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STATE TAX RESEARCH INSTITUTE

Report to the Montana Chamber Foundation: Assessing Montana's Business Tax Structure and Potential Tax Reform Options

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I. Executive Summary

- Montana's economy is changing and will continue to change in the future. Farming and mining will continue to be strengths of the Montana economy, but the economy is diversifying, with greater reliance on services, including tourism.

- Montana has significant comparative advantages in its natural resources, including outdoor activities that attract tourists, entrepreneurs, and remote workers who want to live in Montana. Entrepreneurs, tourists, and even mining companies have choices of where to locate and make their next spending choices. Capital, workers, and tourists are more "mobile" than in the past, and with increasing economic and tax competition are sensitive to prices, including taxes.

- Tax reform provides an opportunity to ensure that the Montana business tax system reflects Montana's economic future and encourages business investment, higher paying jobs, and more job opportunities in the 21st century Montana economy.

- Since Montana does not have a general sales tax, it relies more heavily on property taxes, income taxes, excise taxes, and licenses and other taxes than the U.S. average. When focused on the taxes levied on businesses, the system reflects the same heavy reliance on property taxes and licenses and other taxes, including severance taxes.

- Individual income taxes on business income are slightly higher than the U.S. average. While the corporate income tax collects less as a share of total business revenue than the U.S. average, the average collection share doesn't reflect some important dimensions of the corporate income tax relative to competitor states.

- Montana apportions corporate income using an equally weighted formula of property, payroll, and sales. Montana is one of only six states to use an equally weighted three-factor formula as its generally applicable apportionment method.

- Montana is now the only state that "lists" foreign countries as "tax havens" for purposes of inclusion in the corporate income tax base. The Montana "tax haven" list is antiquated and an outlier among the states and contrary to U.S. and international approaches to the issue of corporate income tax "base erosion."

- From a business tax perspective, local and centrally assessed property taxes are a significant component of effective tax rates on capital investment. Montana's property taxes paid by business account for 51% of the total business tax burden, much higher than the 38% average share for all states. With 16 classes of property subject to varying taxation based on use, the Montana property tax system is complicated and inhibits investment in the state. Any analysis of Montana's business tax competitiveness therefore should include the impact of the property tax.

- The relatively high business tax rates on new investments in Montana create a disincentive to locate and expand in the state. This reduces the potential growth in the

state's economy, jobs and income. Montana is not competitive on business income taxes (high corporate and personal tax rates and unfavorable apportionment). Montana is not competitive with high-tiered tangible property tax rates and relatively high tax rates on commercial property. Montana has some capacity to substitute higher taxes based on a consumption base in order to lower non-competitive business taxes.

- A broad-based consumption tax, whether imposed as a retail sales tax or an entity-level tax, could produce significant benefits in a 21st century Montana tax system. From an economic development perspective, a shift from business income and property taxes to a consumption tax would reduce the tax burden on new capital investment in the state. An additional benefit is that out-of-state purchasers would be expected to bear a greater share of a consumption tax compared to business income and property taxes. A third benefit would be more uniform business tax rates across industries and types of taxpayers if the broad-based consumption tax is imposed through both corporations and pass-through entities.

- If Montana chooses to move toward a consumption tax base, two alternatives are viable and have been modeled for this report: a state retail sales tax (capped at 4% under the State constitution), or a business entity level tax with a consumption (value-added) tax base equal to a firms' total sales minus business input purchases, including all capital purchases.

- The modeled sales tax system has the following features: a broad base, including most consumer product purchases, but excluding most business purchases; most purchases of services are nontaxable, except for utility purchases by households; exemptions for sales to non-profits and government; motor vehicles are taxable; housing is exempt; and exemptions for motor fuels, tobacco and alcohol purchases. Such a tax is estimated to provide approximately $890 million per year.

- The business entity level tax modeled for this report includes all forms of doing business and would apply to both corporations and pass-through entities. The tax is apportioned by 100% destination sales factor, and as such is designed to exclude value added on exports and include value added on imports. Such a tax with a 2% rate is projected to raise approximately $440 million per year.

- To improve the State's competitiveness, the following major reforms have been modeled: repeal the State's business personal property tax ($235 million reduction); equalize real property tax rates between individuals and businesses ($258 million reduction). Incremental reforms that would improve the State's competitiveness include adopting single sales factor apportionment, repealing the tax haven statute, adopting several administrative reforms, and providing rate relief for high individual and corporate income tax rates.

II. Introduction

This report was prepared by the Council On State Taxation's State Tax Research Institute ("STRI") at the request of the Montana Chamber Foundation ("the Foundation"). The Foundation asked STRI to assess Montana's current business tax structure, identify potential deficiencies, and outline potential areas of improvement. Based on this research, the Foundation asked STRI to develop and analyze certain potential incremental and broad-based tax changes to Montana's tax structure. The Foundation selected these potential changes for analysis because of their potential to drive economic growth and enhance business competitiveness in Montana's changing economy. This report reflects the research conducted by STRI, the choices of potential tax reform options selected by the Foundation, and the analysis conducted by STRI to measure the revenue and competitiveness impact of these potential tax changes.

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Dr. Robert Cline has extensive state and local tax policy and research experience, having served as Tax Research Director in the Michigan Department of Management and Budget and in the Minnesota Department of Revenue. He has directed or participated in tax reform and tax policy studies, tax modeling projects, fiscal studies, and economic impact studies in over 45 U.S. states and other countries, including Canada, Australia, Ireland, Moldova, and Georgia.

Dr. Cline served as a Senior Advisor in the Center for Tax Policy Administration at the Organization for Economic Cooperation and Development (OECD) (2014-2015). Prior to joining the OECD, Dr. Cline was National Director of State and Local Tax Policy Economics for 15 years in EY's National Tax Practice in Washington, DC.

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Dr. Neubig received his Ph.D. in Economics from the University of Michigan.

III. Background on Montana's Current Business Tax Structure

a. Montana's Changing Economy and Implications for Tax Reform

Montana's economy is changing and will continue to change in the future. Farming and mining will continue to be strengths of the Montana economy, but the economy is diversifying, with greater reliance on services, including tourism. Technological changes are allowing more Montanans to work remotely, to export to and import from other U.S. states or countries, and to participate in the sharing ("gig") economy.

A state's tax system should reflect the state's vision of what its economy will be in the future. A state's business tax system should reflect the changing composition of the economy, new business models and dynamics, and competitors' tax structures. The tax system should collect the revenue to fund the desired level of government infrastructure and services in the simplest, least economically distortive, and fairest manner possible.

Many other U.S. states and other countries are shifting their tax structures to fall more heavily on consumption than on production and are targeting tax relief to business personal property. Taxes on business income and business property are more detrimental to economic growth, work, and business investment than other types of taxes. Other states are reviewing their tax systems to ensure that out-of-state businesses and tourists that enjoy the benefits of their states are contributing to the funding of essential public services.

Tax systems designed to tax the economies in the 20th century often don't capture taxes on significant shares of the economy, including services, which are growing faster in the 21st century. A table (below) from the Montana Department of Labor and Industry shows Montana employment and projections of employment growth rates by major industry. Industries in the service sector, including business and professional services, health care, accommodations, and food services, account for at least 38 percent of total 2016 Montana employment and have relatively high projected growth rates (with the exception of education).

Montana has significant comparative advantages in its natural resources, including outdoor activities that attract tourists, entrepreneurs, and remote workers who want to live in Montana. The Kauffman Index of Rate of New Entrepreneurs for small states ranked Montana #1 in 2012, 2015, and 2016. The tax system should not discourage entrepreneurs and workers from choosing to locate in Montana.

Table 1

2016 Employment and Projected Annual Growth

By Industry, Sorted by Jobs Added, 2016-2026.

	2016 Employ.	2016-2026 Annual Projections	
		Growth Rate	Jobs Added
Health Care	70,287	1.71%	1,296
Construction	27,123	2.70%	829
Accommodation & Food Service	52,831	1.03%	568
Retail Trade	59,378	0.74%	457
Professional Services	21,632	1.93%	456
Admin. & Waste Services	16,892	1.75%	321
Local Government	20,665	1.37%	302
Arts & Entertainment	11,740	1.71%	217
Other	17,553	0.98%	179
Transportation	15,674	0.99%	162
Manufacturing	19,483	0.80%	162
Finance	15,173	0.86%	135
Wholesale Trade	17,344	0.63%	113
Education	40,141	0.26%	106
Mining	6,413	1.22%	83
Real Estate	5,528	1.33%	78
Agriculture	5,559	1.23%	72
State Government	12,579	0.35%	45
Management	2,071	1.38%	31
Utilities	3,028	-0.06%	-2
Post Office	2,118	-1.31%	-26
Information	6,326	-0.54%	-33
Federal Government	9,506	-1.12%	-101
Total Payroll Employment	**459,046**		**5,448**

Source: Montana Department of Labor & Industry. Employment Projections 2016-2026. Notes: Public employment in healthcare and education is included within those industries. All other public employment is in federal, state, or local government.

http://lmi.mt.gov/Portals/135/Publications/LMI-Pubs/Articles/2017/0717-FutureJobs.pdf

Similarly, larger corporations have operations and subsidiaries in Montana providing high paying jobs and investments. However, significant fluctuations in commodity prices affect the tax revenue from the farming, logging, and mining sectors. Further, significant economic growth is occurring in the non-corporate sector of the Montana economy, through sole proprietorships and pass-through businesses such as partnerships and sub-chapter S corporations.

Entrepreneurs, tourists, and even mining companies have choices of where to locate and make their next spending choices. Capital, workers, and tourists are more “mobile” than in the past, and with increasing economic and tax competition are sensitive to prices, including taxes.

Tax reform provides an opportunity to ensure that the Montana business tax system reflects Montana's economic future and encourages business investment, higher paying jobs, and more job opportunities in the 21st century Montana economy. As Senator Llew Jones recently said, "We're good at taxing barrels of oil, bushels of wheat, tons of coal. We're not so good at taxing services."[1]

b. Montana's Overall and Business Tax Structure

The COST/EY *Total State and Local Business Tax Study* (November 2018)[2] provides the clearest picture of state and local business taxes. Most state tax policy analyses look at all taxes, paid by both households and businesses. As shown below, since Montana does not have a general sales tax, it relies more heavily on property taxes, income taxes, excise taxes, and licenses and other taxes than the U.S. average.

Table 2

Percentage composition of ALL state and local taxes by type, FY2017*

Type of state and local tax	Montana	U.S.
Property taxes	39%	31%
Sales taxes	0%	22%
Excise taxes	14%	11%
Corporate income taxes	3%	4%
Unemployment insurance taxes	2%	2%
Individual income taxes	28%	23%
Licenses and other taxes*	13%	7%

*Totals may not equal 100% due to rounding.
**Includes severance taxes

Source: EY/COST Total State and Local Business Taxes: State-by-State Estimates for FY2017, Nov. 2018

When focused on the taxes levied on businesses, the same heavy reliance on property taxes and licenses and other taxes, including severance taxes, is clearly shown in the table below. Individual income taxes on business income are slightly higher than the U.S. average. The corporate income tax collects less as a share of total business revenue than the U.S. average, but the average collection share doesn't reflect some important dimensions of the corporate income tax relative to competitor states.

[1] http://helenair.com/news/politics/state/legislators-of-both-parties-agree-it-s-time-to-look/article_02294abc-ebed-573f-96bc-66f24c1df0b7.html

[2] Available on the COST website at: https://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/FY16-State-And-Local-Business-Tax-Burden-Study.pdf.pdf.

Table 3
Percentage composition of state and local BUSINESS taxes by type, FY2017*

Type of business tax	Montana	U.S.
Property taxes	51%	39%
Sales taxes	0%	21%
Excise taxes, including public utilities and insurance	12%	12%
Corporate income taxes	6%	9%
Unemployment insurance taxes	5%	5%
Individual income taxes on business income	7%	5%
Licenses and other taxes (including severance taxes)	18%	8%
Total effective business tax rate	5.1%	4.5%
Business share of state/local taxes	48.6%	43.7%

*Totals may not equal 100% due to rounding.
Source: EY/COST Total State and Local Business Taxes: State-by-State Estimates for FY2017, Nov. 2018

The COST/EY study compares total business taxes to private sector state gross product, where Montana is higher than the U.S. average. The Montana business share of total state and local tax collections is 111% of the U.S. average.

Property taxes and severance taxes reduce the profitability of capital investments similar to income taxes. Location decisions for mobile capital investments are affected by total business taxes, not just income taxes. These taxes result in relatively high tax rates on Montana investments, as measured by the total effective business tax rate.

The absence of a general state consumption tax results in greater reliance on other taxes. Economic studies have found that consumption taxes are less detrimental to economic growth and investment than income taxes and business property taxes.

c. Comparison of Montana's Business Tax Structure to U.S. Average

Several analyses rank states on their business tax competitiveness. The two most prominent are the Council On State Taxation (COST)/EY annual reports on total state and local business tax burdens and the Tax Foundation's annual State Business Climate Index. As described below, the COST/EY analysis is based on specific tax collections of businesses, while the Tax Foundation index is generally qualitative, with a preference for states without one or more of the major taxes.

COST/EY Study

The COST/EY *Total State and Local Business Tax Study* (November 2018) provides a 50-state comparison of the estimated amounts of business taxes, by tax type, that are actually paid by business taxpayers.

Overall Level of Montana Business Taxes

The results of the COST/EY study show how significant business taxes are in Montana.[3] The following table compares Montana and the U.S. state average on several key business tax measures.

Table 4
Business Taxes, Montana Compared to U.S. Average

	Montana	U.S Average	Montana as % of U.S.
Business share of taxes			
State taxes	41%	38%	109%
Local taxes	63%	52%	121%
Total S&L taxes	49%	44%	111%
Local share of total business taxes	45%	49%	92%
Property tax share of S&L business taxes	51%	39%	131%
Total effective business tax rate	5%	4.5%	111%

Source: EY/COST Total State and Local Business Taxes: State-by-State Estimates for FY2017, Nov. 2018

The study results indicate that:

- Businesses paid $2 billion of Montana state and local taxes in FY2017, almost half (47.6%) of all state and local taxes. The business share in Montana is relatively high, 9% greater than the U.S. average (43.7%). Montana's business share of state taxes is 41%, while the business share of local taxes is 63%.
- Local business taxes are a significant share of total business tax burden in Montana. Local taxes, primarily the property tax, account for 45% of Montana's total business taxes, slightly below the U.S. average of 49%.
- Without a broad-based consumption tax, Montana relies much more heavily than most other states on business license and other taxes (primarily severance taxes) at the state level and the property tax at the local level. The property tax, a tax that imposes a relatively high burden on new capital investment, accounts for 51% of Montana business taxes, compared to a national average of only 39%. The license and other tax category is over 18% in Montana, 2.2 times the national average.

Comparisons with Other States

The COST/EY study can also be used to compare the burden of business taxes in Montana to other states. The study provides an overall measure of the current business tax burden in each state: the total effective business tax rate (TEBTR).[4] Montana's tax burden is relatively high based on this measure.

[3] The study estimates the state and local taxes that are the legal liabilities of business taxpayers. Business taxes include: property, sales and excise, corporate and business individual income, unemployment insurance and license, and other, including severance, taxes.
[4] The TEBTR equals total state-local business taxes divided by private-sector gross state product (GSP).

- Montana's TEBTR is 5%, over 11% higher than the U.S. average for all states.
- Montana's rate is within one percent of the average of the four surrounding states. However, the rates differ significantly in these states, with North Dakota and Wyoming each equaling 6.7%, and Idaho and South Dakota equaling 4.4% and 4.8%, respectively.

The results of the COST/EY study indicate that Montana's business taxes are relatively high and account for a significant share of total state and local taxes. In addition, local business taxes ($0.9 billion) are 82% as large as state business taxes ($1.1 billion). For this reason, *comprehensive Montana business tax reform needs to reevaluate both state and local taxes on business in designing a more competitive business tax system*.

Other Business Tax Rankings

The Tax Foundation's *2019 State Business Climate Index* study (September 2018) provides a qualitative 50-state ranking of business tax systems. Unlike the COST/EY study, the Tax Foundation report is not based on actual taxes paid by businesses.[5] It uses tax law features, such as tax rates and tax base definitions, to develop qualitative measures of state-local business taxes. The study finds that:

- Montana has the 5th "best" business tax climate in the nation, as measured by the business climate index.
- The tax systems in Wyoming and South Dakota are the 1st and 3rd best business tax climates among all the states.

The business tax climate index rankings are far different from the COST/EY study rankings for Montana and several of the surrounding states. The primary reason for these differences is the absence of any dollar amounts of actual business tax collections in the Tax Foundation business tax climate index. Although property tax collections do indirectly enter the Tax Foundation index, the dollar amounts include property taxes on both residential and business property, not business property taxes alone.

A second major shortcoming of the Tax Foundation index is the disproportionate positive weight given to the absence of one of the major taxes (income or broad-based consumption taxes) in assessing the tax climate. Montana rates in the top 10 states primarily due to the absence of a sales tax, while Wyoming and South Dakota have no corporate or individual income taxes. The top seven states do not impose either an income tax or a general sales tax. A final limitation is the exclusion of severance taxes in constructing the index.

Given these limitations, the Tax Foundation business tax climate index is of limited usefulness in evaluating Montana's business tax competitiveness. As found in the COST/EY study, Montana's overall effective business tax rate (based on estimated taxes actually paid by business) is 11%

[5] The only tax collection information used in developing the Tax Foundation index is total state and local property taxes on real and personal property (for both households and businesses combined). The collections are used to measure effective property tax rates.

higher than the U.S. average. If ranked by the COST/EY measure, Montana would be tied for the *12th highest* business effective tax rate.

A final ranking study that should be mentioned is an earlier study completed by EY in conjunction with COST. The study, *Competitiveness of State and Local Business Taxes on New Investment* (April 2011) provides state-by-state rankings of state-local taxes on hypothetical new business investments in each state.[6] The business tax competitiveness index (a measure of the effective tax rate on the types of included new investment activities) for Montana was 6.1%, compared to a 7.9% U.S. average. Montana ranked 9th lowest among the states on this measure. However, Montana's surrounding states were much closer to Montana, with an average index of 6.8%. Given that the tax laws used in the 2011 business tax competitiveness study are outdated (2009) provisions, it should be considered an example of an effective tax rate analysis, such as that employed in this report, rather than an up-to-date ranking of Montana's current business tax competitiveness for new capital investment.

d. Volatility of Montana's Taxes

Significant fluctuations in different taxes can affect the government's ability to budget for government services. Some taxes are inherently more volatile than others due to their underlying economic bases. The table below shows the major Montana taxes (with greater than $20 million of revenue in FY2017) and their changes between 2006 and 2017. This period includes the Great Recession and large swings in oil and gas prices.

Total taxes grew at an annual average rate of 2% during the past 11 years, with the largest annual drop of -10 percentage points and the largest annual increase of 11 percentage points.

Table 5

Montana change in revenue collections for largest taxes between 2006-17: annual average, minimum and maximum change

	Accomo-dations sales tax	Cigarette tax	Coal severance tax	Corporation income tax	Income tax	Liquor license & excise tax	Lodging facilities use tax	Oil and gas produc-tion tax	Property tax	General fund revenues
Average	7%	-1%	4%	-2%	4%	4%	6%	-6%	3%	2%
Minimum	-5%	-6%	-12%	-43%	-14%	-28%	-4%	-49%	-2%	-10%
Maximum	17%	3%	20%	33%	16%	29%	15%	35%	8%	11%
2017 collections ($m)	21.9	70.4	55.4	124.8	1180.3	27.9	29.6	98.1	275.5	2141.5

[6] The types of hypothetical investments or activities included for each state were: headquarters, research and development, office and call centers, durable manufacturing and non-durable manufacturing.

The changes in state revenue collections show how volatile Montana's tax system is:

- Three of the major taxes were *lower* in FY2017 than in FY2006: cigarette taxes, corporate income tax, and the oil and gas production tax.[7]
- Two of these taxes also had the largest annual fluctuations in revenue. The oil and gas production tax fell 49% in one year, while increasing 35% in another. The corporate income tax declined 43% in one year, while increasing 33% in another.
- The corporate income tax volatility can also be seen in the impact of the Great Recession. Between fiscal year 2007 and fiscal year 2010, the corporate income tax fell by almost 50%, an $86 million reduction in collections.
- Oil and natural gas production taxes have recently shown even greater reductions in tax collections. Revenues fell by $132 million (54%) between fiscal years 2014 and 2017.
- The liquor license and excise tax also varied as much as 30%, plus or minus, during the 11-year period.

Income taxes tend to be more volatile than property and consumption taxes. Severance taxes on natural resources vary with commodity prices. States and countries relying more heavily on income and severance taxes tend to have more volatility in total revenue.

IV. Competitiveness of Montana's Business Tax Structure

a. Description of Competitiveness Comparison: Industries and Competitor States

This report compares Montana's existing business tax structure for six selected industries with six competitor states, each selected by the Montana Chamber Foundation. The features of the Montana's business tax structure identified for comparison are those perceived as placing the State's domestic companies at a cost disadvantage to similar companies based in competitor states. The STRI competitiveness model can be used to simulate changes in Montana's business tax competitiveness under alternative tax reform proposals.

Competitor States:
- Colorado
- Idaho
- North Dakota
- Utah
- Washington
- Wyoming

Industries:
- Small pass-through manufacturer
- Metal fabrication
- Food & beverage retail

[7] The tax collections have not been adjusted for tax rate changes that may have contributed to annual changes in addition to changes due to economic activity.

- Credit card processor
- Wholesale drug distributor
- Data processing (information services)

b. Key Features of Selected Montana Taxes and Comparisons with Competitor States

In addition to business taxes, such as the corporate income tax, a comprehensive Montana tax reform package could include changes in the individual income tax, the local property tax, and centrally assessed property, such as oil and gas and communication property taxes. Nationally, more than 50% of federal taxable business income is reported on individual income tax returns of pass-through entities (sole proprietorships, partnerships, and S corporations). Income taxes on the owners of pass-through entities should be considered in the Montana business tax reform discussion.

From a business tax perspective, local and centrally assessed property taxes are a very significant component of effective tax rates on capital investment. According to estimates in the COST/EY study, Montana's property taxes paid by business account for 51% of the total business tax burden, much higher than the 38% average share for all states. Any analysis of Montana's business tax competitiveness therefore should include the impact of the property tax.

Business Property Taxation

In Montana, all property is subject to tax unless specifically exempted (e.g. all intangible property, which includes software, is exempted). Taxable property is classified into 16 separate classes of property based on use. These classes of property are subject to different tax rates ranging from 0.37% to 12% (sometimes referred to as the "taxable percentage rate") to arrive at taxable value, against which the appropriate mill levy is applied.[8] "Class 8" property, which generally includes personal property used in businesses, is subject to a taxable percentage rate between 1.5% and 3%, whereas other business property is subject to higher rates, such as oil and gas property at 12% and communication property at 6%. The taxable value is then multiplied by the local millage rate to determine property tax liabilities.

All business inventory is exempt. Further, certain types of manufacturing and industrial machinery and equipment are exempt, and local jurisdictions may choose to exempt new or expanding industrial property. Significant other exemptions apply (for example, agricultural implements and machinery valued under $100, down-hole equipment in oil and gas wells, certain motion picture and television property, and machinery and equipment used in canola seed oil processing, malting barley, industrial dairy or milk processing, or in the production of ethanol from grain in the first 10 years). Further, the first $100,000 of aggregate taxable market value of Class 8 property is exempt, and the next $6 million in taxable market value is taxed at a reduced (by 50%) rate.[9] This exemption was significantly expanded by 2013 Senate Bill 96, effective for

[8] See https://revenue.mt.gov/Portals/9/property/property_classifications/2017_class_codes.pdf.
[9] Sources: Bloomberg BNA Tax and Accounting Center, Property tax Navigator; Montana Department of Revenue, Personal Property Assessment Fact Sheet (2017), available at: https://revenue.mt.gov/Portals/9/property/personal%20property/personal_property_assessment_factsheet_2017.pdf.

the 2014 tax year, raising the aggregate exemption from $25,000 to $100,000 and expanding the lower rate cap from $3 million to $6 million in taxable market value.[10]

A comparison of the relatively high business property taxes in Montana relative to competitive states is presented in the Business Tax Comparison section.

Business Income Taxation

Corporate Income Taxation

Like 24 other states and the District of Columbia,[11] Montana requires group taxation (unitary combined reporting) for the corporate income tax, as opposed to allowing the separate entity method which predominates in the remaining states. Montana's mandatory unitary combined filing method is "worldwide" with a "water's-edge" election. Water's-edge filers are subject to a higher tax rate (7% instead of the generally applicable rate of 6.75%).

Montana apportions corporate income using an equally weighted formula of property, payroll, and sales. Montana is one of only six states to use an equally weighted three-factor formula as its generally applicable apportionment method. In contrast, 28 states and the District of Columbia have a generally applicable single sales factor apportionment formula. Moreover, Montana in 2017 adopted market-based sourcing for sales of other than tangible personal property, such as sales of services. Only one other state (Oklahoma) employs equally weighted three-factor apportionment and market-based sourcing for sales of services.

Montana is now the only state (Oregon having repealed its law earlier this year) that "lists" foreign countries as "tax havens." Unitary group members incorporated in these jurisdictions must be included in the Montana corporate income tax return with the domestic water's-edge group. The Montana "tax haven" provisions were adopted in 2003 and subject to minor amendments in 2009. Montana's statute is based on the list of "uncooperative tax havens" published in 2002 by the Organization for Economic Cooperation and Development (OECD). However, the 2002 OECD list was developed and maintained for an entirely different purpose (to promote transparency and information exchange), and by 2009 the OECD found every nation on its earlier tax haven list to have made the necessary commitments to transparency and effective exchange of information to be removed from the list. Thus, the Montana "tax haven" list is antiquated and an outlier among the states and contrary to U.S. and international approaches to the issue of corporate income tax "base erosion."

Montana's tax haven list also represents a partial return to a mandatory worldwide combined filing method that was universally discarded by states in the late 1980s in the face of threats of retaliatory taxation by U.S. trading partners. Further, the "tax haven" approach runs counter to

[10] See http://leg.mt.gov/bills/2013/FNPDF/SB0096.pdf.
[11] Note that Kentucky and New Jersey have also enacted mandatory unitary combined reporting effective in 2019, which would bring this number of states to 26.

the territorial taxation approach which predominates in the world today.[12] This approach also diverges from the general system of international taxation adopted under the federal Tax Cuts and Jobs Act enacted in 2017.

Income Taxation of Pass-Through Entities

In FY2016, businesses paid 6.9 percent of their total Montana state and local tax burden through the individual income tax on pass-through income. This is higher than the national average (5.6 percent), but only slightly more than the corporate income tax share (6 percent). The highest Montana individual income tax rate (6.9 percent) is only slightly higher than the state's general corporate income tax rate (6.75 percent), and about equal to the rate for corporations that elect water's edge filing (7 percent).

Montana does not tax pass-through entities at the entity level, instead generally conforming to the federal tax classification rules taxing this income on individual income tax returns. Montana employs pass-through withholding for nonresident corporations or individual owners with a distributive share of income of $1,000 or more (or the out-of-state owner may instead consent to be taxed). Special rules apply to publicly traded partnerships.

The overall contribution of various taxes to Montana's total revenue, along with statutory tax rates, provides an incomplete picture regarding the incidence of those taxes. In a study – the first of its kind at the state level – released in October 2017 by the State Tax Research Institute, PricewaterhouseCoopers LLP has determined that nationwide, business income earned by corporations incurs a 30 percent higher effective tax rate through state corporate income taxes (6.1 percent) than business income earned by pass-through businesses (4.7 percent).[13] Pass-through income exemptions also have the distortive effect of favoring income earned by partners and other pass-through business owners over income earned as wages.

Data for the respective effective tax rates of pass-through businesses and C corporations in Montana are not currently available. However, it is reasonable to assume that the corporate income tax rate should, at the most, be equal to, and preferably lower than, the top individual income tax rate in Montana to achieve economic parity (since corporate dividends and capital gains are also generally subject to individual income taxes). There are other individual income tax changes besides pass-through business income exemptions and lowering tax rates that would relieve the income tax burden, particularly on small businesses. For example, Montana could consider scaling the individual income tax brackets up to higher income levels than the current $17,600 top bracket. A broader business entity tax reform that would come closer to equalizing business effective tax rates could be an entity-level business tax that applies to all legal forms of doing business, including C corporations and pass-through entities.

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[12] See, "State Tax Haven Legislation: A Misguided Approach to a Global Issue," by Karl Frieden and Ferdinand Hogroian, State Tax Research Institute, February 2016, available at: http://cost.org/WorkArea/DownloadAsset.aspx?id=92483.

[13] *Corporate and Pass-Through Business State Income Tax Burdens: Comparing State-Level Income and Effective Tax Rate*s, PricewaterhouseCoopers LLP, prepared for the State Tax Research Institute, October 2017, available at https://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/etr-study---pwc-stri-combined.pdf.

Table 6
Top income tax rates and apportionment features for Montana and competitor states:

Competitor states	Individual income tax rate (percent)	Corporate income tax rate (percent)	Apportionment (prop/payroll/sale)
Colorado	4.63	4.63	0/0/100%
Idaho	7.4	6.925	25/25/50%
North Dakota	2.9	4.3	0/0/100%
Utah	4.95	4.95	25/25/50%*
Washington	na	na	na
Wyoming	na	na	na
Montana	6.9	6.75	33/33/33%

*Some industries have 33/33/33%

General Taxation of Retail Sales

45 states and the District of Columbia collect state-level retail sales taxes, and local sales taxes are collected in 38 states. Alaska, Delaware, Montana, New Hampshire, and Oregon do not impose state-level retail sales taxes (Alaska and Montana permit local sales taxes to some degree).[14] Montana's Constitution provides that the rate of a general statewide sales or use tax, if such a tax were enacted, may not exceed 4%.[15]

Montana designates certain "resort communities" that may implement a "local resort tax" by ballot initiative. The resort tax is on the retail value of all goods and services sold (except for goods and services sold for resale) within the resort community or area by certain classes of establishments.[16] The resort tax is imposed at a maximum rate of 3% (which is the rate in all localities levying the tax). Thus, some Montana retailers have experience with collecting and remitting what amounts to a local retail sales tax.

[14] See generally, State and Local Sales Tax Rates in 2017, by Jared Walczak and Scott Drenkard, Tax Foundation, January 31, 2017, available at: https://taxfoundation.org/state-and-local-sales-tax-rates-in-2017/.
[15] Montana Constitution, Art. VIII, Sec. 16.
[16] See generally, Montana Department of Revenue, Local Resort Tax, at https://revenue.mt.gov/localresort-tax.

Table 7
General statutory sales tax rates for Montana and competitor states:

Competitor states	State rate (percent)	Local effective rate (percent)	Combined rate (percent)
Colorado	2.9	3.9	6.8
Idaho	6.0	0.0	6.0
North Dakota	5.0	0.8	5.8
Utah	4.7	1.9	6.6
Washington	6.5	1.6	8.1
Wyoming	4.0	1.2	5.2
Montana	0.0	0.0	0.0

Note: Washington's rate does not include the B&O gross receipts tax. Montana's rate does not reflect local resort taxes.

c. Montana Total Business Tax Comparison to Competitor States

Montana's business tax structure imposes relatively high taxes on firms doing business in the state. One way to document the non-competitive Montana business taxes is to estimate the taxes paid by representative taxpayers in different industries in Montana and in other states. By holding the financials the same across the states, this methodology isolates the differences in each state's business tax system. This competitiveness analysis looks at six different types of taxpayers and seven states, including Montana.

The competitive states are Colorado, Idaho, North Dakota, Utah, Washington and Wyoming. The taxpayer examples include a small manufacturer (taxed as a pass-through entity) and five other taxpayers (taxed as C corporations): metal fabricator, food retailer, credit card processor, drug wholesale distributor, and a data processing firm. Income and balance statements were constructed for each hypothetical firm from IRS records.

The following table shows the relatively high property taxes in Montana due to Montana's unique progressive tax on business personal property and relatively high tax rates on business real property. The industrial and commercial rates are calculated from the hypothetical taxpayer calculations. The range of tax rates for Montana illustrate the progressivity in personal property tax rates on larger investments. The top effective tax rate (taxes dividend by market value of property) for industrial property in Montana is second highest only exceeded by the rate in Colorado that is 6% higher. The rate in Montana is just over three times higher than the industrial rate in North Dakota. Montana's relative position for commercial property is little better, but the highest Montana rate is still almost twice as high as the lowest rate in Wyoming.

Table 8
Property tax effective tax rates for Montana and competitor states:

Competitor states	Industrial rate	Commercial rate
Colorado	1.86%	2.31%
Idaho	1.17%	1.42%
North Dakota	0.58%	0.96%
Utah	1.12%	1.39%
Washington	0.69%	0.85%
Wyoming	0.66%	0.61%
Montana*	1.15-1.76%	1.18-1.21%

*Rates vary due to progressive class rates.

The following table compares differences in total business tax burdens across industries and the competitive states. Business taxes include: income taxes, property taxes, and sales and excise taxes that are assumed to be passed forward in higher prices on business input purchases by the hypothetical taxpayers. To summarize the results, the business taxes on each taxpayer in the other competitive states is divided by the tax level in Montana. If the ratio is greater than 100% (highlighted in red), Montana's taxes are higher than in the other state. The ratio exceeds 100% in 55% of the comparisons. For the metal fabricator, taxes in Montana are up to 2.4 times higher than in North Dakota.

Table 9
Montana total business tax relative to competitor states

	Small Manufact.	Metal Fabricator	Food & Bev. Retail	Credit Card Processor	Drug Whole. Dist.	Data Processing
Colorado	87%	125%	60%	231%	112%	80%
Idaho	84%	131%	96%	115%	99%	94%
Montana	100%	100%	100%	100%	100%	100%
North Dakota	139%	241%	132%	299%	159%	120%
Utah	91%	135%	85%	128%	85%	77%
Washington	69%	113%	52%	137%	68%	60%
Wyoming	142%	250%	107%	425%	175%	121%

Note: The ratios equal Montana's total business taxes divided by the total taxes in other states. The ratios in red indicate higher business taxes in Montana.

d. Implications of Montana's "Outlier" Tax Features

Most states rely on a "three-legged stool" of tax types to fund government services: 1) income taxes (individual and corporate), 2) property taxes, and 3) sales and use taxes. Because Montana does not impose a statewide sales tax, its remaining major taxes must compensate in order to provide funding of government services. Thus, the relatively high business tax rates on new investments in Montana (through property taxes and income taxes) create a disincentive to locate and expand in the state, thereby reducing the potential growth in the State's economy, jobs, and income. Montana is not competitive on business income taxes (high corporate and personal tax rates and unfavorable apportionment). Montana is not competitive with its high-tiered tangible property tax rates and relatively high tax rates on commercial property. Accordingly, Montana has some capacity to substitute higher taxes based on a consumption base in order to lower non-competitive business taxes.

V. Alternative Business Tax Restructuring Options

a. Incremental Tax Reforms

Business Property Tax Relief

As previously noted, Montana taxes all property unless specifically exempted. With 16 classes of property subject to varying taxation based on use, the Montana property tax system is complicated and inhibits investment in the state. Disparate rates applied to classes of business personal property create inequities in taxation. "Split roll" taxation of real property – that is, disparate treatment of residential and business real property – creates an overreliance on the taxation of business. Commonly, this disparity between the taxation of residential and business real property increases over time, amplifying the anticompetitive effects of business property taxes and creating instability in the tax base.

In 2013, the legislature enacted significant business tax relief for "Class 8" property (which generally includes personal property used in businesses), raising the aggregate exemption from $25,000 to $100,000 and expanding the cap for a 50% rate reduction from $3 million to $6 million in taxable market value.

The legislature could provide business property tax relief by equalizing business property tax class rates for real property at residential property class rates (residential property is currently taxed at 1.35%). Further, the legislature could provide blanket exemptions for all business tangible personal property, which could be achieved through a phase-out approach. Any discussion of this last option would have to include an evaluation of methods for the state to compensate local governments for lost property tax revenue in future years.

Corporate Income Tax Improvements

Montana's top statutory corporate tax rate at 6.75 percent is higher than the US average and significantly higher than Wyoming and South Dakota, which do not levy income taxes. Montana does not have a lower tax rate for small corporations, unlike some states. A lower corporate tax

rate reduces distortions at a number of economic margins: level of investment, investment location, choice of business entity, and type of financing.

Montana uses an equally weighted three-factor apportionment formula (property, payroll, and sales) for multistate corporations. As previously noted, many states have moved to a more sales-based apportionment formula, whereby out-of-state corporations with sales in the state pay more taxes while in-state exporting corporations would pay reduced taxes. Some states have focused apportionment formula relief on industry sectors disadvantaged by three-factor apportionment (for example, manufacturing). Others have provided special rules for telecommunications, cable, utilities, and others to offset negative impacts on these industries of increasing the apportionment sales factor.[17]

A number of states piggyback on the federal accelerated tax depreciation rules for capital investment that provided "bonus" depreciation and immediate full write-off ("expensing") of certain investments. Montana conforms to the federal tax depreciation rules, which helps reduce the effective tax rate on capital investment. Conformity with accelerated tax depreciation involves a trade-off between reduced tax collections and more favorable treatment of capital investment.

While Montana's law conforms to the immediate expensing provided under the Tax Cuts and Jobs Act enacted in 2017, there are areas of the federal tax reform that should be examined for anticompetitive effect in Montana. The top corporate tax base expansion at the state level from conformity to federal tax reform results from the new interest expense limitations under I.R.C. Sec. 163(j).[18] Montana should consider decoupling from this provision so as not to penalize new investment, similar to the rationale for conforming to federal "bonus" depreciation. Further, Montana should consider decoupling from the taxation of global intangible low-taxed income, which even after applying the 80% Montana dividends received deduction would represent the largest expansion yet of the "water's edge" in Montana.[19]

As previously noted, Montana already expands the water's-edge method of unitary combined filing to a statutory list of "tax haven" jurisdictions. Repealing this tax haven list would respect the water's-edge consensus that has existed in the states since the late 1980s and make Montana more attractive to foreign direct investment. It would also move Montana into the mainstream of states (Oregon was the only other state that employs the tax haven listing approach; in 2018, Oregon repealed its tax haven statute).

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[17] The Montana Legislative Branch, Legislative Fiscal Division has determined that "increased revenue would occur in the retail, transportation, and information sectors as a result of switching to a sales denominator formula. However, revenue would decrease in both the manufacturing and financial sectors. Any changes across the remaining sectors would be quite small. Furthermore, combined collections are nearly identical in all scenarios, ranging from $133.8 million for the double-weighted sales model to $135.2 million under current law." See *Memo from Sam Schaefer to the Joint Subcommittee on the Changing Economy and Impacts to the Long-Term Viability of Montana's Tax Structure*, March 13, 2018.

[18] See *The Impact of Federal Tax Reform on State Corporate Income Taxes*, by Phillips and Wlodychak (EY), March 2018, available at https://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/cost-federal-tax-reform-3-1-2018-cost-v2.pdf.

[19] See *State Taxation of GILTI: Policy and Constitutional Ramifications*, by Donovan, Frieden, Hogroian, and Wood, 90 State Tax Notes 315 (Oct. 22, 2018).

Compliance and Administrative Issues

- Montana currently receives a "B" grade in COST's Scorecard on Tax Appeals & Procedural Requirements.
- The Scorecard seeks to objectively evaluate state statutes and rules that govern the degree of taxpayer access to an independent appeals process and state treatment of selected procedural elements that impact taxpayers' perceptions of fairness and efficiency.
- All of Montana's negative assessments on the Scorecard are in categories that would not require expending funds to remedy, including: extending the number of days to protest an assessment, simplifying rules for reporting federal changes to income, and increasing transparency in tax guidance and rulings.

Montana provides only 30 days following the date of notice to protest a notice of assessment for most tax types. The norm in the states is 60 days from the mailing date of the notice.

Montana provides no definition of "final determination" by the IRS that triggers a reporting requirement to the state, and taxpayers have only 90 days (instead of the COST-recommended 180 days) to file the report. Further, the state asserts that tax adjustments are not limited to federal changes, even if beyond the state statute of limitations for adjustments, if a federal waiver exists.

Montana does not provide private letter rulings to taxpayers (and thus does not publish any redacted versions of such rulings as other states do). The state does provide "declaratory rulings" to taxpayers, but such guidance generally is not sought due to concerns regarding disclosure of confidential taxpayer information.

b. Broader Tax Reform Options

A broad-based consumption tax, whether imposed as a retail sales tax or an entity-level tax, in combination with reductions in other business taxes could produce significant benefits in a 21st century Montana tax system. From an economic development perspective, a shift from business income and property taxes to a consumption tax would reduce the tax burden on new capital investment in the state. An additional benefit is that out-of-state purchasers would be expected to bear a greater share of a consumption tax compared to business income and property taxes. A third benefit would be more uniform business tax rates across industries and types of taxpayers if the broad-based consumption tax is applied to both corporations and pass-through entities.

Adoption of a Retail Sales Tax

- Not all retail sales taxes are "trust" taxes which the seller must impose and collect from the consumer. Some are deemed (or even designated) as "seller privilege taxes" (although often there is dual liability of the seller and purchaser for the tax, and the seller normally charges the consumer the tax). New Mexico's "gross receipts tax" is a type of seller-privilege tax on New Mexico businesses, but it functions as a retail sales tax because it can be passed on to purchasers and resales are treated as nontaxable gross receipts.

- A properly designed sales tax does not discourage business investment because it exempts business-to-business transactions and only taxes retail sales to households.[20] States have struggled with expanding their retail sales tax base to encompass the modern service and digital economy while also limiting existing taxes on business-to-business sales. Building a retail sales tax base encompassing largely business-to-consumer transactions while excluding business-to-business transactions provides a unique opportunity for Montana to compete for business investment amidst national and global efforts to move from taxes on production to taxes on consumption.
- Previously, states that impose sales and use taxes were bound by the Commerce Clause to require some form of physical presence within the state before imposing a collection and remittance requirement on out-of-state retailers. This "physical presence" standard was explicitly overturned by the U.S. Supreme Court in *South Dakota v. Wayfair, Inc*., No. 17-494 (June 21, 2018). However, the Court did not rule on whether a tax collection obligation on remote sellers would discriminate against or impose undue burdens upon interstate commerce in violation of the Commerce Clause.
- One way that states have sought to overcome barriers to requiring out-of-state sellers to collect their sales and use taxes is by forming an interstate cooperative body called the Streamlined Sales Tax Governing Board.

The Streamlined Sales Tax Governing Board has 23 full member states that have adopted uniform sales and use tax procedural rules and definitions contained in the Streamlined Sales and Use Tax Agreement.[21] Of Montana's neighboring and competitor states that impose a state-level sales tax, only Idaho is not a member of the Governing Board.

The Streamlined Sales and Use Tax Agreement was developed with continuous input from industry (now represented by the Business Advisory Council). State members have their compliance with the Agreement's sales tax simplification rules annually certified by a vote of the member states. The ultimate goal of the Streamlined project was to dramatically lower the compliance burden for sellers and to otherwise provide compliance software and service providers, so as to convince Congress to provide the member states with the authority to require collection and remittance by out-of-state sellers with no physical presence.

While the physical presence standard was overturned by the *Wayfair* decision, the Agreement nonetheless could provide a useful framework of best practices for developing a sales tax in Montana with minimized compliance costs. Further, any vendors currently registered through the Streamlined system would be obligated to register in Montana if the state were to enact the Agreement, and Montana would have the same fact pattern considered by the U.S. Supreme Court in the *Wayfair* litigation if Montana were to adopt the Agreement and an economic presence threshold in enacting a sales tax regime.

[20] See generally, "What's Wrong with Taxing Business Services? Adverse Effects From Existing and Proposed Sales Taxation of Business Investment and Services," by Robert Cline, Andrew Phillips, and Tom Neubig, April 4, 2013, available at: http://cost.org/WorkArea/DownloadAsset.aspx?id=83841.
[21] See generally, http://www.streamlinedsalestax.org/.

Alternative Entity-Level Consumption Taxes

While the corporate income tax is the predominate form of entity-level business taxes (based on overall economic activity of the business) at the state level, several states have taken alternative approaches to taxing business that include: 1) entity-level taxes with a base that is designed to approximate consumption spending, and 2) tax bases measured by gross receipts.

Entity-level taxes that use a tax base designed to approximate final consumer spending (excluding business purchases) can be viewed as broad-based consumption taxes, a possible alternative to state retail taxes based on sales transactions. These taxes operate as value-added taxes (VATs) using the books-and-records of business entities, rather than the credit-invoice, value-added tax systems used extensively in other countries. The value-added tax base can be simply defined as a firm's total sales minus all purchases from other firms, including capital equipment. Equivalently, a VAT base equals all the payments to labor and capital (i.e., net income, employee compensation, interest, and dividends paid) used by the firm.

Michigan used this type of tax in several different forms for over 45 years before returning to a net income tax used today. New Hampshire is currently imposing a variation of this tax as a minimum tax in conjunction with its corporate profits tax, and Texas includes this type of base as one of three base options under the state business franchise ("margin") tax. A value-added tax was also proposed by California's Commission on the 21st Century Economy (September 2009).

The second non-income business tax in use today is an entity-level tax based on gross receipts (GRT). Ohio's commercial activities tax (CAT) and Washington State's business and occupation tax (B&O) are examples of state business taxes that use a measure of gross receipts as the tax base. GRTs modeled after Ohio's CAT have been recently considered by Louisiana and Oregon. At least one state (Minnesota) uses gross receipts as the basis of minimum fees in its corporate income tax. Montana's current corporate income tax provides the option for selected taxpayers (whose only economic activity in the state is making retail sales in excess of a threshold) to elect to pay a tax equal to 0.5% of gross sales. In addition, most state utility, insurance, and severance taxes operate as gross receipts taxes on selected industries.

Common Characteristics of the Non-Income State Business Taxes

The alternative state business taxes, not based on income, have several common characteristics and objectives:

- The alternative tax bases are designed to expand beyond current state taxation of consumption, including purchases of both tangible products and services (although gross receipts taxes are not limited to *end* consumption, due to their application to intermediate business purchases).

- They are designed to broaden the business tax base to include all forms of doing business, corporations as well as pass-through entities. This recognizes the need for more uniform business taxation that imposes the same tax rate on all businesses regardless of their legal form. This also recognizes the growing economic importance of

the non-corporate sector of the economy, particularly in services. State experience with these alternative taxes suggests that tax rates are more stable because all businesses are subject to any tax rate change, not just corporations.

- Entity-level value-added tax (VAT) bases can significantly reduce the taxes on mobile capital investment by allowing immediate expensing of capital equipment purchases. This key difference between an entity-level VAT and the standard state corporate income tax can contribute to a more competitive state business tax system.

- States using alternative business tax bases are more likely to extend taxation to out-of-state businesses that may not be taxable under the traditional corporate income tax due to U.S. statutory constraints (*i.e.*, Public Law 86-272).

Comparing the Tax Bases

The following table compares the definitions and breadth of these alternative tax bases. Consumer retail purchases are included as a proxy for a comprehensive retail sales tax base for comparison purposes, although most services are not subject to state retail sales taxes. The size figures provide a rough indication of the relative size of the tax bases (compared to corporate profits) as calculated from national (not Montana-specific) data. Note that the estimated gross receipts tax base is 80% larger than the value added tax base, an approximate measure of the taxation of intermediate business purchases under a gross receipts tax.

Table 10
Alternative tax base measures and their relative size

Tax Base Measure	Description of Base	Size Relative to Corp. Profits
Corporate profits	Gross receipts minus all costs including purchases from other firms, interest, and depreciation	1
Consumer purchases	Gross receipts from consumer spending excluding education, health care, and business purchases	4
Value added	Gross receipts minus all purchases from other firms	10
Gross receipts	Gross receipts, including sales to final consumers and other businesses	18

Issues in Adopting Alternative Business Tax Bases

There are significant challenges to adopting broad-based consumption taxes at the state level that have limited more widespread adoption, even when levied at the entity level.

- The alternative taxes are often not well understood by businesses accustomed to paying state and federal taxes based on net income. This makes it harder for legislators to defend the tax from pressures to reduce the tax base through provisions that reduce taxes for selected industries and taxpayers. Examples include Michigan's more recent

reversion to a business-entity income tax and ongoing pressure to modify the Texas hybrid "margin" tax.

- The alternative bases are very large and generate significant revenue at very low tax rates.

  As shown in the table comparing tax bases, a value-added tax base may be 10 times the corporate income tax base. To generate the same amount of revenue as a 7% corporate income tax, the comparable VAT rate would be 0.7%. Ohio's GRT tax rate is 0.26%, reflecting the roughly 80% larger tax base than value added. The business community is understandably very cautious about state adoption of a tax with this large a revenue potential.

- Closely related is the fact that businesses may be likely to oppose paying taxes on value added or gross receipts when they have no positive net income, although property taxes, a major business tax, are paid irrespective of profitability.

  This opposition depends upon how much a business taxpayer would pay under a profits tax. During periods of weak or no economic growth, political pressure builds to introduce profit-sensitive components into the tax bases, or (as in Michigan's experience) replace the alternative with a profits tax.

- Pass-through entities that are not subject to corporate income taxes at the federal or state level will be likely to oppose to the state adoption of one of the alternative taxes that applies to all businesses.

- There is opposition among economists to adopting gross receipts taxes due to the multiple taxation ("pyramiding") of goods and services on intermediate business purchases.

  As shown in the comparative tax table, a GRT base may be 80% larger than a VAT base due to the taxation of business input purchases. This pyramiding of a GRT increases the effective tax rate on final consumer purchases, with the rate being higher on final consumption that includes more inter-firm sales of intermediate products and services. It should be noted, however, that under the typical state retail sales tax an estimated 40% is collected from transactions on business intermediate purchases. These sales are taxed at very high rates (an average tax rate of 5 to 6 percent) compared to potential GRT rates of less than one percent. Taxation of business inputs varies by industry, which creates tax rate differentials across industries and companies.[22]

[22] See generally, *What's Wrong with Taxing Business Services? Adverse Effects from Existing and Proposed Sales Taxation of Business Investment and Services*, by Cline, Phillips, and Neubig, Ernst & Young LLP, April 4, 2013, available at: https://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/sales-taxation-of-services-and-business-inputs-study.pdf.

c. Revenue Effects of Property Tax and Consumption Tax Options

As noted above, one option for property tax reform that would enhance Montana's competitiveness is to eliminate business and utility personal property taxes. This option would reduce property tax revenues by $235 million a year (at 2016 levels). This represents a 33% reduction in business property taxes and a 15% reduction in total property taxes.

Another option is to equalize the property tax rates (for personal and real property) at 1.35% (the current residential rate). This would result in an annual revenue loss of $412 million (at 2016 levels). This represents a 57% reduction of business property tax and 27% reduction of total property tax. The revenue loss (with equalization) for non-utility businesses would be $100 million, or a 31% decrease in property taxes for non-utility businesses.

If both options are considered (repeal of personal property taxes and equalization of real property tax rates among individuals and businesses), the net revenue effect would be a $493 million property tax reduction.

Table 11
Equalize Business and Residential Class Tax Rates
(dollars in millions)

	Current	Proposed	Change in Taxes	
Business property	**Taxes**	**Taxes**	**Amount**	**Percent**
Commercial land	68	48	-20	-29%
Commercial improve.	173	124	-49	-28%
Business personal	87	55	-32	-37%
Total non-utilities	328	228	-100	-31%
Utilities				
Real	65	14	-51	-79%
Personal	148	26	-122	-83%
Mileage	175	37	-138	-79%
Total utilities	388	76	-311	-80%
Total business property taxes	**716**	**304**	**-412**	**-57%**

Note: Proposed change imposes a 1.35% class tax rate on all business property.

Regarding consumption tax options, estimates of the potential base and tax revenue from adopting a retail sales tax modeled on the sales tax features of a typical state sales tax have been completed. The modeled sales tax system has the following features:

- A broad base, including most consumer product purchases, but excluding most business purchases.
- Most purchases of services are nontaxable, except for utility purchases by households.
- Exemption of sales to non-profits and government

- Motor vehicles are taxable; housing is exempt.
- Exemptions for motor fuels, tobacco and alcohol purchases.

For this modeled retail sales tax, only 36% of total consumer expenditures (products and services) are included in the sales tax base. This retail sales tax would raise approximately $886 million in revenue. Of this total, sales taxes on business inputs would account for $303 million (or 34% of the total revenue raised).

Table 12
Montana Sales Tax Base and Revenue at a 4% Rate

Tax Base Categories	Base ($millions)	Tax Revenue ($millions)	Percent Distribution
1. Tax on household purchases	14,579	583	66%
2. Tax on capital purchases	1,572	63	7%
3. Tax on intermediate business inputs	5,999	240	27%
Total tax base	22,150	886	100%

For the business entity level tax modeled for this analysis, the tax base equals:

- Firms' total sales minus business input purchases, including all capital purchases.
- Equivalently, the base equals the sum of payments to factors of production: capital and labor.

The business entity level tax includes all forms of doing business; it applies to both corporations and pass-through entities. Further, the tax is apportioned by 100% destination sales factor. As such, it is designed to exclude value added on exports and include value added on imports.

A comprehensive business entity tax would raise an estimated $298 million at a 1.0% rate. However, the exclusions from the base for the typical business entity tax would reduce the tax base by 27%. The typical business entity tax base would raise $219 million at a 1% rate.

Table 13
Potential Montana BAT Base and Annual Tax Revenue

Amounts in millions of dollars	Comprehensive BAT base	"Typical" BAT base with selected exclusions
	$29,790	$21,861
Tax rates	**Tax Revenue**	**Tax Revenue**
0.25%	74	55
0.50%	149	109
0.75%	223	164
1.00%	298	219
1.25%	372	273
1.50%	447	328
1.75%	521	383
2.00%	596	437
Revenue per 1/10 of 1% tax rate	$30	$22

VI. Two Potential Tax Restructuring Packages

This section estimates the impact of two potential tax restructuring packages on Montana's business tax competiveness. (See the property tax discussion above for a description of the modeling methodology.) The two tax restructuring packages provide the same business income and property tax reductions, but differ in terms of the offsetting tax increases. Both packages would: 1) adopt single sales factor (destination) apportionment for business income taxes, and 2) eliminate business personal property taxes, while reducing the class tax rate on business real property to 1.35%.

The two packages differ in terms of a new consumption-based tax to fund the business tax reductions:

- Package 1 includes a 2% business-entity tax (BAT, using the "typical" tax base) based on companies' value added.
- Package 2 finances the business tax reductions using a 4% retail sales tax. (The 4% state rate is the maximum allowed in the Montana Constitution.) This package does not account for any potential changes to the local "resort" sales tax.

Although the sales tax package would raise additional revenue, that revenue could be used to reduce other taxes consistent with this report, or fund additional spending.

Table 14
Aggregate revenue effects of the two tax restructuring packages
($millions)

	Package 1	**Package 2**
Repeal business personal property taxes	- $235	- $235
Equalize real property tax rates	-$258	-$258
100% destination sales income tax	$0	$0
2% Business Activity Tax	+$440	n/a
4% Sales tax	n/a	+$890
Overall effect	-$53	+$397

Table 15 presents the change in business taxes in Montana under Package 1. The change in taxes equals proposed law taxes minus current law taxes.[23] It shows that the business tax changes range from a decrease of 77% to an increase of 90%. This wide variation in impacts reflects the importance of changes in the income tax apportionment formula and the new BAT. For firms that export a larger portion of the sales from the new investment, shifting to a 100% destination-based income tax apportionment provides substantial income tax savings. For firms that are

[23] It should be noted that the competitiveness model is calculating the change in business taxes directly attributable to the new investment in a state. In other words, it does not look at the change in existing taxes that the hypothetical taxpayer could be paying before the expansion. For example, a taxpayer may already have substantial property taxable in Montana before the expansion. The calculations do not include the effect of lower property tax rates on existing property. It is also true that the addition of new in-state payroll, property and sales could change a firm's overall apportionment percentage compared to current law. This indirect feedback effect is not included in the calculations because it is very sensitive to facts and circumstances of each taxpayer.

assumed to have a larger portion of their sales in Montana (100% for the retail firm and 50% for the wholesale firm), this reduction is relatively small or zero. In effect, the BAT is also apportioned based on the percentage of sales in Montana. As a result, the retail and wholesale examples experience more significant BAT tax increases because of the concentration of their sales in Montana.

The last two lines present Montana's ranking among the seven states under Package 1 and current law. In terms of rankings, Montana moves down to 6th or 7th highest under Package 1 for the four firms with relatively high percentages of exports; Montana's tax ranking actually increases for the retail and wholesale firms.

Table 15
Tax Reform Package 1: BAT (2%) Used to Pay for Business Tax Reductions
Change in Total Business Taxes, Proposed Law Minus Current Law

Taxes	Small Manufact.	Metal Fabricator	Food & Bev. Retail	Credit Card Processor	Drug Whole. Dist.	Data Processing
Property Taxes						
Amount ($thousands)	-7.1	-61.7	-15.8	-4.4	-10.6	-8.4
Percent	-55%	-79%	-49%	-64%	-56%	-59%
Income Taxes						
Amount ($thousands)	-12.5	-39.3	0.0	-40.9	-25.9	-19.5
Percent	-86%	-86%	0%	-86%	-40%	-86%
Excise Taxes, BAT						
Amount ($thousands)	1.7	5.2	70.8	4.3	39.0	3.6
Percent	84%	434%	1167%	381%	746%	532%
Total Business Taxes						
Amount ($thousands)	**-17.9**	**-95.7**	**55.0**	**-41.1**	**2.5**	**-24.2**
Percent	**-61%**	**-77%**	**90%**	**-74%**	**3%**	**-65%**
MT Rankings (1 is highest business taxes)						
Current Law Rank	5	1	6	1	4	5
Proposed Law Rank	7	7	2	6	3	7

Table 16 shows the impact on Montana's competitiveness from Package 2 that funds business tax cuts through a 4% retail sales tax. Although the proposed sales tax is designed to minimize sales taxes paid on input purchases, the model attributes some sales taxes to the hypothetical examples.[24] The estimates of the sales taxes are on based on calculations of the percentage of

[24] The sales and excise tax line in the table shows the change in sales and excise taxes combined. Because there is no change in excise taxes under Package 2, the change in combined sales and excise taxes is equal to the estimated sales taxes paid by the hypothetical taxpayers.

input purchases by business that would be subject to the new sales tax. The table shows that in all cases, Montana business taxpayers would have the lowest or next to lowest tax burdens among all seven states. The tax reductions vary from 24% to 80%. The retail and wholesale examples both rank sixth because they benefit relatively less from the change in the income tax apportionment formula.

As the calculations for the included representative taxpayers show, either reform package would improve Montana's business tax competitiveness significantly for those taxpayers that export a significant percentage of their sales from the expansion outside of Montana.

Table 16

Tax Reform Package 2: Statewide Sales Tax (4%) Used to Pay for Business Tax Reductions

Change in Total Business Taxes, Proposed Law Minus Current Law

Taxes	Small Manufact.	Metal Fabricator	Food & Bev. Retail	Credit Card Processor	Drug Whole. Dist.	Data Processing
Property Taxes						
Amount ($thousands)	-7.1	-61.7	-15.8	-4.4	-10.6	-8.4
Percent	-55%	-79%	-49%	-64%	-56%	-59%
Income Taxes						
Amount ($thousands)	-12.5	-39.3	0.0	-40.9	-25.9	-19.5
Percent	-86%	-86%	0%	-86%	-40%	-86%
Sales and Excise Taxes						
Amount ($thousands)	1.5	5.2	2.6	0.8	1.9	1.3
Percent	77%	429%	43%	71%	36%	197%
Total Business Taxes						
Amount ($thousands)	**-18.1**	**-95.8**	**-13.2**	**-44.6**	**-34.6**	**-26.5**
Percent	**-61%**	**-77%**	**-24%**	**-80%**	**-43%**	**-71%**
MT Rankings (1 is highest business taxes)						
Current Law Rank	5	1	6	1	4	5
Proposed Law Rank	7	7	6	7	6	7

Tables 15 and 16 only show the taxes which are the liability of the businesses. Retail operations would collect and remit significantly more tax to the government from retail consumers than shown since Table 16 only shows the sales tax on business inputs. Retail food operations would collect and remit sales tax on their total sales to customers, whereas the BAT liability of food retailers shown in Table 15 would be imposed at the entity level (although those retailers would be expected to pass the cost of the tax along to their customers through higher prices).

In both Tables 15 and 16, the six industries presented do not represent all of the industries and companies that would be affected by the tax restructuing proposals. Although Table 15 shows all six industries with reductions in business taxes, the overall package would be revenue neutral, so other taxpayers would be paying additional taxes. Some of the taxpayers paying more would be out-of-state firms and tourists.

VII. Conclusion

Most states rely on a "three-legged stool" of tax types to fund government services: income taxes, both individual and corporate; property taxes; and sales & use taxes. At the same time, most economists agree that consumption-based taxes are far more neutral in their impact on state economies; that is, they have a much smaller impact on decisions to save, invest, or spend. Because Montana does not impose a state-wide retail sales (consumption) tax, its remaining major taxes are forced to overcompensate through high rates in order to provide adequate levels of funding of government services. As a result, these relatively high business taxes on new investments in Montana (through property taxes and income taxes) create disincentives to locate and expand in the State, thereby reducing potential growth in Montana's economy, jobs and income. One way to address these disincentives is to balance the State's revenue system by enacting a consumption-based tax -- either a retail sales tax or an entity-level tax with a value-added (consumption) base – and using a portion of the revenue to address the anti-competitive features of the current Montana tax system.

Montana's tax system should reflect the vision of what its economy will look like in the future by reflecting the changing composition of its economy, new business models and dynamics, and competitors' tax structures. Montana's tax system should also collect sufficient revenue to fund the desired level of government infrastructure and services in the simplest, least economically distortive, and fairest manner possible. Many other U.S. states and other countries are shifting their tax structures to fall more heavily on consumption than on production and are targeting tax relief towards disincentives to capital investment. Taxes on business income and business property are more detrimental to economic growth, work, and business investment than other types of taxes. Other states are reviewing their tax systems to ensure that out-of-state businesses and tourists that enjoy the benefits of their states are contributing to the funding of essential public services. Montana should take similar steps as well.