Give & Take

As state economic-development teams offer tax breaks to attract companies, revenue departments seek to get that money back.

By Kate O'Sullivan

ILLUSTRATIONS BY TIM BOWER

revenue-based gross-receipts taxes, for example, and stepping up state audit efforts. The conflict is brewing even in some states generally known for being business-friendly, like Ohio and Texas.

It's no wonder corporate tax directors don't know which way to turn.

"Clearly, states and businesses continue to be in very adversarial roles," says Joe Crosby, legislative director for the Council on State Taxation (COST), a nonprofit association of businesses with multistate operations. Many states have restored the health of their coffers, which were drained by the dot-com bust and the post-9/11 slowdown. Treasuries are swelling, thanks to the income-tax revenues that improved corporate earnings have produced. Still, many state revenue departments are designing strategies as if they fear the prospect of future downturns. Further, says Crosby, "administrators continue to believe that there is a lot of abusive activity going on, which leads to more-difficult and more-costly audits and more fishing expeditions."

ALL ABOUT AUDITS

This year's edition of *CFO's* state tax survey, last conducted in 2004, underscores the confusion that corporate finance chiefs feel about these trends. The tax director's biggest headaches now include "inconsistency in treatment," along with "the limited knowledge of state officials of the changes in the laws that they enforce." Not far behind: "dealing with the states' aggressiveness in obtaining additional revenue."

State revenue departments, which were under pressure to close loopholes and scare up tax dollars at the troubled dawn of the new millennium, did make progress in improving their collection abilities. They have recruited MBAs and CPAs in their efforts to improve their processes and run their departments more efficiently. Most have moved into the black, and corporate income-tax collections showed a 10.4 percent year-to-year increase in the September quarter, according to the Nelson A. Rockefeller Institute of Government.

This improved efficiency on the states' side is a double-edged sword for companies. Richard Skeen, tax director at HealthTronics, an Austin, Texas-based medical-testing service provider, says that the state of Texas has improved the quality of its auditing team. That doesn't make his job any easier, though. "It seems to me that they're more knowledgeable," he says, "but they also seem to be more aggressive because they know the issues they're supposed to go after." HealthTronics has seen an increase in correspondence from the Department of Revenue, including inquiry letters and requests for more information on various issues. Still, Skeen notes that the state's representatives are more interested in understanding his thinking about tax decisions and less likely to reject his explanations out of hand.

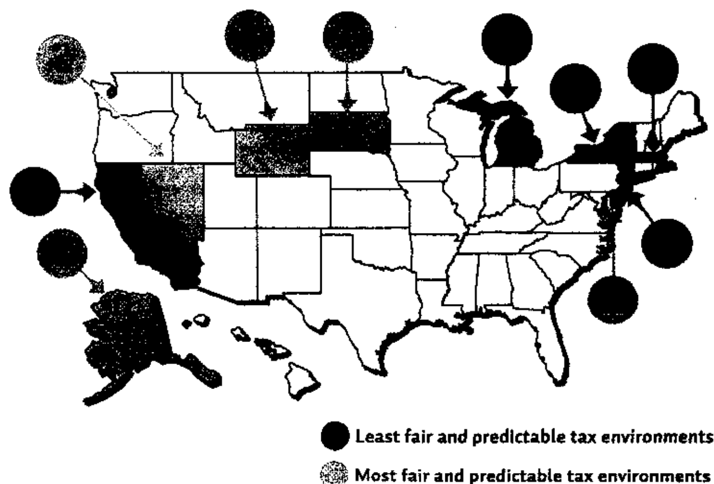
Few other respondents to the survey have anything positive to say about their state-government interactions. Some finance executives call state auditors "unreasonably antagonistic," "arbitrary," or "out of control," and one laments auditors "who think any income they can't tax must be because of tax cheating."

States are broadening their reach, increasingly taking advantage of their own improvements in technology and pooling corporate tax information with other states. This makes it easier to track down businesses that may have minimal—but potentially taxable—contact with their jurisdictions.

"You can have an auditor for the state of Pennsylvania share information with auditors in New York, New Jersey, and Maryland, and those states may not have even realized that the company in question had a business connection to their state," says Pat Pelino, a tax consultant with Vertex, a tax software and services provider. As a result, tax directors are fielding an increasing number of nexus questionnaires, often from surprising places. States can also search information from their neighbors to pick up clues about a company's level of compliance. A company that filed in California as part of the state's voluntary tax-amnesty program, for example, might have its returns flagged for a closer look in other states. So much for amnesty.

CALIFORNIA SCREAMIN'

What is your overall impression of the tax environment in this state?
California, the state tax directors love to hate, narrowly edged out 2004's "winner," New Jersey, for the crown as the nation's worst tax environment. Despite the presence of Republican governor Arnold Schwarzenegger since 2003, complexity continues to plague California's tax structure, making the process of filing there "nearly as difficult as filing a federal return," says Donna Castellano, product manager at tax software and services provider Vertex.

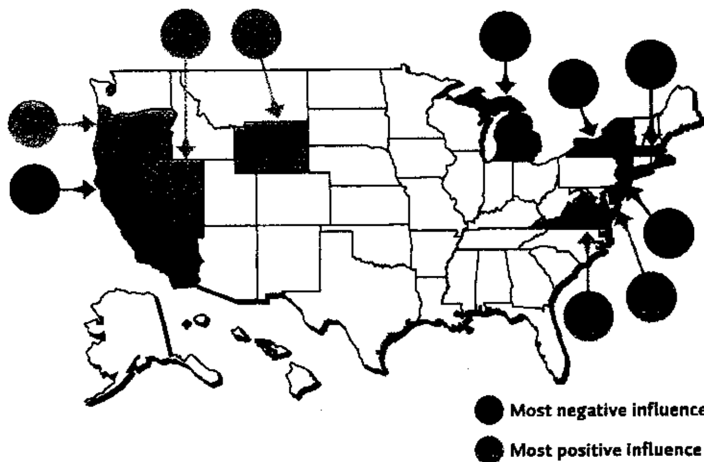


Source for all charts: CFO survey

JERSEY BARRIERS

How do this state's revenue-department policies and systems influence your company's decision to locate or expand there?

Economic-development officials have their work cut out for them in New Jersey, the state with the most negative influence on tax directors' plans for expansion in this year's survey. The Garden State's ongoing fiscal crisis has led to changes, including a sales-tax rate hike last July and an expansion of the sales tax last October. New Jersey now levies sales taxes on services ranging from accounting to lawn care. "In most cases, you don't see states raise the sales tax and then turn around and start taxing additional things. Usually it's one or the other," says Pat Pelino, a consultant with Vertex, a tax software and services provider. "In New Jersey, they hit it from both sides."



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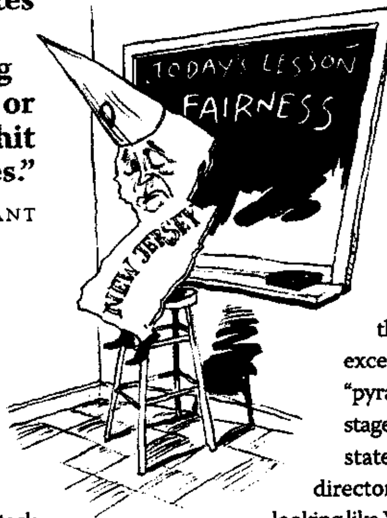


IN WITH THE NEW

IN ADDITION TO CONDUCTING INCREASingly wide-ranging and aggressive audits, states are introducing new taxes to help shore up their revenue base. Many survey respondents cited the constant stream of tax changes as a leading concern. "It's a really daunting task to make sure you're on top of all the things that are potentially occurring so that you can try to minimize your tax burden before you learn that, effective last month, you have a tax bill in Montana," says Joe Levanduski, CFO of Hawk Corp., a Cleveland-based industrial-component maker.

The movement among states to adopt gross-receipts taxes is also gaining steam. Taxing the top line instead of the less-certain bottom line reflects states' past revenue-sapping experience with the dot-com crash. "Revenue departments are trying to make sure their base is more stable in the future," says Timothy Gillis, national partner in charge of the state and local tax practice at KPMG.

"It's a disturbing trend from a corporate standpoint," says G. Brint Ryan of the tax advisory firm Ryan & Co. "States have figured out that corporate earnings are too volatile to plan their budgets around them. With a gross-receipts tax, if you have earnings, great. If you don't, that's OK, since you pay the state either way."

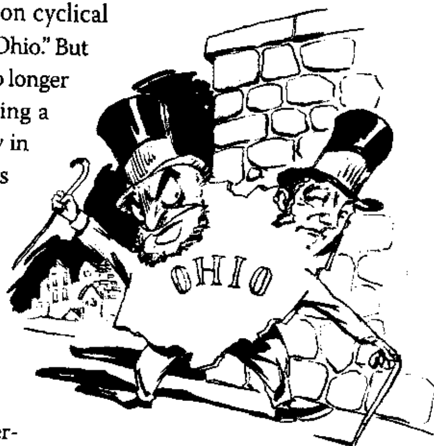
Finance executives have mixed reactions to gross-receipts taxes, in part because most are so new that their full impact isn't yet known. There hadn't been a new gross-receipts tax passed in the United States in decades until New Jersey instituted one in 2002. That tax reached its sunset in June 2006, and has not been extended. But Ohio recently adopted a version of the tax, and Texas and Kentucky have followed.

In Texas, the gross-receipts tax, officially called the alternate-margins tax, was passed in 2006 as part of an overhaul designed to help the state fund its schools. It replaces the tax on capital spending and was accompanied by a 25 percent reduction in the property tax. Manufacturers will now pay the state 1 percent of their taxable receipts, while retailers and wholesalers will pay 0.5 percent. The tax also applies to limited liability partnerships, which had formerly avoided tax in the state.

Ohio enacted its gross-receipts-based commercial-activity tax, or CAT, as part of a major tax reform in 2005. Critics like COST and the Ohio Chamber of Commerce opposed the tax on the grounds that it would hurt high-volume, low-margin firms, and that while the rate is low—0.26 percent of receipts exceeding $1 million—it could add up or "pyramid" as receipts are taxed at multiple stages of the production process within the state. Doug Lindholm, COST's executive director, worries that the CAT could end up looking like Washington State's often-criticized business and occupation tax, a gross-receipts-based tax employing different rates for different types of businesses. "It makes it difficult for a big business to know which classification to use," he says.

"A gross-receipts tax has a compound negative effect during recessions or times of financial duress, because the company pays tax whether it's profitable or not," says Dan Navin, assistant vice president of tax and economic policy for the Ohio Chamber of

Commerce. "So it's more onerous on cyclical businesses like the manufacturers in Ohio." But Navin stresses that the Chamber is no longer fighting the tax, and instead is taking a wait-and-see approach. "It's too early in the transition to make judgments about it," he says.



Despite the arguments against it, the CAT has received the support of several business groups within the state, including the Ohio Business Roundtable. The tax will gradually replace the state's franchise tax as well as the business personal-property tax on inventory and equipment, a development that some businesses like. The new duty was also accompanied by a 21 percent reduction in the personal income tax rate. "We anticipate our tax burden will go down significantly," says Dennis Blackburn, tax manager at Hawk, which ships most of its product to equipment makers outside of Ohio and thus won't feel much impact from a tax on Ohio sales. "As long as you have income, it works out well. But the nature of gross receipts is that if you're a business going through hard times, you'll still have that liability."

JEKYLL AND HYDE

OHIO OFFICIALS ARGUE THAT THEIR NEW TAX SYSTEM ultimately will prove a valuable tool in attracting businesses. And some that have recently relocated there cite the tax overhaul as a motivating factor. "The tax reform was something we did for the purpose of helping economic development in the state," says former lieutenant governor Bruce Johnson, who until last month was also Ohio's director of economic development. "While the commercial-activity tax is new, it is less onerous than all the taxes it replaced." Johnson says that since the tax applies only to Ohio sales, large multinationals and other companies that sell most of their product outside Ohio shouldn't be greatly affected. Not coincidentally, these are the very companies that the state business-development department usually targets.

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Certainly, Ohio illustrates the potential for conflict between the revenue-raising and the corporation-welcoming roles. "It's hard because our job is to attract jobs, and in the department of taxation, their job is to collect revenue," the lieutenant governor says. "But I think we work it out pretty well."

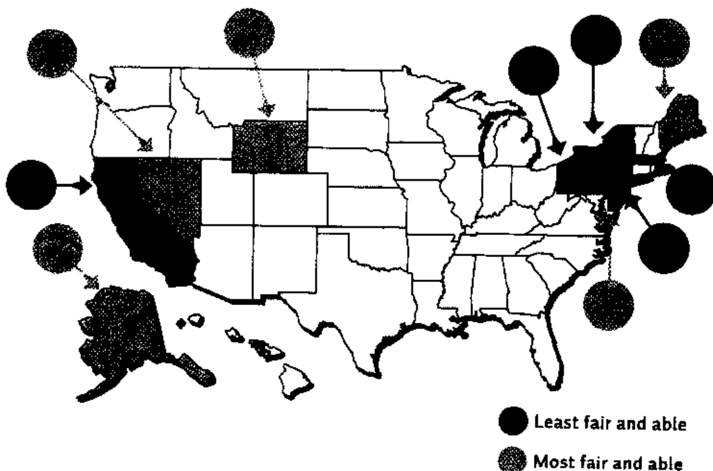
Still, the Tax Foundation ranked the Buckeye State's business climate next-to-last among the 50 states in its 2007 State Business Tax Climate Index, with Ohio topping only Rhode Island. The Foundation cited Ohio's gross-receipts tax and the complexity caused by its temporary overlap with the franchise tax. At the same time, the state is well known for its jobs credits and investment tax credits; personal involvement with industry from outgoing governor Bob Taft's office; and establishment of the $1.7 billion Third Frontier Project, an initiative to fund high-tech business expansion in the state.

While the jury may be out on Ohio's efforts, the disconnect between the economic-development activities and the tax-collection and -enforcement efforts is clear in numerous states that offer tax breaks for new business, while snubbing existing industry. "The incentives people will bend over backwards to put together lucrative packages for facilities and jobs. Once you've signed on, the revenue guys will come in and just whack you," says Ryan, the tax adviser. "It's like Dr. Jekyll and Mr. Hyde."

In North Carolina, some corporate tax directors see the state revenue department and economic-development officials in the Department of Commerce working at just such cross-purposes. "It's frustrating because you've typically got somebody in economic development who is aggressively trying to attract business to the state. So you're promised these incentives," says the vice president of tax at one North Carolina–based retailer, who asked not to be named, due to ongoing disagreements with the state. "Then when you take them, you're dealing with the Department of Revenue, which is not at all inclined to grant those credits.

FAIRNESS DOCTRINES

How do you rate state audit departments on their ability to settle "gray issues" at the auditor level?



It's almost routine that the credits get refused."

The retailer applied for both jobs credits and investment credits. The tax director asserts, however, that they were denied in essence because only newly relocated businesses qualify. "North Carolina is very aggressively working to bring in new businesses," he says, "but it doesn't seem to care about the business that's already here." North Carolina officials contest this claim.

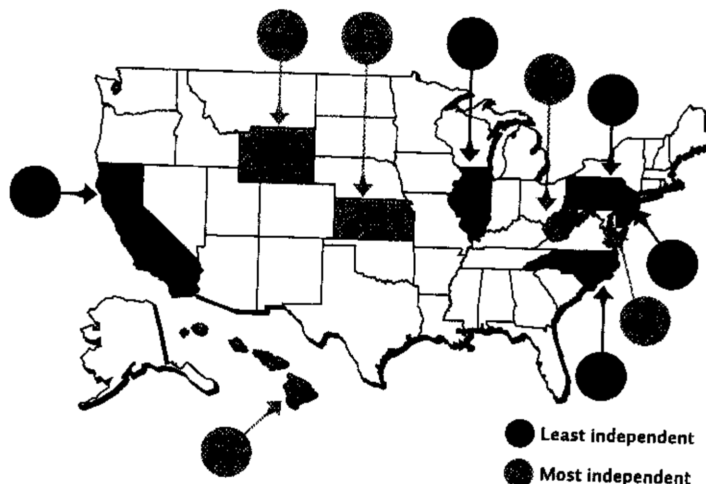
He also says that in North Carolina, "to effectively take on the Department of Revenue, you have to pay and then sue for a refund." COST gave the state a preliminary "D" grade in its 2006 study of tax procedures and administration. In *CFO's* survey, it ranked as having one of the least independent appeals processes in the country.

North Carolina officials say they work hard to coordinate the two departments. "In the past there was sometimes confusion about claiming credits," says Linda Millsaps, assistant secretary of tax administration. "But we now have someone in tax administration who focuses primarily on incentives to try to create better communication." The secretary of revenue and the secretary of commerce also meet monthly to discuss common issues. An update of the state's tax-credit program, due to take effect this month, is expected to ease some of the confusion.

Skeen of HealthTronics says that Texas, too, reviews the fine print on incentive agreements very carefully once a new business relocates to the state. "A lot of the incentives seem pretty restrictive," he says. "You have to follow certain guidelines and be able to prove that you're meeting them to claim the credit."

SEPARATION OF POWERS

How would you rate the independence of this state's administrative appeals process from its audit department?



BRIDGING THE GAP

TENNESSEE IS ONE STATE THAT HAS ADDRESSED THE divide between the revenue and economic-development departments. Before taking office in January 2003, Gov. Phil Bredesen contacted incoming Commissioner of Revenue Loren Chumley and Commissioner of Economic Development Matt Kisber. "He said, 'I want you all to get along and get this right on the front end,'" according to Chumley. While campaigning, Bredesen had heard complaints about frequent conflicts between the two departments. Chumley, who had been audit director for the revenue department, acknowledges that communications weren't always smooth. "The Department of Revenue was sometimes coming in on the back end and wearing the black hat for the state," she says.

Today, revenue-department representatives get involved in economic-development projects from the outset. Chumley or her deputy often attend meetings with targeted firms, and in some cases a state audit supervisor will join the discussions. "We'll work with them on setting the record straight on how someone would need to account for the credit to which they would be entitled," she says. To claim a jobs tax credit, for instance, a company needs to track the hire dates and wage rates for each job it hopes to claim. "It sounds simple," she says, "but it's one of those things that might get overlooked in a large corporate relocation."

The tone of the revenue department has changed, too. "Part of the environment we've created for our auditors is to show them that if a company makes a large capital investment and creates jobs, that will expand the total tax base. The credits may mean that a certain business will reduce its tax burden, but hopefully it will have far-reaching implications for the state," says Chumley.

If the chorus of complaints from survey respondents is any indication, though, such attitudes remain rare. Until more states learn to make peace with their dual missions—raising revenue while creating a hospitable environment for business—confusion seems likely to reign. And the tax director's job will continue to demand extreme flexibility and patience. **CFO**

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>> Full results of the *CFO* state tax survey, including a look at states' treatment of nexus issues, and surveys from past years, are available at www.cfo.com/statetax.

The 2007 Survey Results