers, accountants, and lobbyists (Yilmaz and Zahradnik 2008).

On the other hand, the federal government is the main reason there is so much activity in the District, supporting significant commercial property tax revenue and the business taxes discussed here. In some ways, the District is a "captive" market where the magnet is the federal government.

Who bears the burden of taxes depends on supply and demand conditions in various markets. Businesses are a construct of various individuals and any tax on the business is passed through to these individuals (Cordes and Watson 1998). Taxes may be passed on to shareholders or owners (through lower profits), customers (through higher prices), or workers (through lower wages), depending on market conditions. A company in an industry with a tight labor market, for example, may not be able to lower wages. A company in a highly competitive national marketplace may not be able to raise prices. Who bears the burden of the tax system can also be affected by other government rules or decisions. For example, if there is a minimum wage in place employers would also be limited in how much they can offset taxes by lowering wages.[3]

In addition, taxes on business can be controversial because they are perceived as subtracting from the "bottom line," representing an amount that cannot be reinvested or paid out in dividends, wages, or lower prices. The tax revenue, however, does not disappear but supports the government services that businesses rely upon. Infrastructure, education, affordable housing, health systems, and public safety all help businesses access markets, employ capital and labor, and manage operations. There is a symbiotic relationship that may allow a business to perform better in a community with good public services versus if it had the money from lower taxes to reinvest.

Finally, decisions to locate, expand, or terminate a business in the District are made for many reasons, including but not limited to market access, labor force, quality of life, quality of government services, and taxes. Area Development (2013), a site selection trade magazine, surveyed corporate executives and the corporate tax rate came up seventh in a list of 26 factors they consider when selecting sites.[4] Luna and Murray (2010) find evidence that state taxes influence the decision to incorporate, form a partnership, or operate as a sole proprietorship. If the tax system could be shown to be a major influence on these types of decisions, the system might be inefficient and reform might be necessary.

To answer the question of the tax impact on the economy is difficult because we must pose a counterfactual test commonly associated with economic development. Is the District's economy relatively strong because of its tax system or despite its tax system? A tax system that is capricious and spending that is inefficient would be a drag on an economy absent other forces (such as location and purchasing power). However, we must also examine whether the current system is more or less of an obstacle than that found in neighboring jurisdictions and whether there are changes to the tax system that would improve the city's relative competitiveness.

This report addresses these issues. First we present an overview of the business tax system in the District and the country— noting that businesses often pay more money to the government through other taxes and fees, including property and sales taxes, than they do through business income taxes. We then discuss the mechanics of business franchise taxes, explaining some of the jargon and mechanics of corporate income taxes in a federal system. In this section we also briefly note what rules or choices DC makes and the history behind some of those rules. We next examine how the District compares with other jurisdictions, focusing on its neighbors in the Washington metropolitan area. A discussion about the relationship of business taxes and the economy and competitiveness of the District with other jurisdictions follows. The last section explores options to consider as part of tax reform process.

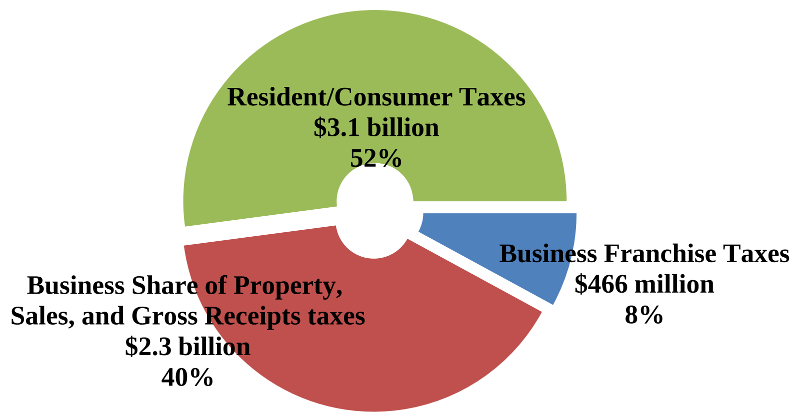
[3] The District's minimum wage is $8.25, $1 higher than the federal.

[4] The six factors above the corporate tax rate were labor costs, highway accessibility, availability of skilled labor, availability of advanced communication infrastructure, occupancy or construction costs, and energy costs.

The Current Business Tax Structure in the District

A business operating in the District is liable for several different taxes and fees, including property and sales taxes as well as specific business income taxes and fees. Because the District is both a state and local government, the District has taxes and responsibilities found at both levels of government. Almost half of the tax revenue in the District is from taxes paid by businesses. The largest shares are the commercial property and sales taxes.[5] There are also personal property taxes, taxes on using public space, and special gross receipts taxes on utilities, telecommunications, insurance providers, and health care providers. Businesses face different income taxes depending on the structure of the business. If the business is a sole proprietorship, taxpayers who are District residents are generally subject to the individual income tax. If the business is incorporated, it is subject to the CFT. An unincorporated business, including a partnership or a sole proprietor with more than $12,000 business income, is subject to the UBFT apart from the individual income taxes for District residents. This report discusses the CFT and UBFT in detail and does not address the other taxes on business.

Figure 1: Fiscal Year 2012 General Fund Tax Revenue



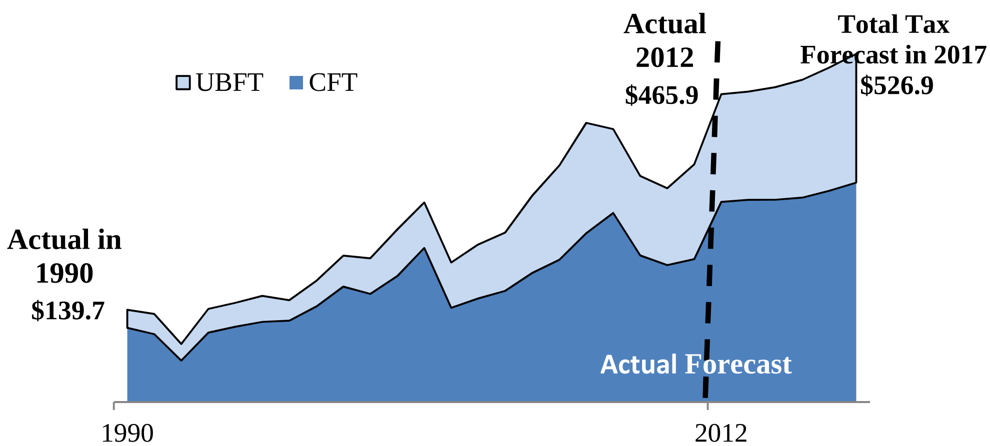
Source: Author's analysis of February 22, 2013 Revenue Estimate (OCFO 2013); revenue shown is gross of dedicated taxes.

CFT and UBFT taxes account for 8 percent of total tax revenue in the District (Figure 1).[6] That share is forecast to remain relatively constant over the next five years. By comparison, corporate income taxes nationally have been declining as a share of total state and local tax revenue collected from 5 percent in 1980 to 3 percent in 2010.[7] DC total franchise taxes, on the other hand, have grown approximately 6 percent annually, from $140 million in 1990 to $466 million in 2012 and from 6 percent of total tax revenue in 1990 to 7 percent in 2010 and 8 percent in 2012 (Figure 2). In the latest revenue estimate, the forecast growth of CFT and UBFT is less than 2 percent per year, which assumes continued federal cutbacks (OCFO 2013a).

[5] These taxes are discussed in other chapters of the Commission's report. See appendix D for table of taxes.
[6] Total tax revenue here refers to gross tax revenue before earmarks and does not include nontax or lottery revenue.
[7] TPC State and Local Finance-Data Query System using Census data.

Corporate and Unincorporated Business Franchise Tax

Figure 2: Business Taxes in the District



Source: OCFO; dollars in millions.

The CFT and UBFT are taxes on the net taxable income earned in the District. The tax rate is 9.975 percent and the minimum tax is $250 for companies with gross receipts of $1 million or less and $1,000 for companies with gross receipts greater than $1 million.

There are several steps between a company's revenues and the tax it pays in the District. First, identifying which companies are subject to the District franchise taxes requires a determination the company has *nexus* in the District. Once a company is defined as a taxpayer, the business (and government) needs to calculate what the appropriate base is for taxation. There are three important steps that need to be taken: calculation of net income, the combining of related entities and allocation of the income among them, and the apportionment of District and non-District income. Finally, the rate is applied to determine the tax before credits. The UBFT tax has additional unique features which will be discussed at the end of this section. Finally, the taxpayer needs to apply any of the credits and incentives provided by the District before calculating the final tax bill.

Nexus

Nexus, or whether a taxpayer has sufficient connection with a jurisdiction to be subject to taxation, is the Holy Grail or third rail of multistate tax policy, depending on your perspective. With nexus, a taxpayer is subject to the taxes in the jurisdiction. There are different standards for nexus with an income tax than with a sales and use tax. For the income tax, the federal Interstate Commerce Act, Public Law 86-272, prohibits a state from taxing the income of a business if the only connection of the business to the state is the solicitation of orders for sales of goods (McLure 2000). Because P.L. 86-272 refers only to "tangible personal property"—in other words, goods—states have more latitude when the sales are intangibles, like services.[8] Nexus for income tax purposes is generally defined using one of three tests: physical presence, economic presence, and factor-based.

- Physical presence is the most restrictive and is the same test used by a state to compel a company to collect sales and use tax.
- Economic presence is the "doing business" standard and has been used by states to assert a broader nexus for income tax purposes. For example, Oregon's tax law states "substantial nexus exists where a taxpayer regularly takes advantage of Oregon's economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in the state."[9]
- Factor-based presence is a mechanical application of economic nexus and has been recommended by the Multistate Tax Commission (MTC).[10] Under a factor-based definition, substantial economic nexus is defined by specific levels of sales, payroll, or property, or if a specific percentage of a factor is present in a state.

Many states have adopted economic presence as the standard for nexus (Setze 2012). In these states, a company may be subject to income tax but may not be required to collect sales tax on tangible goods.

- **The District (as a part of implementing combined reporting) repealed the statutory requirement of physical location of an office, warehouse, or other place of business in the District to be subject to the franchise tax. The District should formally adopt economic presence to assert nexus over companies that do not have nexus under a physical presence test.**

Calculating taxable income

Understanding what taxable income is for a business in a given location is complicated. Like the personal income tax, the states and the District use the federal tax definitions of income as a starting point. Many states start with federal taxable income directly from the federal return but the District builds up District taxable income from federal components and then reconciles with the federal taxable income in a separate worksheet (CCH 2012).[11] This amounts to the same thing as taking the line item from the federal form but gives the District more latitude to define the components; other states have a schedule of additions and subtractions to deviate from federal definitions. Below are the components of gross income and the deductions. The items in bold are where District law deviates from federal law:

[8] For the sales tax, however, nexus is complicated by the fact that the tax is levied on the purchase and the tax may be collected from either the buyer or the seller. The Supreme Court in Quill Corp. v. North Dakota ((91-0194), 504 U.S. 298 (1992)) ruled that a state could not require out-of-state companies to collect sales taxes for state and local taxing authorities, without a physical presence (Fox 2012).
[9] Oregon Administrative Rule 150-317.010.
[10] The MTC is an intergovernmental state tax agency established by the Multistate Tax Compact.
[11] Nineteen states use federal taxable income as the starting point and 18 use federal taxable income before special deductions. These are taken directly from the federal form (lines 28 and 30 on the 2012 1120 return).

- Gross income consists of gross profits (gross receipts after returns and allowances minus costs of goods/operations), **dividends received**, **interest received**, **rents** and royalties, net capital gain, and **other business income**.
- Deductions from income include compensation of officers, salaries and wages, repairs, bad debt, rent, **taxes**, **interest paid**, charity, amortization, **depreciation**, depletion, **royalty payments**, pension and profit sharing plans, and other deductions.

The deviations from federal definitions of income include treatment of the following:

- **Dividends**: Foreign dividends from subsidiaries in which the taxpayer owns more than 50 percent and dividends from wholly owned subsidiaries, captive insurance companies, and real-estate investment trusts are not included. Dividends from other DC corporations, including insurance and banks that are part of a holding company, unrelated to regular trade or business are treated as non-business income. The federal return includes most dividends as income and only taxes part of certain types of dividends.
- **Interest received**: Interest on out-of-state bonds is included and interest on US obligations is excluded.
- **Rents**: Bonus depreciation deducted to calculate federal rental income is added back.
- **Other business income**: Other business income, or non-business income as it is defined by the District, is only included to the extent the parent company or headquarters is located in the District.

Deviations from federal definitions of deductions:

- **Taxes**: Excludes income and excess profits tax, DC franchise tax.
- **Interest and royalty payments**: Payments to related entities only allowed if the payments were not for tax avoidance, were arms-length transactions, and were taxed at a weighted 4.5 percent in another jurisdiction.[12]
- **Depreciation**: Federal bonus depreciation is not allowed and Section 179 expenses are limited to $25,000.[13]

Apportionment

One of the key questions facing states and subnational (and even national) governments, after establishing nexus, is what income falls within their jurisdiction. In response to possible federal action, in 1957, the National Conference of Commissioners on Uniform State Laws, an organization formed in 1892 representing state tax commissioners to provide states with uniform model legislation, sought to identify a common way to apportion the income of a company operated in more than one state (Huddleston and Sicilian 2009). The Uniform Division of Income for Tax Purposes Act (UDITPA) became model legislation, establishing

[12] An "arm's length" transaction is one where both parties are independent, without any special relationship.
[13] Section 179 expenses are equipment purchases made and put in place within the year. Federal stimulus programs increased the allowable deduction to $500,000 in 2013 for federal income tax.

an equally weighted three factor method of apportionment that considered different types of business behavior:

$$(\frac{Sales_{state}}{Sales_{total}} + \frac{Payroll_{state}}{Payroll_{total}} + \frac{Property_{state}}{Property_{total}})/3$$

The Multistate Tax Commission, an intergovernmental state tax agency that works with the states and multistate companies to administer the tax law, incorporated UDITPA into a compact adopted by 17 states and the District.[14] Other states adopted UDITPA as a stand-alone statute. However, over the last 20 years there has been a trend to modify the formula as an economic development incentive by weighting sales more heavily (Ebel et al. 2013). Now there are four major apportionment methods in common use: three factor as described above; double-weighted sales, which multiply the sales factor by two and change the denominator to four; super-weighted sales, where the sales factor is more than 50 percent of the formula; and single-sales factor, where only the sales factor is used to apportion income. A company with a base of operations in a state but selling to a national market would prefer more heavily weighted sales factor formula as the amount of income apportioned to the home state is reduced.

Apportionment using a heavily weighted sales factor can be seen as a violation of the benefits principle of sound tax policy (Brunori 2010). The government services needed by companies with physical property and payroll may be greater than the services required to support a marketplace for imported goods and services. Under single-sales factor apportionment, the companies with the physical presence have a much lower tax liability than a company with no assets in the state.

To illustrate, table 1 shows three companies with the same net income may have different tax outcomes depending on their factor presence in the District. UDITPA favors Company C because it does not have as much of the payroll or property factors. The single-sales factor results in the highest tax for Company C. Company A, which has most of its business operations in the District, sees a significant reduction in tax liability. As a result, this apportionment is attractive to states looking to attract manufacturing and headquarters. Because of the geographic limitations of the District—that is, not enough connected parcels to do large-scale development—changing to single factor is unlikely to attract these companies, but it will increase the amount of taxable income from companies like C.

[14] The MTC is considering changes to UDITPA to "bring it into conformity with the practices of the majority of states" (Miller 2013).

Table 1: How Apportionment Works under Different Formulas

	Company A	Company B	Company C
Net Income	$ 50,000	$ 50,000	$ 50,000
Sales Factor	*10%*	*90%*	*50%*
Payroll Factor	*50%*	*75%*	*1%*
Property Factor	*67%*	*67%*	*1%*
DC Apportionment Factor under:			
UDITPA (3 factor)	42%	77%	17%
Double Wt Sales (Current law)	34%	80%	25%
Single Sales (proposed)	10%	90%	50%
Taxable income			
UDITPA (3 factor)	$ 21,111	$ 38,611	$ 8,528
Double Wt Sales (Current law)	17,083	40,208	12,646
Single Sales (proposed)	5,000	45,000	25,000
Tax			
UDITPA (3 factor)	$ 2,106	$ 3,851	$ 851
Double Wt Sales (Current law)	1,704	4,011	1,261
Single Sales (proposed)	499	4,489	2,494

In some of the MTC states, there is an inconsistency between the UDITPA and other methods. States that are full members of the MTC, like the District, should monitor the *Gillette* and *IBM* cases for possible vulnerabilities with their own statutes (see box titled "*Gillette* and *IBM*"). As part of the 2014 budget, the DC Council amended the MTC provisions relating to the UDITPA with this in mind.[15]

Many states recognize the factors in UDITPA are not useful for certain industries and use or allow an alternative formula. Below are the most common special cases with the number of states that require special rules in parentheses (CCH 2012):

- Transport industries may be required to apportion based on passenger and freight statistics. (40)
- Financial companies may have special definitions for sales that more accurately capture financial revenue. (33)

[15] DC B20-199 available here: http://www.dccouncil.us/files/user_uploads/budget/Bill_20-199_–_Fiscal_Year_2014_Budget_Support_Act_of_2013.pdf.

- Airlines may be required to apportion flight crew and flight property using departure and cargo data. (39)
- Construction companies may be required to apportion based on completed contracts. (16)

The District uses a double-weighted sales factor formula to apportion net income to the District, which was enacted for tax years beginning 2011.

$$(2\,x\,\frac{Sales_{state}}{Sales_{total}} + \frac{Payroll_{state}}{Payroll_{total}} + \frac{Property_{state}}{Property_{total}})/4$$

Maryland uses a double-weighted sales factor formula for most companies and a single-sales factor for manufacturers. Virginia uses a double-weighted sale factor as well but is phasing in a single-sales factor for retail companies. Virginia also allows manufacturers that meet certain job targets to triple-weight the sales factor.

- **Adopting a single-sales factor for apportioning income would further expand the District's tax base, as many multistate companies operating in the District have more sales than payroll and property in the District, relative to their total operations. It would also be an incentive for companies to locate facilities and workforce to the District but is unlikely to play a major role in these decisions.**

Combined reporting

In many cases, multistate companies consist of a parent company and satellite companies. For example, a vertically integrated company that makes widgets may own a company that makes the screws to attach the widget. It may also own a company that holds the trademark for the widget and has no other business activity except the leasing of the trademark to the parent. If one of the companies does business in a state, the state has to determine how or whether to

Gillette* and *IBM

The ruling by the California Court of Appeal in the *Gillette Co. et al. v. Franchise Tax Board* case held that companies can use the alternative formula provided by the MTC statute despite California having a "mandatory" apportionment method. The MTC statute, which all member states have adopted, allows taxpayers in more than one member state to choose the MTC option, the three factor formula, over another required by the state. This means that a company with primarily sales in a single-sales state can opt to apportion based on payroll, property, and sales. California subsequently withdrew from the compact.

In *International Business Machines Corp. v. Dep't of Treasury*, the Michigan Court of Appeals ruled that because Michigan's Business Income Tax required (by use of the word "shall") single factor sales apportionment, the MTC language did not apply.

Both these cases are being appealed to higher courts.

account for the relationships with the other companies to calculate the taxable income.

Prior to 2011, the District required “separate entity” reporting by treating the parent company (widget maker) independently from the subsidiary (screw maker) and the affiliated entity (trademark holder). Each company included payments from the other companies as income and deducted payments to the other companies as expenses to determine net income, regardless of whether one of the other companies had nexus in the District or had headquarters in a no-tax or low-tax state. This created an incentive for companies to establish holding companies that owned intangibles, like patents and trademarks in states without income taxes, such as Nevada and Delaware. These holding companies might charge royalties for the use of the patents and trademarks, which would then be deducted from the parent’s gross income. In 2010, the District enacted an “add-back” rule, disallowing deductions of these types of payments from the income of the taxpayer.

Another way to determine taxable income is by treating a company as *unitary*, combining the net income of all the related entities. Referred to as combined reporting, this method, like add-back provisions, captures transactions with related entities for the principal purpose of shifting income from a high-tax state to a low- or no-tax state. The goal of combined reporting is to prevent the kind of tax avoidance described above but is also much broader. In 2011, the District began requiring combined reporting, which ensured the income of the related entity would be included in gross income, essentially canceling any deductions. This prevents companies from establishing subsidiaries for the sole purpose of avoiding tax. Combining entities, however, also captures subsidiaries established for other reasons and the tax liability of any particular company could increase or decrease due to mandatory combination.

The MTC has model legislation to encourage adoption of uniform laws in the states. Over time, the model legislation has evolved to account for issues that arise, mostly through litigation. Some states adopt the model without modification but there is significant pressure to modify from different parts of the business community. There are five important areas where states have had to make choices.

Table 2: States with Combined Reporting

Alaska	Illinois	Montana	Texas
California	Kansas	Nebraska	Utah
Colorado	Maine	New Hampshire	Vermont
Dist. of Columbia	Massachusetts	New York	West Virginia
Hawaii	Michigan	North Dakota	Wisconsin
Idaho	Minnesota	Oregon	

As shown in table 2, 23 states, including the District, require combined reporting for multistate companies.[16] Combined reporting has evolved over the years, and the statutes of states that recently enacted combined reporting have refined the parameters to address foreign subsidiaries/ownership, net operating losses, and credits.

[16] In April 2013, New Mexico adopted combined reporting for large retailers only. Because of the narrow application it is not included in this list. Arizona allows but does not require combined reporting.

Apportioning income (*Joyce* or *Finnigan*)

Based on case law in front of the California Board of Equalization, the agency that administers the California corporate income tax, two methods for apportioning income among the members of a combined group have evolved. In both, the denominator is all income from the combined group. The *Joyce* method is the more restrictive and it only allows income in the numerator from entities that have nexus in the home state. The *Finnigan* method includes all income regardless of nexus. For example, take a corporation made up of three entities: A, B, and C. Entities A and B both have sales in the District and C does not. Entity A has nexus in the District because it has a branch office here but entity B only has sales. Under the *Joyce* method, the income of the combined group would be apportioned by the ratio of the sales of A to total sales.[17] Under the *Finnigan* method, the income would be apportioned by the ratio of A and B to total sales, resulting in a larger apportionment factor.[18] More states adopt *Joyce* (table 3).

Table 3: *Joyce* or *Finnigan*

States using *Joyce*	Alaska, Colorado, Dist. of Columbia, Hawaii, Idaho, Illinois, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, Texas, Vermont, West Virginia
States using *Finnigan*	Arizona, California, Kansas, Maine, Massachusetts, Michigan, New York, Utah, Wisconsin

[17] Appeal of Joyce Inc., Cal. State Bd. of Equalization, Dkt. No. 66"SBE"070, Nov. 23, 1966.
[18] Appeal of Finnigan, Cal. State Bd. of Equalization, Dkt. No. 88"SBE"022, Aug. 25, 1988.

Combined Reporting in Maryland and Virginia

Maryland:
The Maryland Business Tax Reform Commission (2010), which was explicitly charged with evaluating combined reporting, decided not to recommend requiring combined reporting after three years of data from informational returns showed mixed revenue results and increased volatility. The results in 2006 and 2007 exceeded the $20 to $50 million revenue estimates of proposed legislation but 2008 was negative, contrary to the assumption that it would increase revenue (Schaufele 2011). Three of the five years reported so far show that combined reporting would have increased revenue, and the other two show decreases.

Virginia:
House Bill 1267 was debated in 2012 and would have required combined reporting. The fiscal impact statement projected revenue near $100 million (out of $828 million) but cautioned that it was a "highly speculative" estimate (Virginia Department of Taxation 2012).

- **The District follows the narrower *Joyce* method, which is consistent with most states. Maryland and Virginia do not require combined reporting (see box). In all the years for the Maryland informational returns, the *Finnigan* method would have increased the tax liability (Schaufele 2011).**[19]

Water's edge or worldwide

States adopting combined reporting have to decide how broad the scope should be. Worldwide reporting captures all income and apportionment factors everywhere including outside the United States. Water's edge reporting narrows the scope to just the United States.

- **The District adopted water's edge as the default method but allows an election for worldwide reporting.**[20]

Treatment of net operating losses (NOLs)

Whether or not to allow NOLs to be shared among the members of a combined group is another decision a state adopting combined reporting has to make. Not allowing NOLs to be shared may contradict the principle of a unitary group.

[19] The Maryland report also shows that combined reporting is not necessarily a revenue raiser for a state and, depending on the industry mix, can have uncertain outcomes. In three of the five years documented (2006–10), revenue would have been higher under *Finnigan* but varied significantly across industries.
[20] DC ST § 47-1810.07.

- **The District disallows the sharing of NOLs, and an entity's NOLs that existed pre-combination remain with that entity and are not shared with the combined group. If an entity ceases being part of the group, the NOLs for that entity are removed from the group and belong to the entity.**

Treatment of credits

Similar to NOLs, states decide whether credits remain with the entity or are allowed to be shared among the group.

- **In the District, credits remain with the entity eligible and are not shared within the group.**

FAS 109 deduction

Recently, publicly traded companies have expressed concern about the financial market effect of mandatory combined reporting. The Financial Accounting Standards Board rule 109 (FAS 109) requires publicly traded companies to report major tax changes affecting deferred tax liabilities in their quarterly earnings statements.[21] As a result, a company projecting an increase in tax liability from the combination must include a statement in its quarterly earnings statement filed at the time of the law's enactment.[22] Companies have expressed concern over the perception of the financial markets, and in a few states—Massachusetts, Michigan, and the District—a deduction has been allowed for any reported increase in the combined group's net deferred tax liability resulting from the switch to combined reporting. This mitigates any adverse effect of the FAS 109 requirement.[23]

- **In the District, publicly traded companies reporting an increase in net deferred tax liability when combined reporting became mandatory may be eligible for a deduction for the increase in tax liability spread over seven years beginning in 2016. The choice of 2016 for the first year the deduction could be claimed was to move the cost of allowing the deduction outside the District's financial plan.**

Special features of UBFT

Partnerships operating businesses in the District and owners of property in the District often are subject to the UBFT. In other states, partnerships generally are not taxed. Rather, the partners are taxed, resident or not, on the income allocated to them. However, for reasons discussed below, the District is prohibited from taxing the personal income of a nonresident, directly or at the source. Thus, the District cannot tax the personal income of nonresidents. And the UBFT excludes professionals (such as doctors, lawyers, engineers, accountants, and

[21] http://www.fasb.org/st/summary/stsum109.shtml. A deferred tax liability is the anticipated tax due on a transaction that is booked for accounting purposes but not due for tax purposes.
[22] PHI, Inc., the holding company for Pepco, for example, reported setting aside $2 million due to combined reporting in its 11/4/2011 quarterly SEC report. http://phx.corporate-ir.net/phoenix.zhtml?c=62854&p=IROL-secToc&TOC=aHR0cDovL2FwaS50ZW5rd2l6YXJkLmNvbS9vdXRsaW5lLnhtbD9yZXBvPXRlbmsmaXBhZ2U9Nzg4NzIxMSZzdWJzaWQ9NTc%3d&ListAll=1&sXBRL=1.
[23] Massachusetts FAS 109 claims indicate that the credit is equivalent to 28 percent of the revenue expected from mandating combined reporting (Bal 2009).

architects) and a trade or business in which more than 80 percent of the gross income is derived from the personal services actually rendered by the individuals or partners. This language rules out most professionals who work independently or for partnerships but reside outside the District. It leaves landlords, contractors, and money managers, among others, subject to the tax.

Any taxpayer with unincorporated business income greater than $12,000 has to file a UBFT return. A deduction is allowed for up to 30 percent of income for salaries and there is a $5,000 exemption against positive income. Individual taxpayers can deduct the UBFT income when calculating taxable income in the District and Maryland. In Virginia, however, there is no credit so the income is taxed twice for Virginia residents who have income subject to the UBFT in the District. Virginia believes the UBFT is an illegal income tax.[24]

New York City Unincorporated Business Tax

New York City has an unincorporated business (NYC UB) tax similar to the UBFT. The tax is levied on any individual or entity (e.g., partnership) that does business in the city and has gross receipts greater than $95,000, a higher threshold than the District. This includes the income from "the practice of law, medicine, dentistry, architecture, or any other profession" (Instructions for Form NYC-201).

The tax rate is 4 percent, and there is a phased-out tax credit that starts at $3,400. There is a 20 percent deduction up to $10,000 for taxpayer compensation. New York State income tax allows a credit for the full amount of the NYC UB for taxpayers with taxable income less than $42,000. The credit is reduced as income increases until taxable income reaches $142,000 and the credit is 23 percent of the tax.

Source: http://www.nyc.gov/html/dof/html/business/ubt.shtml

Philadelphia Net Business Profit Tax

Philadelphia has a net profits tax levied on the net profits from the operation of a trade, business, profession, enterprise, or other activity by residents (even if business is conducted outside Philadelphia) and nonresidents who conduct business in Philadelphia. Renting property is considered a business activity.

The resident taxable income is taxed at 3.928 percent, the same as the Philadelphia wage tax; nonresident taxable income is taxed at 3.4985 percent. There is a credit for 60 percent of the Philadelphia Business Income and Receipts tax.

Source: http://www.phila.gov/Revenue/businesses/taxes/Pages/NetProfitsTax.aspx

[24] Mathy v. Commonwealth Department of Taxation 253 Va. 356, 483 S.E.2d 802 (1997).

Credits

The District has several incentive programs for companies to relocate or expand here. Most of the incentives are targeted at property tax relief rather than franchise tax relief, indicating the relative importance of the commercial property tax. There are four for CFT and UBFT, listed below, but they are not widely claimed.

1. Economic Development Zone Incentives Credit: This credit is a nonrefundable credit with a maximum value of $7,500 and is designed to encourage business development in economic development zones. The credit is for 50 percent of wages and workers compensation insurance paid by the taxpayer plus a credit for child care center subsidy. To date, there have not been any claims (OCFO 2012a).

2. Qualified High Technology Company Credit (QHTC): This credit is a refundable credit against either CFT or UBFT designed to encourage high-technology investment in the District. (A QHTC also qualifies for other tax benefits, such as exemption from personal property tax for 10 years.) The QHTC offers a credit equal to the entire franchise tax in the first five years from when they accrue tax liability, limited to an aggregate of $15 million. After five years, the credit reduces the franchise tax to from 9.975 percent to 6 percent. The QHTC must have at least two employees in the District, and at least 51 percent of its gross receipts in the District have to be from one or more listed technology activities. The QHTC must file as a separate entity and not part of a combined group. There were 114 QHTCs claiming this credit in 2009, and the amount of credit was approximately $9 million (OCFO 2012a).

3. A QHTC that is also a social e-commerce company is allowed an additional credit based on hiring performance. The criteria for social e-commerce were written in such a way that it is likely only one company, Living Social, qualifies for the status.

4. Organ and Bone Marrow Donor Credit: This credit allows a credit for 25 percent of the wages of an employee who takes leave to donate organs or bone marrow. Only two taxpayers in 2009 claimed this credit. Several other states provide a similar credit.

5. Job Growth Incentive Act: This credit was enacted in response to the Great Recession of 2007–09 and is a temporary credit for companies for tax years 2010 to 2014. A credit can be claimed if the project is responsible for 10 net new jobs in the District with wages 120 percent of the District resident average wage and increases income tax and payroll revenue in the District. The net new jobs have to last at least one year. There is currently no data available on the participation rate for this credit.

Both Maryland and Virginia offer a broader range of credits and incentives than the District. However, they have a broader range of industries (appendix B). Both states offer incentives for agriculture and mining. Maryland incentives break down in four groups: incentives aimed at creating or preserving jobs, incentives aimed at improving workplaces and human capital investment, incentives for alternative energy use and production, and incentives for specific industries. Virginia has incentives in these groups as well as incentives aimed at increasing international trade and conservation (historic or natural).

All three have comparable job creation credits (appendix C). They all have credits for locating businesses in economically distressed areas. “Zone” credits are those that encourage businesses to locate, relocate, or expand in a particular area, usually defined by poverty and unemployment criteria. Job creation credits are general credits for companies that hire new employees usually above a threshold and with wage and duration criteria.

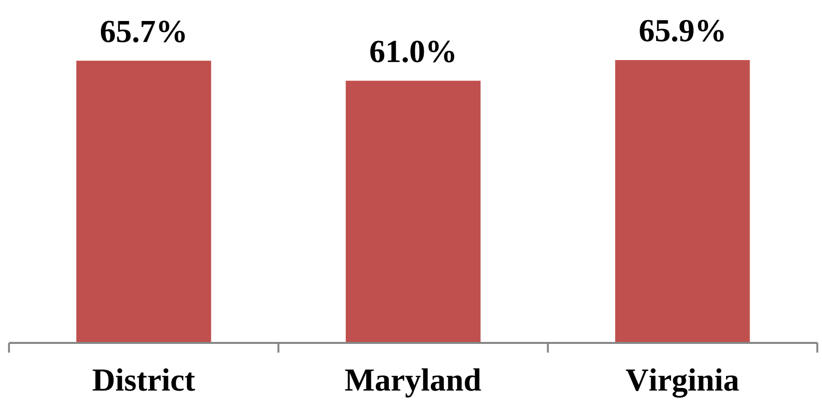
Comparison of Business Franchise Taxes across Jurisdictions

Comparing business taxes across the states is difficult since there are so many variations. Forty-five states including the District levy a tax on net corporate income. Ohio has a commercial activity tax (CAT), and Washington has a business and occupation tax; both are percentages of gross receipts. Texas has a business margin tax, calculated in three different ways.[25] Three states—Nevada, South Dakota, and Wyoming—have no tax on income, corporate or individual. The District, Philadelphia, and New York City have specific taxes on unincorporated business income though most states tax unincorporated business income through the personal income tax. Below we provide some comparison information on DC and its neighbors. Appendix A has a table showing all states with select attributes.

Zero liability

One of the frequently cited statistics about the District franchise taxes is only one-third of the filers have a tax liability and pay more than the minimum tax. This is not unique to the District: Virginia and Maryland have similar rates of filers with no liability, as shown in figure 3. These neighbors, however, do not have a minimum tax like the District.

Figure 3: Share of Tax Filers with No or Minimum Tax Liability



Source: State tax departments 2010.

Tax rates

Thirty-one states have flat corporate rate structures similar to the District, but only Iowa and Pennsylvania have higher rates. Iowa's top rate, 12 percent (imposed on taxable corporate income above $250,001), is higher than the District's flat rate, but single-sales factor apportionment greatly reduces the income of Iowan companies. For unincorporated business, most states, including Virginia and Maryland, use the individual income tax return. Maryland

[25] Texas's margin tax is on (1) gross receipts less cost of goods, (2) gross receipts less labor compensation, or (3) 70 percent of gross receipts.

has a local-option county income tax that increases the rate. DC's 9.975 percent statutory rate is higher than either Maryland or Virginia (table 4).

Table 4: Comparison of Business Taxes–Regional

	Corporate tax rate
District of Columbia	9.975
Maryland	8.250
Virginia	6.000

Virginia also allows local governments to impose gross receipts taxes on professional occupations; these taxes can be as high $0.58 per $100 of gross receipts for financial, real estate, and professional services.[26] Fairfax County, Arlington County, and the City of Alexandria all levy gross receipts taxes.

Pass-through entities

Unlike the District, most states require a nonresident to file a return to pay tax on the income from ownership in pass-through entities (PTEs) that are engaged in business in the state or require the PTEs to file a composite return on behalf of their partners. These states tax the partner's income in a professional corporation, like a law firm, regardless of where the partner lives.

Both Maryland and Virginia require PTEs to report the income of partners or owners. The partners use that information to file individual or corporate tax returns. Nonresidents file a nonresident personal income tax return to report partnership income. Maryland levies surtax on nonresidents of 1.5 percent.

New York City and Philadelphia have unincorporated business taxes similar to the District. Unlike the District, there is no prohibition on taxing nonresident income in these cities so they are able to tax professional and personal service businesses (see box on page 20).

Dividends

The federal Form 1120 schedule C records dividends received by the taxpayer. The list of dividends includes those from foreign companies, public utilities, wholly owned subsidiaries, and affiliated group members. A major portion of dividends received from domestic corporations and domestic-sourced portions of dividends received from foreign-owned corporations are deductible from federal income (called a special deduction on the IRS Form 1120). Twenty-one states use federal taxable income as the starting point for determining state income and so permit the deduction of dividends.

[26] Code of Va. Ch 37 § 58.1-3706; these taxes would be deductible for computing federal taxable income so would also be deductible from Virginia taxable income.

Table 5: Treatment of dividends in DC, MD, and VA	
DC	There are no deductions allowed for dividends except that dividends from wholly owned companies and dividends from foreign sources unrelated to business income are subtracted from income.
MD	The starting point for Maryland income is federal taxable income after the special deductions, so Maryland allows deductions of dividends from corporate income. Foreign dividends from majority-owned corporations, however, are subtracted from income.
VA	The starting point for Virginia income is federal taxable income, so Virginia allows the federal dividend deduction. Like Maryland, foreign dividends from majority-owned corporations are subtracted from income.

History of Business Franchise Taxes in the District

The federal Tax Act of 1947 (P.L. 80-195) established the District's ability to tax income of residents and the District business portion of income on nonresidents. At the time the District was a federal entity and the council was appointed by the president. The District was allowed to manage its own affairs when the Home Rule Act (HRA) was signed in 1973 and became effective in 1975. Under the HRA, residents of the District were allowed to choose the council and mayor and adopt laws, including those related to taxation, subject to congressional oversight.[27] As part of the legislation, however, the HRA narrowed the tax base by expressly prohibiting the council from taxing the income of nonresidents:

> § 1-206.02. Limitations on the Council
> (a) The Council shall have no authority to pass any act contrary to the provisions of this chapter except as specifically provided in this chapter, or to:
> …
> (5) Impose any tax on the whole or any portion of the personal income, either directly or at the source thereof, of any individual not a resident of the District (the terms "individual" and "resident" to be understood for the purposes of this paragraph as they are defined in § 47-1801.04)

This provision was litigated in two cases with regard to the UBFT. As a result of these laws and the court cases, the District is one of the few jurisdictions to have a tax on unincorporated business income because it cannot use the normal personal income tax.[28] Since home rule, the District has revisited business franchise taxes several times. There were two prior tax commissions, a reform package that was enacted but was later reversed, and a spate of recent legislation, which, taken together, could be considered major tax reform.

Previous Tax Revision Commission study

In 1998, the District, operating under a federal control board that was created as a result of financial problems, undertook a review of its current tax system. As part of that study, the DC Tax Revision Commission received several business income tax policy recommendations from Cordes and Watson (1998) for reforming the CFT and UBFT. Most of the recommendations were not part of the commission's final report but some were subsequently adopted by the council. It is worth reviewing these prior recommendations and what changes they caused.

Recommendations enacted:

1. *Retain the CFT and increase the minimum tax from $100 to $500.*
   A variant of this was enacted for tax year 2012 when the minimum tax increased from $100 to a two-tiered minimum of $250 for companies with $1 million sales or less and $1,000 for those with more than $1 million.

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[27] DC Council history of home rule act: http://dccouncil.us/pages/dc-home-rule.
[28] Virtually every state has a nonresident tax form to collect the tax on nonresidents doing business through partnerships.

2. *Double-weight sales in the apportionment formula.*
   This was enacted for tax year 2012.
3. *Adopt combined reporting.*
   This was enacted beginning 2011.

Recommendations not enacted:

1. *Conform the franchise tax to that of either Maryland or Virginia.*
   The recommendation was to conform the tax base to that of Maryland or Virginia and realize administrative savings and reduced complexity as well as encourage start-up affiliates of Maryland or Virginia parent companies. The primary difference was the treatment of NOL and whether a newly established affiliate could use the parent company NOL to offset profits. The combined reporting legislation addressed sharing of NOLs in the District.
2. *Replace UBFT with a license fee for nonresident business.*
   The recommendation was to replace the UBFT with a license fee for nonresident businesses because the UBFT "serves as the administrative vehicle for taxing most business income of District residents and is a very crude benefit tax on nonresident owners who are engaged in business activities that are not exempt from the tax" (Cordes and Watson 1998).
3. *Replace the CFT and UBFT with an expanded gross receipts tax.*
   This recommendation was to enact a tax on gross receipts without deductions. The Commission rejected the proposal, citing its impact on low margin industries like wholesale and retail and the pyramiding that would result.[29]
4. *Replace the CFT and UBFT with value-added tax.*
   This was the only recommendation adopted by the Commission which recommended replacing the CFT and UBFT as well as the personal property and corporate license fee with a 1.5 percent tax business activities or value-added tax. The recommendation for the District was to adopt a "Michigan style" value-added tax and laid out how it would work and how it could benefit the District (Cordes and Watson 1998). The Michigan Single Business Tax, which provided a model, replaced seven different taxes and was in place from 1976 to 2006 when it was repealed and replaced with the Michigan Business Tax (which has now been replaced with a more conventional net income tax).

Tax Parity Act of 1999

In 1999, the Tax Parity Act was enacted to reduce the CFT and UBFT rates down to the individual income tax rates over several years, with a first reduction to 9.0 percent in 2003, followed by a second in 2004 to 8.5 percent. However, when the first reduction was to take place in 2003, the nation and the District were facing a fiscal gap following the 2001

[29] Pyramiding refers to multiple levels of tax when taxes are levied on gross receipts without deductions for goods and services purchased as part of the production process. A Washington state tax study reports that pyramiding in that state's business and occupation tax causes the tax on a final sale to be applied 2.5 times. (Washington Tax Structure Study Committee 2002).

recession. As a consequence, the rate reduction was reversed and the future reduction was suspended.

Recent legislative changes

Many major changes to the tax code affecting businesses occurred in the last four years and were enacted primarily as a way to raise revenue during the Great Recession. However, the changes also follow national trends and have been recommended by other state tax commissions. Many of these were suggested by Cordes and Watson (1998) during the prior Tax Revision Commission. These actions are major changes to the franchise tax system and taken together represent a reform of the way franchise taxes are levied and collected in the District. They include the requirement of combined reporting, the increase in the minimum tax, and the change to double-weighted sales apportionment (table 6). The additional revenue in fiscal year (FY) 2012 from these reforms was estimated to increase revenue by $64 million, or about 14 percent of franchise tax revenue.[30]

Table 6: Recently Enacted Changes to CFT and UBFT

Enacted change	Estimated new 2012 revenue (000s)	Legislative act
Decouple from domestic production activity	$ 3,400	FY 2009 Budget Support Act
Decouple from bonus depreciation/179 expensing	6750	FY 2009 Budget Support Act
Require combined reporting	22,400	FY 2010 Budget Support Act
Related party interest add-back	12,300	FY 2010 Budget Support Act
New two tier minimum tax	12,000	FY 2012 Budget Support Act
Double-weight sales in apportionment formula	7,233	FY 2012 Budget Support Act
Changes to QHTC	(a)	Technology Enhancement Act
Social e-commerce QHTC	(a)	Social E-Commerce Job Creation Tax Incentive Act of 2012
Total	$ 64,083	

Source: OCFO Fiscal Impact Statements; Revenue estimated at time of consideration legislation.
(a) No fiscal impact in 2012.

Details of legislation recently passed with analysis:

[30] Estimates for legislation are usually calculated long before the legislation goes into effect. Although the final fiscal year (FY) 2012 collections for CFT and UBFT was $78 million above the revised estimate, they were below the estimate made in 2009 (OCFO 2013b; OCFO 2009). The franchise tax estimates were subsequently revised down as the economy continued to struggle throughout 2009 and 2010 (appendix E).

- Decoupling from federal actions.
  Beginning tax year 2008, the District decoupled from the federal provisions allowing bonus accelerated depreciation and expensing (Section 179). Beginning tax year 2009, the District also decoupled from the federal domestic production activities deduction.
    - *Analysis:* Decoupling from federal stimulus measures makes sense for states. Accelerating or allowing bonus depreciation is merely shifting or concentrating the tax benefits of depreciation to the current period. Since states can't borrow for current year operations, they have less ability to pay for stimulus out of future tax dollars.

- Mandatory combined reporting.
  In 2009, as part of a package of tax changes to close a budget gap in the five-year financial plan, the council and mayor enacted legislation requiring combined reporting beginning with tax year 2011. The original legislation lacked any of the enabling legislation necessary to implement the new requirement. The original fiscal impact was $22.6 million in FY 2012 and $19.4 million annually in subsequent years. The passage was controversial because it was not well publicized and included in a mixture of other tax changes (Setze 2009).
    - *Analysis*: Requiring combined reporting was appropriate for the District to capture the income from aggressive tax planning. From early reports, it may have increased revenue more than originally estimated suggesting it did expand the base of taxable income. Some features—the selection of *Joyce* and the default of water's edge—should be revisited as data becomes available. In the original implementing legislation, the OCFO was directed to report on the economic impact of requiring combined reporting.

- Related party interest add-back.
  The add-back for the "Delaware holding company," added back interest paid to related entities. According to OCFO (2009), this would close the loophole where companies reduce taxable income by paying interest, which is deductible, to related subsidiaries in low- or no-tax states.
    - *Analysis:* This was an appropriate action for the District to take in absence of requiring combined reporting, which came later. For the add-back, related entities were defined as companies at least 50 percent owned by the taxpayer. Combined reporting also captures this income.

- Increase in the minimum tax.
  Beginning tax year 2011, the minimum tax was increased to $250 for companies with sales of $1 million or less and $1,000 for companies with sales greater than $1 million. The minimum had been $100 for all companies since 1983. This change affected two-thirds of businesses that pay only the minimum tax (OCFO 2011).
    - *Analysis:* On the surface, this seems like a good policy since two-thirds of the tax filers owe only the minimum tax and that level had not been increased since 1983. The two-tiered levels, however, create a cliff effect which means a tax filer with District gross receipts of $1 million pays $750 less than a taxpayer with one dollar more. A phased-in approach would be more sensible

from an economic perspective but would add complexity. Maryland and Virginia do not have minimum taxes.

- Double-weighted sales apportionment.
  Beginning tax year 2012, multistate companies must use a double-weighted sales factor formula to apportion income to the District. The previous method was a formula that equally weights payroll, property, and sales (UDITPA).
  - *Analysis:* The double-weighted sales tax formula is generally adopted as an economic development tool in other states (and, typically, a revenue loser) but with the nature of the District economic base and the companies supplying our markets, the double-weighted sales tax formula was estimated to increase tax revenue. The change is unlikely to create significant economic activity in the District.

- Credits and incentives.
  The two major changes to the CFT and UBFT credits involve QHTCs.
  - The Technology Sector Enhancement Act of 2012 changed some of the definitions of QHTC in subtle but fundamental ways. First, it repealed the requirement that QHTCs be in economic development zones to get the zero rate tax credit (see above for description of QHTC program). Second, it changed the requirement that a QHTC has employees and revenue to a requirement that the QHTC has employees "in the District."[31]
    - *Analysis:* The change to the QHTC credit to eliminate the zones reflected the constantly changing focus for development. The changes to the criteria for qualifying appropriately narrowed the scope to companies that actually had District income and employees. This will reduce the number of QHTCs but the remaining ones should reflect the type of company originally targeted.

  - The "Social e-Commerce Job Creation Tax Incentive Act" created a series of tax incentives for a QHTC with "a primary business of marketing or promoting retail or service businesses by delivering or providing members with access to discounts or other commerce based benefits."[32]
    - *Analysis:* This legislation was tailored for a specific company at a specific time and so is not a useful credit for long-term economic development goals. The tax and job targets are complicated, also limiting its usefulness as a broad business tax incentive.

- Compliance.
  Not included in the table above are several measures that increase compliance:
  - Federal Treasury Offset Program: captures delinquent taxes from federal disbursements.

[31] L19-0211 http://dcclims1.dccouncil.us/images/00001/20121019175931.pdf.
[32] L19-074 http://dcclims1.dccouncil.us/images/00001/20120724123156.pdf.

- Safe-harbor: in 2011, for the purpose of calculating estimated quarterly payments, the District increased “safe harbor” thresholds to 110 percent of the prior year tax.

Franchise Taxes and the Economy

There is considerable debate about the impact of corporate income taxes on the economy. Researchers examining ostensibly the same data come to different conclusions. Part of the reason is that corporate income is opaque and subject not only to the laws of the economy but the laws of accounting as well. Gupta and colleagues (2009) note that state income taxes were declining when corporate profits were increasing. There are also several other taxes that businesses are subject to that may overshadow the corporate income tax.

Wheeler (2005) summarizes several studies on the impact of corporate income tax on employment, investment, and site location. There is some evidence that lower corporate income tax rates leads to higher investment, particularly foreign direct investment in manufacturing, but the increase in employment is less significant. Studies on the impact of a reduction in the corporate tax rate have to take into account the balanced budget requirements of states and the District: reduction of one tax, at least in the short run, necessarily means that another tax has to increase or expenditures have to be reduced (Mazerov 2010). Both of these will also have an impact on the economy.

Recent economic history: District, Maryland, and Virginia

The District economy has thrived in comparison with other parts of the country and even within the region where the District appears to be more robust. Prior to the Great Recession, employment, businesses, and wages all grew faster than other jurisdictions (table 7). Notably, there was positive growth in all three variables during the recession, though neighboring counties also did better than the nation as a whole and Arlington County, VA, outperformed the District. However, the resilience of businesses in the metro area may in part reflect the expansionary policies undertaken by the federal government, first with the expanded military spending in support of the wars in Afghanistan and Iraq and then with the adoption of stimulus programs under the American Recovery and Reinvestment Act of 2009. Recently, with the federal sequester and declining troop levels overseas, federal government activity in the region is contracting. This has already translated into forecasts of slower business activity growth in the District and surrounding areas than otherwise would be the case (OCFO 2013a; Fuller 2013).

Table 7: Average Annual Growth in Private Employment, Establishments, and Wages over Last Decade (2001–2011)

		2001–2007	2007–2011	2001–2011
District	Employment	1.2%	0.7%	1.0%
	Establishments	2.8%	1.7%	2.3%
	Wages	5.8%	2.7%	4.6%
Maryland	Employment	0.9%	-1.2%	0.1%
	Establishments	2.0%	-0.4%	1.0%
	Wages	4.7%	1.0%	3.2%
MD – Montgomery Co	Employment	0.5%	-1.3%	-0.2%

	Establishments	1.8%	-0.3%	0.9%
	Wages	4.7%	0.9%	3.2%
MD – Prince George's Co	Employment	0.2%	-2.2%	-0.8%
	Establishments	1.6%	-0.6%	0.7%
	Wages	3.1%	-1.1%	1.4%
Virginia	Employment	1.0%	-1.0%	0.2%
	Establishments	2.5%	0.6%	1.7%
	Wages	4.8%	1.5%	3.5%
VA – Arlington Co	Employment	-0.6%	1.9%	0.4%
	Establishments	2.1%	2.3%	2.2%
	Wages	3.9%	4.5%	4.1%
VA – Fairfax Co	Employment	1.1%	-0.3%	0.5%
	Establishments	2.1%	1.2%	1.7%
	Wages	5.5%	2.6%	4.3%
VA – Alexandria City	Employment	0.5%	-1.5%	-0.3%
	Establishments	1.6%	0.5%	1.2%
	Wages	4.9%	0.8%	3.3%
United States	Employment	0.7%	-1.3%	-0.1%
	Establishments	2.0%	0.3%	1.3%
	Wages	4.2%	0.6%	2.7%

Source: BLS Quarterly Census of Employment and Wages.

Another useful comparison is to look at cities that play a similar role to the District. The Washington metro area outperformed most of the country during the recession and the recovery. The District, as the center of the metro area, outperformed other center cities (table 8).

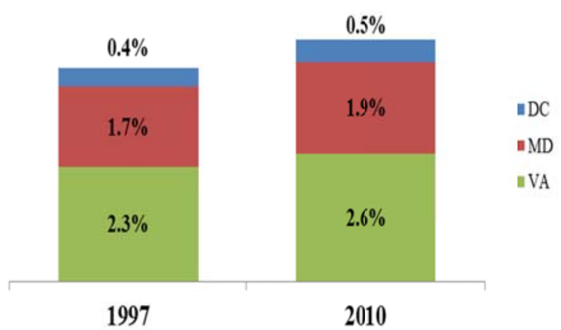
Table 8: Growth in business establishments–select cities

	2001–07	2007–11	2001–11
Las Vegas, NV	8.9%	-0.7%	4.9%
Washington, DC	**2.8%**	**1.7%**	**2.3%**
Philadelphia, PA	1.2%	3.4%	2.1%
Boston, MA	0.6%	2.4%	1.3%
New York, NY	1.1%	1.6%	1.3%
Atlanta, GA	0.2%	2.0%	0.9%
Denver, CO	0.8%	-0.4%	0.4%
Dallas, TX	0.4%	-0.5%	0.0%
Seattle, WA	-1.4%	1.6%	-0.2%
Cleveland, OH	-0.6%	-1.3%	-0.9%

Source: BLS Quarterly Census of Employment and Wages (data shown for each city's primary county).
Note: Private sector establishments.

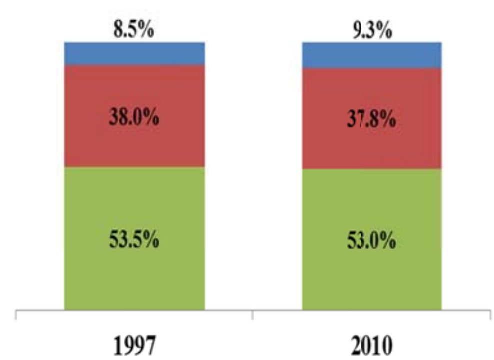
The District also increased its share of the economy over time. In 1997, the District's share of national gross operating surplus, a proxy for profits, was 0.4 percent and grew to 0.5 percent by 2010.[33] The District's share of the regional gross operating surplus rose from 8.5 percent to 9.3 percent, reducing both Virginia's and Maryland's share (figures 4 and 5).

Figure 4: State Share of National Gross Operating Surplus



Source: BEA

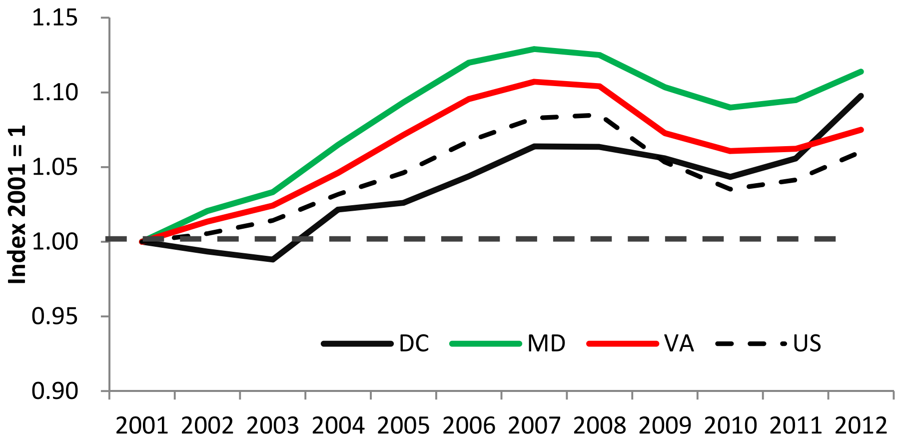
Figure 5: State Share of Regional Gross Operating Surplus



A similar story can be told about small business. The growth in business establishments with 5–49 employees did decline during the recession but has risen since 2010 and the number of small businesses in the District is now growing faster than Virginia (figure 6). The District did lag behind the neighboring states and the US average in the early part of the decade but over the last two years has exceeded the national average.

[33] Gross operating surplus is the value derived as a residual for most industries after subtracting total intermediate inputs, compensation of employees, and taxes on production and imports less subsidies from total industry output. Gross operating surplus includes consumption of fixed capital (CFC), proprietors' income, corporate profits, and business current transfer payments (net). Source: BEA.

Figure 6: Small Business Growth: DC, MD, VA, and US



Source: BLS; establishments with 5 to 49 employees.

Who legally pays the franchise taxes?

In an attempt to address how businesses of different sizes were taxed under the CFT and UBFT, ORA analyzed the 2011 UBFT and CFT data (see table 9). Using gross sales as a proxy for business size, most taxpayers reported paying only the minimum tax, which in 2011 was either $250 or $1,000. Fourteen percent of all tax filers are classified as large businesses with sales greater than $5 million and more than half only pay the minimum.[34]

Table 9: Business Size–Franchise Taxes in 2011

	CFT	UBFT	All tax filers	Share of total
Small Business (Sales < $5 Million)	**18,709**	**17,652**	**36,361**	**86%**
paying minimum	13,391	11,402	24,793	
paying more than minimum	5,318	6,250	11,568	
Large Business (Sales > $5 Million)	**5,230**	**889**	**6,119**	**14%**
paying minimum	3,003	450	3,453	
paying more than minimum	2,227	439	2,666	
Total Number of Returns	**23,939**	**18,541**	**42,480**	

Source: DC Chief Financial Officer, ORA.

[34] Sales are total sales of the tax filer, not just sales in the District.

Who actually pays?

Identifying the ultimate payer of business taxes is important to evaluate a business tax reform proposal in the District. If the taxes are assumed to be paid out of profits, the incidence is on the shareholders of the company, but a company may be able to pass on the tax to the consumer in the form of higher prices or to the employees in the form of lower wages.

Felix (2009) identifies a correlation with high state corporate tax rates and lower wages, particularly among high-skilled labor. Nunns (2012) describes how the model used for federal corporate income tax at the Tax Policy Center originally assumed the tax was borne by the shareholders but has been updated to reflect a greater burden on labor. Cline and colleagues (2010) suggest that households pay 24 percent of taxes from changes in the corporate tax but these results may not apply to the District due to the differences in structure (the District has both state and local functions) and the differences in markets.

The methodology from Cline et al. rests on whether taxes are origin or destination and determines that 85 percent of District business taxes are origin. In the District, however, the economic activity is more likely to be services sold to the government rather than to other businesses, which would affect Cline's calculations.

Tax avoidance also determines who pays. Notwithstanding illegal tax evasion or tax fraud, some companies make business structure decisions to avoid tax liability in a state. The use of passive investment companies and real estate investment trusts for the sole purpose of avoiding tax liability increased during the 1980s and 1990s. States have enacted laws to reduce the lost income: add-back and combined reporting are two examples. Gupta et al. (2012) suggest that some of the increase in state corporate tax revenue in 2007 and 2008 came not only from better economic conditions but from a change in an accounting rule. The Financial Accounting Standards Board Interpretation No. 48 (FIN 48) was adopted in 2006 requiring public corporations to report any "uncertain tax positions" (UTPs). According to the IRS, which requires publicly traded companies to report UTPs as part of the federal return, 4,120 UTPs were disclosed in 2012 from 1,783 taxpayers.[35] This is a relatively small number of taxpayers but, by modeling firm behavior around the time of the rule, Gupta and colleagues (2012) conclude that companies reacted by settling tax positions before having to report them.

Competitiveness

Several studies purport to gauge a state's "competitiveness" with other states. Fitting the District into these studies is usually difficult because of (1) the inability of the District to tax nonresidents and (2) the melding of state and local functions in the District.[36] Some of the studies—Cline and colleagues (2011), Tax Foundation (2012)—weigh items that make more sense in a state with a high concentration of manufacturing but not in a service economy like the District. These studies use representative firms that are not generally appropriate comparisons for the District. Anderson (2012) analyzes several of the studies and concludes

[35] http://www.irs.gov/Businesses/Corporations/UTPFilingStatistics.

[36] In a report on Maryland's business tax competitiveness, the District was not even mentioned. (Ernst & Young 2010).

that while each study has useful comparisons of state tax structures, the evidence that the rankings are correlated with economic performance is not robust. He warns that "policymakers should be careful to understand the measures included in any index, the weights placed on those measures, and the subjective judgments incorporated into the computation of the weights." This is particularly important when neighboring jurisdictions have both state and local business taxes: the cumulative tax burden must be calculated.

The Commission's 1998 report also studied competitiveness and how the taxes affected the economy. Mark et al. (1998) modeled the corporate tax rate and employment for the District and several surrounding jurisdictions and found that there was little evidence to show that the higher rate affected employment levels.

Other business taxes

Business taxes to finance the Nationals baseball stadium

In addition to the CFT and UBFT, there is a tax on all businesses with sales over $5 million. The "ballpark fee" is a four-tier tax paid by about 2,000 businesses and raised $32.7 million in 2012, dedicated to the Baseball Fund (see table 10). There are also surtaxes on nonresidential utility consumption—gas and electric—and telecommunications that are dedicated to the Baseball Fund. The utility surcharge is equivalent to one percentage point, but denominated in either kilowatt hours or thermal units. In 2012, the transfer to baseball from these surcharges was $10.7 million. These taxes are in addition to special taxes on concessions and ticket sales that also go into the fund. The fund is used to pay off the bonds that financed the construction of the Washington Nationals baseball stadium.

Table 10: Baseball Fee Collected in 2012*

Tier		Fee	# of returns	2012 collections
1	$5,000,000–$8,000,000	$5,500	508	$3,815,887
2	$8,000,00–$12,000,000	$10,800	414	$5,469,764
3	$12,000,001–$16,000,000	$14,000	226	$3,958,137
4	Greater than $16,000,000	$16,500	807	$16,402,671
	Unattributable			$3,015,453
		Total:	1,955	$32,661,912

Source: OCFO Economic Development Finance.
* Includes approximately $6.3 million attributable to prior years.

Personal Property Tax

Another business tax is the personal property tax, which is not included in the scope of this report but deserves mention as a business operations tax (as opposed to a real property tax). The personal property tax despite its name is generally regarded as an equipment value tax. The tax rate is $3.40 per $100 of assessed value. The first $225,000 of personal property is exempt.

Certain property is excluded:

- Tangible property, other than office equipment or furniture, of wireless telecommunications companies
- Inventories
- Personal property of digital audio radio satellite companies licensed by the Federal Communications Commission and subject to the toll telecommunications gross receipts tax
- Personal property of utilities, cable companies, and energy generation plants
- Personal property of a qualified supermarket for the first 10 years
- Personal property of a QHTC for 10 years from purchase

Maryland taxes all business equipment and has both city and county rates. In Montgomery County, the county rate is $1.81 per $100 and the median city rate is $0.52. Inventories are exempt at the county level but most cities in Montgomery and Prince George’s counties, which border the District, tax inventories at the city rate only.

Personal property in Virginia includes business property and vehicles and the rates are higher than both Maryland and the District. The rates vary by location. In Arlington County, the rate is $5.00 per $100 assessment; in Fairfax County, the rate is $4.57; and in the City of Alexandria, the rate is $4.50 for vehicles and $4.75 for most other property.

Options for the Commission to Consider

The Commission's charge is to provide the Council and the Mayor with comprehensive recommendations with five goals in mind: (1) fairness, (2) broad base, (3) more competitive, (4) job creation and business growth, and (5) simplicity, transparency, and modernity. As many of the fundamental reform measures that are typically considered for business franchise taxes have been adopted by the District, the most important step is to evaluate the impacts these changes have had.

Recommendation: Analyze the business taxpayer data before and after tax year 2011 and prepare a report showing how companies' liabilities changed and how the details of the filings changed.

Should include:

- *a. An analysis of the before and after of net income*
- *b. An analysis of the before and after apportionment factors*
- *c. A review and report on the FAS 109 deductions claimed*
- *d. An assessment of changes due to economic conditions versus the changes in policy*

This may take a few years to determine, but the additional revenue appears to have been realized and there does not appear to be an exodus of companies due to the new laws. It will be important to know what kind of companies were "winners" and what kind were "losers." It may be the case that requiring combined reporting had a mix of winners and losers like Maryland saw in its analysis. (Schaufele 2011).

The Commission should also consider two options to strengthen the District's tax base:

- *Expand nexus definition to economic presence–uncertain but positive revenue impact*
  Expanding the standard from physical presence to substantial economic presence would broaden the base by allowing OTR to assert nexus over more economic activity in the District. Expanding nexus will increase revenue but estimating the amount is difficult as the data is not available.

  Advantage: The District is a destination market for out-of-state companies and a physical presence standard misses a large share of the economic activity. One way to expand the nexus in a clear and simple manner would be to adopt the MTC factor thresholds, asserting nexus over any company with at least $50,000 property value, $50,000 payroll, or $500,000 sales, or 25 percent of any one of the factors.

  Disadvantage: Setting explicit factors also means that corporations near the thresholds may make adjustments for tax reasons rather than economic reasons, creating a distortion. For a small market like the District, however, this planning should be rare.

- *Apportion using single-weighted sales formula–estimated to increase revenue $15–20 million annually*
  The District could adopt the single-sales factor method of apportionment. Adopting single-sales factor will expand the base and may provide an incentive for companies to

move to the District. Virginia is already phasing-in single- sales factor apportionment for retailers and certain manufacturers.

Advantage: Single-sales factor has become more common than UDITPA and so the District's apportionment method would be in line with other states. The District would also benefit from a single-sales factor since most companies doing business in the District do not have significant payroll or property. This will, according to analysis of taxpayer records, increase revenue for the District and at the same time may entice a larger facility to locate here. We estimate this will increase District revenues between $15 and $20 million, based on 2009 taxpayer information developed by ORA for the 2011 legislation adopting double-weighted sales factor.

Disadvantage: If the mix of companies changes from pre-2011, when the estimate of revenue was calculated, there could be revenue loss from this policy. Another important consequence may be that companies will fine-tune their sales to the District to avoid nexus. The single-sales factor can also be seen as a violation of the benefits principle of sound tax policy which says that the tax levied should be commensurate with the benefits received.

Following are several options that were considered but are not recommended at this time.

1. *Equalize tax rate with Maryland.*
This proposal to reduce the franchise tax rates to 8.25 percent would reduce revenue by about $75 million. Decreasing the rate alone would not, in our view, increase economic activity. As noted, the District has always had a higher rate than its neighbors but has not exhibited reduced economic growth. Part of the reason is the nature of the marketplace in the District as a primarily destination market for out-of-state sellers. Further, the franchise taxes make up a relatively small part of the total tax burden so absent a broader business package of tax reform, a rate reduction alone will not be enough of an incentive to encourage business activity that would not otherwise take place.

2. *Replace the CFT and UBFT with an expanded gross receipts tax.*
This proposal is attractive because of its simplicity. This is an option that is worthy of future consideration but could only be recommended in a broader discussion of all business taxes. A tax rate of 0.5 percent should produce sufficient revenue to repeal the CFT, UBFT, baseball gross receipts, and personal property taxes. This is a rough approximation and a more thorough analysis by ORA should be done before recommending this option. There are several states with gross receipts taxes, including some that also have a corporate income tax. Virginia allows a gross receipts tax at the local level. Fairfax County, Arlington County, and the City of Alexandria have gross receipts taxes.

Advantages: One of the primary advantages is the business receipts taxes would not tax "income," so they could potentially reach nonresident professionals. The federal and District definitions for gross sales are the same so tax filers would just use the number already calculated for the federal return, apportion to the District, and apply the District rate, making the administration very simple. There would be no deductions or other income to interpret, which would reduce opportunities to do aggressive tax planning. The revenue would be much more stable as gross receipts are less volatile than corporate profits. The rate would also appear to be much lower than other states.

Disadvantages: The major criticism of gross receipts taxes, as opposed to net income or value-added taxes, is that the tax is "pyramided," or applied at more than one stage of production. This creates different effective tax rates for different industries and particularly impacts low margin industries. Washington State (2002) reported the extent of pyramiding of its business and occupation tax by industry and found that the manufacturing industry, which is almost nonexistent in the District, had the highest rates of pyramiding. In New Mexico, pyramiding may have represented one-third of the gross receipts tax collections (Del Valle 2005).

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Appendix A: Corporate Income Tax by State

	Tax Rate (Bold if top rate)	Recently changed (prior rate)	Apportionment Formula	Combined Reporting Required	Joyce or Finnigan
ALABAMA	6.5		Double-Wtd Sales		
ALASKA	9.4		3 Factor	Y	F
ARIZONA	6.968		Double-Wtd Sales 80-10-10 for MFG		
ARKANSAS	**6.5**		Double-Wtd Sales		
CALIFORNIA *	8.84		Sales	Y	J
COLORADO *	4.63		Sales	Y	J
CONNECTICUT	7.5		Double-Wtd Sales Single Sales for MFG		
DELAWARE	8.7		3 Factor		
DIST. OF COLUMBIA	**9.975**		**Double-Wtd Sales**	**Y**	**J**
FLORIDA	5.5		Double-Wtd Sales		
GEORGIA	6		Sales		
HAWAII *	6.4		3 Factor	Y	J
IDAHO *	7.4	2013 (7.6)	Double-Wtd Sales	Y	J
ILLINOIS *	9.5	2011 (7.3)	Sales	Y	J
INDIANA	8	2011 (8.5)	Sales		
IOWA	12		Sales		
KANSAS *	4		3 Factor	Y	F
KENTUCKY *	6	2007 (7)	Double-Wtd Sales		
LOUISIANA	8		Single-Sales 3 Factor		
MAINE *	8.93		Sales	Y	F
MARYLAND	8.25	2008 (7)	Sales Double-Wtd Sales		
MASSACHUSETTS	8	2012 (8.25)	Sales Double-Wtd Sales	Y	F
MICHIGAN	6	2012 (4.95)	Sales	Y	F
MINNESOTA	9.8		96-2-2	Y	J
MISSISSIPPI	**5**		Sales Other (2)		
MISSOURI *	6.25		3 Factor Sales		
MONTANA *	6.75		3 Factor	Y	J
NEBRASKA	7.81		Sales	Y	
NEW HAMPSHIRE	8.5		Double-Wtd Sales	Y	J
NEW JERSEY	9		90-5-5		
NEW MEXICO *	7.6		3 Factor		
NEW YORK	7.1	2010 (7.5)	Sales	Y	F
NORTH CAROLINA *	6.9		Double-Wtd Sales		
NORTH DAKOTA *	5.15	2012 (6.4)	3 Factor	Y	J
OKLAHOMA	6		3 Factor		
OREGON	7.6	2011 (7.9)	Sales	Y	J

	Tax Rate (Bold if top rate)	Recently changed (prior rate)	Apportionment Formula	Combined Reporting Required	Joyce or Finnigan
PENNSYLVANIA	9.99		Sales		
RHODE ISLAND	9		3 Factor		
SOUTH CAROLINA	5		Sales		
TENNESSEE	6.5	2003 (6)	Double-Wtd Sales		
UTAH	5		Sales	Y	F
VERMONT	8.5	2007 (9.75)	Double-Wtd Sales	Y	J
VIRGINIA	6		Double-Wtd Sales Triple-Wtd Sales (1)		
WEST VIRGINIA *	7	2012 (8.5)	Double-Wtd Sales	Y	J
WISCONSIN *	7.9		Sales	Y	F

States with gross receipts taxes

OHIO	0.26% over $1m on Gross Receipts	Triple-Weighted Sales (3)		
TEXAS	1% on revenue over $1.03 million (0.5% for retail)	Sales	Y	F
WASHINGTON	Business and occupation tax rate between 0.1% and 0.48 %			

States without income taxes

NEVADA
SOUTH DAKOTA
WYOMING

Notes:
* State has adopted substantial portions of the UDITPA (Uniform Division of Income Tax Purposes Act).
3 Factor = sales, property, and payroll equally weighted.
Double-Wtd Sales = 3 factors with sales double-weighted
Sales = single-sales factor.
Virginia is phasing in a single factor sales formula.
Source: Compiled from Federation of Tax Administrator reports and state tax departments.

Appendix B: Credits Offered in DC, MD, and VA

Tax Credits and Incentives Available to Business Franchise Taxpayers

District of Columbia – Source: DC Office of Tax and Revenue Form D-20 and D-30, Schedule UBFT	Economic Development Zone Credit Qualified High Technology Company Organ and Bone Marrow Donor Job Growth Credit
Maryland – Source: Comptroller of Maryland, Form 500CR	Enterprise Zone Tax Credit Disability Employment Tax Credit Job Creation Credit Community Investment Businesses that Create New Jobs Long term Employment of Ex-Felons (expired tax year 2011) Work-based Learning Credit Employer Provided Long Term Care Insurance Research and Development Credit Biotechnology Investment Incentive Commuter Tax Credit Clean Energy Incentive Tax Credit Maryland Mined Coal Credit One Maryland Economic Development Credit Green Building Credit Bio-Heating Oil Credit Cellulosic Ethanol R&D credit Job Creation and Recovery (expired tax year 2011) Maryland Film Production Employment Credit Electric Vehicle Recharging Equipment

Virginia – Source: Virginia Department of Taxation Schedule 500CR	Neighborhood Assistance Act Enterprise Zone Conservation Tillage Biodiesel and Green Diesel fuels Precision Fertilizer and Pesticide Application Equipment Recyclable Materials Processing Equipment Rent Reduction Program (expired tax year 2010) Clean Fuel Vehicle and Emissions Testing Equipment Major Business Facility Jobs Clean fuel Vehicle Jobs Historic Rehabilitation Day Care Facility Investment Low Income Housing (expired fiscal year 2010) Agricultural Best Management Practices Worker Retraining Waste Motor Oil Burning Equipment Riparian Waterway Buffer Land Preservation Virginia Coal Employment and Production Community of Opportunity Green Job Farm Wineries and Vineyards International Trade Facility Port Volume Increase Barge & Rail Usage Livable Home Research and Development Expense Telework Expenses

Appendix C: Comparison of Job Creation/Retention Credits

District of Columbia	
Economic Development Zone Incentive (EDZI) Not used (OCFO, 2012a)	The EDZI Amendment Act allows a qualified business, under certain circumstances, to take various credits against its franchise tax liability. (The maximum annual credit is $7500.) A qualified business is one that is approved as qualified under Section 5 of EDZI by the DC Office of Economic Development. You MUST complete the worksheet below and include it with the other attachments to your return. The following credits are allowed under EDZI to qualified businesses: 1. A credit against the franchise tax in an amount equal to 50 percent of the wages of all certified employees who meet the requirements of Section 10(b) of EDZI; 2. A credit against the franchise tax in an amount equal to 50 percent of the insurance premiums attributable to all employees for whom it obtains employer liability insurance under the District of Columbia Workers Compensation Act of 1979; and 3. A rent credit for lessors against the franchise tax. The credit allowed is the difference between the rental market value of the space leased to a licensed non-profit child care center and the actual rent stated in the lease agreement as indicated in the DC Council resolution approving the qualification of the business. A nonprofit child care center is a child development center as defined in Section 10 of EDZI. A credit carry forward for five years is available for any EDZI credit not used in a previous year. The maximum amount that may be claimed in any year is $7500, including any carry forward.
Job Growth Incentive Act	In order to apply for the credit, the employer must be planning a project that will: • Bring a net job growth to DC of at least 10 new jobs with an average yearly wage of at least 120% of the average yearly wage of DC residents; • Increase income tax and payroll revenue for DC; • Result in a retention of any new positions for at least one year; and • The project would not have occurred but for the job growth tax credit.
Qualified High-Technology Company There were 114 QHTCs in 2009, claiming a total of $8.7 million.	See above for detailed description of eligibility requirements. The various DC tax credits and other tax benefits available to a QHTC are Tax Credits for: • Costs of retraining qualified disadvantaged employees; • Wages paid to qualified disadvantaged employees (corporations only); • Wages paid to qualified employees (corporations only); • Payments for or reimbursements of employee relocation costs (corporations only). • Reduction of the corporate franchise tax rate; • Partial exemption from the personal property tax; • Exemption for 5 years from the DC corporate franchise tax when located in a designated high technology development zone; • Deduction for Internal Revenue Code (IRC) section 179 expenses (up to $40,000); • Exclusion of capital gains from taxation for qualified assets

	held more than 5 years; and • Rollover (deferral) of certain capital gains.
Maryland	
Enterprise Zone	Businesses located in an enterprise zone may be eligible for tax credits based upon wages paid to qualifying employees. For businesses located in a focus area (an area within an enterprise zone that is especially in need) the credit amounts are higher. Businesses that own, operate, develop, construct or rehabilitate property intended for use primarily as single or multifamily residential property are not eligible for the enterprise zone tax credit. Qualifying employees are those employees who: 1. are new employees or employees rehired after being laid off for more than one year; 2. were employed at least 35 hours per week by the business for at least six months before or during the business entity's tax year for which a credit is claimed; 3. spent at least one-half of their working hours in the enterprise zone on activities of the business resulting directly from its location in the enterprise zone; 4. earn 150% or more of the federal minimum wage; and 5. were hired by the business after the later of the date on which the enterprise zone was designated or the date on which the business entity located in the enterprise zone. In addition, an employee may not have been hired to replace an individual employed by the business in that or the three previous tax years except an economically disadvantaged employee hired to replace a previously qualified economically disadvantaged employee, for whom the business received the corresponding first or second-year credit in the immediately preceding tax year.
Job Creation	Certain businesses that create new qualified positions in Maryland may be eligible for tax credits based on the number of qualified positions created or wages paid for these positions. The business facility must be certified as having created at least 60 qualified positions, 30 high-paying qualified positions, or 25 qualified positions if the business facility established or expanded is in a State Priority Funding Area. A qualified position is a full-time position which pays at least 150% of the federal minimum wage, is located in Maryland, is newly created as a result of the establishment or expansion of a business facility in a single location in the state and is filled. Qualified business entities are those that are certified as such by the Maryland Department of Business and Economic Development. A qualified employee is an employee filling a qualified position.
Businesses that Create New Jobs	To qualify, businesses must be located in Maryland and create new positions or establish or expand business facilities in the state. If a property tax credit (or an enhanced property tax credit) as defined in Section 9-230 of the Tax-Property Article is granted by the Mayor and City Council of Baltimore City or the governing body of a county or municipal corporation, certain businesses may be entitled to an income tax credit.
Long-Term Employment of Ex-Felons ***This credit expired tax year 2011***	A credit is allowed to businesses that hire qualified ex-felons under a program approved by Maryland Department of Labor, Licensing and Regulation. This credit may not be claimed if the Employment Opportunity Tax Credit or Maryland Disability Employment Tax Credit

	has been claimed for that employee. A qualified employee is a "qualified ex-felon" in accordance with Section 51(d)(4) of the Internal Revenue Code. A business may not claim a credit for an employee who is hired to replace a laid-off employee or an employee who is on strike, or for which the business simultaneously receives federal or state employment training benefits. A credit is allowed for each qualified ex-felon for a two-year period beginning with the first year the employee was qualified. The credit for each qualified employee hired is equal to 30% of the first $6,000 of qualified first year wages and 20% of the first $6,000 of qualified second year wages. The employer cannot claim the credit until employment has continued for at least one full year unless the employee: (a) voluntarily leaves the employer; (b) becomes disabled or death occurs or; (c) is terminated for cause. The credit must be prorated for the portion of the year the employee worked unless the employee voluntarily left to take another job.
One Maryland Economic Development	Credits may be claimed for eligible project costs and for eligible start-up costs incurred to establish, relocate, or expand a business facility in a distressed Maryland county. In order to qualify for the credit for project costs, a minimum of $500,000 must be spent on eligible project costs. At least 25 newly hired qualified employees must be employed for at least one year at the new or expanded facility. This credit may also be claimed by tax-exempt nonprofit organizations.
Virginia	
Enterprise Zone: 157 claims in 2010 for total of $1,329,645	Businesses located within an Enterprise Zone prior to July 1, 2005 are eligible for a credit based on job creation.
Clean Fuel Vehicle Jobs 96 claims in 2010 for total of $135,538	A credit is allowed for the creation of full-time clean fuel vehicle and biofuel jobs. The allowable credit is $700 per qualifying job created for the first taxable year and the 2 succeeding taxable years for a maximum "per job" credit of $2,100. Unused credits can be carried forward for five years.
Major Business Facility Jobs 138 claims in 2010 for total of $4,297,690	A nonrefundable credit equal to $1,000 per qualifying new job in excess of 50 jobs outside of an enterprise zone or economically distressed area and 25 jobs within, spread over two years. The credit expires tax year 2014.
Green Jobs Creation 0 claims in 2010	Expires tax year 2014. Taxpayers who create green jobs paying an annual salary in excess of $50,000 are allowed a credit per job of $500 for the first 350 jobs. The job must be continuously filled for each year a credit is claimed.

Appendix D: Taxes on Individuals and Businesses in the District

Fiscal Year 2012 General Fund Taxes in the District

		Individual	Business
Real Property	1,822,014	612,197	1,209,817
Personal Property	55,734	-	55,734
Public Space Rental	32,506	-	32,506
Sales	1,218,577	647,515	571,062
Income	1,956,590	1,490,694	465,896
Gross receipts	360,874	99,186	261,688
Deed and recordation	415,512	204,598	210,914
Total	5,861,807	3,054,190	2,807,617
Share of Total		52%	48%

Source: Author's analysis of FY 12 revenue from OCFO (2013).
Note: Real property taxes were divided using the FY 2009 District Data Report and deed taxes were distributing using the real property liability share.

Appendix E: Revenue Estimate of Business Franchise Taxes

Revenue Estimate Chronology

Date of Budget Submission:	FY 2012	SP Forecast	GDP Forecast
September 28, 2009 *	$ 497.6	10.7%	5.5%
July 1, 2010	407.6	6.4%	5.0%
August 10, 2011**	377.5	7.2%	2.4%
June 22, 2012	387.9	0.0%	2.0%
Actual	$ 465.9		

* $469 million base plus $22.6 million for combined reporting and $6 million for PIC add-back.
** $358.1 million base plus $12 million for increasing minimum tax and $7.4 million for double-weighted sales factor.
Source: OCFO Fiscal Year Budget submissions–revenue chapter.