

# Get a better handle on local and state taxes

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Like all businesses, child care facilities pay a number of taxes that contribute to the public good. In the Winter 2004 issue, we looked at the kinds of federal taxes you pay based on the legal structure of your business. In Spring 2005, we looked at federal and state taxes you pay on employees.

In this issue, we will look at local and state government taxes. These are the taxes that support the services closest to us and our communities—namely, education, health and social services, fire and police protection, and transportation. While not the only source of revenue to support these services, taxes do provide the largest source of their funding.

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SMALL BUSINESSES PLAY  
A CRITICAL ROLE  
IN THE U.S. ECONOMY.

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No one likes to pay taxes, but they're part of the cost of doing business. Many argue that taxes hamper business, especially small businesses (defined by the Small Business Administration as businesses with fewer than 500 employees). Small businesses deserve protection from burdensome taxes because they play a critical role in the U.S. economy. In particular, small businesses employ about half of all private sector employees, and they have generated nearly two-thirds of all new jobs in recent years ([www.sba.gov/sites/default/files/sbfaq.pdf](http://www.sba.gov/sites/default/files/sbfaq.pdf)).

Looking at taxes in general, many economists advocate a fairness principle: those with a greater ability to pay should contribute more in taxes. Economists characterize a given tax as **progressive** if

it takes a larger percentage of the income of high-income groups (for example, the U.S. federal income tax), and **regressive** if it takes a larger share of the income of low-income groups. Taxes that take the same percentage from both income groups are said to be **proportional**.

With that in mind, what are the most common local and state taxes that small businesses pay?

## Property tax

Businesses that own the building and land in which they operate pay **real property taxes** to local governments, usually county, city, and school district. Even if you rent the property, the landlord probably passes on the tax to you as part of the rental fee, so you pay indirectly.

Businesses also pay taxes on their furniture, fixtures, and equipment, known collectively as **personal property taxes** (even though they belong to the business and not a person).

Property taxes are **ad valorem** taxes, which means the rate is in proportion to the property's value if sold on the open market. Property owners can—and often will—challenge their property tax bills if they seem too high.

Schools may be exempt from these taxes, depending upon state laws and regulations. In Texas, for example, an exemption may be granted to charitable nonprofits (including religious groups) and private schools under certain conditions. (See "Building a business" in the Fall 2008 issue.) Exemptions causing the greatest controversy in recent years have been those given to new profit-making businesses as a way to induce them to move to a community and provide jobs.

Property taxes are usually considered regressive and can create unequal tax burdens between poor and affluent communities. Nonetheless, property

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taxes remain attractive to many governments because they can be collected more effectively than other taxes and form the largest source of tax revenue.

## Business taxes

In addition to property taxes, businesses in most states pay some sort of business tax. One category is the **corporate income tax**, which is assessed on net profits at a flat rate—say, 5 percent—or on a sliding scale.

A related levy is the **privilege tax**, so called because the local or state government gives the business the privilege of operating in an area. Texas, for example, calls its privilege tax a **franchise tax** and levies it on corporations chartered in the state or doing business in Texas. It is also known as the **margins tax**.

Explanation of the Texas franchise tax rate is best left to CPAs, but in practice it's assessed on business capital or profits. Small businesses with gross receipts of \$300,000 or less were originally exempt, and in 2006 the Texas Legislature exempted more small businesses by raising the threshold to \$1 million. Unfortunately, this change lowered state revenue and created what many observers have called a "structural deficit" in the state's budget. It's unclear what will happen on this issue in the future.

Even though a business may owe no franchise taxes, it may still be required to file a No Tax Due Information Report. For more information on the Texas franchise tax, see the State Comptroller's website, [www.window.state.tx.us/taxinfo/franchise/](http://www.window.state.tx.us/taxinfo/franchise/).

Corporate and franchise taxes are often passed off to consumers in higher prices of goods and services, and in that sense may be considered regressive. Critics of this tax claim that it deters corporations from locating in the state. But businesses generally consider a wide range of factors in choosing locations, including access to markets, raw materials, labor costs, skilled labor, energy, unemployment insurance, and environmental regulations.

Another kind of state tax that businesses pay is the **unemployment tax**. This topic was covered in the Spring 2005 issue.

## Sales taxes

Sales taxes can go unnoticed, except at the cash register or point of purchase. Child care businesses pay sales taxes on the equipment and supplies they buy to provide services to children and families.

Five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) do not charge a general sales tax. For states that do, sales taxes are often the most important source of tax revenue. When the economy sours, however, consumers spend less, and sales tax revenue declines.

Sales taxes are considered regressive because it's assumed that a poor family spends most of its income on purchases, whereas a wealthy family can save or invest a larger portion of its income. In an effort to reduce this burden on the poor and middle class, states have exempted some purchases, such as food and medicine, from the tax. Sales taxes are attractive to governments because they can be applied to non-residents such as tourists and commuters.

## FIVE STATES DO NOT CHARGE A GENERAL SALES TAX.

Seventeen states have sales tax holidays in early August to help families shopping for back-to-school items. Tax-free items include clothing, diapers, and school supplies (for elementary and secondary students). In Texas in 2012, because public schools may choose an earlier start date, the tax-free weekend will be July 27-29.

## Excise taxes

Excise taxes refer to levies added to the price of selected items and services. The principal excise tax borne by child care businesses is that on **telephone service**. In recent years, states have targeted cell phone use in particular as a way to help alleviate deficits. According to one report ([www.foxbusiness.com/markets/2011/02/22/fixing-state-deficits-higher-cell-phone-taxes](http://www.foxbusiness.com/markets/2011/02/22/fixing-state-deficits-higher-cell-phone-taxes)), the combined local-state-federal taxes on cell phone use can account for as much as a fifth of your entire bill.

Child care facilities that operate vans or pay mileage expenses to employees will pay excise taxes on **gasoline**. Buying a van to use in a child care business will entail a **motor vehicle tax**, a percentage of the vehicle's purchase price, as well as a property tax discussed earlier.

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The combined local-state-federal gasoline tax is highest in Connecticut (68 cents a gallon) and lowest in Wyoming (32.4 cents). See the most recent updates at the website of the American Petroleum Institute, [www.api.org/statistics/fueltaxes/](http://www.api.org/statistics/fueltaxes/). On average, the combined taxes account for 22 percent of the price at the pump. See [www.fueleconomy.gov/feg/gasprices/faq.shtml](http://www.fueleconomy.gov/feg/gasprices/faq.shtml).

Gasoline taxes are regressive, but many of us tolerate them because we believe they are used to build and maintain bridges and roadways. In Texas, however, less than a third of the state gas tax goes to transportation. Most of it is diverted to other purposes, including public education.

## PAY TAXES PROMPTLY AND AVOID PENALTIES AND INTEREST.

Citizens are divided about raising the gas tax. Some argue that over the long term a higher tax would lead to more fuel-efficient cars and reduce the nation's dependence on foreign oil. Others oppose a higher tax because it would hurt working people and the revenue generated might be used for purposes unrelated to roads and bridges.

### User charges

User charges, while not technically taxes, are the fastest-growing source of revenue for local and state governments. Proponents justify them as directly linking the cost of public services to the people who benefit from them.

User fees are charged for the use of facilities or services. Examples are tolls on freeways and charges for electricity, natural gas, water, sewerage, and garbage collection as well as fees for public parking spaces and admission to public parks and zoos. User fees may include "convenience" fees tacked on to a bill that you pay by phone or online.

A related category of fees charged to businesses are **corporate filing and licensing fees**. Before beginning operations in a state, a new business must obtain a charter, an official document issued by the secretary of state that describes a company's purposes and

privileges. Filing for a charter entails a fee. In Texas, it's \$300.

Certain kinds of businesses are required to obtain a license to operate in a state. In Texas, child care centers pay a \$35 application fee and a \$35 licensing fee to start out, and they pay an annual fee thereafter.

### Get help if needed

While the list of taxes can be daunting, knowing about them can help you avoid problems and save money. No one expects you to be a tax expert, however. Suggestions:

- Hire a competent CPA to review all your tax obligations and give advice. A professional stays informed of tax laws and regulations and can help you avoid time-consuming audits.
- Keep accurate records. File all receipts and photocopy paid tax bills.
- Pay taxes promptly and avoid penalties and interest. If you can't pay the entire amount by the deadline, your taxing authority may be able to work out an installment plan.
- Learn more about doing business in your state at [www.irs.gov/businesses/small/article/0,,id=99021,00.html](http://www.irs.gov/businesses/small/article/0,,id=99021,00.html).

### Reference

Dye, Thomas R. and Susan A. MacManus. 2008. "Chapter 14: An overview of government finances." *Politics in States and Communities*. New York: Longman, 492-502. ■