

SOUTH CAROLINA

A ROAD MAP FOR TAX REFORM

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SOUTH CAROLINA
CHAMBER FOUNDATION

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INTRODUCTION

A blue-tinted landscape photograph of a mountain. The mountain features a prominent, light-colored rock formation with vertical striations, partially obscured by mist and dense forest. The foreground is filled with dark, dense trees, and the sky is filled with soft, white clouds. The overall mood is serene and atmospheric.

Introduction

Two decades before he published his famous treatises on government, John Locke's *Fundamental Constitutions of Carolina* were adopted as the governing document of provincial Carolina. Voltaire praised the document, encouraging his readers to "behold Carolina, of which the wise Locke was the legislator," but the early constitution bore few marks of the philosophy for which the Enlightenment giant would later become known.

A feudal document, it upheld the prerogatives of the proprietors. Indeed, it granted them extremely broad powers; unlike the constitutions with which we are now most familiar, it did not operate as any significant check on political power. Whereas the U.S. Constitution, more than a century later, would establish a government of enumerated powers based in no small part on Lockean principles, the constitution Locke wrote had such a strong assumption of governmental authority that it never even mentions the power to tax. It simply wasn't necessary to spell that out.

Not until South Carolina's postbellum Constitution of 1865 did the state's governing charter first impose any limitation on the taxing power, and not until the twentieth century did anything approaching South Carolina's modern system of taxation come into view. And it was partly due to the boll weevil.

The destruction wrought by the boll weevil reverberated throughout the state, with farmers' livelihoods destroyed and state revenues—already buffeted by an economic downturn after the conclusion of the First World War—plummeting. In response, lawmakers adopted an individual income tax, an inheritance tax, and a motor fuel tax, the first time the state created taxes on anything other than property and the privilege of doing business. Today, that income tax features the highest top marginal rate in the Southeast, and the highest effective rates in the region for many wage earners.

The sales tax would arrive in the 1950s, followed eventually by a proliferation of local option sales taxes—for property tax relief, for capital projects, for school district funding and education capital improvements, for transportation, and tourism development. The entire property tax system would be remade multiple times, most recently with the controversial implementation of Act 388. A robust, and often byzantine, system of fees in lieu of taxes has emerged to offset an otherwise deeply uncompetitive property tax system for many businesses. Meanwhile, local governments choose among a bevy of tourism- and accommodation-related taxes, each with their own strictures.

The problems with South Carolina's tax code are not, ultimately, questions of revenue. South Carolina is by no means a high tax state in the main, though it can feel that way for certain taxpayers. The problems, rather, come down to questions of tax structure. This book is intended to help policymakers identify ways to make the state's tax code more competitive.

In the following pages, we examine South Carolina's economy, outline the existing tax structure, and offer recommendations for reforming the tax code. We seek to identify what the state does well and to point out opportunities for improvement. Underlying our analysis is the goal of enhancing South Carolina's competitive standing and a commitment to the principles of sound tax policy—that, to the greatest extent possible, taxes should be simple, transparent, neutral, and stable, and that the best tax structures are those with broad bases and low rates.

In the course of our research, we pored over South Carolina's tax code, dusted off old tax studies, reviewed the economic literature, and examined successful reforms implemented by other states. First and foremost, however, we talked to South Carolinians: state and local government officials, business leaders, and everyday taxpayers alike. The insights and perspectives of those who actually interact with South Carolina's tax system inform every page of this book.

The South Carolina Chamber Foundation commissioned the Tax Foundation to prepare a review of the South Carolina tax system and recommend possible solutions, and this book is the result. While they supported our study, they did not direct our study or any of our recommendations. We offer our thanks to the many South Carolinians of all walks of life who met with us as we worked on this book. It is our hope that this book will help reform a robust and much-needed debate about the future of the state's tax code.

A Menu of Tax Reform Solutions

Corporate Taxes

South Carolina's corporate income tax is imposed at a low rate, with a base heavily carved out by incentives. Many firms face little or no liability under the corporate income tax, but for others, the tax's treatment of capital investment, combined with an antiquated capital stock tax in the form of the corporate license fee, can be an impediment to growth. Our recommendations would create a more neutral corporate tax environment which avoids penalizing capital expansion.

Improving Treatment of Capital Investment. While a number of states follow the federal government in allowing the full and immediate expensing of machinery and equipment purchases, South Carolina instead relies on an inefficient and eligibility-limited tax credit for qualified investment. A more neutral tax code would allow all corporations to fully deduct the cost of their machinery and equipment purchases in the first year.

Conforming to Federal Treatment of Net Operating Losses. Federal law now provides for unlimited net operating loss carryforwards, capped at 80 percent of tax liability in any given year. Policymakers might consider conforming to federal treatment for simplicity's sake.

Shifting to Market Sourcing of Service Income. South Carolina has followed the recent trend of adopting single sales factor, which is popular in part because it exports a significant portion of tax liability to out-of-state firms. Oddly, however, the state continues to source service income based on the location of income-producing activity—which is, essentially, an emphasis on payroll and property for services, but sales for manufacturing and production. These policies are at cross-purposes. The state should consider aligning its policies.

Reviewing Business Tax Incentives. A growing number of states have established panels, commissions, or *ad hoc* committees to review tax incentives periodically. Given South Carolina’s heavy reliance on tax credits, periodic evaluation to assess return on investment is advisable.

Repealing the Antiquated Corporate License Fee. South Carolina’s corporate license fee generates little revenue but is harmful for highly capitalized businesses and is imposed without regard to ability to pay. Policymakers should consider phasing out the tax.

Individual Income Tax

South Carolina’s individual income tax features a high top marginal rate and produces high effective rates for many middle-class taxpayers and small businesses which are structured as pass-through entities and are subject to the individual income tax. Our recommendations are focused on creating a more regionally competitive individual income tax.

Lowering and Flattening Rates and Brackets. For a single filer at every level of taxable income above \$70,500, South Carolina features either the highest or second-highest income tax burden in the Southeastern United States. Policymakers should consider consolidating rates and brackets, and perhaps even adopting a single-rate income tax with a more generous standard deduction. We offer several options, with flat rates ranging from 4.65 to 5.7 percent (based on the inclusion or exclusion of other policies), along with an across-the-board rate reduction within the current graduated rate structure.

Addressing Anomalies within the Graduated Rate Structure. If policymakers retain a graduated rate structure, they should consider fully eliminating the marriage penalty—ameliorated but not eliminated by a credit—which increases tax liability for joint filers and adopting full (not partial) inflation indexing to avoid “bracket creep,” where a greater share of taxpayers’ income is subject to higher rates over time.

Capping the Earned Income Tax Credit (EITC). The earned income tax credit can be a valuable tool for providing low-income family assistance structured in a way that rewards and facilitates work, particularly if lawmakers opt to adopt a single-rate income tax. However, if the EITC is permitted to expand to 125 percent of the federal amount—an amount intended to offset far higher federal tax liability—the median *household* in South Carolina will be just on the cusp of having any income tax liability in South Carolina. The new EITC may be a positive development, but it should not be allowed to phase all the way up to an unprecedented 125 percent of the federal EITC.

Rolling Back Tax Incentives. Some of South Carolina’s tax incentives are barely claimed at all, and others fall far short of their objectives, but they create administrative costs by their mere existence. While individual income tax credits only carve out the tax base slightly, a cleanup of the existing credit structure is appropriate.

State and Local Sales Taxes

The state’s sales tax is imposed on an extremely narrow base that exempts many goods and most services, a holdover from an earlier era. Our proposals would modernize the sales tax, bringing it in line with today’s economy.

Broadening the Sales Tax Base. A well-structured sales tax applies to all final consumer purchases, both goods and services, while exempting business inputs. South Carolina’s sales tax falls far short of this goal, and in an increasingly service-oriented economy, it erodes further each year. We offer a menu of base-broadening options to enhance the stability of the sales tax and generate additional revenue that could be used to reduce the sales tax rate or pay down reforms elsewhere.

Eliminating Impediments to Online Sales Tax Collections. Although South Carolina is moving forward with remote sales tax collections, the state is not fully in accord with the provisions commended by the Supreme Court in the *Wayfair v. South Dakota* case. The state should take the steps necessary to pass the “Wayfair Test,” such as adopting uniform definitions and providing lookup software, which will reduce compliance costs for sellers (and thus likely increase compliance) while providing the state greater protection against a legal challenge.

Excluding Business Inputs. South Carolina policymakers have long recognized the importance of excluding business inputs from the sales tax base to avoid tax pyramiding, but efforts to expand the scope of these important exemptions have been piecemeal, targeted at specific industries, and sometimes only made available to particularly large purchasers. We recommend eliminating eligibility requirements for exemptions and working to improve the overall treatment of business inputs in the sales tax code.

Property and Related Taxes

Act 388 remade the property tax landscape in South Carolina—and not in an entirely positive way. The exceedingly light taxation of some classes of property has resulted in heavy, uncompetitive burdens on others. Some businesses get the benefit of specially negotiated deals, while others face one of the nation’s highest tax burdens on industrial and manufacturing property. Our solutions involve reducing distortions in the property tax, creating a more competitive system and putting local—and particularly school—finance on a firmer footing.

Narrowing Disparities in Assessment Ratios. South Carolina's current property classification schedule imposes widely disparate assessment ratios on different classes of property, then exempts select property owners from feeling the brunt of those disparities. All residences should face the same assessment ratio, and, at the very least, the manufacturing and business personal property ratios require a downward adjustment.

Reforming Property Tax Limitations. Assessment limitations create serious inequities, tie the hands of local governments, and influence decisions about whether to improve or sell a property. We offer a range of options for relaxing or even repealing the assessment limitation while maintaining the protections of a rate limitation.

Addressing the School Operating Costs Differential. The exclusion of the millage associated with school operating costs from taxes on primary residences yields extremely attractive effective rates for those properties, but at a cost in overall state competitiveness and, ultimately, in the ability to ensure appropriate levels of school funding. We propose options for rebalancing some of the inequities between different classes of property.

Reducing Reliance on Personal Property Taxes. South Carolina imposes tangible personal property taxes on business machinery, equipment, and other movable property. These taxes are nonneutral and impose high compliance costs. We list options for reducing reliance on, or even eliminating, the taxation of tangible personal property.

Business License and Accommodations Taxes

South Carolina's local business license taxes are unusually onerous, imposing significant compliance costs on many businesses. A tangle of accommodations taxes adds to the complexity of local tax regimes. Our recommendations seek to bring about simplification and a reduction in compliance costs.

Simplifying Business License Tax Compliance. Many businesses are required to remit business license taxes to multiple—sometimes many—jurisdictions, which can be an arduous process. We offer suggestions for streamlining the process, including moving to uniform tax cycles and classification schedules, but also suggest centralized payment processing, creating a single point of collections but with the state operating only as a payment processor for local governments without ever depositing the moneys in a state account. We also explore moving away from a gross income base, and replacing the tax with an alternative business tax structure.

Granting Greater Local Authority over Accommodations and Hospitality Taxes. Local governments already stretch the bounds of what accommodations and hospitality taxes are permitted to fund. The existing constraints sometimes force governments to levy more or higher taxes than they would otherwise, since some available revenue is tied up and can only be put to lower-priority expenditures.

Comprehensive Reform

Most of our proposals can stand on their own, providing policymakers with discrete ways of improving the competitiveness of each element of the state's tax code. Often, however, successful tax reform is more comprehensive in nature, which is not only good policy but often good politics, including additional stakeholders and facilitating a broader rebalancing of the code.

In some cases, moreover, it may be strictly necessary: reduced reliance on a counterproductive tax may require offsets elsewhere in the system. Therefore, while we intend this book to facilitate conversations about priorities within each tax type, it is also important to illustrate the ways that they can complement each other. A broader sales tax base, for instance, would raise additional revenue at both the state and local levels, which could be used to pay down reforms to other taxes.

Below, we offer four packages of comprehensive reforms, ranging from a highly aggressive overhaul of the state's tax code to modest competitive improvements, with ideas drawn from the pages that follow. These are only four of many possible permutations, but they illustrate how a comprehensive plan could come together. We offer projections for how each plan would improve the state's ranking on our *State Business Tax Climate Index*. State-level provisions are designed to be roughly revenue neutral, and the referenced sales tax base-broadening options are outlined in Chapter 5.

Option A

This approach is the most comprehensive, a bold reform that would make South Carolina a leader on competitive tax policy. It contemplates outright repeal of the corporate income tax and its outmoded counterpart, the corporate license fee. It also simplifies and cuts the individual income tax and reduces the state sales tax rate. These reforms would be paid for by substantial sales tax base broadening. This plan would also see the gradual reintroduction of the school operating cost millage onto owner-occupied real property, to help offset the cost of other property tax reforms designed to make the overall system more competitive. Option A includes:

- Full repeal of the corporate income tax and the antiquated corporate license fee;
- Adopting a 4.0 percent single rate individual income tax with a \$12,000 standard deduction (for single filers) and the retention of the personal exemption;
- Freezing the earned income tax credit at 2018 levels, while repealing other individual income tax credits and deductions;
- Reducing the state sales tax rate from 6.0 to 5.25 percent;
- Meaningfully expanding the sales tax base as outlined in Sales Tax Base-Broadening Option A (see Chapter 5) to offset the above reductions and repeals;
- Implementing the reforms necessary to ensure that the state's remote sales tax collections are legally compliant;
- Gradually phasing the school operating costs millage back onto owner-occupied residential property;
- Reassessing property on a recurring basis, and not just at point of sale;
- Phasing the assessment ratio for nonowner-occupied residential real property down to 4 percent, in line with primary residences;
- Extending the current phasedown of the manufacturing and industrial property assessment ratio to 6 percent in line with commercial property;
- Exempting property newly placed in service from tangible personal property taxation, reducing reliance on the tax over time; and
- Creating a single point of collections and administration for the business license tax, while reforming the structure of the tax to eliminate tax pyramiding.

Option B

This option is similar in approach to Option A but expands the sales tax base more modestly in exchange for a less aggressive individual income tax rate cut and keeping the state sales tax rate at 6.0 percent. It also repeals the corporate income tax and corporate license fee, while improving property tax structure. Option B includes:

- Full repeal of the corporate income tax and the antiquated corporate license fee;
- Adopting a 4.75 percent single rate individual income tax with a \$12,000 standard deduction (for single filers) and the retention of the personal exemption;
- Freezing the earned income tax credit at 2018 levels, while repealing other individual income tax credits and deductions;
- Expanding the sales tax base as outlined in Sales Tax Base-Broadening Option B (see Chapter 5) to offset the above reductions and repeals;
- Implementing the reforms necessary to ensure that the state's remote sales tax collections are legally compliant;
- Gradually phasing the school operating costs millage back onto owner-occupied residential property;
- Reassessing property on a recurring basis, and not just at point of sale;
- Phasing the assessment ratio for nonowner-occupied residential real property down to 4 percent, in line with primary residences;
- Extending the current phasedown of the manufacturing and industrial property assessment ratio to 6 percent in line with commercial property;
- Exempting property newly placed in service from tangible personal property taxation, reducing reliance on the tax over time; and
- Creating a single point of collections and administration for the business license tax, while reforming the structure of the tax to eliminate tax pyramiding.

Option C

This option also contemplates sweeping reform, though it keeps the corporate income tax in place. Its rate would be reduced to 4 percent, while the individual income tax would be set at a flat rate of 5 percent. Other provisions are similar to those in Option A, except that sales tax base broadening is not as aggressive and local property tax reform is somewhat attenuated. Option C includes:

- Lowering the corporate income tax rate to 4 percent;
- Conforming to the federal policy of full expensing of machinery and equipment purchases;
- Repealing the antiquated corporate license fee;
- Adopting a 5 percent single rate individual income tax with a \$12,000 standard deduction and the retention of the personal exemption;
- Freezing the earned income tax credit at 2018 levels, while repealing other individual income tax credits and deductions;
- Introducing modest sales tax base broadening (Sales Tax Option C) to raise enough revenue to help pay for the individual and corporate income tax cuts, full expensing, and corporate license fee repeal;
- Implementing the reforms necessary to ensure that the state's remote sales tax collections are legally compliant;
- Replacing existing local school operation millages with a new statewide revenue source to address property tax inequities and school funding concerns;
- Reassessing property on a recurring basis, and not just at point of sale;
- Extending the current phasedown of the manufacturing and industrial property assessment ratio to 6 percent in line with commercial property;
- Exempting property newly placed in service from tangible personal property taxation, reducing reliance on the tax over time; and
- Creating a single point of collections and administration for the business license tax, while reforming the structure of the tax to eliminate tax pyramiding.

Option D

This approach focuses on a more competitive individual income tax and the reform of the least attractive elements of business taxation. It pairs an attractive 5.2 percent flat individual income tax with modest sales tax base broadening and a smattering of other reforms. Option D includes:

- Conforming to the federal policy of full expensing of machinery and equipment purchases;
- Repealing the antiquated corporate license fee;
- Adopting a 5.2 percent single rate individual income tax with a \$12,000 standard deduction and the retention of the personal exemption;
- Freezing the earned income tax credit at 2018 levels, while repealing other individual income tax credits and deductions;
- Taxing recreational services and admissions (or a smattering of smaller personal services and consumption goods) to raise enough revenue to help pay for the individual income tax cuts and business tax reforms;
- Implementing the reforms necessary to ensure that the state's remote sales tax collections are legally compliant;
- Extending the current phasedown of the manufacturing and industrial property assessment ratio to 8 percent;
- Exempting property newly placed in service from tangible personal property taxation, reducing reliance on the tax over time; and
- Creating a single point of collections and administration for the business license tax, while reforming the structure of the tax to eliminate tax pyramiding.

The above options would result in the following changes to South Carolina's rankings in our *State Business Tax Climate Index*, compared to the current system.

	Overall	Corporate	Individual	Sales	U.I. Tax	Property
Current System	35th	19th	34th	34th	27th	27th
Option A	5th	1st	10th	18th	27th	12th
Option B	5th	1st	10th	32nd	27th	12th
Option C	13th	10th	11th	32nd	27th	12th
Option D	14th	16th	11th	33rd	27th	12th

South Carolina's property tax system is so unique—and not in a good way—that several harmful aspects of the code are not reflected in the *Index*. All our options show the same resulting rank on the property tax component of the *Index*, but some of these options make the property tax far more competitive than others. While they are not currently reflected in the *Index*'s methodology, more substantial property tax reforms will have a significant impact on business investment.

The Lincoln Institute of Land Policy ranks South Carolina 6th highest on industrial property tax burdens, with an effective rate of 2.28 percent.¹ We estimate that moving to a 6 percent assessment ratio, as proposed in Options A, would shift the state from having the 6th highest effective rate on unincentivized industrial property to the 18th highest—still high, but significantly more competitive, particularly in tandem with other reforms. Adopting an 8 percent assessment ratio, as contemplated in Option C, would yield the country's 13th highest effective rate.²

Our Objective

We hope these solutions contribute to the tax conversation in South Carolina by providing a framework upon which legislators and citizens can base future decisions. The menu of options we present all ensure that the state builds a tax system for a diversified economy and positions itself as a destination for investment, entrepreneurs, and talented individuals in the years ahead.

1 Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence, "50-State Property Tax Comparison Study for Taxes Paid in 2017," April 2018, 80-81, https://www.lincolninst.edu/sites/default/files/pubfiles/50-state-property-tax-comparison-for-2017-full_1.pdf.

2 Tax Foundation calculations using Lincoln Institute of Land Policy data on effective rates in other states.



CHAPTER 1

**SOUTH CAROLINA'S
ECONOMY**

Introduction

Like its peers throughout the Southeastern United States, South Carolina boasts a growing population—not on pace with North Carolina or Georgia, but burgeoning nonetheless. It is also, however, an aging population, and one with substantial exposure to declining industry sectors. The state has, to some extent, bucked the tide of the decline of domestic manufacturing. The sector remains more robust in South Carolina than in most of its peer states, and policymakers can point to key successes in attracting and retaining multinational firms.

Still, the industry is losing ground as a percentage of the state's economy, while other sectors are growing. The tax code, which can be very attractive to major employers in select industries, is not always dynamic enough to adjust to shifting economic winds. It is certainly not flexible enough to adjust to an aging population, particularly given the state's many tax preferences for older South Carolinians. South Carolina's economy has grown consistently in recent years, but the state remains comparatively low-income compared to some of its peers and certainly compared to the nation as a whole.

The following pages provide an overview of the South Carolina economy and offer context that informs the tax analysis in this book.

State Gross Domestic Product (GDP)

South Carolina's gross domestic product (GDP) places it firmly in the middle stratum. In 2017, South Carolina had the 26th largest state economy in the U.S. based on total production.³ The state's overall economic output is slightly larger than that of Kentucky (28th), but substantially smaller than the economies of regional competitors like Florida (4th), Georgia (9th), North Carolina (10th), Virginia (12th), and Tennessee (18th).

With the port of Charleston and the presence of major multinational manufacturers, South Carolina is substantially integrated into global markets. Such aggregate figures, however, fail to capture the economic realities for many lower-income South Carolinians. On a per capita basis, South Carolina's gross state product is one of the lowest in the nation,⁴ and any proposal for reforming the state's tax code must focus on expanding the economic opportunities for working South Carolinians.

In 2017, South Carolina ranked 45th in the nation on per capita GDP, lagging most regional peers and only narrowly edging Alabama.⁵ Table 1.1 compares South Carolina's GDP per capita to that of select regional competitors.

3 Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*, "Gross Domestic Product (GDP) by state (millions of current dollars)."

4 Bureau of Economic Analysis, Regional Economic Accounts, *Population (number of persons)*, "SQ1 Personal Income Summary: Personal Income, Population, Per Capita Personal Income."

5 Bureau of Economic Analysis, "Gross Domestic Product (GDP) by state (millions of current dollars)," with population adjustment.

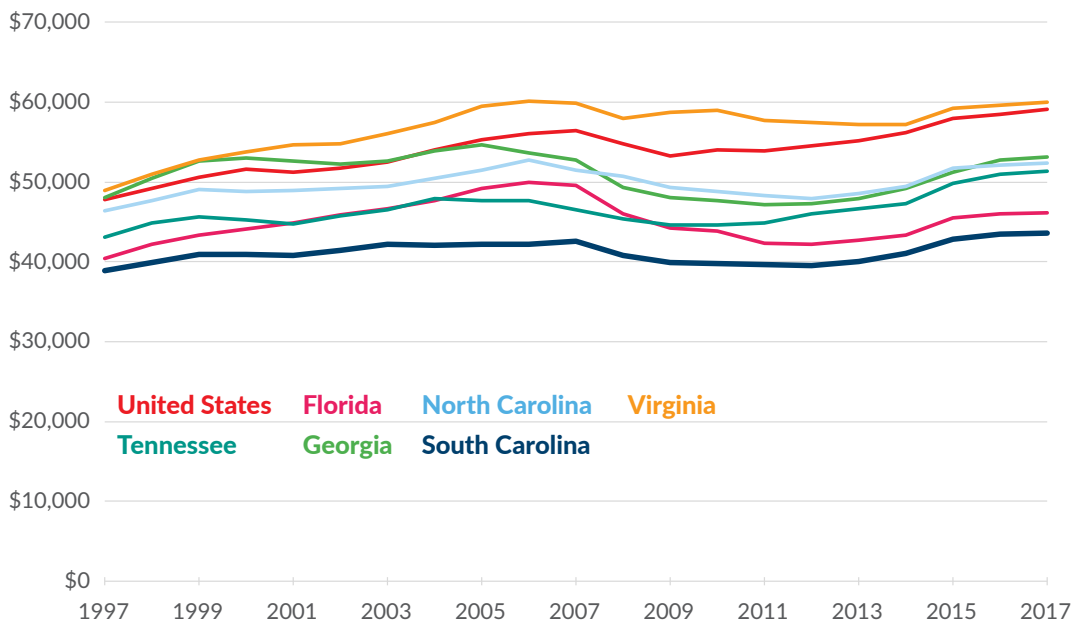
TABLE 1.1.
GDP Per Capita, South Carolina
and Regional Competitors (2017)

State	GDP Per Capita
South Carolina	\$43,606
Florida	\$46,098
Tennessee	\$51,402
North Carolina	\$52,396
Georgia	\$53,145
Virginia	\$60,054
U.S. Average	\$59,141

Source: Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*.

Figure 1.1 shows the real state GDP per capita for these states and the United States as a whole between 1997 and 2017.⁶ South Carolina and some of its regional peers have trailed average growth levels in recent years, and have only recently regained the losses of the Great Recession (in inflation-adjusted terms). Though manufacturing has been a point of strength for the state, it also represents a vulnerability in a shifting economy.

FIGURE 1.1.
State Gross Domestic Product Per Capita, 1997-2017
(in 2017 dollars)



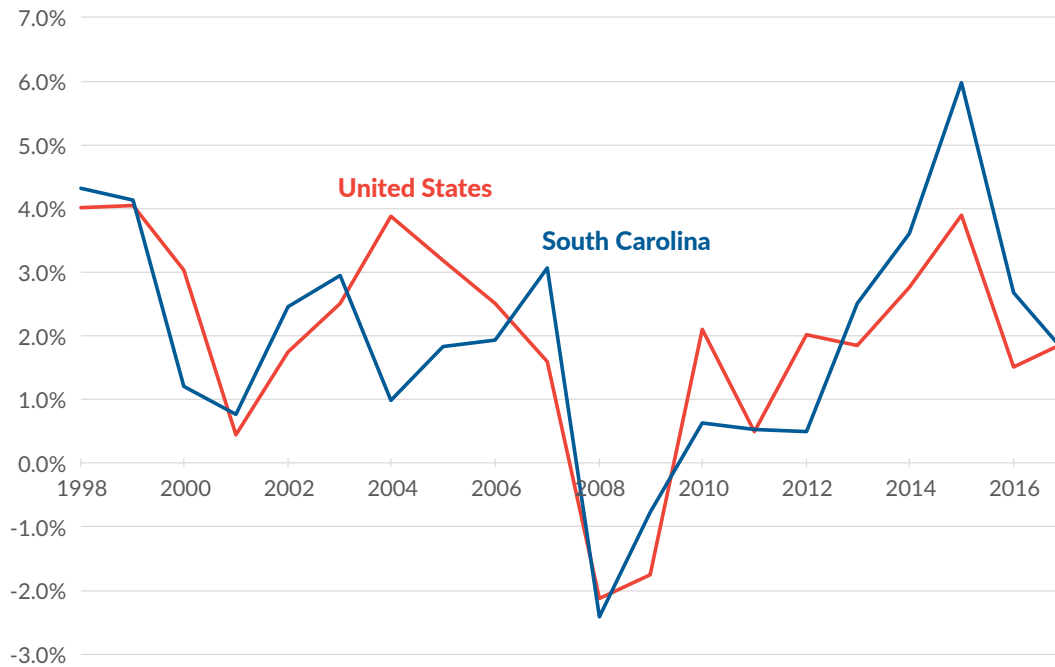
Note: Dollar amounts were adjusted for inflation and expressed in 2017 dollars using the Consumer Price Index for All Urban Consumers (CPI-U) from the Bureau of Labor Statistics.
 Source: Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*; Bureau of Labor Statistics, *Consumer Price Indexes (All Urban Consumers)*.

Figure 1.2 illustrates the annual percentage changes in real GDP over time for both South Carolina and the United States as a whole.⁷

6 Bureau of Economic Analysis, "Gross Domestic Product (GDP) by state (millions of current dollars)." Adjusted for inflation using Bureau of Labor Statistics, "Consumer Price Index - All Urban Consumers."

7 Bureau of Economic Analysis, "Gross Domestic Product (GDP) by state (millions of current dollars)."

FIGURE 1.2.
Annual Percent Change in Real GDP, 1998-2017



Source: Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*; Bureau of Labor Statistics, *Consumer Price Indexes (All Urban Consumers)*.

Personal Income

In 1929, the average inflation-adjusted personal income of a South Carolina resident was \$3,822, far less than the U.S. average of \$10,005.⁸ Although the gap has narrowed in percentage terms in the intervening decades, it remains significantly below the national average. As of 2017, the average income in South Carolina trailed the national average by \$9,971, putting it 20 percent below the national average income.

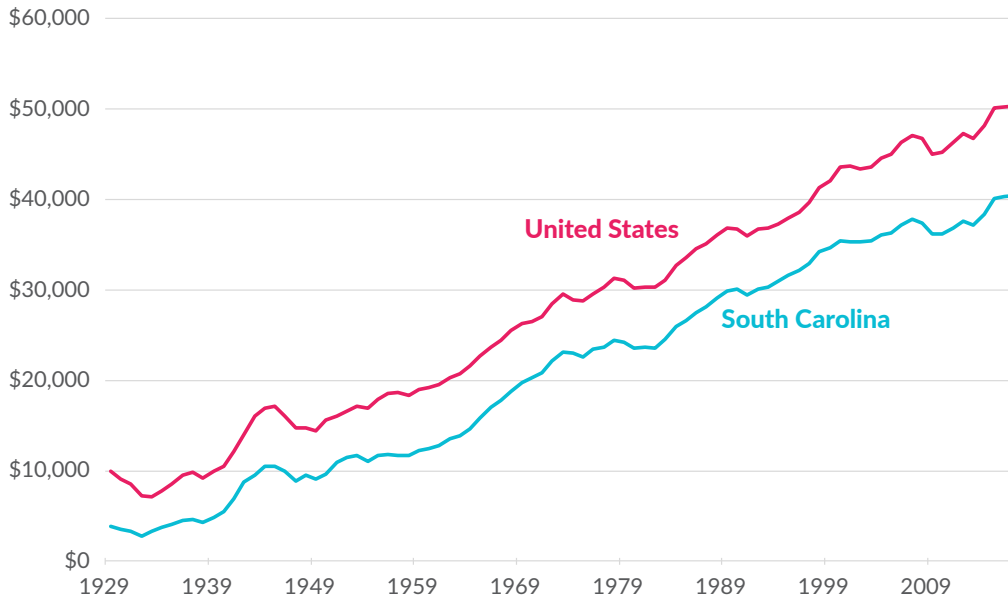
The state's low incomes—which often result in very little taxable income—are a major reason why South Carolina often features high tax rates, particularly in the individual income tax, with modest tax collections. Figure 1.3 shows inflation-adjusted personal income levels for South Carolina and the U.S. overall from 1929 to present.

While to some extent this is the story of the entire region, South Carolina has consistently trailed its geographical peers. The growth of the Sun Belt economies is evident in South Carolina's performance, but not with the degree of dynamism elsewhere associated with the "New South." While, with the exception of Virginia (which has long benefited from its proximity to the nation's capital), South Carolina's regional competitors have tended to trail the national average income, most have exceeded South Carolina itself, which has made up little new ground for more than four decades.⁹

⁸ Bureau of Economic Analysis, Regional Economic Accounts, *Personal Income Summary: Personal Income, Population, Per Capita Personal Income (Table SA1)*.

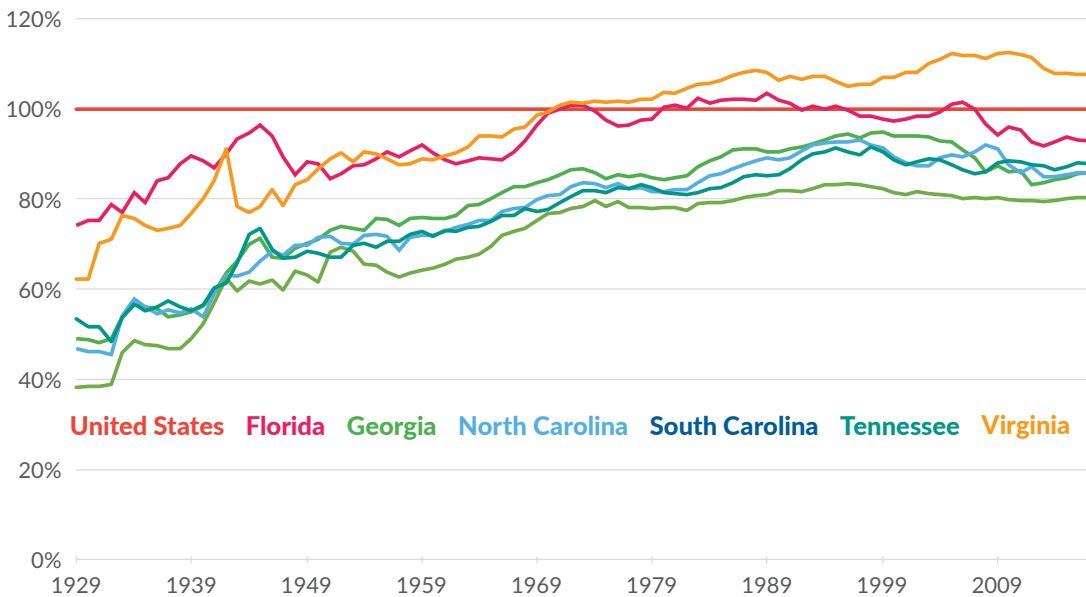
⁹ Id.

FIGURE 1.3.
Personal Income Per Capita, 1929-2017 (in 2017 dollars)



Note: Dollar amounts were adjusted for inflation and expressed in 2017 dollars prior to calculating percentage changes using the Consumer Price Index for All Urban Consumers (CPI-U) from the Bureau of Labor Statistics.
 Source: Bureau of Economic Analysis, Regional Economic Accounts, *Personal Income Summary: Personal Income, Population, Per Capita Personal Income (Table SA1)*; Bureau of Labor Statistics, *Consumer Price Indexes (All Urban Consumers)*.

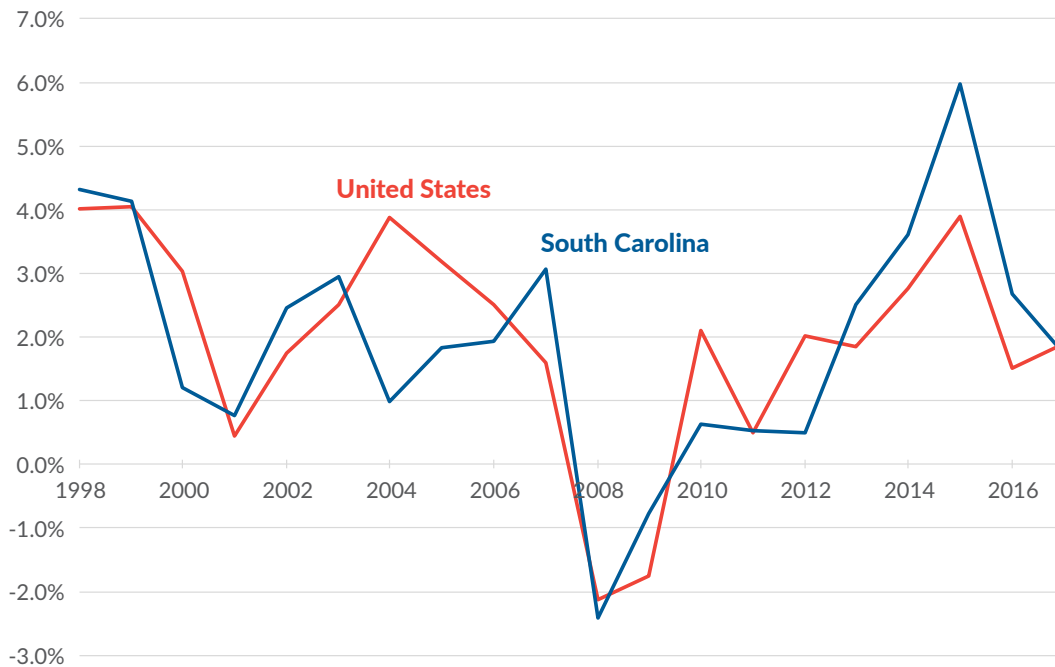
FIGURE 1.4.
Personal Income Per Capita as a Percentage of U.S. Income, 1929-2017



Source: Bureau of Economic Analysis, Regional Economic Accounts, *Personal Income Summary: Personal Income, Population, Per Capita Personal Income (Table SA1)*.

Unsurprisingly, metropolitan areas perform better economically than nonmetro areas, though the disparity in South Carolina has historically been smaller than in the nation as a whole. In 2006, the gulf between metro and nonmetro areas peaked at 25 percent, declining to 19 percent in the aftermath of the recession.¹⁰ There are also wide economic variations across regions. The Charleston metropolitan statistical area (MSA) is the state's wealthiest, while the Myrtle Beach MSA is the poorest, Myrtle Beach itself notwithstanding.¹¹

FIGURE 1.5.
Annual Percent Change in Real GDP, 1998-2017



Source: Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*; Bureau of Labor Statistics, *Consumer Price Indexes (All Urban Consumers)*.

Major Industries

South Carolina's economy has a heavy reliance on manufacturing, which distinguishes it from the nation overall, which has seen a far more precipitous decline in reliance on manufacturing. In South Carolina, manufacturing represents the single largest industry sector, responsible for 17 percent of state GDP, with government (all levels) coming in second at 15 percent. Conversely, the professional services, finance and insurance, and information sectors notably trail the national average.¹²

The presence of a "Panamax" port,¹³ competitive labor policies, and low corporate income taxes have all helped the state attract manufacturing from other states—but only when local governments offset exceedingly high taxes on manufacturing property, a tax benefit not available to many smaller manufacturers.

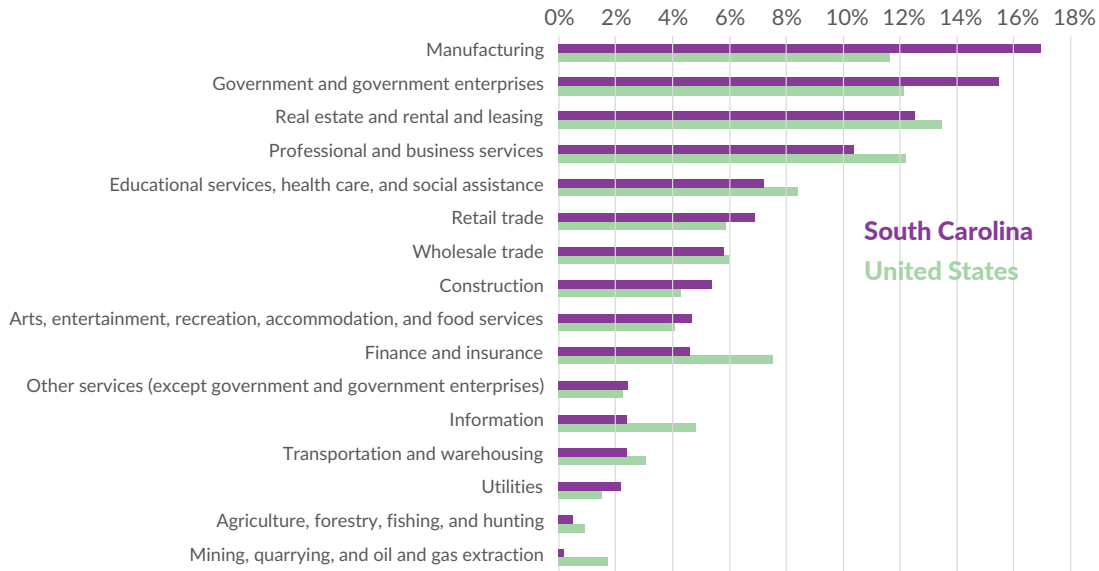
¹⁰ Bureau of Economic Analysis, Bureau of Labor Statistics, *Consumer Price Indexes (All Urban Consumers)*.

¹¹ Bureau of Economic Analysis, *Gross domestic product (GDP) by metropolitan area*.

¹² Bureau of Economic Analysis, "Gross Domestic Product (GDP) by State."

¹³ The Port of Charleston is rated for large "neo-Panamax" container ships.

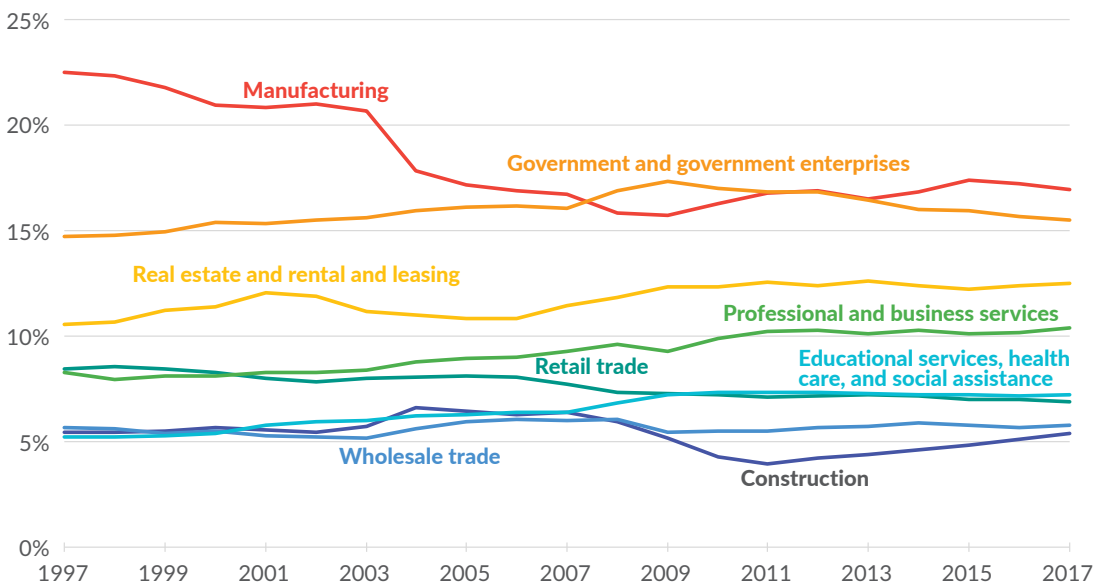
FIGURE 1.6.
Percentage of Total State GDP by Industry, South Carolina and U.S., 2017



Source: Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*.

Nevertheless, manufacturing remains in decline as a share of economic output, though levels have fluctuated for the past decade. It comprised 23 percent of the state economy as recently as two decades ago but is down to 17 percent today. Meanwhile, though they continue to trail national averages, sectors like finance and insurance, professional and business services, and educational services, health care, and social assistance have posted dramatic growth in recent years. Figure 1.7 shows South Carolina's eight largest sectors' share of the total state economy since 1997.

FIGURE 1.7.
Percentage of Total State GDP by Industry, 1997-2017



Source: Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*.

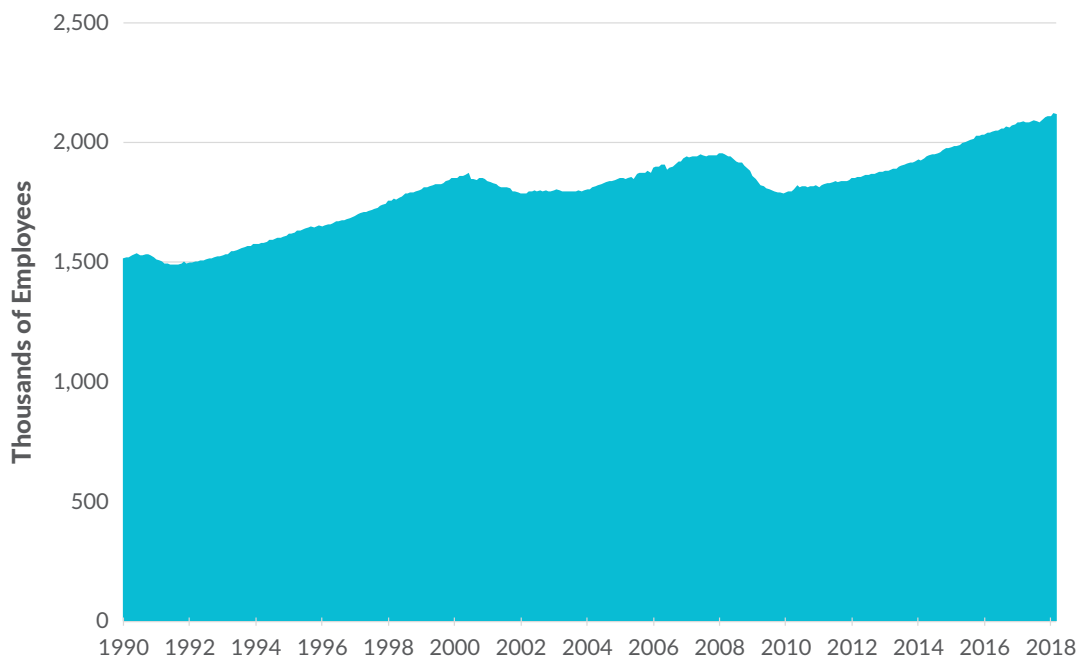
Although tourism and agriculture are not among the state's largest industries, both form an important part of the fabric of the state and are particularly significant in lower-growth rural areas. The vast majority of agricultural businesses are organized as sole proprietorships, LLCs, partnerships, or cooperatives, and are thus exposed to the state's individual income tax. They also receive unique property tax treatment, discussed later. Meanwhile, tourism is not only a significant source of economic activity, but the basis for a fleet of local tourism and accommodations taxes which are considered later in this book.

Employment

Nominal employment figures in South Carolina have largely tracked population growth, rising from 1.5 million in 1990 to just over 2.1 million in 2018, at a time when the state's population grew from about 3.5 million to 5 million (see Figure 1.8).¹⁴ These figures show a state attracting new residents and putting them to work, though population growth has not been as dramatic as in the neighboring states of North Carolina and Georgia, which saw their populations boom by 55 and 63 percent, respectively, since 1990 compared to 42 percent growth in South Carolina.

South Carolina shed 165,000 jobs during the last recession and maintained a peak unemployment rate of 11.7 percent from December 2009 to February 2010. The national unemployment rate peaked at 10.0 percent in October 2009. As of September 2018, South Carolina's unemployment rate of 3.2 percent was better than the national figure of 3.7 percent.¹⁵

FIGURE 1.8.
Total Nonfarm Employment, 1990-2018



Source: Bureau of Labor Statistics, All Employees: Total Nonfarm in South Carolina, Thousands of Persons, Monthly, Seasonally Adjusted.

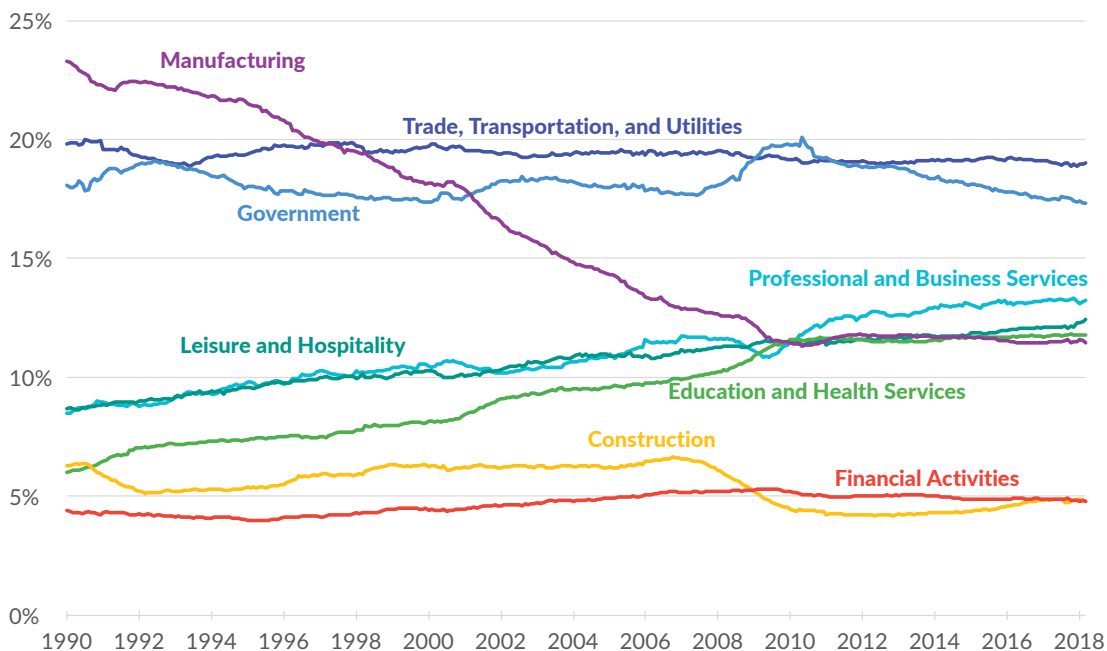
¹⁴ Bureau of Labor Statistics, "All Employees: Total Nonfarm in South Carolina, Thousands of Persons, Monthly, Seasonally Adjusted."

¹⁵ Bureau of Labor Statistics, "Local Area Unemployment Statistics, South Carolina, seasonally adjusted."

Almost half of South Carolina jobs are concentrated in three sectors, with the largest share in the trade, transportation, and utilities industry (19 percent), as of March 2018.¹⁶ The government sector (17 percent) and the professional and business service industry (13 percent) also comprise large percentages of South Carolina's total employment.

In tandem with manufacturing's decline in its share of total GDP, the sector's share of the state's total employment has also been steadily decreasing. Employment in education and health services and in professional and business services has been on the rise in recent years, while many of the other top industries' employment levels have remained flat. Figure 1.9 illustrates the employment level changes since 1990 within the top eight sectors of South Carolina's economy as of March 2018.

FIGURE 1.9.
Employment by Industry, 1990-2018



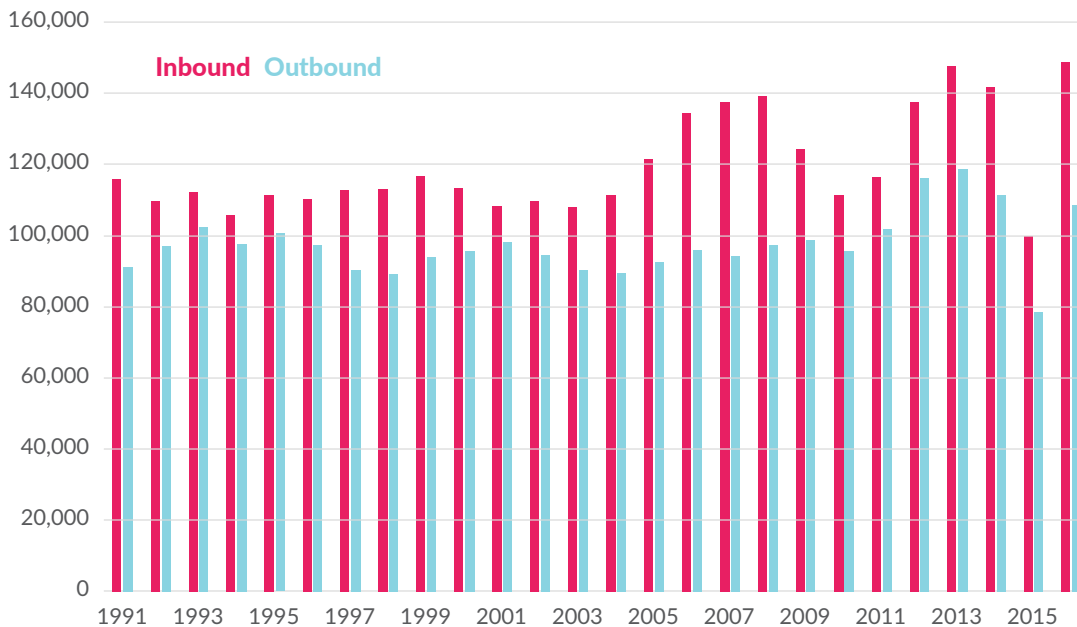
Source: Bureau of Labor Statistics; State and Area Employment, Hours, and Earnings, South Carolina, Seasonally Adjusted.

Migration Patterns

There are many ways to measure interstate migration, but one way is to compare the movement of individual federal income tax returns, and the corresponding exemptions, between states and abroad, and over time. The Internal Revenue Service's State Migration Data provides the inbound and outbound number of federal tax exemptions, which serves as our measure of "people."

Between 1991 and 2016, South Carolina had a net inflow of people every year.¹⁷ The greatest influx of residents occurred in the early part of the Great Recession, when the state saw a net increase of 124,074 people between 2006 and 2008. Overall, this migration has boosted South Carolina's net population by 582,158 people since 1991.¹⁸ Figure 1.10 illustrates South Carolina's migration levels from 1991 to 2016.

FIGURE 1.10.
Inbound and Outbound Migration, 1991-2016



Source: Internal Revenue Department: Statistics of Income Tax Stats – Migration Data, "U.S. Population Migration Data."

Between 1991 and 2016, South Carolina both lost and gained people from every state and the District of Columbia. Most often, South Carolina lost residents to North Carolina (483,162), Georgia (330,464), Florida (248,876), and Virginia (151,239).¹⁹ South Carolina also lost a considerable amount of its population to Texas, Tennessee, and New York.

Similarly, over the same period, South Carolina gained the most individuals from North Carolina (537,976), Georgia (327,380), Florida (280,540), New York (189,176), and Virginia (166,181).²⁰ Other notable inflows came from Texas, Pennsylvania, and abroad.

¹⁷ Internal Revenue Service, *Statistics of Income Tax Stats – Migration Data*, "U.S. Population Migration Data."

¹⁸ Id.

¹⁹ Id.

²⁰ Id.

Even with the large influx of residents, South Carolina still faces the same issue as many other states: an aging population. Compared to nearby states, South Carolina has one of the oldest populations, second only to Florida in terms of residents aged 65 years or older.²¹ Between 2000 and 2016, South Carolina experienced the largest percent increase in its 65+ population than any other nearby state (see Figure 1.11).²²

FIGURE 1.11.
Population by Age Group, 2000 and 2016



Source: U.S. Census Bureau, Population Division, "Annual Estimates of the Resident Population by Sex, Age, Race, and Hispanic Origin for the United States and States"; U.S. Census Bureau, "Age Groups and Sex: 2000 Census", 2000 Summary File 1.

As the baby boomer generation transitions into retirement, South Carolina must grapple not only with the increased expenses associated with providing services to an aging population, but also a shrinking tax base under a tax code which includes many tax preferences for retirees (which itself attracts more retirees). Like most southern states, South Carolina has grown dramatically in recent years, but South Carolina's industry mix and aging population strongly suggest the need for policymakers to reposition the state to reflect changing realities. Tax reform is only part of that, but it is an important part—and one wholly in the hands of the legislature.

21 U.S. Census Bureau, Population Division, "Annual Estimates of the Resident Population by Sex, Age, Race, and Hispanic Origin for the United States and States."

22 U.S. Census Bureau, "Age Groups and Sex: 2000 Census."

CHAPTER 2

SOUTH CAROLINA'S TAX AND BUDGET STRUCTURE



Introduction

Although South Carolina continues to have modest tax collections per capita, the growth in state spending in recent years is putting increasing pressure on this system. Even after adjusting for inflation, the state's budget has risen twice as fast as population growth over the past two decades. As a low-income state, South Carolina relies more heavily on federal funding than does the average state (largely due to the federal share of means-tested programs which are administered by state government), but much of this revenue must come from its own system of taxation, which is the focus of this book.

Subsequent chapters will examine each major tax type—individual and corporate income taxes, sales taxes, property taxes, business license taxes, and accommodations taxes—in turn. But first, this chapter provides a brief overview of the tax system as a whole, providing a framework for what follows. It also examines the state's performance on our *State Business Tax Climate Index*, a measure of tax structure, both overall and on the *Index's* constituent components (corporate, individual, sales, property, and unemployment insurance taxes).

There are high-tax states which should tighten their purse strings and reduce overall levels of taxation to enhance competitiveness. South Carolina is not one of them. The proper size of government is a matter for lawmakers to determine, but the issues of tax competitiveness in the state stem not from how much the state raises in tax revenue but *how* it raises it. A low-income population serves as a significant policy constraint—higher tax rates are necessary to raise a given amount of revenue in South Carolina than would be required in many peer states—but some of the least competitive elements of the state's tax code have little or nothing to do with demographics. Following an overview of the state's budget and tax structure, this book will dive into the current code, highlighting uncompetitive policies and offering recommendations for improvement.

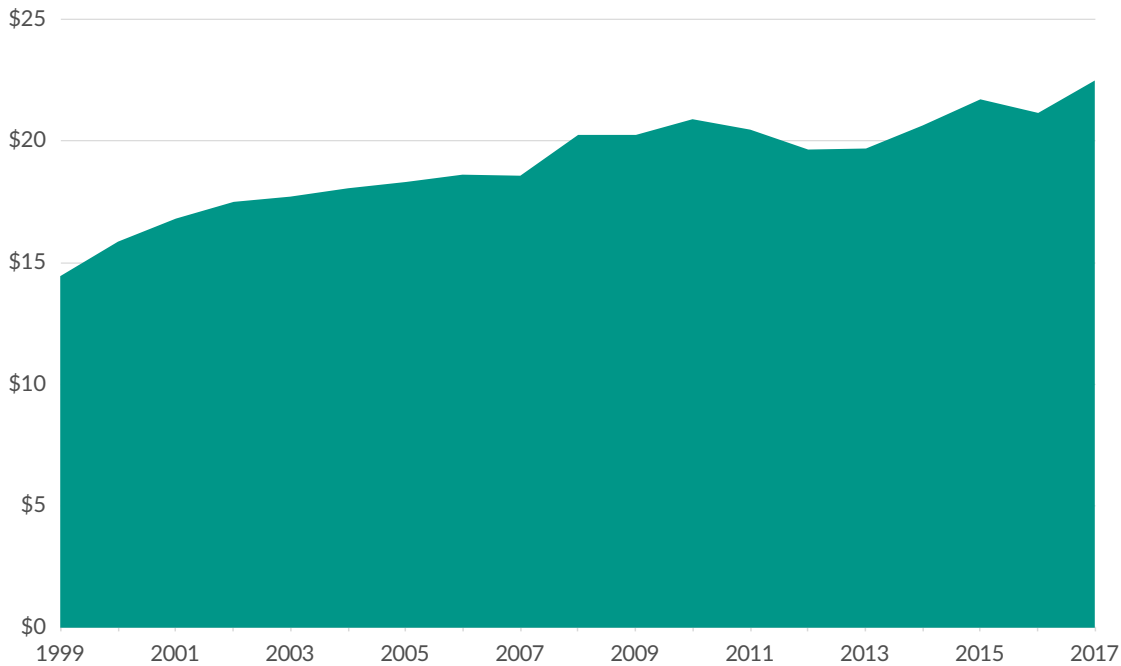
Recent Tax and Spending Policies

South Carolina's inflation-adjusted expenditures increased by 56 percent between 1999 and 2017, rising from \$14.4 billion to \$22.5 billion in constant (2017) dollars.²³ Inflation-adjusted spending increased at more than twice the rate of population growth (26 percent) over the period.²⁴ Figure 2.1 illustrates South Carolina's total expenditures in recent years.

23 South Carolina Comptroller General, "Comprehensive Annual Financial Report 2016-2017," 2017, 244-245, <http://www.cg.sc.gov/publicationsandreports/Pages/CAFRFY20162017.aspx>.

24 U.S. Census Bureau, State Intercensal Datasets; Bureau of Labor Statistics, *Consumer Price Indexes* (All Urban Consumers).

FIGURE 2.1.
Total State Expenditures, 1999-2017 (in 2017 dollars)



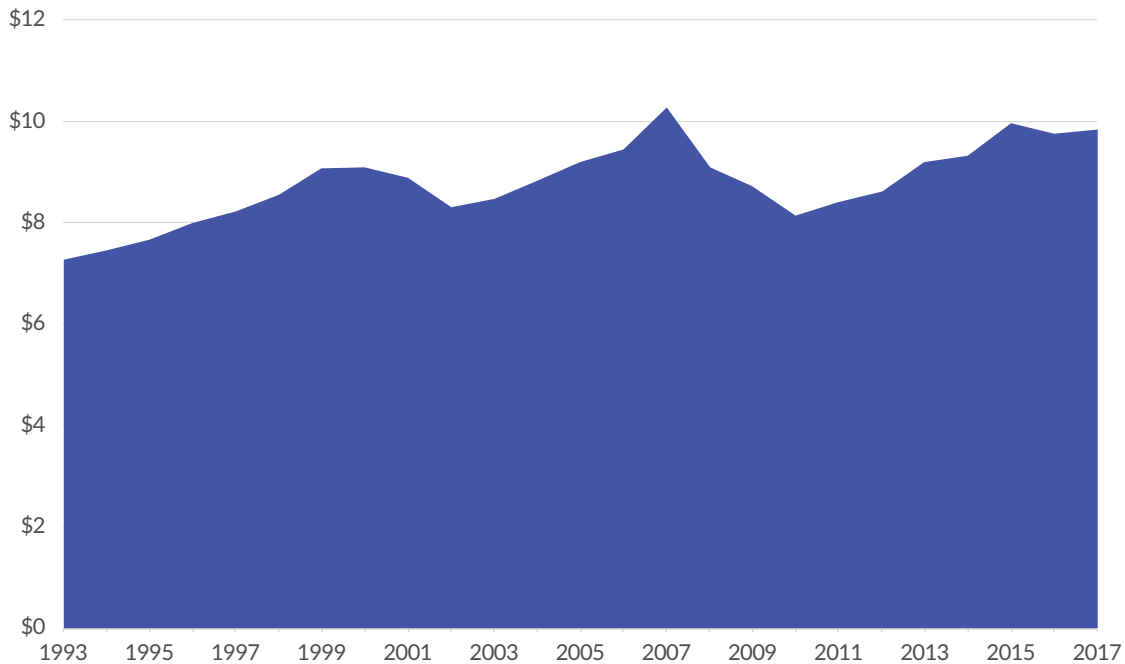
Source: South Carolina Comptroller General, *Comprehensive Annual Financial Reports* (multiple years).

In many states, health care and education are the largest drivers of spending increases. Those are substantial growth sectors in South Carolina as well. However, transportation infrastructure has seen the greatest growth, rising from \$447 million in 1999 to \$1 billion in 2017, a 134 percent increase, in real (inflation-adjusted) terms. This reflects the state's investment in transportation in recent years, part of a package which included a motor fuel tax increase. Over the same time period, inflation-adjusted education expenditures rose 111 percent, while the cost of social service provision increased 82 percent over inflation. Although the percentage increase in health and environmental expenditures was not quite so high, at 69 percent, those budget areas have seen the largest dollar-denominated growth, from \$5.01 billion in 1999 to \$8.56 billion in 2017, again in constant dollars.

Between 1993 and 2017, state tax collections increased by 35 percent in real terms (see Figure 2.2).²⁵ A large portion of the increase occurred between 1993 and 2000, as inflation-adjusted tax collections rose from \$7.28 billion to \$9.09 billion. State tax collections peaked at \$10.27 billion in 2007 before plummeting 21 percent during the Great Recession. The state has not quite returned to its prerecession high-water mark at the time of this writing.

25 U.S. Census Bureau, "2017 Annual Survey of State Government Tax Collections."

FIGURE 2.2.
Total State Tax Collections, 1993-2017 (in 2017 dollars)



Source: U.S. Census Bureau; *Annual Survey of State Tax Collections: 1993-2017*.

South Carolina's Current Budget Makeup

South Carolina derives 61 percent of its total revenue from state sources, while the other 39 percent is composed of federal funds.²⁶ Reliance on federal transfers peaked in 2010, when 46 percent of the state's revenues came from the federal government, primarily due to the American Recovery and Reinvestment Act of 2009 (the stimulus package).²⁷ Based on 2015 Census data, South Carolina ranks 29th nationwide in federal aid reliance, and is third lowest among nearby states, trailing North Carolina and Virginia.²⁸ Forty-seven percent of revenue comes from state taxes, while 14 percent comes from a range of other sources, like fees, fines, and interest payments (see Figure 2.3).

Within South Carolina's state tax system, the individual income and sales taxes are the two largest levies, generating 42 and 33 percent of total state tax collections, respectively (Figure 2.4).²⁹ Corporate income tax collections, at 4 percent of total tax revenue and about 2 percent of all revenue, comes after motor fuel sales taxes (6 percent) and state licenses (5 percent).

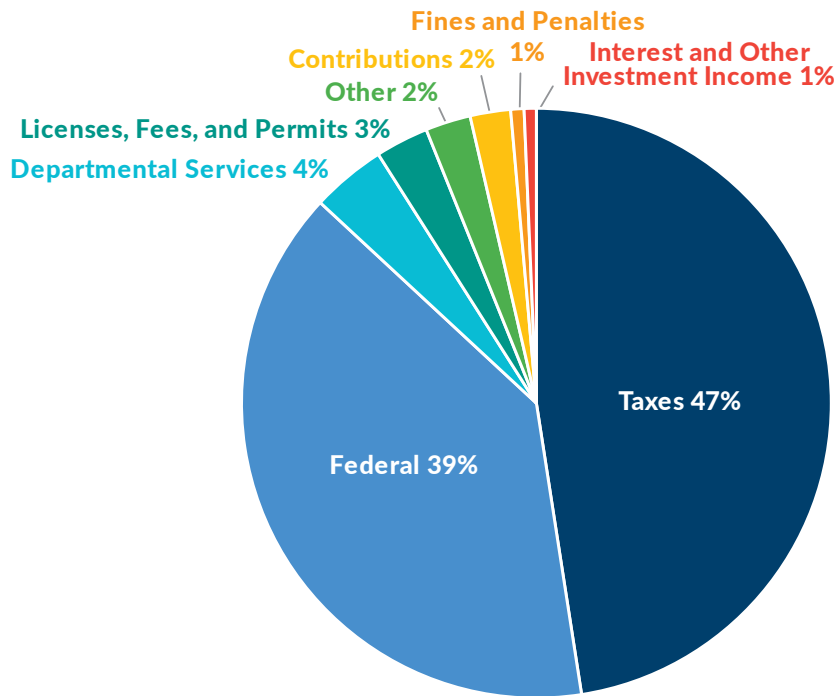
²⁶ South Carolina Comptroller General, "Comprehensive Annual Financial Report 2016-2017," 244-245.

²⁷ Id.

²⁸ Morgan Scarboro, "Which States Rely the Most on Federal Aid?" Tax Foundation, Jan. 18, 2018, <https://taxfoundation.org/state-federal-aid-2018/>.

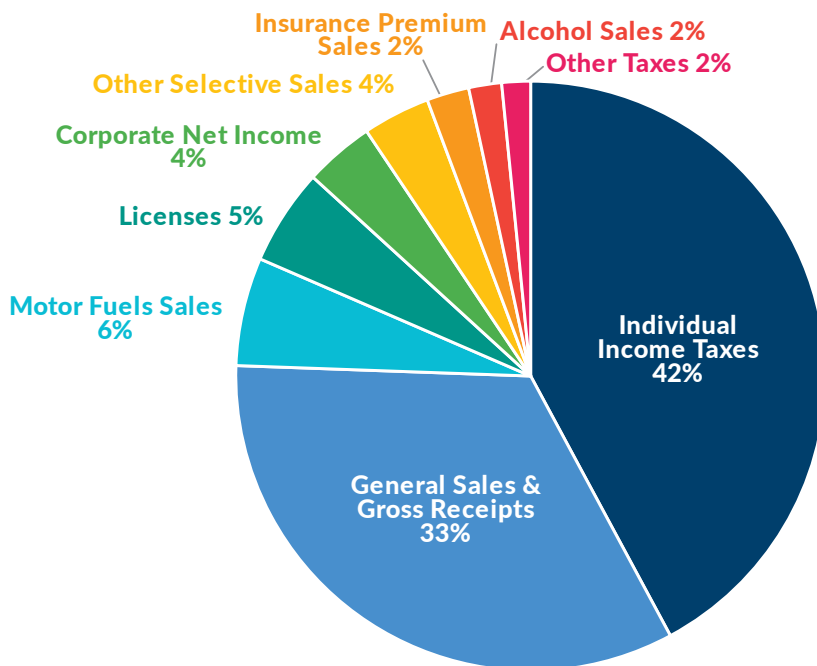
²⁹ U.S. Census Bureau, "2017 Annual Survey of State Government Tax Collections."

FIGURE 2.3.
Total State Tax Revenue by Source, 2017



Source: South Carolina Comptroller General, *Comprehensive Annual Financial Report 2016-2017*.

FIGURE 2.4.
State Tax Collections by Source, 2017

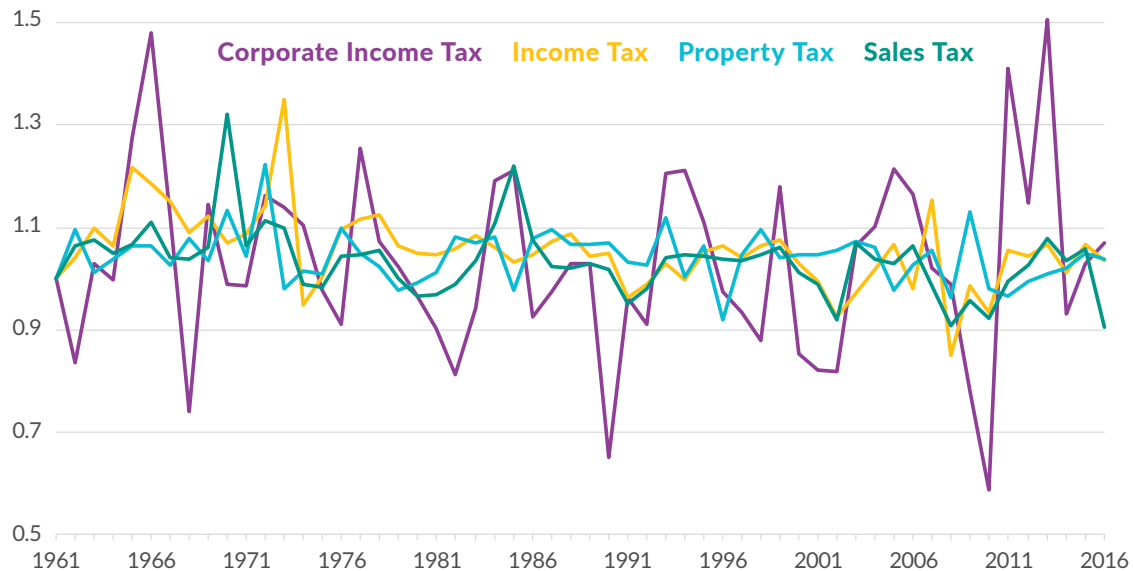


Source: U.S. Census Bureau; *Annual Survey of State Tax Collections 2017*.

The state has two “rainy day” funds, the General Revenue Reserve Fund, required to be funded at 5 percent of the revenues of the prior fiscal year, and the Capital Reserve Fund, with a recurring appropriation of 2 percent of general fund revenue. The legislature has done a good job of meeting these obligations, which allows the state to weather a modest economic downturn without being forced to make hasty and undesirable policy changes.

Figure 2.5 compares year-over-year changes in revenue collections for individual income, sales, and corporate income since 1973.³⁰ The volatility of the corporate income tax is apparent immediately. While all taxes can be volatile, the corporate income tax is particularly so.

FIGURE 2.5.
Volatility of Major State Taxes



Source: U.S. Census Bureau.

Measures of State Tax Competitiveness

Tax reform can improve the budgeting process, making it easier and more consistent, and can reduce compliance costs for both individuals and businesses. Most importantly, though, tax reform can improve a state’s competitiveness.

Two Tax Foundation publications, *State-Local Tax Burden Rankings* and the *State Business Tax Climate Index*, provide different perspectives on each state’s tax competitiveness. The *State-Local Tax Burden Ranking* estimates the combined state and local tax burden as a percentage of state income, essentially showing how much a resident of each state pays in state and local taxes. Conversely, the *State Business Tax Climate Index* compares each state’s tax structure across more than 100 different variables.

30 U.S. Census Bureau, “Annual Survey of State Government Finance,” multiple years.

The *State-Local Tax Burden Rankings* report seeks to answer the question of “how much does a state collect in revenue?” while the *State Business Tax Climate Index* answers “how complex is a state’s tax code?” Combined, these two reports serve as diagnostic for a state’s tax code to determine how competitive a state is compared to its regional and national peers.

State and Local Tax Burdens

Many people are familiar with tax collections measures, which tally the amount of taxes collected by state and local governments. Tax burdens, however, measure the impact of those collections on taxpayers.

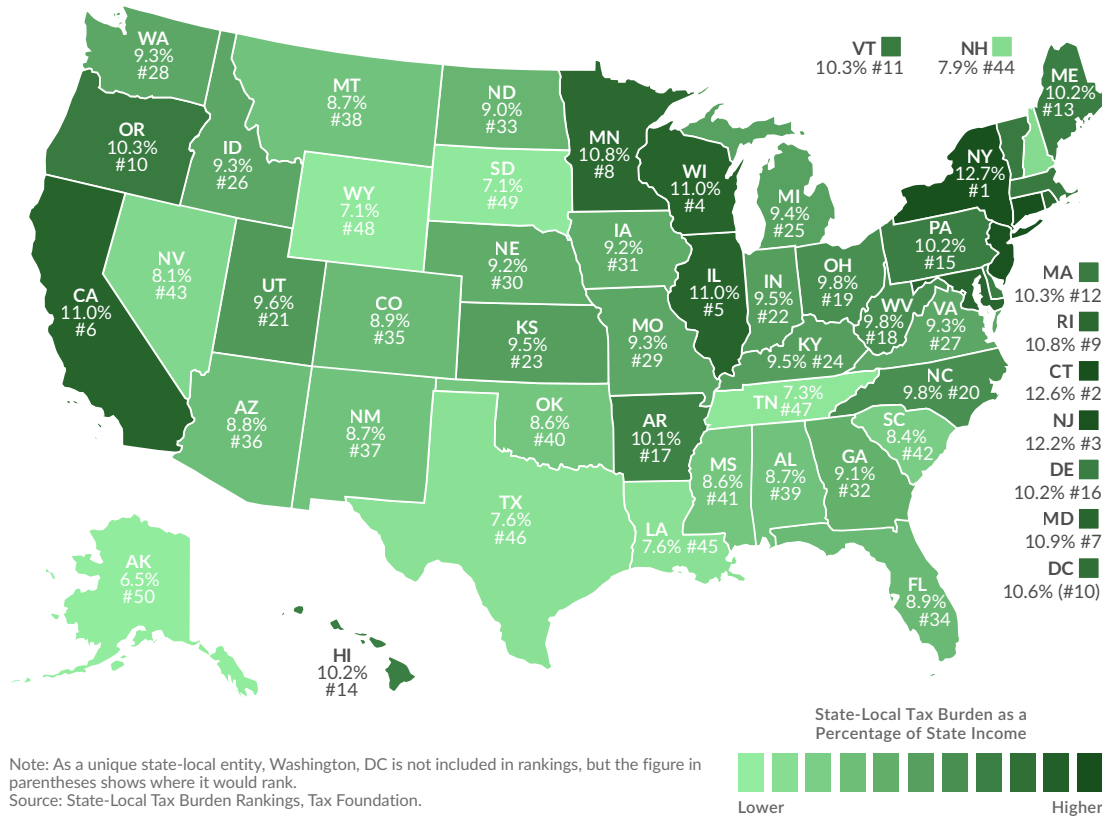
In the Tax Foundation’s *State-Local Tax Burden Rankings*, collections data are adjusted for tax importation and tax exportation to reflect the economic—not legal—incidence of taxation. State taxes are not just paid by state residents, but rather are borne by individuals across the country. For example, while Alaska’s state and local tax collections are among the highest in the country, its burden is the lowest (6.5 percent of personal income in fiscal year 2012). This is because Alaska generates the bulk of its revenue from its oil and natural gas severance taxes, which are not paid by Alaskans but rather the rest of the country when they put fuel into their automobiles or buy other petroleum-based products. The *State-Local Tax Burden Rankings* report allows us to capture the impact of tax exporting.

In fiscal year 2012 (the most recent year in which data is available), New Yorkers paid the most in state and local taxes (12.7 percent of total state income), while Alaskans paid the least (6.5 percent).³¹ South Carolina experiences significantly below-average state and local tax burdens, ranking 42nd nationally. In fiscal year 2012, residents of the state paid \$2,936 in state and local taxes per capita, including \$937 in taxes to other states, or 8.4 percent of total state income.³² Figure 2.6 shows the total state and local tax burden for each state in the 2012 fiscal year.

31 Tax Foundation, *State-Local Tax Burden Rankings FY 2012*, Jan. 20, 2016, <https://taxfoundation.org/state-local-tax-burden-rankings-fy-2012/>.

32 Id.

FIGURE 2.6.
State and Local Tax Burdens by State (FY 2012)



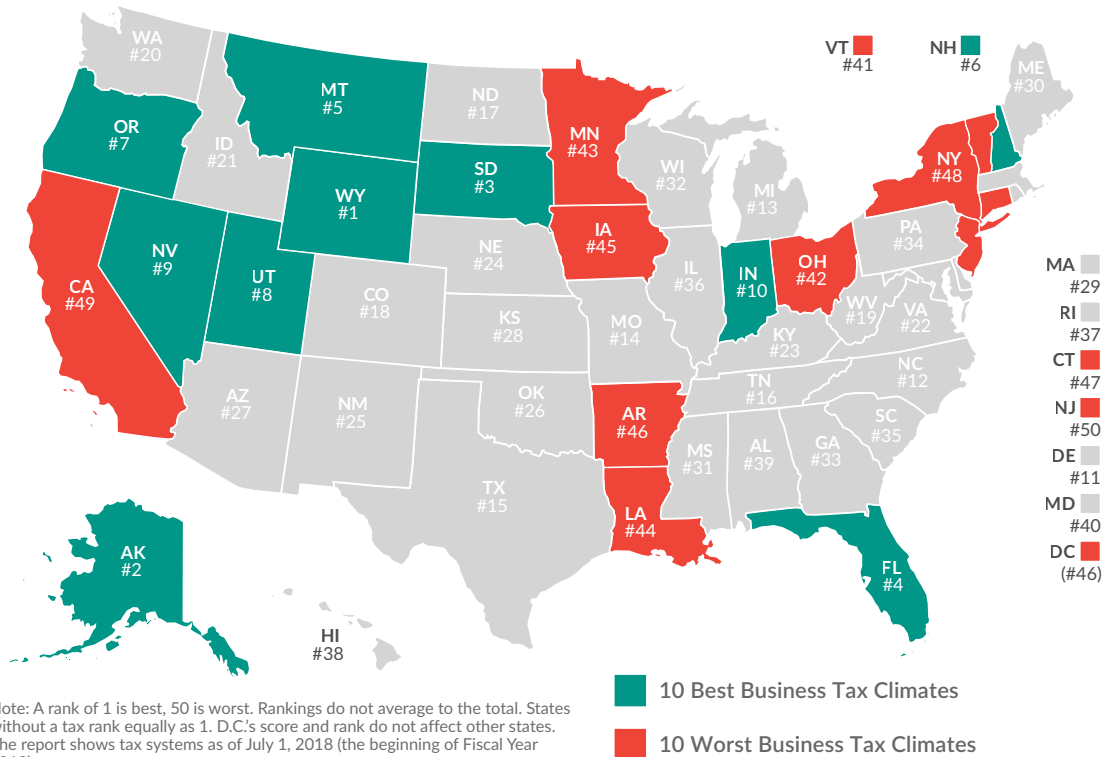
Business Tax Climate

While how much is paid in taxes each year is an important consideration for competitiveness, equally important is *how* those taxes are imposed. Taxes vary significantly, with certain levies being more harmful to growth than others or imposing high compliance costs.

Each year, the Tax Foundation produces the *State Business Tax Climate Index* to enable business leaders, state policymakers, and taxpayers to gauge how these structural elements compare. The *Index* examines over 100 variables in individual income tax, corporate income tax, sales tax, unemployment insurance tax, and property tax categories to reduce these many complex considerations into a ranking.

In the most recent 2019 edition, which evaluates state tax codes as of July 1, 2018, the states with the best tax systems are Wyoming, Alaska, South Dakota, Florida, Montana, New Hampshire, Oregon, Utah, Nevada, and Indiana. The states with the worst tax systems are New Jersey, California, New York, Connecticut, Arkansas, Iowa, Louisiana, Minnesota, Ohio, and Vermont. Figure 2.7 highlights each state's overall ranking.


FIGURE 2.7.
State Business Tax Climate Index Rankings



South Carolina's overall tax structure ranking of 35th among states leaves much to be desired. The state's top marginal income tax rate of 7 percent is the highest in the Southeast, businesses are burdened by capital stock and gross receipts taxes in addition to the corporate income tax, the sales tax is imposed at high rates on a narrow base, and the property tax system is decidedly nonneutral and uncompetitive for many businesses.

Fundamental tax reform is about improving these shortcomings so that South Carolina can collect the revenue necessary for government services while still maintaining a competitive position that allows the state's economy to grow. By broadening tax bases and lowering tax rates, the state can have a meaningful impact on the quality of life for South Carolina residents.

Throughout this book, we will use the *State Tax Business Climate Index* as a way to compare South Carolina's taxes to states that are regional competitors and the country as a whole. Occasionally we situate the state in the context of all Southeastern states as defined by the U.S. Bureau of Economic Analysis, but more frequently, the states chosen for comparison are the regional peers of Florida, Georgia, North Carolina, Tennessee, and Virginia.



CHAPTER 3
**CORPORATE
TAXES**

Introduction

With a flat rate of 5 percent and generous incentives for many businesses, the corporate income tax—although, structurally, a poor tax—is a relatively minor concern for most businesses in South Carolina. This is particularly true for multistate or multinational firms based in South Carolina which have few if any in-state sales, as these companies' income would not be apportioned to South Carolina for tax purposes (discussed later). The tax is, however, inequitable, particularly from the point of view of smaller corporations operating chiefly within the state's borders. Despite being carved out by incentives, moreover, its structure penalizes capital investment by some firms.

Meanwhile, the state's Corporate License Fee (a tax in all but name), while small, is inherently nonneutral, imposed on a company's capital stock without regard to profits or ability to pay. It is low enough to be an afterthought to most profitable companies, but it is much more of a burden to struggling businesses, or those just starting out. Properly speaking, it is a corporate property tax on net worth, but it will be considered here, with the state's other major corporate tax, rather than under the separate header of property taxation.

In this chapter, we provide a broad overview of South Carolina's two corporate taxes, outline issues to consider regarding the current system, and provide options for reform.

Overview of South Carolina Corporate Income Taxation

South Carolina adopted its corporate income tax in 1927, in tandem with changes bringing the individual income tax (adopted five years earlier) into something approaching its current form. In the early 1920s, an economic downturn following World War I, exacerbated by catastrophic crop failures—largely the workings of the boll weevil—undercut traditional sources of state revenue while increasing demand for state expenditures. Even later in the decade, while other parts of the country participated in the ill-fated euphoria that came to characterize the “Roaring '20s,” South Carolina revenues were low, and political attitudes were changing.

In this context, the legislature saw fit to adopt both the corporate income tax and the corporate license fee, paired with modifications to the individual income tax. That tax overhaul, more than nine decades' old, is still the basis for the state's system of income taxation, both corporate and individual. In 1988, the state commenced a two-year phasedown of the rate from 6 percent to its present rate of 5 percent.³³ Other than the accumulation of tax incentives, the only other major revision to the tax code in recent years was the adoption of single sales factor apportionment in 2007 (phased in through 2011).³⁴

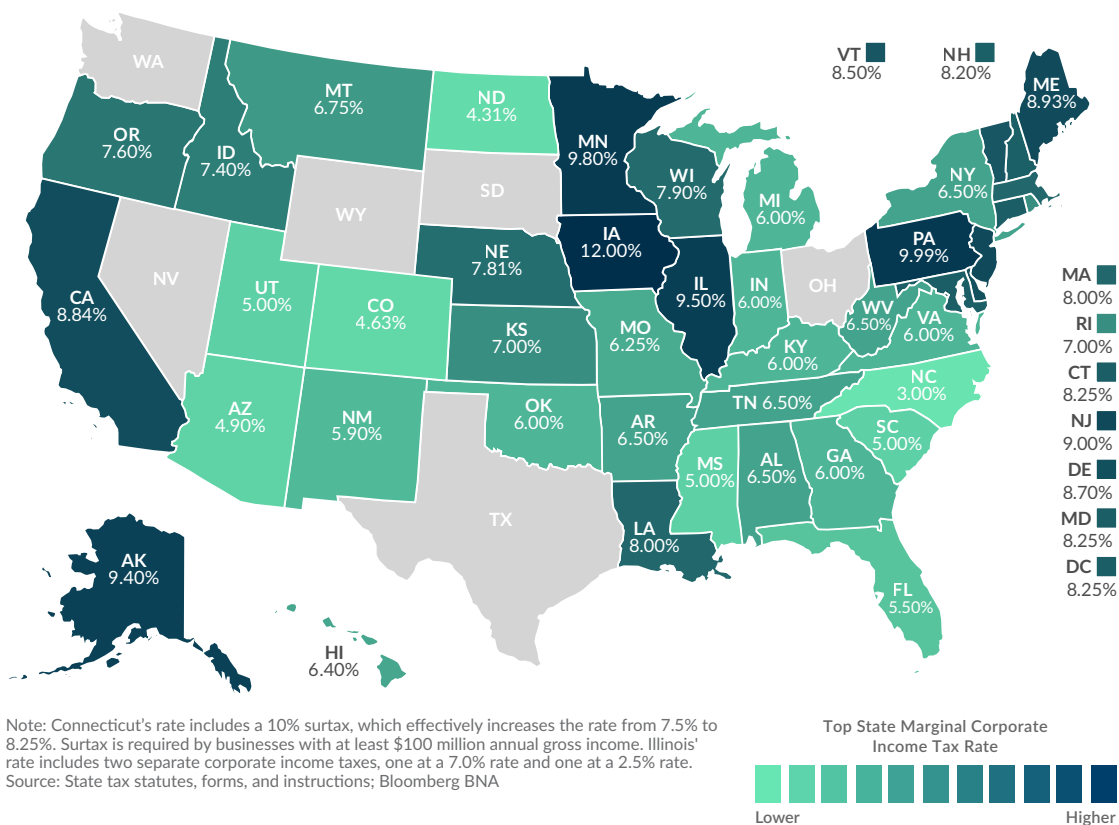
33 South Carolina Revenue and Fiscal Affairs Office, Board of Economic Advisors, “South Carolina Revenue Sources and Fiscal Impacts,” April 25, 2018, 21, <http://rfa.sc.gov/files/South%20Carolina%20Revenue%20Sources%20and%20Fiscal%20Impacts%20-%20FY2018-19%20%28April%2025%202018%29.pdf>.

34 South Carolina Department of Commerce, “Corporate Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina,” 2010, 3, <https://docplayer.net/15285970-Statewide-economic-growth-and-taxation-issues-in-south-carolina-sc-department-of-commerce.html>.

Like most states, South Carolina carves out its corporate base with a range of targeted tax incentives, which contribute to a higher rate overall to maintain collections. For many businesses, these credits may be enough to eliminate any liability under the corporate income tax—as of a few years ago, an estimated 89 percent of filers had no liability³⁵—which is one reason why property taxes play such an outsized role in business taxation in South Carolina.³⁶

All of South Carolina’s regional competitors impose corporate income taxes. Recent reforms in neighboring North Carolina have reduced the rate to 3 percent as of 2018, with a scheduled reduction to 2.5 percent in 2019.. Virginia and Georgia impose corporate income taxes at a rate of 6 percent, while Florida’s corporate rate is 5.5 percent.³⁷ Figure 3.1 shows top marginal corporate income tax rates for all 50 states and the District of Columbia.

FIGURE 3.1.
Top State Marginal Corporate Income Tax Rates, 2018



35 Id., 6.
 36 Jared Walczak, *Location Matters: The State Tax Costs of Doing Business*, Tax Foundation, 2015, 22, http://taxfoundation.org/sites/taxfoundation.org/files/docs/TF_LocationMatters_2015.pdf.
 37 Morgan Scarborough, "State Corporate Income Tax Rates and Brackets for 2018," Tax Foundation, Feb. 7, 2018, <https://taxfoundation.org/state-corporate-income-tax-rates-brackets-2018/>.

Forty-four states levy a corporate income tax, and of those, 27, including South Carolina, have a single tax rate. Single-rate systems are more consistent with the principles of simplicity and neutrality. In contrast to the individual income tax, there is no meaningful “ability to pay” concept in corporate taxation. Jeffery Kwall, a professor at Loyola University Chicago School of Law, notes that

graduated corporate rates are inequitable—that is, the size of a corporation bears no necessary relation to the income levels of the owners. Indeed, low-income corporations may be owned by individuals with high incomes, and high-income corporations may be owned by individuals with low incomes.³⁸

A single-rate system minimizes the incentive for firms to engage in expensive, counterproductive tax planning to mitigate the damage of higher marginal tax rates that some states levy as taxable income rises. In this regard, South Carolina does well.

Since 2008, 16 states and the District of Columbia have cut corporate income taxes, and Michigan shifted from a gross receipts tax to a traditional corporate income tax.³⁹ South Carolina is not counted among this number, having last reduced its corporate rate nearly three decades ago, though its 5 percent rate remains competitive regionally and nationally.

Reductions in corporate rates elsewhere reflect a trend toward decreased reliance on a highly volatile tax imposed on a declining amount of taxable income, and, in some instances, an effort to simplify the tax structure by broadening the base and lowering the rate. Corporate income tax revenue is in decline across the country as more businesses choose to structure as S corporations and limited liability corporations (LLCs), single sales factor apportionment schemes become more common, and states give away more of their tax base in special credits and deductions.⁴⁰

Corporate income taxes also tend to be complex and impose substantial administrative burdens for payers and government alike, and this complexity has not abated as the tax base has eroded. Finally, revenue volatility necessarily follows from the nature of the tax, since in periods of economic distress, many companies may post losses and thus lack exposure to a corporate income tax.

38 Jeffrey L. Kwall, “The Repeal of Graduated Corporate Tax Rates,” *Tax Notes*, June 27, 2011, 1395.

39 See Joseph Bishop-Henchman, “Trend #3: Corporate Tax Reductions, Top 10 State Tax Trends in Recession and Recovery, 2008 to 2012,” Tax Foundation, June 13, 2012, <http://taxfoundation.org/article/trend-3-corporate-tax-reductions>; Tax Foundation, *Facts and Figures: How Does Your State Compare?* multiple years.

40 Scott Greenberg, “Pass-Through Businesses: Data and Policy,” Tax Foundation, Jan. 17, 2017, <https://taxfoundation.org/pass-through-businesses-data-and-policy/>.

Comparing South Carolina's Corporate Income Taxes Regionally and Nationally

South Carolina ranks 19th in corporate income tax structure according to our *2019 State Business Tax Climate's* corporate income tax component ranking, yielding high marks for its low, flat rate while being penalized for carving out the tax base with an excessive reliance on targeted tax incentives. The *Index* measures tax structure, not collections, focused on the *how*, not the *how much*, of state taxation. For this reason, while South Carolina's ranking is not bad, it is worse than those of its regional competitors, even though corporate income tax liability in the state is modest.

TABLE 3.1.
State Business Tax Climate Index
Corporate Income Tax Component Rankings

South Carolina and Regional Competitors

State	Component Ranking
South Carolina	19th
North Carolina	3rd
Georgia	8th
Virginia	10th
Florida	6th

Source: Tax Foundation, *2019 State Business Tax Climate Index*.

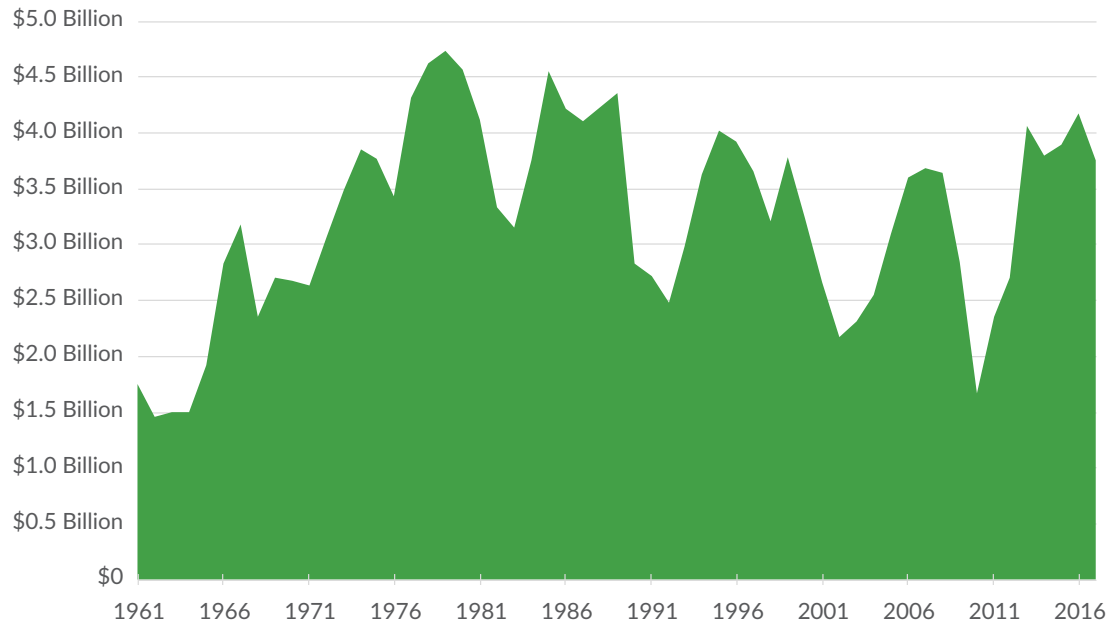
Corporate Income Tax Collections

Corporate income taxes are among the most volatile sources of state revenue, as many companies may generate little or no net income during economic downturns. While practically all revenue streams are cyclical, with collections lower during periods of economic distress, corporate income taxes experience particularly deep troughs. Property values may decline during a recession, but they are rarely wiped out, limiting how low property tax collections can go. Similarly, consumption patterns may decline, leading to lower sales tax revenues than when the economy is booming, but sales can only drop so far. Many companies' net income, by contrast, can bottom out or even go into negative territory. As such, collections tend to be highly volatile, spiking sharply in good years and collapsing in bad ones.

As demonstrated in Figure 3.2, corporate income tax collections took a significant hit during the Great Recession, just at the time when South Carolina most needed revenue stability. All revenue sources took a hit during the downturn, but not with this intensity. South Carolina does not rely on its corporate income tax collections particularly heavily, ranking 36th nationwide in state corporate income tax collections per capita and 42nd in combined state and local corporate income tax collections per capita (the state does not allow local corporate income taxes).⁴¹ The following figure illustrates the volatility of South Carolina's corporate net income tax collections in real (inflation-adjusted) terms.

41 Morgan Scarborough, *Facts and Figures 2018: How Does Your State Compare?* Tax Foundation, <https://taxfoundation.org/publications/facts-and-figures/>.

FIGURE 3.2.
Corporate Income Tax Collections, 1961-2016 (in 2017 dollars)



Note: Dollar amounts are inflation-adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U)
 Source: Census Bureau, *State and Local Government Finances*; Bureau of Labor Statistics, *Consumer Price Indexes (All Urban Consumers)*.

Structural Elements

Net Operating Loss Carrybacks and Carryforwards

The corporate income tax is designed to tax only the profits of a corporation. However, a yearly profit snapshot may not fully capture a corporation's true profitability. For example, a corporation in a highly cyclical industry may look very profitable during boom years but post substantial losses during bust years. When examined over the entire business cycle, the corporation may actually have an average profit margin, or even a poor one.

Although corporate income tax liability is determined on an annualized basis, business cycles do not follow the calendar. This can be problematic for corporations with cyclical income, enjoying high profitability one year and losses the next. To mitigate this reality, states (along with the federal government) allow corporations to deduct losses from previous years and future years to offset current taxes owed. These net operating loss (NOL) "carrybacks" and "carryforwards" smooth out tax obligations over time, ensuring that industries with cyclical income are not at a competitive disadvantage against industries with more consistent and stable revenue streams.

Under a well-designed system of net operating losses, businesses which experience a period of negative income but return to profitability have the opportunity to deduct their losses against future taxable income. The NOL deduction helps ensure that, over time, the corporate income tax is a tax on average profitability. Without the NOL deduction, corporations in cyclical industries pay much higher taxes than those in stable industries, even assuming identical average profits over time.

There are two important variables of a state's NOL provisions: the number of years allowed for carrybacks and carryforwards, and caps on the amount of carrybacks and carryforwards. The maximum that any state allows for carrybacks is three years, with no cap (that is, an unlimited dollar amount allowed up to the entirety of current year taxable income). Among the states that allow carrybacks, the most common time span is two years with no cap.

Prior to the adoption of the new federal tax reform law, the maximum carryforward given in any state was 20 years, again with no cap (most states allow either 15 or 20 years, though 20 is more desirable). The new federal law provides for unlimited years but caps the amount that can be deducted in any given year at 80 percent of tax liability, a convention some states will now follow. The longer the overall time span, the higher the probability that the corporate income tax is being levied on the corporation's average profitability.

Currently, South Carolina disallows carrybacks and has a 20-year NOL carryforward period for losses, with no cap.⁴² Businesses that experience a period of negative income but return to profitability have the opportunity to deduct their losses against future taxes, but companies that fail to turn the corner lose this opportunity.

Every state with a corporate income tax offers a carryforward provision. Thirty-one states and the District of Columbia offer carryforward periods of at least 20 years. Of these, 17 states and the District of Columbia follow the number of years offered by the federal government and are positioned to offer unlimited year carryforwards absent an effort to decouple from the provision.⁴³ Six states limit carryforwards to 15 years, and the remaining eight states with corporate income taxes offer more limited carryforward periods. Seventeen states permit net operating loss carrybacks.⁴⁴

Table 3.2 shows the treatment of net operating losses in South Carolina and regional competitor states. Two states—Florida and Georgia—conform to the new federal law, allowing unlimited carryforwards. Virginia, meanwhile, offers a two-year carryback, which is not available in South Carolina.

TABLE 3.2.
Treatment of Net Operating Losses
South Carolina and Select Regional Competitors

State	Carrybacks		Carryforwards	
	Years	Cap	Years	Cap
South Carolina	0	\$0	20	Unlimited
Florida		Conforms to federal treatment		
Georgia		Conforms to federal treatment		
North Carolina	0	\$0	15	Unlimited
Virginia	2	Unlimited	20	Unlimited

Source: State statutes; Tax Foundation research.

42 Jared Walczak, Scott Drenkard, and Joseph Bishop-Henchman, 2019 *State Business Tax Climate Index*, Tax Foundation, Sept. 26, 2018, <https://taxfoundation.org/publications/state-business-tax-climate-index/>.

43 Jared Walczak, "Tax Reform Moves to the States: State Revenue Implications and Reform Opportunities Following Federal Tax Reform," Tax Foundation, Jan. 31, 2018, 28, <https://taxfoundation.org/state-conformity-federal-tax-reform/>.

44 Jared Walczak, Scott Drenkard, and Joseph Bishop-Henchman, 2019 *State Business Tax Climate Index*.

Treatment of Capital Investment

Broadly speaking, corporate income taxes are imposed on net income (essentially profits), meaning that businesses deduct compensation and other costs in arriving at taxable income. Generally, however, they are not able to deduct the cost of investment in the first year, which creates a bias against investment. Instead of claiming the full deduction immediately, businesses “recover” the cost across the depreciable life of the asset, which can run many years, deducting a portion of it each year.

Various federal policies have sought to attenuate this disincentive. The Modified Accelerated Cost Recovery System (MACRS) frontloads the deductions somewhat,⁴⁵ and a policy called bonus expensing—initially at 30 percent, later at 50 percent, and briefly at 100 percent—allowed a greater share of the deduction to be taken in the first year, with the remainder amortized over the rest of the depreciation schedule. Classes of assets are assigned different asset lives, with recovery periods for tangible property ranging from three to 20 years.

As part of the federal tax overhaul adopted in late 2017, machinery and equipment purchases are now shifted to a policy called full expensing, meaning that the full cost can be deducted in the first year. While this dramatically improves the treatment of capital investment at the federal level, South Carolina does not conform to the change or provide any sort of bonus depreciation. This penalizes capital investment in South Carolina, at least for firms with meaningful exposure to the corporate income tax. Companies have to pay tax up front on revenue reinvested in the company, only recovering those tax costs over a period of years as the property depreciates.

South Carolina leans heavily on targeted incentives to favor certain economic activities, but ironically, it also includes a marked disincentive to capital investment. An investment tax credit serves as a partial backdoor “fix,” but it is only available to certain firms. Instead of relying on selectively available credits, it would make sense for South Carolina—which conforms to many provisions of the federal tax code—to follow the federal government in allowing the full expensing of machinery and equipment purchases.

Apportionment and Sourcing

When businesses operate in more than one state, income must be apportioned among those states for tax purposes. The legal term for whether a state has the power to tax is *nexus*—which typically requires a business to have some physical presence, either property or employees, in a state—and the determination of the amount of that business’s income subject to a given state’s corporate income tax is known as *apportionment*. States apportion business profits based on some combination of the percentage of company property, payroll, and sales located within their borders.

45 U.S. Department of the Treasury, Internal Revenue Service, “How to Depreciate Property,” Publication 946, 2017, <https://www.irs.gov/publications/p946>.

South Carolina uses single sales factor apportionment, meaning that only sales are taken into account in determining income apportionment. If, hypothetically, a business owned all its property and employed all its personnel in South Carolina, but only sold 10 percent of its sales in the state, then 10 percent of its net income would be subject to South Carolina's corporate income tax. For decades, most states adopted an evenly weighted three-factor apportionment formula of property, payroll, and sales, but now 20 states, including South Carolina, use single sales factor apportionment.⁴⁶

Among South Carolina's neighbors, North Carolina and Georgia have also adopted single sales factor apportionment, while Florida and Virginia use three-factor apportionment with a double-weighted sales factor (that is, 50 percent sales, 25 percent payroll, and 25 percent property).⁴⁷ Beneficially, South Carolina forgoes a throwback rule, which some states utilize in an attempt to capture and tax so-called "nowhere income" that is earned out of state in jurisdictions where it is not subject to foreign taxation. North Carolina, Georgia, Virginia, and Florida do not have a throwback rule either.⁴⁸

Inconsistent with its approach to apportionment, South Carolina sources service income based on the location of income-producing activity.⁴⁹ This means that when a South Carolina firm performs a service which is enjoyed in another state, the income is sourced to South Carolina for tax purposes. Conversely, when an out-of-state firm provides a service, the benefit of which is enjoyed in South Carolina, the state makes no claim on that activity. Single sales factor apportionment is a means of tax exporting; the use of an income-producing activity (IPA) service sourcing rule, as opposed to market sourcing, has the opposite effect.

Corporate Income Tax Expenditures

South Carolina offers a range of deductions, exemptions, and credits against corporate income tax liability. These tax expenditures function as incentives for select industries and favored business activities, and for funneling growth into particular regions.

Incentives can be effective, but they are not efficient. By lowering tax costs for targeted industries or rewarding specific business activities, they can yield higher employment or greater investment in those sectors. Unfortunately, the cost of these incentives must be borne by other, non-favored businesses which bear a correspondingly higher tax burden. Ultimately, incentives involve picking winners and losers, and seek to guide the economy in keeping with policymakers' (often competing) visions. A well-structured tax code with a broader base—eliminating many of the incentives—and a lower rate would do far more to encourage job creation and economic growth.

46 Jared Walczak, Scott Drenkard, and Joseph Bishop-Henchman, *2019 State Business Tax Climate Index*.

47 Federation of Tax Administrators, "State Apportionment of Corporate Income," Jan. 1, 2018, <https://www.taxadmin.org/assets/docs/Research/Rates/apport.pdf>.

48 Jared Walczak, Scott Drenkard, and Joseph Bishop-Henchman, *2019 State Business Tax Climate Index*.

49 PwC, "South Carolina ALJ holds apportionment of service income is neither costs of performance nor market based, it is a flexible standard based on industry," May 2016, <https://www.pwc.com/us/en/services/tax/state-local-tax/library/newsletters/salt-insights/south-carolina-apportionment-service-income-flexible-industry.html>.

All states rely on incentives to some degree, but South Carolina leans on them with unusual vigor. Tax preferences, however, represent a poor approach to reducing burdens. In many cases, companies must navigate an application process to be approved for such incentives, and of course, some companies fail to qualify.

Deductions, exemptions, and credits all serve to reduce tax liability, but they do so in distinct ways that are important to bear in mind while attempting any comparison. Deductions reduce taxable income by a given amount, whereas credits are a subtraction against tax liability. Imagine, for instance, a corporate taxpayer with \$50,000 in South Carolina corporate income tax liability. A \$5,000 credit will reduce tax liability to \$45,000, whereas a \$5,000 deduction would reduce tax liability by \$250, as the reduction in liability will be equal to the tax on that \$5,000. An exemption, meanwhile, excludes certain revenue from the tax rolls altogether.

Tax Credits

South Carolina offers a range of generous tax credits for economic development purposes, the most noteworthy of which is a credit for new job creation. The credit amount varies from \$1,500 to \$8,000 per year, depending on the location of the taxpayer's facility.⁵⁰ Counties are organized into four tiers, with more generous credits granted to businesses creating jobs in lower-tier—which is to say, lower-income—counties. In select locations, a supplemental \$1,000 per job credit is also available. Unused credit can be carried forward for 15 years.⁵¹

TABLE 3.3.

County Tiers and Annual Credit Value Per Job

Tier	Credit Value	Counties
Tier I	\$1,500	Anderson, Beaufort, Charleston, Dorchester, Greenville, Lexington, Newberry, Richland, Spartanburg, York
Tier II	\$2,750	Aiken, Berkeley, Florence, Georgetown, Greenwood, Jasper, Kershaw, Lancaster, Oconee, Pickens, Saluda, Sumter
Tier III	\$4,250	Abbeville, Calhoun, Cherokee, Chesterfield, Colleton, Darlington, Edgefield, Fairfield, Horry, Laurens, McCormick, Union
Tier IV	\$8,000	Allendale, Bamberg, Barnwell, Chester, Clarendon, Dillon, Hampton, Lee, Marion, Marlboro, Orangeburg, Williamsburg

Source: South Carolina Department of Revenue.

- Corporate headquarters locations are incentivized by a headquarters credit worth up to 20 percent (against the corporate income tax) of the real property costs incurred in design, construction, and lease costs for the first five years of headquarters operations. The credit's size doubles if additional criteria are met, including creating at least 75 new full-time headquarters jobs with average salaries more than twice South Carolina's per capita income.⁵²
- A generous research and development credit is worth 5 percent of a taxpayer's qualified research expenses—not just new R&D investment—in South Carolina.

50 S.C. Code Ann. §12-6-3360(C).

51 South Carolina Department of Revenue, "South Carolina Tax Incentives for Economic Development," 2018 Edition, 25-38, https://dor.sc.gov/resources-site/lawandpolicy/Documents/SC_TIED_Complete.pdf.

52 S.C. Code Ann. §12-6-3410.

Claims are capped at 50 percent of any tax liability remaining after the application of all other credits, and unused credits may be carried forward up to 10 years from incurring the expenses.⁵³

- The community development corporation investment credit is a credit against South Carolina's income tax, bank tax, or insurance premium tax for a business that invests in a community development corporation or a community development financial institution, worth 33 percent of the investment. The total credit that taxpayers can claim is \$1 million in one year and \$5 million for all years. The provisions of this credit are set to terminate in 2020.⁵⁴
- The job development credit is a discretionary incentive permitting businesses to obtain a refund of employee withholding either to use for, or to reimburse the cost of, approved business expenditures. The purpose of the credit is to encourage growth in certain industries, including manufacturing, technology, and the service sector. Like the jobs credit, the value of the job development credit varies by county. Because the credit is discretionary, it is not something on which most businesses can rely and is available on a decidedly nonneutral basis.⁵⁵
- The investment tax credit is awarded on a one-time basis to manufacturers locating or expanding in the state. The credit is worth between 0.5 and 2.5 percent of the company's investment in new production equipment, depending on the recovery period for the new investment. A company can use the credit to offset up to 100 percent of its corporate income tax liability and can carry forward unused credits for up to 10 years.⁵⁶

Select corporate taxpayers may also qualify for a 10-year moratorium on corporate income and insurance premium taxes. To qualify, a taxpayer must create 100 or more new full-time jobs in economically depressed counties within five years. At least 90 percent of the taxpayer's total investment in the state must be in the depressed county. The moratorium is extended to 15 years if 200 or more jobs are created within five years.⁵⁷

The state also offers a range of green initiative credits and industry and facility revitalization credits, including a recycling facility tax credit, solar energy tax credit, biomass resources tax credit, renewable fuels tax credit, renewable energy systems and components tax credit, energy conservation and renewable energy tax credit, textile revitalization credit, and the revitalization of abandoned building credit.⁵⁸ The following tax credits were claimed in fiscal year 2016, the most recent year for which we have data.⁵⁹

53 S.C. Code Ann. §12-6-3415.

54 South Carolina Department of Revenue, "South Carolina Tax Incentives for Economic Development," 130-131.

55 *Id.*, 59-63.

56 South Carolina Department of Commerce, "Business Incentives," January 2017, 9-10, https://www.sccommerce.com/sites/default/files/17-50-scd_business_incentive_booklet_v_3.pdf.

57 South Carolina Department of Revenue, "South Carolina Tax Incentives for Economic Development," 73-76.

58 South Carolina Department of Commerce, "Corporate Income Tax & Incentives," 2018, <https://www.sccommerce.com/incentives/corporate-income-tax-and-incentives>.

59 South Carolina Department of Revenue, "2015-2016 Annual Report," 24, https://dor.sc.gov/resources-site/publications/Publications/2015-2016_Annual_Report.pdf.

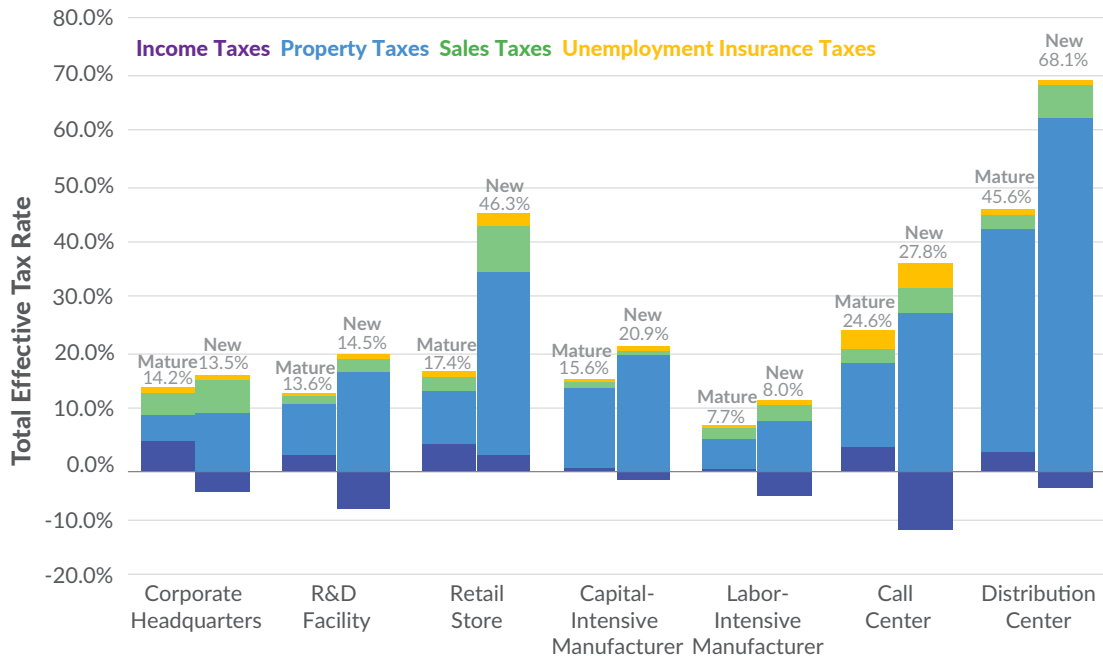
TABLE 3.4.
Corporate Tax Credits by Value Claimed,
Fiscal Year 2016

Tax Credit	Value
Capital Investment	\$34,069,954
New Jobs	\$30,675,447
Research Expenses	\$17,753,353
Recycling	\$11,929,350
Infrastructure (two credits)	\$9,673,405
Unidentified	\$7,182,514
Corporate Headquarters	\$2,147,742
Gift of Land for Conservation	\$901,540
Port Cargo Volume Increase	\$265,700
Textile Rehabilitation	\$238,769
Certified Historic Structure	\$213,711
Retail Facilities Revitalization	\$149,983
Scenic Rivers	\$140,000
Socio/Econ Disadvantage Small Business	\$58,745
Apprenticeship	\$50,309
Solar Energy System	\$40,909
Family Independence Payments	\$39,520
Exceptional Needs Education Scholarship	\$18,000
Whole Effluent Toxicity Testing	\$8,536
Community Development	\$4,715
SC Quality Forum	\$2,500
Total Claimed	\$115,564,702
Carried Over From Prior Years	\$851,571,148

Source: South Carolina Department of Revenue.

These and other incentives wipe out corporate income tax liability for many firms, leaving unincentivized businesses to bear the brunt of the tax. These incentives also make property taxes far more significant for many businesses. In *Location Matters*, our model firms study, we calculated that property taxes could constitute 94 percent of the state and local tax burdens experienced by a distribution center based in South Carolina. For some businesses, the corporate income tax is clearly an afterthought.⁶⁰

FIGURE 3.3.
Effective Tax Rates on Model Firms



Finally, because many of these credits are so generous, some companies earn them far faster than they accrue tax liability to offset, yielding large pools of unclaimed credits. Many of these credits will never be claimed, but as long as they are outstanding, they represent a significant source of state revenue uncertainty. The amount of outstanding credits soared from \$84 million in fiscal year 2001 to \$887 million in fiscal year 2016, a mere 15 years later.⁶¹

Corporate License Fee

South Carolina also imposes what is styled as an annual license fee for the privilege of doing business, but is, in practice, a tax on each company's net worth. The corporate license fee is a capital stock tax with a base of \$15, plus \$1 for every \$1,000 of capital stock and paid-in or capital surplus that the corporation shows on its records at the beginning of the tax year. (Specifically enumerated companies, including utilities, pay a license fee based on South Carolina gross receipts and property, rather than a fee based on capital stock and paid-in or capital surplus.) In all cases, the minimum license fee is \$25, and there is no maximum amount.⁶² In fiscal year 2017, the corporate license fee collected \$68.2 million, a sharp decline from \$88.7 million in fiscal year 2016 and \$129.9 million in fiscal 2015.⁶³

61 South Carolina Department of Commerce, "Statewide Economic Growth and Taxation Issues in South Carolina: Corporate Income Tax," 4; South Carolina Department of Revenue, "2015-2016 Annual Report," 24.

62 South Carolina Department of Revenue, "South Carolina Tax Incentives for Economic Development," 1-15.

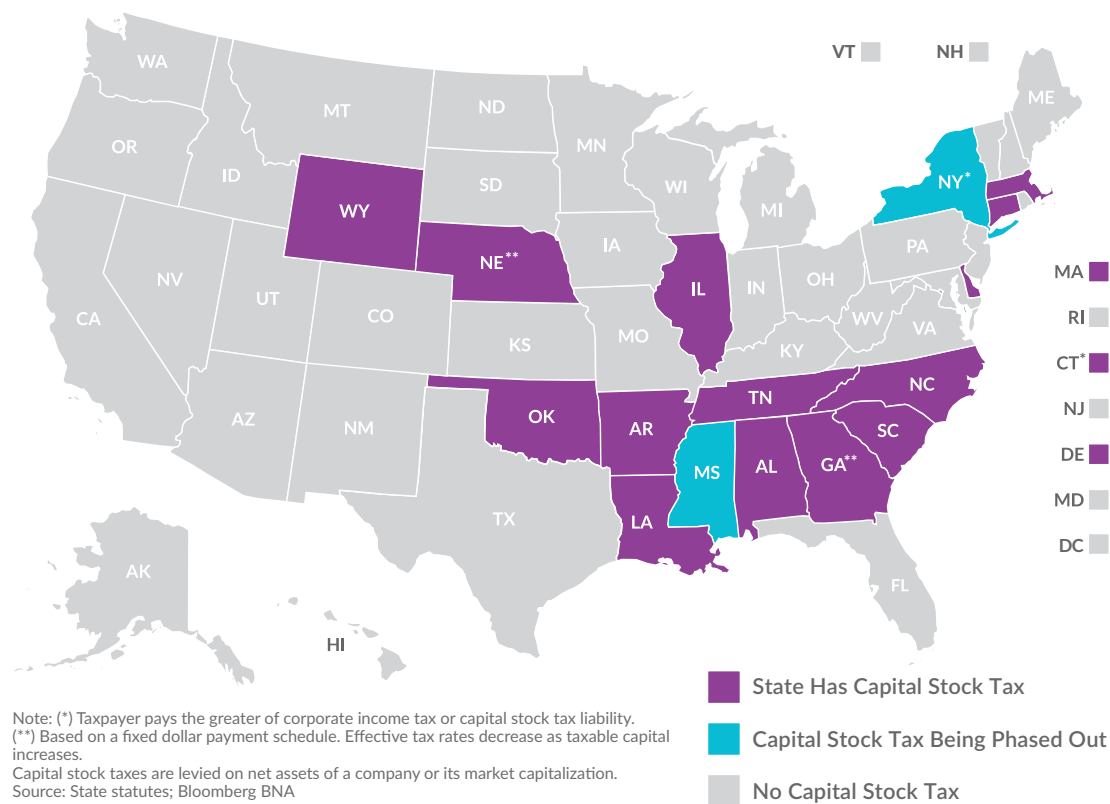
63 South Carolina Board of Economic Advisors, "South Carolina General Fund Revenue Monitor," Aug. 24, 2017, 10,

<http://rfa.sc.gov/files/Final%20FY%202016-17%20General%20Fund%20Revenue%20Monitor.pdf>.

Although the corporate license fee has a lofty-sounding purpose—it is “imposed on the privilege of doing business as a corporation in South Carolina to compensate South Carolina for protection and opportunities commensurate to doing business in South Carolina”—capital stock taxes are a harmful form of taxation.⁶⁴ They are nonneutral, because they are imposed without regard to profitability or ability to pay, and they impose an economic drag, as they penalize capital investment.

Widely recognized as economically inefficient, capital stock taxes have fallen out of favor nationally, though they still linger in the South. Currently, only 16 states levy a tax on capital stock, and two of them—New York and Mississippi—are in the process of phasing them out.⁶⁵ South Carolina’s tax is the same rate as North Carolina’s; Georgia, meanwhile, uses a rate schedule with fixed dollar amounts.

FIGURE 3.4.
Capital Stock Tax Rates
State Capital Stock Tax Rates as of January 1, 2018



States are increasingly shifting away from capital stock taxes in recognition of their detrimental economic effects. Kansas eliminated its capital stock tax in 2011, and Rhode Island and West Virginia completed phaseouts in 2015. Missouri and Pennsylvania eliminated their tax as of the 2016 tax year. New York’s tax continues to phase out, and Mississippi passed phaseout legislation in 2016.⁶⁶

64 South Carolina Department of Revenue, “South Carolina Revenue Ruling #05-11,” July 12, 2005, <https://dor.sc.gov/resources-site/lawandpolicy/Advisory%20Opinions/RR05-11.pdf>.
 65 Katherine Loughead, “Does Your State Levy a Capital Stock Tax?” Tax Foundation, Aug. 1, 2018, <https://taxfoundation.org/state-levy-capital-stock-tax-2018/>.
 66 Tax Foundation, “Facts and Figures: How Does Your State Compare?” multiple years.

Corporate Tax Solutions

Our corporate tax solutions simplify the state tax code and improve tax neutrality and revenue stability.

Improve Treatment of Capital Investment

An ideal tax code would provide for the full expensing of all capital investment, as a corporate net income tax—as the very name implies—should fall upon net income, after expenses (including investment expenses). Most states fall short of this goal, but 13 of the 44 states with corporate income taxes allow the full and immediate expensing of machinery and equipment purchases in line with federal policy, and another two (including North Carolina) allow first-year bonus depreciation above and beyond the normal depreciation schedule, though short of full expensing. South Carolina offers a credit for qualified investment, tied to asset lives. A far better policy would be to forgo the targeted credit and instead allow all corporations to fully deduct the cost of their machinery and equipment purchases in the first year.

Conform to Federal Treatment of Net Operating Losses

South Carolina follows the federal tax code in most respects but diverges slightly in terms of net operating losses. The state offers an uncapped 20-year carryforward period but no carryback period, slightly stingier than the former federal law, which included a two-year carryback. Under the new law, carryforwards are unlimited, though capped at 80 percent of tax liability in any given year. Policymakers might consider conforming to federal treatment for simplicity's sake.

Consider Market Sourcing of Service Income

Questions of tax apportionment are not easily resolved by an appeal to basic tax principles. Income should only be taxed once, which argues against the states' current patchwork approach, but it does not necessarily follow that one particular apportionment formula is best—just that it is best that all states use the same one.

South Carolina has followed the recent trend of adopting single sales factor, which is popular in part because it exports a significant portion of tax liability to out-of-state firms. Oddly, however, the state continues to source service income based on the location of income-producing activity—which is, essentially, an emphasis on payroll and property for services, but sales for manufacturing and production. These policies are at cross-purposes. The argument for shifting to a market sourcing approach is not so much that, as a matter of principle, the corporate taxation of services should be destination-based, but rather that the state's choices should be consistent and not undercut each other.

Review Business Tax Incentives

A growing number of states have established panels, commissions, or *ad hoc* committees to review tax incentives periodically. Often they task a state fiscal or revenue office with conducting a rolling analysis of credits to estimate their return on investment. Given South Carolina's heavy reliance on tax credits, a formalized review process would help ensure that the credits on the books are actually achieving their stated purpose and could contribute to reforms where they fail to do so.

Repeal the Antiquated Corporate License Fee

South Carolina's corporate license fee generated a mere \$68.2 million in 2017, but though it raises little revenue, it is harmful for highly capitalized businesses. Lowering the rate or phasing out this tax completely merits serious consideration in an overhaul of South Carolina's tax code. It could be paid for by broadening the corporate income tax base (reducing incentives) or through revenue offsets elsewhere in the code, including sales tax base broadening. Alternatively, as a small and declining revenue source, it could be phased out over time subject to revenue availability.

A photograph of a cable-stayed bridge at sunset. The bridge features two tall, A-frame pylons with numerous stay cables. The sky is filled with soft, orange and yellow clouds. In the foreground, there is a field of tall, golden grasses. The bridge spans across a body of water, with a line of trees visible in the distance.

CHAPTER 4

INDIVIDUAL INCOME TAXES

Introduction

South Carolina's individual income taxes are high for the region. This needs to be said, and it needs to be explained, because it defies the perceptions of many—yet it's all too apparent to small business owners, and it takes a serious bite out of the paychecks of middle-class taxpayers.

In the course of our research, we met with legislators, local government officials, business owners, accountants, and everyday taxpayers. We frequently heard that while the state's top marginal income tax rate was on the high side, at 7.0 percent, the effective rate was quite low. The people we didn't hear this from: entrepreneurs feeling the sting of a regionally uncompetitive tax, especially when coupled with a host of local taxes.

Economists tend to be concerned with marginal rates even when effective rates are competitive, since it's at the margin that decisions are made about working longer, enhancing productivity, or growing one's business. But here, there is an even more basic point to make: for many middle-class South Carolinians, the effective rates are quite high too. Many taxpayers experience higher income tax liability in South Carolina than they would anywhere else in the Southeast.

South Carolina's individual income tax has a five-bracket graduated-rate structure. The top marginal rate of 7.0 percent—the region's highest—kicks in at \$14,860 in taxable income. Even after accounting for the standard deduction and other policies which reduce taxable income, it is entirely typical for South Carolina wage earners to have income exposed to the top marginal rate.

It is important to bear in mind that individual income taxes are not exclusively of interest to individual taxpayers, as many businesses (S corporations, LLCs, partnerships, and sole proprietorships) pay individual income taxes as well. Since these taxes impact South Carolina employers, it is important to consider business as well as individual payers when contemplating changes to the individual tax code.

In this chapter, we explore the burdens of the individual income tax and its impact on the state's economy. We provide a broad overview of the state's individual income tax, outline issues with the current system, and offer potential reform options. We conclude with *State Business Tax Climate Index* rankings for our proposed solutions.

A Short History of the Individual Income Tax

With the tax law of 1701, South Carolina became an extremely early adopter of an income tax—one which, if not exactly like the income taxes we know today, was at least a clear forerunner, and which establishes the state as one of the few to tax income fairly consistently for several centuries.⁶⁷ In most of the country, state income taxes came into their own during the Great Depression.⁶⁸ In South Carolina, income began to be taxed while the colony still shared a governor with North Carolina.

That original tax was extremely broad, levied on property and the profits of employment of anyone residing in the province.⁶⁹ The tax remained in effect more or less consistently through 1868, when a new constitution forbade it,⁷⁰ though the tax on incomes produced very little revenue during the century and a half when it was in effect.⁷¹ The state's next experiment in income taxation was adopted in 1898, and represented an early graduated-rate income tax authorized under the Constitution of 1895. Levied on “gains, gross profits and income” from all sources, it contained an exemption for the first \$2,500 in income (the equivalent of about \$75,000 in current dollars) and thus fell predominantly on high-income individuals. The top rate of 3 percent was imposed on income above \$15,000 (about \$450,000 today).⁷²

This tax, like its predecessor, raised very little revenue (a mere \$26,879 in fiscal year 1918,⁷³ worth about \$800,000 now), both due to its exclusions and difficulties in enforcement. The tax was repealed in 1918, and two years later, a Joint Special Committee on Revenue and Taxation tore into the recently repealed tax, terming it a “dead letter and a failure” which collapsed because it “sought to impose an unjust tax and could not be enforced.”⁷⁴

The Committee did not condemn the concept of income taxes and looked favorably upon what it saw as more equitable income taxes blossoming elsewhere. Ironically, South Carolina repealed its income tax during the first wave of modern state income taxes, the product of the Progressive era and spurred by the adoption of a federal income tax in 1913.⁷⁵ The Committee did, however, believe that a superior system of income taxation was impractical in South Carolina at that time.⁷⁶

67 Peter Harris, *Income Tax in Common Law Jurisdictions: From the Origins to 1820* (Cambridge, United Kingdom: Cambridge University Press, 2006), 211.

68 Ronald Snell, “State Finance in the Great Depression,” National Conference of State Legislatures white paper, March 2009, 3, <http://www.ncsl.org/print/fiscal/statefinancegreatdepression.pdf>.

69 Peter Harris, *Income Tax in Common Law Jurisdictions: From the Origins to 1820*, 211.

70 Charles R. Metzger, “Brief History of Income Taxation,” *American Bar Association Journal* 13:11 (November 1927), 667, <https://www.jstor.org/stable/25707292>.

71 Delos O. Kinsman, “The Present Period of Income Tax Activity in the American States,” *The Quarterly Journal of Economics* 23:2 (February 1909), 300, <https://www.jstor.org/stable/pdf/1882801.pdf>.

72 Id., 301.

73 State of South Carolina, “Report of the State Treasurer of South Carolina for the Fiscal Year 1909,” 1910, 24.

74 State of South Carolina, “Reports of State Officers Boards and Committees to the General Assembly of the State of South Carolina,” Vol. I, January 1921; “Report of the Joint Special Committee on Revenue and Taxation” [Joint Special Committee Report], 92.

75 See Alzada Comstock, “Fiscal Aspects of State Income Taxes,” *The American Economic Review* 10:2 (June 1920), <https://www.jstor.org/stable/1804865>.

76 Joint Special Committee Report, 93.

A few short years later, the legislature reconsidered, adopting a new income tax in 1922 and making it retroactive to 1921. The tax anticipated the state's current reliance on federal taxable income as the base of taxation, adopting the entirety of the federal income tax and levying a tax in the amount of one-third the amount owed to the federal government.⁷⁷ By 1926, when the state moved to its modern structure, 11 other states were taxing income, including North Carolina, Mississippi, Missouri, and Virginia.⁷⁸

In the modern era, South Carolina's income tax is imposed on a graduated rate structure independent of federal rates but highly dependent on the federal tax base, since the state uses federal taxable income (discussed later) as the basis for its own calculations. The top rate of 7 percent has stood unchanged since its adoption in 1959, and the tax has included five brackets since 2008, when the lowest bracket (with a rate of 2.5 percent) was eliminated in favor of a "zero bracket" exempting all income under a partially inflation-adjusted \$2,500 (currently \$2,970 as of tax year 2018),⁷⁹ thus returning full circle to a similar provision in the 1898 tax.⁸⁰

Tax brackets were briefly indexed for inflation in the 1980s, after which the policy was suspended until more recently. Had brackets been consistently indexed to inflation since the 7 percent rate was implemented in 1959, that rate would currently kick in at \$85,941.

TABLE 4.1.
Income Tax Rate History Since 1927

1927		1930		1933		1959	
1.0% >	\$0	1.0% >	\$0	2.0% >	\$0	2.0% >	\$0
1.5% >	\$2,500	2.0% >	\$2,000	3.0% >	\$2,000	3.0% >	\$2,000
2.5% >	\$5,000	3.0% >	\$4,000	4.0% >	\$4,000	4.0% >	\$4,000
3.5% >	\$7,500	4.0% >	\$6,000	5.0% >	\$6,000	5.0% >	\$6,000
4.5% >	\$10,000	5.0% >	\$8,000			6.0% >	\$8,000
5.0% >	\$15,000					7.0% >	\$10,000
1987		1990		1991		2008	
3.0% >	\$0	2.75% >	\$0	2.5% >	\$0	0.0% >	\$0
4.0% >	\$4,000	3.0% >	\$2,030	3.0% >	\$2,070	3.0% >	\$2,670
5.0% >	\$6,000	4.0% >	\$4,060	4.0% >	\$4,040	4.0% >	\$5,340
6.0% >	\$8,000	5.0% >	\$6,090	5.0% >	\$6,200	5.0% >	\$8,010
7.0% >	\$1,000	6.0% >	\$8,120	6.0% >	\$8,280	6.0% >	\$10,680
		7.0%	\$10,150	7.0%	\$10,350	7.0% >	\$13,350

Sources: South Carolina Department of Revenue; state statutes; Tax Foundation research.

77 *Prentice-Hall Federal Tax Service for 1922*, Vol. II (New York: Prentice-Hall, Inc., 1922), 9124.

78 Charles R. Metzger, "Brief History of Income Taxation," 668.

79 S.C. Code Ann. § 12-6-515.

80 South Carolina Department of Commerce, "Personal Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina," 2010, 2-3.

Comparing South Carolina's Individual Income Taxes Regionally and Nationally

Compared to other state individual income tax systems, South Carolina's is somewhat below average on the *State Business Tax Climate Index*. Table 4.2 shows South Carolina's individual income tax component ranking on the *Index*, in addition to those of select regional competitor states' rankings. The *Index* provides a measure of a state's tax structure, not its collections, where South Carolina has moderate collections per capita (19th lowest), reflecting the state's below-average personal income.

TABLE 4.2.
State Business Tax Climate Index
Individual Income Tax Component Rankings

South Carolina and Select Regional Competitors

State	Component Ranking
South Carolina	34th
Florida	1st (tie)
Georgia	38th
North Carolina	16th
Tennessee	8th
Virginia	35th

Source: Tax Foundation, 2019 *State Business Tax Climate Index*.

South Carolina's top marginal rate is the highest in the region (see Figure 4.1). Two Southeastern states (Florida and Tennessee) forgo taxes on wage income altogether, while North Carolina and Kentucky levy single-rate income taxes at rates of 5.499 and 5.0 percent, respectively. (Kentucky's single-rate tax is new for 2018, the product of a recently-adopted tax reform package.) The region's highest rate outside of South Carolina is the 6.5 percent top marginal rate in West Virginia.

South Carolina's generous standard deduction and personal exemption—historically tied to federal levels, and discussed later—help reduce effective rates for lower-income South Carolinians. But by the time a single filer reaches \$70,500 in income, he or she is exposed to some of the highest effective income tax rates in the Southeast, rivaled only (at some income levels) by Arkansas, which is moving forward on a comprehensive tax reform package at the time of this writing.

Table 4.3 shows income tax liability for a single filer (with no dependents) with \$75,000, \$150,000, and \$250,000 in taxable income—middle-class to upper middle-class incomes, and in line with what one might expect from a small business owner—in South Carolina and other states in the Southeast, broadly defined. At every level of taxable income above \$70,500, South Carolina features either the highest or second-highest income tax burden.

FIGURE 4.1.
Top State Marginal Individual Income Tax Rates, 2018

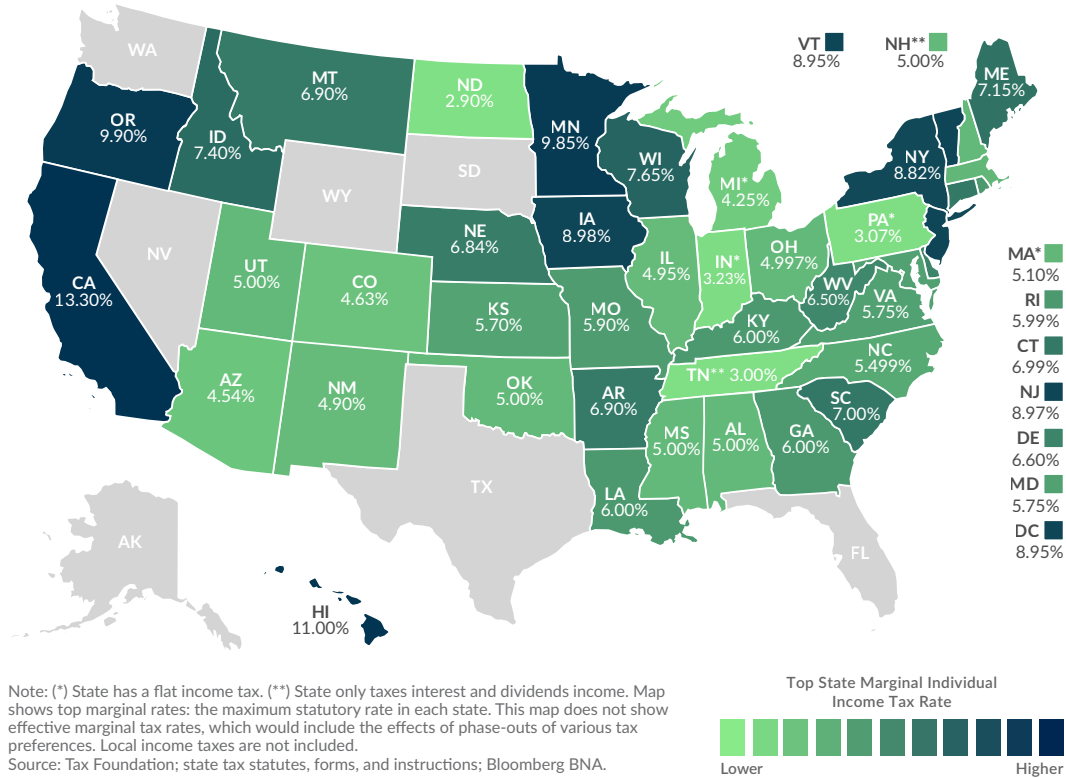


TABLE 4.3.
Income Tax Burdens at Different Levels of Taxable Income (Single Filer)

State	\$75,000	\$150,000	\$250,000
Alabama	\$3,260	\$7,260	\$12,260
Arkansas	\$3,604	\$9,283	\$16,183
Florida	\$0	\$0	\$0
Georgia	\$3,872	\$8,372	\$14,372
Kentucky	\$3,622	\$7,372	\$12,372
Louisiana	\$2,980	\$7,480	\$13,480
Maryland	\$3,263	\$6,826	\$11,576
Mississippi	\$3,155	\$6,905	\$11,905
North Carolina	\$3,643	\$7,767	\$13,266
South Carolina	\$4,013	\$9,263	\$16,263
Tennessee	\$0	\$0	\$0
Virginia	\$3,829	\$8,142	\$13,892
West Virginia	\$3,350	\$8,225	\$14,725

Note: Maryland calculation does not include local income taxes, which can be substantial.
 Source: Author's calculations.

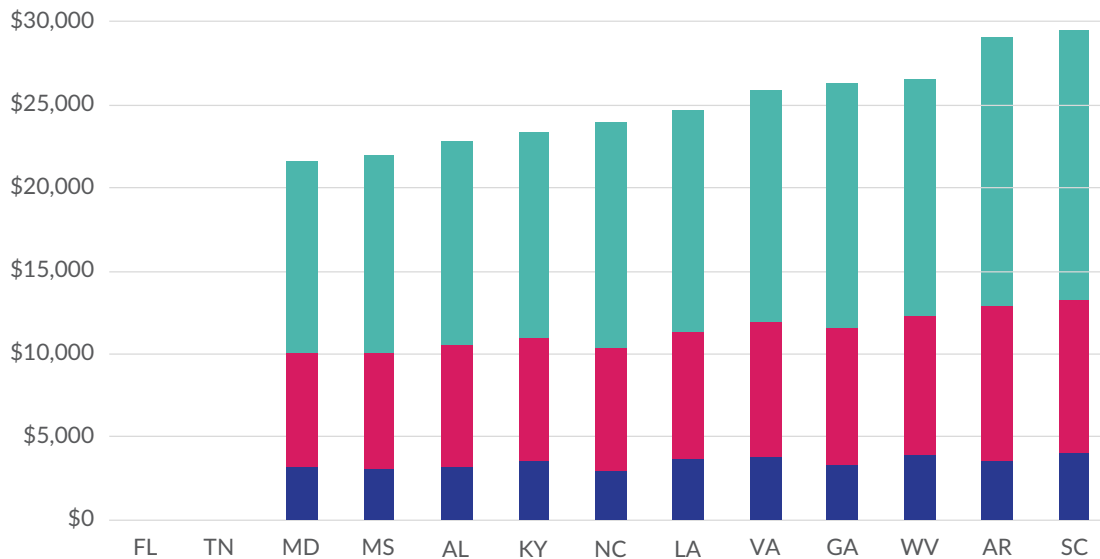
At \$75,000 in taxable income, the effective rate in South Carolina is 5.4 percent, compared to 4.6 percent for other Southeastern states which impose an individual income tax.⁸¹ At \$250,000, the South Carolina effective rate is 6.5 percent, compared to 5.4

81 Florida and Tennessee do not tax earned income and are excluded from these calculations.

percent in the rest of the region. Below-average per capita incomes can give the mistaken impression that South Carolina's effective rates are low; in fact, they are anomalously high, and this matters for many taxpayers, particularly small business owners.

FIGURE 4.2.

Income Tax Burdens at Different Levels of Taxable Income (Single Filer)



Note: Maryland calculation does not include local income taxes, which can be substantial.
Source: State statutes; Tax Foundation calculations

Excessive taxes on income are generally less desirable than taxes on consumption because they discourage wealth creation. In a comprehensive review of international econometric tax studies, Arnold et al. (2011) found that individual income taxes are among the most detrimental to economic growth, outstripped only by corporate income taxes. The authors found that consumption and property taxes are the least harmful.⁸²

The economic literature on graduated-rate income taxes is particularly unfavorable.⁸³ The Arnold et al. study concluded that reductions in top marginal rates would be beneficial to long-term growth, and Mullen and Williams (1994) found that higher marginal tax rates reduce gross state product growth. This finding even adjusts for the overall tax burden of the state, lending credence to the precept of broad bases and low rates.⁸⁴

Marginal tax rates, defined as the rate on the last dollar of income earned, matter because they are the rates at which decisions are made. As an analysis by the South Carolina Department of Commerce noted in 2010, “[I]t is possible for individuals qualifying for substantial deductions and exemptions to face a moderate average tax on income but also face a high marginal tax on any activities that increase income, investment, or entrepreneurship.”⁸⁵

82 Arnold, Jens, Bert Brys, Christopher Heady, Åsa Johannsson, Cyrille Schwellnus, and Laura Vartia. “Tax Policy for Economic Recovery and Growth,” *The Economic Journal* 121:550 (February 2011).

83 See William McBride, “What is the Evidence on Taxes and Growth?” Tax Foundation, Dec. 18 2012, <http://taxfoundation.org/article/what-evidence-taxes-and-growth>.

84 Mullen, John, and Martin Williams, “Marginal Tax Rates and State Economic Growth,” *Regional Science and Urban Economics* 24:6 (1994).

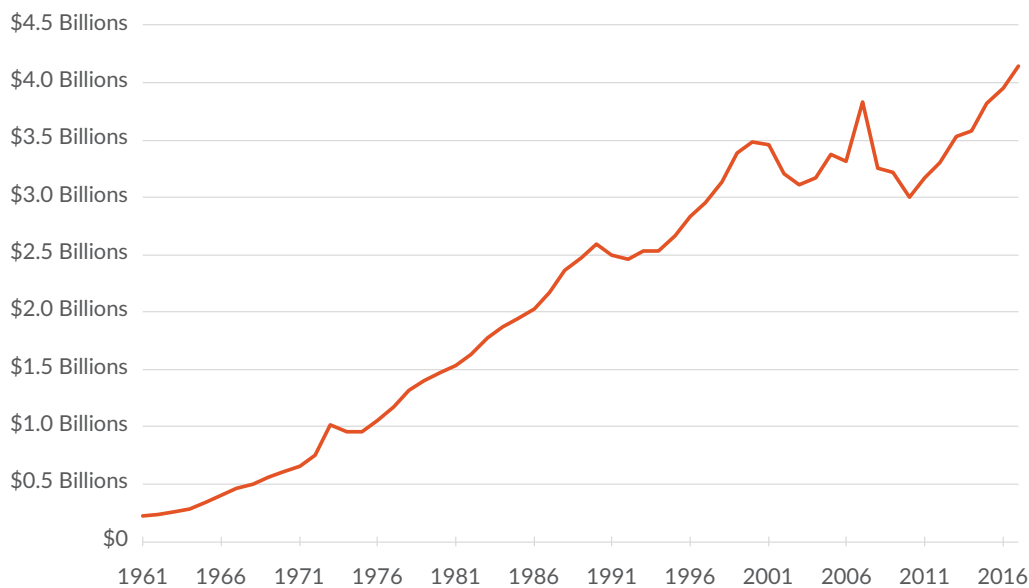
85 South Carolina Department of Commerce, “Personal Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina,” 1.

With reference to a substantial literature on this point, the Department's analysis concludes that "higher marginal tax rates may not simply incentivize people to work less, but they may also induce people to acquire less training (human capital) or accept easier but less productive jobs."⁸⁶ Which is why it matters that South Carolina's top marginal rate is the region's highest, even if some taxpayers may face modest overall burdens due to deductions and exemptions.

Individual Income Tax Collections

Individual income tax collections have grown significantly through the years, but have seen sizable swings, dipping notably during recessionary periods.

FIGURE 4.3.
South Carolina Individual Income Tax Collections (1961-2017, in 2017 Dollars)



Note: Dollar amounts are inflation-adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2017 base year. Source: Census Bureau, *State and Local Government Finances*; Bureau of Labor Statistics, *Consumer Price Indexes (All Urban Consumers)*.

Individual income taxes accounted for 42 percent of state tax collections in 2017, representing the largest single source of state tax revenue.⁸⁷ Distributionally, South Carolina's income tax looks as if it has two rates, one at 0 percent and the other at 7 percent. Since the top marginal rate kicks in at less than \$15,000, its distribution is very nearly proportional for taxpayers in most income classes, though the lowest classes of taxable income face little to no liability.⁸⁸

86 Id., 2.

87 U.S. Census Bureau, "State Government Tax Collections, FY 2017."

88 South Carolina Department of Revenue, "2015-2016 Annual Report," 2016, 12, https://dor.sc.gov/resources-site/publications/Publications/2015-2016_Annual_Report.pdf.

In tax year 2015, 42 percent of all returns had no tax liability,⁸⁹ up from 27 percent in 2000.⁹⁰ Meanwhile, 55 percent of all tax liability was concentrated in 7.7 percent of returns.⁹¹ A Department of Revenue analysis conducted on the previous year's returns found that 99.6 percent of tax liability was concentrated in the top half of returns, and 87.3 percent in the top quarter.⁹²

TABLE 4.4.

Share of Taxable Income and Tax Liability by Income Group (Tax Year 2015)

Income Class	Tax Returns		State Taxable Income		State Tax Liability	
	Number	Percentage	Amount	Percentage	Amount	Percentage
\$0	745,880	33.1%	-\$26,345,388	0.0%	\$35,072,428	1.0%
\$1-\$9,999	450,964	20.0%	\$1,955,696,174	3.2%	\$32,486,544	0.9%
\$10,000-24,999	370,529	16.4%	\$6,224,683,562	10.2%	\$248,427,367	7.2%
\$25,000-\$49,999	320,835	14.2%	\$11,514,225,597	18.8%	\$613,597,557	17.8%
\$50,000-\$74,999	158,235	7.0%	\$9,688,142,714	15.8%	\$559,287,726	16.2%
\$75,000-\$99,999	84,268	3.7%	\$7,257,492,678	11.9%	\$432,970,640	12.5%
\$100,000-\$199,999	92,810	4.1%	\$12,375,640,256	20.2%	\$761,925,172	22.1%
\$200,000-\$499,999	24,486	1.1%	\$7,004,576,682	11.4%	\$449,397,913	13.0%
\$500,000+	4,950	0.2%	\$5,205,624,339	8.5%	\$321,425,595	9.3%
Totals	2,252,957	100.0%	\$61,199,736,614	100.0%	\$3,454,590,942	100.0%

Source: South Carolina Department of Revenue.

Structural Elements

With the exception of indexation of brackets, South Carolina's current individual income tax structure has changed only modestly since 1959. Inflation indexing, which was first introduced four decades ago before being suspended and reintroduced more recently, is designed to avoid "bracket creep," where inflation erodes the value of the lower brackets, leaving taxpayers with more of their income subject to higher marginal rates. Until 2018, South Carolina only allowed an adjustment worth half the inflation adjustment determined by the Internal Revenue Service, with a cap of 4 percent, guaranteeing that some bracket creep takes place.⁹³

89 Id., 11.

90 South Carolina Department of Commerce, "Personal Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina," 7.

91 South Carolina Department of Revenue, "2015-2016 Annual Report," 11.

92 South Carolina Revenue and Fiscal Affairs Office, "SC Individual Income Tax Distribution," Dec. 9, 2016, 1, <http://rfa.sc.gov/files/SC%20Individual%20Income%20Tax%20Distribution%2C%202004%20and%202014.pdf>.

93 S.C. Code Ann. § 12-6-520.

As part of tax conformity legislation adopted in late 2018, the state now offers a full inflation adjustment, though it remains capped at 4 percent. As noted earlier, had brackets been inflation-adjusted since the current top marginal rate was adopted in 1959, the kick-in would be \$85,941, not \$14,860.

A “zero bracket,” which imposes no tax on the first \$2,970 of taxable income, provides a tax savings of about \$74. Additionally, the state currently offers a standard deduction of \$6,350, with a personal exemption of \$4,050, in line with federal levels before the adoption of the Tax Cuts and Jobs Act in 2017. Were the state to conform to current federal law without modification, the standard deduction for single filers would increase to \$12,000, while the personal exemption would be eliminated.

TABLE 4.5
South Carolina’s Current Income Tax Rate Schedule (2018)

3.0%	>	\$2,970
4.0%	>	\$5,940
5.0%	>	\$8,910
6.0%	>	\$11,880
7.0%	>	\$14,860

Source: South Carolina Department of Revenue.

Internal Revenue Code Conformity

For reasons of administrative simplicity, states frequently seek to conform many, though rarely all, elements of their state tax codes to the federal tax code. This harmonization of definitions and policies reduces compliance costs for individuals and businesses with liability in multiple states and limits the potential for double taxation of income.⁹⁴ No state conforms to the federal code in all respects, and not all provisions of the federal code make for good tax policy, but greater conformity substantially reduces tax complexity and has significant value.

South Carolina begins its income tax calculations with federal taxable income, one of only six states to do so. Twenty-nine states and the District of Columbia begin with federal adjusted gross income, while the remaining states which tax wage income use state-specific definitions of income, although they do selectively incorporate some provisions of the Internal Revenue Code.⁹⁵

Electing federal taxable income as a starting point for state income taxes has the effect of incorporating federal standard and itemized deductions, the personal exemption (now zeroed out), and a new deduction for qualified pass-through business income, unless the state expressly decouples from these provisions. States which begin with adjusted gross income do not capture these federal provisions unless they expressly conform to them by statute.

⁹⁴ Ruth Mason, “Delegating Up: State Conformity with the Federal Tax Base,” *Duke Law Journal* 62:7 (April 2013), 1269–1270.

⁹⁵ Jared Walczak, “Tax Reform Moves to the States: State Revenue Implications and Reform Opportunities Following Federal Tax Reform,” Tax Foundation, Jan. 31, 2018, 5-6, <https://taxfoundation.org/state-conformity-federal-tax-reform>.

Some states have “rolling” conformity, meaning that they automatically conform to relevant changes made to federal law. South Carolina, however, has “static” (or “fixed-date”) conformity, meaning that while state law relies on federal definitions of taxable income, it does so for those definitions as they existed on a certain date. In a special session, legislators adopted a tax conformity bill which adopts most individual income tax provisions of the new federal law, including the new higher standard deduction. Because most states, including South Carolina, stood to generate additional revenue due to the base-broadening provisions of federal tax reform, the conformity bill also adds a \$4,110 state tax deduction for dependents, doubled for children under the age of six.

Marriage Penalty

Because the individual income tax brackets are identical for single and joint filers, South Carolina’s income tax contains a “marriage penalty,” with married couples paying more in taxes when filing jointly than they would if they filed separately.

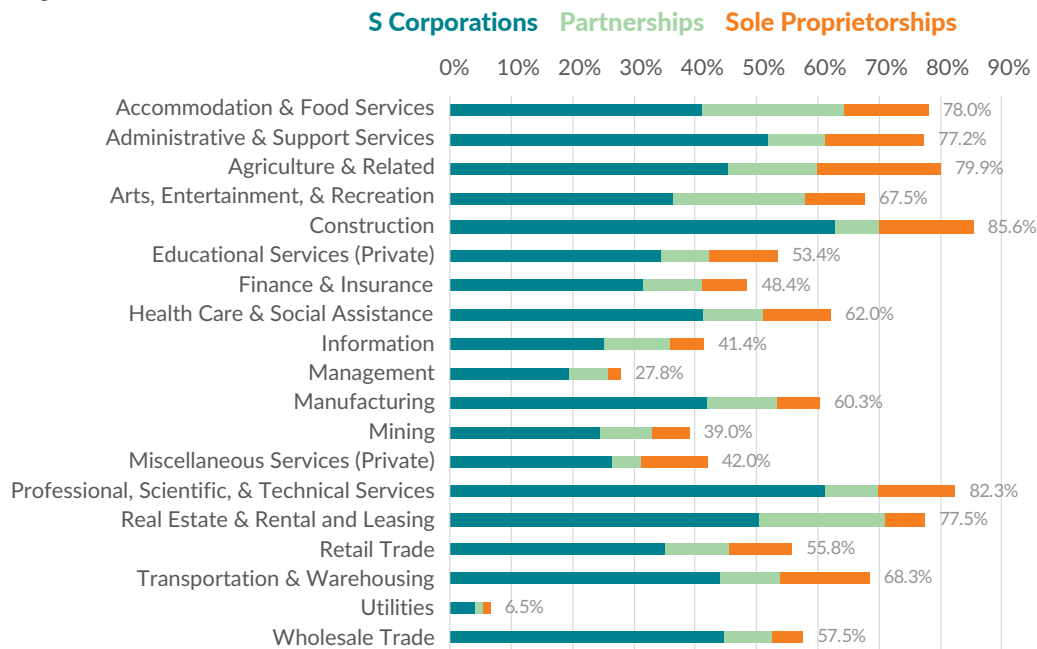
Filers in South Carolina must select the same filing status at the federal and state level, so a married couple opting to file separately loses the advantage of many tax provisions, at both levels of taxation, that would otherwise be available to them. Those filing jointly are eligible for a two-earners credit intended to reduce the impact of the marriage penalty, but the offset is only partial. The credit is worth 0.7 percent of either the earned income of the lower earner or \$50,000, whichever is less. That makes the maximum value of the credit \$350, yet for any couple where both spouses have more than \$14,860 in taxable income, the marriage penalty runs \$509.

If the spouse with the lower salary makes \$25,000, the credit offsets \$175 of that \$509 (34 percent). At \$50,000, \$350 is offset (69 percent). At no point does the credit make married taxpayers whole. While inflation indexing the brackets protects against “bracket creep,” moreover, it also has the effect of increasing the marriage penalty. In 2015, 842,175 couples (1.68 million taxpayers) filed joint returns, representing 55 percent of all taxpayers in the state. Most of them paid more than they would have were they not married.⁹⁶

Preferential Rate for Pass-Through Businesses

Individual income taxes are of considerable importance to pass-through entities, businesses that pay the individual income tax in lieu of the corporate income tax because the earnings “pass through” to the income tax form of the owners or shareholders rather than being remitted by the business entity itself. Because S corporations, partnerships, sole proprietorships, and limited liability corporations (LLCs) remit their income tax payments through the individual income tax, the individual code is a significant policy issue for the majority of South Carolina businesses. Figure 4.4 shows the share of employer firms in each sector that pay individual income taxes in South Carolina (separated by type).⁹⁷

FIGURE 4.4.
South Carolina Employer Businesses Subject to the Individual Income Tax



Note: Does not include non-employer firms.
Source: Census Bureau, *County Business Patterns*.

In South Carolina, pass-through businesses receive a preferential 3 percent flat income tax rate on “active trade or business income,” in lieu of the graduated rate structure that applies to other income.⁹⁸ The provision is relatively new, with two sets of phase-ins, the first beginning in 2006.⁹⁹ Ostensibly, this is to enhance competitiveness for small businesses, a worthy goal, as well as to bring pass-throughs to parity (or better) with C corporations subject to the state’s corporate income tax. In practice, the result is a marked preference for pass-through businesses, as the rate is not only lower (3 percent compared to 5 percent), but C corporations face multiple layers of tax, first at the entity level and then when income is distributed.

97 U.S. Census Bureau, “County Business Patterns, Geographic Area Series: County Business Patterns by Legal Form of Organization,” 2016.

98 S.C. Code Ann. § 12-6-545.

99 South Carolina Department of Commerce, “Corporate Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina,” 2010, 3.

Pass-through businesses earned \$3.7 billion in business and professional net income in South Carolina in 2016,¹⁰⁰ and the preferential rate saved them more than \$100 million in state tax liability. Were the state to conform to the new 20 percent deduction for qualified pass-through income created by the Tax Cuts and Jobs Act, this would double down on the policy, creating an effective rate of 2.4 percent on qualifying income.

Traditional C corporations care about individual income tax rates as well, since high rates can impede their ability to attract and retain talented employees. In our conversations with business leaders in South Carolina, the individual income tax came up more frequently than the corporate income tax, with many expressing the belief that the state's high individual income tax rate is a deterrent for their potential employees and their suppliers, and thus undermines their own competitiveness.

Tax Expenditures

Individual Income Tax Credits

Although tax credits reduce the state's individual income tax base by nearly 10 percent—theoretically sufficient to fund a top rate reduction of as much as 0.9 percentage points—the overwhelming share of credits are either necessary to reach a proper definition of income or represent social welfare spending likely to enjoy high levels of political support. In tax year 2015, tax credits reduced collections by \$378 million, but \$242 million of this was subsumed by a credit for taxes paid to other states (necessary to avoid double taxation, with two states claiming the same income) and another \$50 million devoted to the two-wage-earner credit, intended as a partial offset of the state's marriage penalty.

Another \$22 million was devoted to child care program credits, claimed in small amounts by nearly 122,000 taxpayers. An earned income tax credit, not yet in place when the last tax expenditure study was published, is currently phasing in. The remaining credits, many of them intended for pass-through businesses for economic development purposes and available (to far greater effect) against the corporate income tax, merit scrutiny, though their reduction in individual income tax collections is too modest to offset major rate or other tax changes.

Economic development tax credits tend to be inefficient and diverge from principles of tax neutrality. Because these credits only play a modest role in individual income taxes, discussion is reserved to the corporate income tax chapter, though the same principles apply here. In tax year 2015, the most recent year for which a full accounting of tax credits is available, 16 credits cost the state \$1 million or more in income tax collections. They are listed in the table below.

TABLE 4.6.

Tax Credits Claimed Against Individual Income Tax Liability

Credit	Claims	Amount
Taxes Paid to Other States	94,968	\$241,908,465
Two-Wage-Earner Credit	366,140	\$50,089,714
Child Care Program Credit	121,870	\$21,764,367
Educational Credit for Exceptional Needs Children	542	\$7,595,052
Qualified Conservation Contribution Credit	254	\$5,618,120
Industry Partnership Fund Credit	260	\$5,439,654
New Jobs Credit	501	\$4,627,997
Textile Rehabilitation Credit	122	\$4,222,823
Solar Energy or Small Hydropower System Credit	659	\$2,841,790
Angel Investor Credit	203	\$2,636,227
Excess Insurance Premium Credit	2,708	\$2,616,151
Abandoned Buildings Revitalization Credit	79	\$2,253,044
Certified Historical Structure Credit	50	\$1,774,680
Research Expenses Credit	375	\$1,601,346
Economic Impact Zone Investment Tax Credit	174	\$1,318,780
Certified Historical Residential Structure Credit	45	\$1,162,513
All Others	8,016	\$25,108,555
Total	596,844	\$378,356,455

Source: South Carolina Department of Revenue

Notably, in 2017 the state adopted an Earned Income Tax Credit (EITC) that will ultimately reach 125 percent of the value of the federal credit, an astonishing amount. The provision is being phased in over six years, beginning with a credit worth 20.83 percent of the federal amount in 2018.¹⁰¹ The credit is nonrefundable, meaning that it can reduce a family's tax liability to zero but cannot result in the state writing a check.

Most states with earned income tax credits offer them at small fractions of the value of the federal credit. Maryland offers a nonrefundable credit worth 50 percent of the federal credit, and California offers one at 85 percent, but only available for half the federal phase-in range, functionally yielding a match of less than 50 percent.¹⁰² When fully phased in, South Carolina's EITC will be two and a half times as generous as the next-largest state program, and more than 40 times the size of the least generous program.

101 S.C. Code Ann. § 12-6-3632.

102 National Conference of State Legislatures, "Tax Credits for Working Families: Earned Income Tax Credit (EITC)," April 17, 2018, <http://www.ncsl.org/research/labor-and-employment/earned-income-tax-credits-for-working-families.aspx>.

TABLE 4.7.
State EITC Credits as a Percentage of the Federal Credit

State	Percentage of Federal Credit	Refundable?
California	85% up to half phase-in range	Yes
Colorado	10%	Yes
Connecticut	30%	Yes
Delaware	20%	No
Hawaii	20%	No
Illinois	10%	Yes
Indiana	9%	Yes
Iowa	15%	Yes
Kansas	17%	Yes
Louisiana	3.5%	Yes
Maine	5%	Yes
Maryland	50%	No
Massachusetts	23%	Yes
Michigan	6%	Yes
Minnesota	Separate Schedule	Yes
Montana	3%	Yes
Nebraska	10%	Yes
New Jersey	35%	Yes
New Mexico	10%	Yes
New York	30%	Yes
Ohio	10% with limitations	No
Oklahoma	5%	No
Oregon	8%	Yes
Rhode Island	15%	Yes
South Carolina	125% in 2023	No
Vermont	32%	Yes
Virginia	20%	No
Washington	10%	Yes
Wisconsin	Up to 34%	Yes
District of Columbia	40%	Yes

Source: National Conference of State Legislatures.

Functionally, a tax credit at 125 percent of the federal credit (designed, of course, around a system with far higher tax rates than states impose) should eliminate all income tax liability for practically any filer eligible for even a modest EITC benefit. A married couple with two children would not be too far south of \$50,000 in household income when they faced their first dollar of state income tax liability. Such households, of course, already benefit from many of the other deductions and exemptions South Carolina offers.

Tax Deductions and Exemptions

South Carolina provides a deduction equal to 44 percent of net capital gains,¹⁰³ a policy with similar scale and effect to the preferential rate for capital gains afforded at the federal level. For federal tax purposes, long-term capital gains rates range from 0 to 20 percent based on tax bracket and reduce capital gains income tax liability by 45.9 percent for filers facing the top marginal rate. The provision reduces tax collections by about \$25 million a year.¹⁰⁴

The first \$10,000 in income from qualified retirement accounts is deductible for taxpayers 65 or older, or \$3,000 for younger retirees.¹⁰⁵ Senior citizens are also eligible for a \$15,000 income exemption separate from the exemption of retirement income, and the state exempts Social Security benefits and all disability retirement income.¹⁰⁶ An exemption for children under the age of six is linked to the personal exemption, and could be zeroed out in conformity.¹⁰⁷

103 S.C. Code Ann. § 12-6-1150.

104 South Carolina Board of Economic Advisors, "Estimated Tax Expenditures," multiple years.

105 S.C. Code Ann. § 12-6-1170.

106 S.C. Code Ann. § 12-6-1140.

107 S.C. Code Ann. § 12-6-1160.

Individual Income Tax Reform Solutions

Our individual income tax solutions would enhance South Carolina's competitiveness by simplifying the tax code, with a goal of greater neutrality, targeting a broader base and lower rate.

Roll Back Tax Incentives

In 2015, South Carolina handed out \$31 million in credits to small businesses, along with a variety of social credits of varying significance. Since credits cost money to administer, credits with little uptake should be reviewed alongside the scrutiny of economic development incentives to determine whether they provide a suitable return on investment. For instance, South Carolina offers a \$50 tax credit (\$25 each) for couples who receive premarital counseling, a noble cause but one which saw only 38 takers in 2015. An ethanol and biodiesel production credit on the books disbursed a mere \$1,775, while fewer than five filers took a credit for installing fire sprinkler systems (for privacy reasons, the number is not recorded if there are fewer than five credit recipients).¹⁰⁸

Cap the Earned Income Tax Credit

The earned income tax credit can be a valuable tool for providing low-income family assistance structured in a way that rewards and facilitates work. It can be especially valuable if lawmakers opt for the simplicity of a single-rate tax, as it introduces a significant element of progressivity for the taxpayers who need it most. Especially pared with broader income tax reform, therefore, the EITC can represent good policy. However, 44 percent of filers in South Carolina already pay no income tax, and if the EITC is permitted to expand to 125 percent of the federal amount—an amount intended to offset far higher federal tax liability—the median *household* in South Carolina will be just on the cusp of having any income tax liability.

While limiting liability for lower- and middle-income South Carolinians may be desirable, that is an astonishingly large exclusion, perhaps unrivaled in the rest of the country. It must be considered, moreover, in the context of a broader tax environment where homeowners—many of them with school-age children—are also excluded from paying for school operating costs through their property taxes. The new EITC may be a positive development, but it should not be allowed to phase all the way up to an unprecedented 125 percent of the federal EITC.

Truly Eliminate the Marriage Penalty

The two-earners credit was intended to address the marriage penalty created by the state's failure to double bracket widths for joint filers, but the credit does not actually make taxpayers whole. Lawmakers should consider finishing the job—the right way—by replacing the credit with a joint filer scheduler with doubled bracket widths. The adoption of a single-rate tax also eliminates the marriage penalty by definition.

108 South Carolina Department of Revenue, "2015-2016 Annual Report," 15-16.

Eliminate the Inflation Indexing Cap

Given its heavy reliance on credits, deductions, and exemptions, South Carolina functionally taxes at two rates: 0 and 7 percent. Because of this, policymakers should give serious consideration to a single-rate tax which eliminates the complexity associated with the current system. However, should a graduated-rate income tax be maintained, inflation indexing of brackets should be allowed to run with inflation—without a cap.

Lower and Flatten Tax Rates and Brackets

South Carolina's 7 percent top marginal rate is uncompetitive and the state's income tax is too heavily carved out. Existing proposals, including one considered by lawmakers in early 2018,¹⁰⁹ would have imposed a flat 4.85 percent income tax on a revenue-neutral basis by eliminating nearly all credits, deductions, and exemptions except for a \$10,000 standard deduction (\$20,000 for joint filers) and personal exemptions of \$4,150 per person. There is much to commend in this approach, and we include it as an option. In our scenario, however, we nudge the flat rate up to 5 percent and set the standard deduction at the newly adopted \$12,000 level, reflecting the fact that the original proposal anticipated capturing tax conformity revenue that has since been put to other purposes (including a higher standard deduction).

Policymakers could also consider a higher single rate to pay for the cost of a more generous standard deduction (matching the new federal level of \$12,000), the restored personal exemption, and the earned income tax credit at its current federal match (20.83 percent). We estimate that, on a revenue-neutral basis, this would require a single rate of about 5.4 percent, with progressivity maintained through the very generous standard deduction, personal exemption, and EITC.

The current governor has proposed a five-year reduction in individual income tax rates, ultimately resulting in an across-the-board 1 percent rate cut, to be paid for by restricting the growth of government over that period. We consider that proposal, and also explore what would happen if a phasedown with a similar dollar value were applied against a flat rate tax with the provisions described previously. We estimate that, over five years, this would permit a 4.35 percent flat rate while retaining the standard deduction, personal exemption, and EITC. These two options are not revenue neutral, though they could be achievable through lower rates of government growth over time or through offsets from sales tax base broadening or other reforms elsewhere.

As part of a package lowering rates overall, policymakers might also consider eliminating the preferential rate for pass-through businesses or bringing that rate to 5 percent (in line with the corporate income tax rate) under a proposal where the flat rate is higher than 5 percent.

109 S.C. Legis., H 5203, Sess. 122 (2017-2018).

A single-rate tax, which has the ancillary benefit of fixing the inflation indexing problem and eliminating the marriage penalty, would result in a dramatic improvement in South Carolina's ranking on the *State Business Tax Climate Index*, both on the individual income tax component and overall.

TABLE 4.8.
Index Ranks for Rate Reduction Options

Reform Option	Overall Rank	Component Rank
Current System	35th	34th
6.00% Top Rate (1% across the board cut after phasedown)	32nd	32nd
5.70% Flat Tax with \$12K Std. Ded., PE, and 20.83% EITC	18th	12th
4.95% Flat Tax with \$10K Std. Ded. (repealing most other preferences)	17th	10th
4.65% Flat Tax (after phase-down) with \$12K Std. Ded., PE, and EITC	17th	10th

Source: Author's calculations



CHAPTER 5

**SALES AND
ACCOMMODATIONS
TAXES**

Introduction

South Carolina did not impose a sales tax until 1951, when it was levied, at a rate of 3 percent, to help fund education. Since then, the rate has been increased three times, reaching 6 percent in 2007. That state rate has three components: a 4 percent base rate with revenues to the general fund, an additional 1 percent under the Education Improvement Act to support elementary and secondary education, and a further 1 percent under the 2007 “tax swap” which dedicates revenue to the Homestead Exemption Fund to offset revenue losses due to property tax relief under Act 388 (discussed elsewhere).

TABLE 5.1.
State Sales Tax Rate History

Year	Rate
1951	3%
1970	4%
1984	5%
2007	6%

Source: South Carolina Department of Revenue.

In addition to the state sales tax, South Carolina authorizes a dizzying eight different local option sales taxes, not even counting hospitality and accommodations taxes,¹¹⁰ though most jurisdictions only impose a couple of local sales taxes at any given time. “Robin Hood” provisions provide for a measure of revenue sharing across jurisdictions from local sales tax collections, which has limited the popularity of local sales tax options in localities likely to be “donor” jurisdictions.

The sales tax base is carved out in many ways, but in addition to the exclusion of some tangible goods and most services, there are also caps on the maximum amount of sales taxes payable on particular transactions, most notably vehicles.

South Carolina’s sales tax faces challenges common to many of its regional competitors: a shrinking tax base, limited taxation of the service sector, constraints on collecting taxes on remote transactions, and uncertainty over tax definitions and administration. In recent years, legislators, policy organizations, and the Taxation Realignment Commission (TRAC) have contemplated sales tax base broadening to include some or most services, but these proposals failed to gain traction.

In this chapter, we provide a general overview of South Carolina’s sales tax system and offer recommendations for modernizing the sales tax. We explore the state’s current sales tax structure, place South Carolina’s sales tax in both a regional and national context, consider the state’s treatment of business inputs, explore options for expanding the base to include additional services, and review requirements incumbent upon the state as it moves forward with remote sales tax collections. We also consider local accommodations taxes in this chapter, since they are imposed on an *ad valorem* basis.

110 Municipal Association of South Carolina, “Overview of Local Sales and Use Taxes in South Carolina,” Appalachian Council of Governments presentation, Feb. 28, 2014, <http://www.scacog.org/Portals/9/Local%20Sales%20Tax%20Presentation%20-%20February%202014.pdf>.

We conclude the chapter by outlining proposals for reform, including a menu of sales tax base expansion options.

Sales Tax Collections

Sales taxes are a significant driver of state revenue but only a modest source of local government revenue despite the wide range of local option sales taxes available in the state, accounting for 34.2 percent of total state tax collections and 6.7 percent of local tax collections.¹¹¹ In fiscal year 2016, South Carolina state and local governments raised \$3.8 billion in state and local sales taxes, \$3.3 billion of which went to state coffers. According to state sources, the local option sales tax raised \$414 million that year, more than four times the amount raised by all other local sales tax add-ons combined.¹¹²

South Carolina is in line with its regional peers in reliance on the sales tax as a percentage of state revenue, but with the Southeast as a whole deriving more than 18 percent of local revenue from sales taxes, South Carolina stands out by leaning much more heavily on property tax, business license tax, and other local taxes.¹¹³ The state's narrow sales tax base—discussed later—and state-heavy rates (compare Georgia, where 45 percent of the rate is local, or North Carolina, where 32 percent is local, to South Carolina, at 19 percent) make local sales taxes a fairly modest source of local government funding.

The narrow base affects state revenue as well, but South Carolina still derives a slightly above-average share of state sales tax collections from a middle-of-the-pack 6 percent rate. This is because other taxes, particularly the individual income tax, also underperform. A low-income state yields low-income tax collections, particularly under a progressive structure which carves out the income of many lower-income earners.

Local sales tax collections have risen from an inflation-adjusted \$43 million in 1992, the first year the local option sales tax was available, to about \$500 million today, reflecting the increased uptake of the tax among jurisdictions.

The state sales tax, meanwhile, has performed inconsistently. Although sales taxes tend to be more stable than income taxes, the problem in South Carolina is not volatility so much as gradual erosion as fewer and fewer transactions are subject to the tax. In Figure 5.1, the effect of recessions, including the Great Recession, can be seen, and these are important. However, from a policy perspective, they are less significant than the overall trend given that the state's population is growing so rapidly.¹¹⁴

111 This does not include selective sales (excise) taxes like the gas tax or cigarette tax but does include special purpose sales taxes in addition to the local option sales tax.

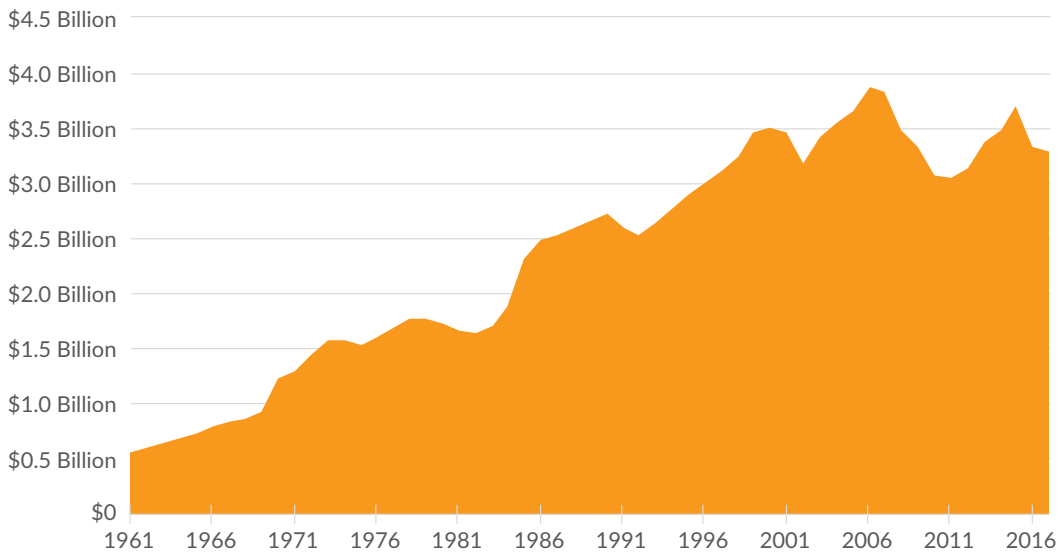
112 South Carolina Revenue and Fiscal Affairs Office, "2016 Local Government Finance Report," revised Jan. 12, 2018, <http://rfa.sc.gov/econ/localgovt>.

113 Jared Walczak, "Unpacking the State and Local Tax Toolkit: Sources of State and Local Tax Collections," Tax Foundation, June 20, 2017, <https://taxfoundation.org/toolkit-sources-state-local-tax-collections/>.

114 U.S. Census Bureau, "State Government Tax Collections," multiple years.

In real terms, collections are the same as they were a decade ago, even though the state's population has grown 13 percent over that period. Economies recover from recessions, but South Carolinians aren't returning to the more goods-heavy economy for which the state's sales tax is built. Rate increases have boosted collections temporarily, but only a modernization of the sales tax base can reverse this negative trend.

FIGURE 5.1.
Sales Tax Collections, 1961-2017 (in 2017 dollars)



Source: U.S. Census Bureau

Sales Tax Rate Composition

As of July 2018, South Carolina has an average combined state and local sales tax rate of 7.43 percent, which is high nationally but fairly typical of southern states.¹¹⁵ It is somewhat higher than the rates in neighboring Georgia (7.23 percent) and North Carolina (6.95 percent), and exceeds the rates imposed in Florida (6.80 percent) and Virginia (5.65 percent). It is much lower than Tennessee's combined average rate of 9.46 percent, however, as well as the rates of some other southern states like Louisiana (9.45 percent) and Alabama (9.15 percent).

TABLE 5.2.
Average Combined State and Local Sales Tax Rates

South Carolina and Select Regional Competitors (2018)

State	State Rate	Avg. Local Rate	Combined Rate
South Carolina	6.0%	1.43%	7.43%
Florida	6.0%	0.80%	6.80%
Georgia	4.0%	3.23%	7.23%
North Carolina	4.75%	2.20%	6.95%
Tennessee	7.0%	2.46%	9.46%
Virginia	5.3%	0.35%	5.65%

Note: Average local rates are population-weighted.
Sources: Sales Tax Clearinghouse; Tax Foundation calculations.

115 Jared Walczak and Scott Drenkard, "State and Local Sales Tax Rates, Midyear 2018," July 16, 2018, <https://taxfoundation.org/state-local-sales-tax-rates-midyear-2018/>.

Most states—South Carolina’s regional competitors among them—have a two-part sales tax: a state-level rate that is levied throughout the entire state, and local option sales taxes that are levied in specific jurisdictions or tax districts. South Carolina’s sales tax consists of a 6 percent state rate, a standard local option sales tax of 1 percent, and a variety of additional specific-purpose sales taxes for school district funding, capital projects, transportation, education capital improvement, and tourism development.

Sales Tax Base Composition

Like most states, South Carolina imposes its sales tax on a base that consists of most goods—with economically significant policy carveouts—and exceedingly few services. Most state sales tax bases are narrower than economists would recommend, but South Carolina’s is particularly limited.

South Carolina, under its state sales tax, does not tax food, candy, and soda, or prescription and nonprescription drugs. The state also imposes low caps on the maximum amount of sales tax owed on the purchases of automobiles (currently set at \$500). It thus exempts a sizable and stable portion of consumer spending. The state also exempts most services and select other goods. By law, tangible personal property is included in the sales tax base unless expressly exempted, whereas services are only subject to tax if specifically enumerated.

The enumeration is brief—very brief. For a variety of reasons, the sales tax ultimately reaches a small miscellany of services like telephony, printing, sign construction, and software development,¹¹⁶ where the service is generally taxed in conjunction with the provision of a tangible good, and laundry, dry cleaning, and linen services.¹¹⁷ Otherwise, services are untaxed.

Apples-to-apples comparisons of state sales tax bases are difficult, but one method is to calculate the value of taxed transactions as a percentage of personal income. Hawaii, for instance, has a sales tax breadth of 107 percent of state income.¹¹⁸ The state exempts some transactions which arguably should be taxed, but double-taxes others. South Carolina also exposes some transactions to multiple levels of taxation but omits far more transactions altogether. The state’s sales tax breadth, as a percentage of state income, is an anemic 27.9 percent. A robust sales tax base would not reach 100 percent, as not all income is consumed in any given year, but could tax as much as 75 percent of state income.

Another way of coming at the question of just how much South Carolina carves out of its sales tax base is to multiply all personal consumption in the state (\$169 billion in 2017) by the state sales tax rate of 6 percent, which yields \$10.2 billion in state sales tax collections, more than three times what the state actually collects.¹¹⁹ Even if the sales tax

116 Federation of Tax Administrators, “Sales Taxation of Services, 2017 Update,” August 2017, <https://www.taxadmin.org/sales-taxation-of-services>.

117 S.C. Code Ann. § 12-36-910.

118 Calculation by Prof. John Mikesell, Indiana University, FY 2016.

119 Bureau of Economic Analysis, “Total personal consumption expenditures (PCE) by state (millions of dollars),” GDP & Personal Income series, 2016.

base actually included all final consumer transactions, collections on those transactions would fall short of this figure since the state does not achieve 100 percent tax compliance, but at the same time, the state's current collections also include significant revenue from business to business transactions which do not form a part of personal consumption. Whatever measure is used, the conclusion is inescapable: South Carolina's sales tax is failing to capture the lion's share of consumption.

Much of South Carolina's narrow base owes to the inclusion of relatively few services in the state's sales tax base. Services comprise an ever-larger share of consumer transactions. Combined with pressure to exempt certain other goods from time to time, base erosion is inevitable. As the tax base shrinks, lawmakers may look to rate increases for additional revenue. A better option is to broaden the tax base, which can permit rate reductions even in revenue positive scenarios.

Taxation of Business Inputs

When contemplating broadening the sales tax base, it is important to maintain proper treatment of business inputs. A well-structured sales tax is imposed on all final consumer goods and services while exempting all purchases made by businesses that will be used as inputs in the production process. This is not because businesses deserve special treatment under the tax code, but because applying the sales tax to business inputs results in multiple layers of taxation embedded in the price of goods once they reach final consumers, a process known as "tax pyramiding." The result is higher and inequitable effective tax rates for different industries and products, which is both nonneutral and nontransparent.

Ideally, business inputs would be exempted based upon the identity of the purchaser. In practice, however, states must generally make binary choices which are not always entirely clear-cut, as there are many goods and services which are consumed by businesses and individuals alike. For instance, when a business retains an outside accounting firm, that is clearly a business input, but individuals sometimes hire accountants as well.

Sometimes this conundrum can be resolved, if only imperfectly, by considering typical use. It is true, for instance, that a select few individuals might occasionally rent a cold storage facility or take out advertising, but these services are overwhelmingly purchased by businesses, and the rare exception should not guide policy. A more interesting case arises with goods which are consumed by both businesses and individuals but which, when used by businesses, are not a direct part of the production process.

Businesses and individuals both buy desk chairs and both procure landscaping service. In such cases, exemption certificates are optimal, as they can address the use case of the company ordering a thousand desk chairs. If, however, a sales tax fails to distinguish the ultimate purchaser for goods which are *consumed* by the business rather than used in the course of production and sale (equipment, machinery, raw materials, packaging, advertising, etc.), the consequent tax pyramiding may still be modest.

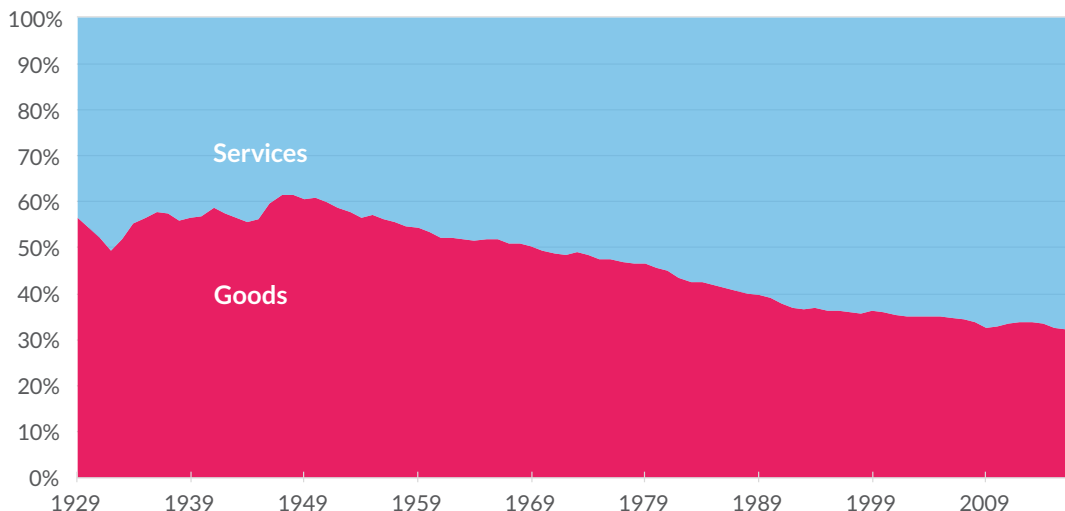
Nonprofits and agricultural purchasers are often granted exemption certificates which exempt transactions from tax based on the purchaser's identity rather than a determination of whether the good or service is most likely to be purchased by a business or a consumer. The chief shortcoming of exemption certificates is the administrative hassle they create for the state, the seller, and the purchaser alike. A policy of exempting transactions which are overwhelmingly or exclusively business inputs, while allowing exemption certificates to be used to avoid tax on mixed-use goods and services when the purchaser is a business, represents the best available policy option.

While most states make some effort to exclude business inputs from taxation, few do so consistently or uniformly. It has been estimated that 17 percent of total business taxes paid in South Carolina are general sales taxes, and that as much as 37 percent of sales tax collections come from business payers.¹²⁰ In a perfectly structured tax code, that share would be zero. The state has taken steps to address the taxation of business, exempting machinery, equipment, raw materials, and repair parts from the sales tax. Nevertheless, other inputs continue to be subject to the tax. In some cases, as with purchases of material-handling equipment, the exemption is only available to the largest manufacturers.¹²¹ These shortcomings undermine tax neutrality and allow tax costs to be embedded in the final price of goods several times over.

Taxation of Services

Another major contributing factor to the shrinking sales tax base over time—in South Carolina and elsewhere—is that American consumption habits have shifted over the years. Whereas the U.S. economy was heavily weighted towards goods when sales taxes were first imposed, today the economy is increasingly service-oriented. Figure 5.2 shows national goods and services consumption shares since 1929.

FIGURE 5.2.
Percentage of Personal Consumption Expenditures on Goods and Services



Source: Bureau of Economic Analysis, National Income and Product Accounts, "Personal Income and Outlays."

120 Jason Horwitz and Brian Peterson, "2017 State Business Tax Burden Rankings," Anderson Economic Group, April 17, 2017, www.andersoneconomicgroup.com/Portals/0/AEG%20Tax%20Burden%20Study_2017_FINAL.pdf.

121 South Carolina Department of Commerce, "Business Incentives," January 2005, 10-11.

As mentioned previously, South Carolina’s sales tax breadth, at just under 27.9 percent of state income in fiscal year 2016, is well below the U.S. median rate of 35.9 percent or average of 37.3 percent.¹²² Among regional competitors, only Virginia has a narrower base. Failure to modernize the state sales tax base presages continued erosion and commensurate pressure to raise rates. Unsurprisingly, sales tax base broadening has been considered by several of the state’s tax reform commissions and studies through the years, including the Taxation Realignment Commission (TRAC).

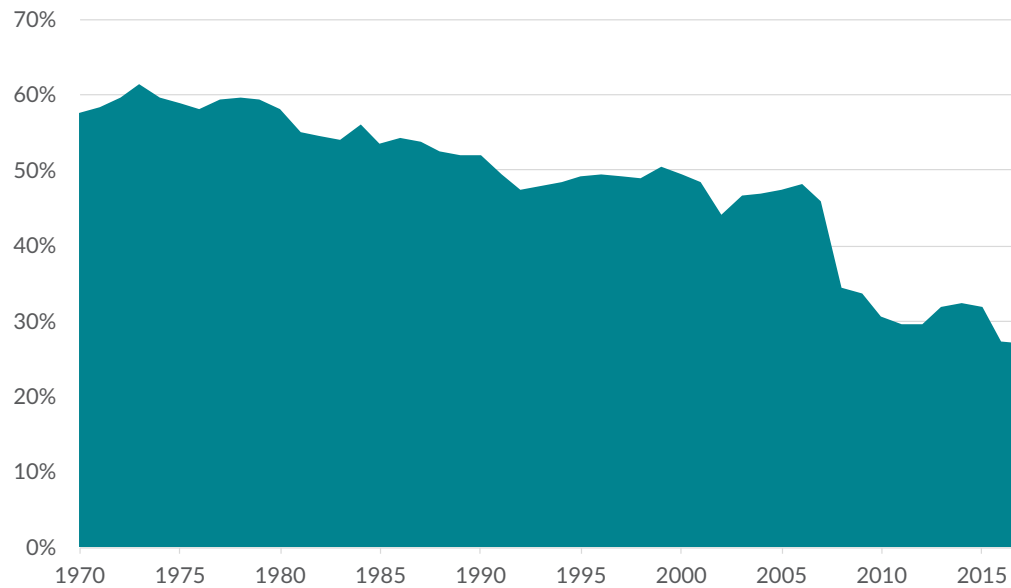
TABLE 5.3.
Sales Tax Breadth

South Carolina and Regional Competitors (2016)

State	Breadth
South Carolina	27.9%
Florida	39.3%
Georgia	31.8%
North Carolina	35.5%
Tennessee	34.7%
Virginia	23.1%

Sources: Prof. John Mikesell, Indiana University; Tax Foundation, *Facts & Figures 2018*.

FIGURE 5.3.
South Carolina’s Sales Tax Breadth, 1970-2016



Sources: Prof. John Mikesell, Indiana University

122 Morgan Scarboro, *Facts & Figures 2018: How Does Your State Compare?* Tax Foundation, March 21, 2018, Table 22, <https://taxfoundation.org/facts-figures-2018>.

The Federation of Tax Administrators (FTA) periodically publishes a survey of services taxable under each state's general sales tax, with the most recent data compiled in 2017. The survey includes both business-to-business services (which should be exempted under a well-structured sales tax) and final consumer services. As of 2017, South Carolina taxed 39 of the 176 services enumerated in the FTA survey under the general sales tax. Of those, at least 18 should be exempted because they are business inputs, while 59 final consumer service transactions went untaxed, as did 12 services that could represent business inputs or final purchases depending on the identity of the purchaser.

Existing Sales Tax Exemptions

A tax expenditure is something that would have been taxed but was specifically exempted or abated. It has been several years since South Carolina has published a sales tax expenditure report, and this report mostly covers exemption to the implicit base, one which begins with the taxation of goods by default, but services only if enumerated.¹²³ Nevertheless, this report serves as a good starting point for understanding the state's system of sales tax exemptions.

In the tables that follow, we have slightly adjusted figures derived from the tax expenditure report to account for increased sales in the intervening years (an increase of about 2.5 percent).

South Carolina forgoes about \$1.8 billion in revenue each year from exempted consumer goods, ranging from food and prescription drugs to newspapers. All these goods would be included in an ideal sales tax base, though in practice, some of them are commonly exempted in most states. For groceries, we only list the revenue forgone on purchases not made through federal aid programs like SNAP (commonly known as "food stamps") and WIC, as federal law prohibits states from taxing such purchases.

123 South Carolina Comptroller General, "Estimated Revenues for Sales Tax Exemptions (Fiscal Year 2013)," <https://www.cg.sc.gov/fiscaltransparency/Pages/TaxExpenditureReports.aspx>.

TABLE 5.4.
Exemption of Consumer Goods (in millions of dollars)

Consumer Goods	Amount
Motor fuel (on-highway use)	\$717.5
Pharmaceuticals and medical devices	\$460.7
Groceries (other than those subject to SNAP and WIC)	\$446.8
Telephone toll charges	\$59.4
Lottery ticket sales	\$39.6
Water sold by public utilities	\$20.2
Textbooks and other educational reading material	\$16.0
Newspapers and periodicals	\$13.5
Sale of manufactured homes	\$5.2
Hearing aids	\$3.0
Sales tax holiday	\$2.3
Other	\$1.3
Total	\$1,785.5

Source: South Carolina Comptroller General.

Business inputs should be exempted from an ideal sales tax base to avoid tax pyramiding, but in practice, South Carolina's sales tax exemptions for business inputs are narrow and do not come close to covering the full range of business purchases.

TABLE 5.5.
Exemption of Business Inputs (in millions of dollars)

Exempt Business Inputs	Amount
Manufacturing fuel and electricity	\$230.5
Livestock sales	\$84.4
Manufacturing machinery	\$71.8
Livestock feed	\$43.0
Off-highway fuel (e.g., dyed diesel)	\$23.6
Insecticides, fertilizers, etc.	\$21.1
Construction materials for manufacturing facilities	\$14.5
Commercial fishing vessels	\$14.5
Farm machinery and tractors	\$10.2
Construction	\$7.2
Machines used in research and development	\$5.6
Other	\$16.8
Total	\$543.1

Source: South Carolina Comptroller General.

Finally, South Carolina's sales tax extends to very few services. The state's tax expenditure report enumerates the costs of some of these exemptions—worth nearly \$3.6 billion in forgone revenue—but the list is far from complete.

TABLE 5.6.
Exemption of Services (in millions of dollars)

Service	Amount
Hospitals	\$826.3
Outpatient physician and paramedical services	\$706.7
Residential electricity and heating	\$284.1
Nursing care	\$276.7
Financial institution fees	\$227.6
Tuition (college, vocational training, and instruction)	\$184.8
Miscellaneous recreation services	\$153.8
Clubs and admissions	\$152.2
Motor vehicle maintenance, repair, and other services	\$148.5
Professional services	\$127.6
Personal care services	\$102.8
Gambling	\$102.6
Dental services	\$99.2
Public transportation	\$77.2
Household maintenance	\$52.9
Internet access	\$50.1
Total	\$3,573.1

Source: South Carolina Comptroller General.

Taxation of E-Commerce

The rise of e-commerce also plays a role in the erosion of state sales tax bases. Prior to the U.S. Supreme Court's recent ruling in *South Dakota v. Wayfair*,¹²⁴ retailers were only obligated to collect and remit sales taxes in states in which they had a physical presence, defined as having property or employees within the state. That geographic limitation on the scope of state sales tax authority, defined by the Supreme Court in *Quill v. North Dakota*,¹²⁵ became increasingly important as online transactions drove remote sales upward.

The *Quill* decision was handed down in 1992, at what was very nearly the low ebb of consumer remote sales. The great mail order businesses of the twentieth century, like Sears Roebuck, Montgomery Ward, and Bella Hess (itself the subject of a prior Supreme Court ruling on the taxation of remote sales), were either gone or on their last legs, victims of the discount department store chains, while e-commerce was still largely in the future, not yet a meaningful presence on the fledgling World Wide Web. Today, online sales account for nearly 10 percent of all consumer transactions by value—this despite the fact that e-commerce has only begun to make a dent in some of our costliest consumer markets, like the automobile market.¹²⁶

124 *South Dakota v. Wayfair, Inc.*, 585 U.S. ____, slip op. (2018).

125 *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

126 Statistics are for sales of personal, not real, property, and thus exclude real estate transactions.

Consumers are, as a point of law, required to pay a compensating use tax on any goods they purchase for which sales tax is not collected. In practice, this requirement is generally observed by businesses but only practiced in the breach by individual taxpayers, few of whom track or pay use tax on transactions where tax was not collected at the point of sale. This creates a disparity in the practical, if not legal, tax treatment of goods purchased online and those purchased in brick-and-mortar stores, and it erodes the sales tax base as an ever-greater share of purchases are shifted to online retailers.

Keeping the sales tax aligned with the modern economy is important, therefore, both for tax neutrality and tax collections. At the same time, with more than 10,000 sales taxing authorities across the country with widely disparate rates, bases, and collection regimes, the prospect of remitting sales tax in every jurisdiction nationwide is understandably daunting for many businesses, and without some degree of uniformity, perhaps even prohibitive. States, then, were not only constrained by law, but also by the need to avoid imposing incredibly high compliance costs on retailers.

An Increased Push to Tax Internet Services

Americans spent about \$453.5 billion in internet retail purchases in 2017, representing a 16 percent increase over the previous year and comprising about 8.9 percent of total retail sales.¹²⁷ This growth rate has been fairly steady, and it is likely that e-commerce will continue to grow as a share of national retail sales. In the aftermath of the *South Dakota v. Wayfair* decision, moreover, it is economic activity that states are increasingly likely to tax. While South Carolinians already have an obligation to remit use tax on remote sales, in practice, compliance is extremely low, and many taxpayers may not even be aware of the requirement, even though a self-reporting line is included on the individual income tax form.

While revenue is undoubtedly the single largest reason for state interest in taxing internet sales, tax neutrality is also an important consideration. There is no good reason why the same good or service should be untaxed if purchased online but taxed if purchased in a brick-and-mortar store. The tax, moreover, should be based on the consumer's location, not the seller's. The sales tax is not intended as a tax on business utilization of state or local services; that is the role of property and other taxes levied on business facilities. Sales taxes, rather, are collected on consumption, and are intended to be levied where a good or service is consumed—regardless of where the transacting company is located. In public finance parlance, sales taxes are *destination-based*, not *origin-based*. The discrepancies resulting from the current system improperly favor online purchases over purchases made at traditional retail establishments.

127 U.S. Census Bureau, "Quarterly Retail E-Commerce Sales 2nd Quarter 2018," August 17, 2018, https://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf. This percentage continues to rise, and hit 9.6 percent of total sales in the second quarter of 2018, compared to 8.8 percent in the second quarter of 2017.

Prior to the *Wayfair* decision, state sales taxing authority was generally limited to individuals and businesses within the state's borders. States have become increasingly creative, not to say aggressive, in their efforts to increase the share of taxed transactions. Some probed the limits of the *Quill* decision, while others have effectively ignored it, inviting challenges.

Some have adopted “click-through nexus” or “cookie nexus” statutes, which assert that when a retailer's website deposits a “cookie” (locally-stored data with information about the user) on a consumer's computer, the presence of that file on an in-state computer establishes physical presence. Others have adopted “affiliate nexus,” requiring out-of-state retailers to collect sales tax if any of their affiliates—including individuals compensated for “referral” links—have a physical presence in the state.¹²⁸ And still others have pursued “marketplace sales,” obligating any company which itself has nexus to collect and remit sales tax for any businesses that use its sales platform, even if those businesses would not have physical presence in the state on their own.

Then there are states which dispensed with physical presence altogether, even while *Quill* was still good law, adopting what is known as “factor presence,” by which a retailer must collect sales taxes if it meets certain thresholds, even in the absence of any physical presence in the state. Under *Wayfair*, substantial nexus can be achieved without a physical presence in the state, provided that the state's approach to collecting tax on remote sales does not impermissibly burden interstate commerce.

Finally, several states, led by Colorado, have begun requiring remote sellers to notify both purchasers and the state of any in-state sales. The retailer is not obliged to collect the tax but must expend time and resources notifying customers of their obligation, and to report that transaction to state tax authorities, who may act on it. Because this approach ties a particular taxpayer to specific transactions, it also raises privacy concerns. The state may not know the specific good or service purchased, but it would be apprised of the fact that a taxpayer made purchases of a certain amount at a specific, named retailer—information which some may prefer not to have disclosed.

These types of laws are problematic because they're nonneutral, only applying to certain online retailers. Further, they can discourage companies from locating distribution facilities or other operations in states with such laws, and in some cases can be triggered by *de minimis* contact with a state (e.g., the presence of an affiliate, or even of a website visitor).

128 Joseph Bishop-Henchman, “The Marketplace Fairness Act: A Primer,” Tax Foundation, July 14, 2014, <http://taxfoundation.org/article/marketplace-fairness-act-primer>.

Even in the new, post-*Wayfair* environment, not all state laws are likely to make the cut. The Supreme Court established that a business can have substantial nexus in a state without establishing a presence there, with the majority commenting favorably upon safeguards built into the South Dakota statute. It is not necessarily the case that depositing a cookie on a shopper's computer constitutes substantial nexus, or that marketplace sales are automatically covered if the marketplace facilitator is within the state's taxing jurisdiction, for instance. These issues and others may yet be litigated.¹²⁹

South Carolina's Approach

Technically, the *Wayfair* decision only establishes that a seller can have nexus in a state without physical presence; the decision does not resolve whether remote sales tax regimes may be impermissible on other constitutional grounds. Most observers, however, see the opinion as providing a "test," outlining several characteristics of the South Dakota statute which make it highly likely to survive any further legal challenges, and commending these provisions to other states which wish to ensure the viability of their own laws. In particular, the Court highlighted that South Dakota's law provides a safe harbor for small sellers, is not retroactive, has single state-level administration, uses uniform definitions of products and services, has a simple rate structure, provides software solutions for sellers, and grants immunity for any errors arising from reliance on that software.¹³⁰

Under a recent revenue ruling, South Carolina established November 1, 2018 as the date on which to begin collecting sales tax from remote sellers.¹³¹ These regulations are based on an existing provision in state law which requires any entity soliciting business or advertising in South Carolina to remit sales tax,¹³² which had not been enforced due to prior court decisions. These regulations adopt a \$100,000 threshold, consistent with the safe harbor provision the Supreme Court commended in South Dakota, though such a threshold is not expressly provided for in South Carolina law.

South Carolina has a few other things going for it: the provisions are not retroactive, for instance, and there is a single source of sales tax collections. Moreover, the sales tax base is uniform across all jurisdictions. However, South Carolina falls short of the *Wayfair* "test" in other ways.

Many states are part of the Streamlined Sales and Use Tax Agreement (SSUTA) and have adopted a uniform set of base definitions. South Carolina has not. (Legislation authorizing the state to enter into the SSUTA was adopted in 2002, but the state is not currently a member of the Agreement.¹³³) Uniform definitions does not mean identical bases. It simply means that the terms used to delineate potentially taxable transactions have the same meaning in each participating state. South Carolina has not taken this step.

129 *South Dakota v. Wayfair, Inc.*

130 Joseph Bishop-Henchman, Hannah Walker, and Denise Garbe, "Post-Wayfair Options for States," Tax Foundation, Aug. 29, 2018, <https://taxfoundation.org/post-wayfair-options-for-states/>.

131 South Carolina Department of Revenue, "SC Revenue Ruling #18-14," Sept. 18, 2018, <https://dor.sc.gov/resources-site/lawandpolicy/Advisory%20Opinions/RR18-14.pdf>.

132 S.C. Code Ann. § 12-36-70.

133 S.C. Code Ann. § 12-35-50.

To date, moreover, South Carolina has not offered a free software solution to remote sellers. Although the state offers web lookup tools, it does not offer a free integration with sales tax collection vendor services or provide software sellers can use separately. States within the SSUTA have a uniform solution, but even states outside the Agreement can develop software to facilitate compliance. To date, South Carolina has not.

For these reasons, South Carolina's new remote seller provisions may be vulnerable to a legal challenge. Joining the SSUTA or separately aligning definitions and providing a free software solution for remote sellers would address those legal uncertainties and create a more equitable system that permits the state to collect sales tax on internet sales and other transactions but does not unduly burden retailers.

Accommodations and Hospitality Taxes

South Carolina's climate, charm, and seashore combine to make the state a popular tourist destination, so it is unsurprising that government officials would look to accommodations and hospitality taxes to export some of the tax burden to visitors. The system stands out, rather, for its duplicative structure, with a state accommodations tax with revenues distributed to localities, a local accommodations tax with revenues retained by the collecting localities, a local hospitality tax, and a local option tourism development fee. The latter, despite its supposed designation as a "fee," is an optional addition to the sales tax.

The state accommodations tax is a 2 percent tax on room rentals, which is collected by the South Carolina Department of Revenue and disbursed to counties by formula. While most of the revenue is returned to the county in which it is collected, a so-called "Robin Hood" provision redistributes some of the money to counties with less tourism-related revenue.¹³⁴ Accommodations taxes, which are also called transient occupancy taxes, hotel taxes, or, more generically, lodging taxes, are common across the country.¹³⁵ Most states, including South Carolina, also include room rentals in their sales tax, though that is not always the case.

134 South Carolina Taxation Realignment Commission, "Final Report," December 2010, 222, <https://www.scstatehouse.gov/CommitteeInfo/HouseTaxPolicyReviewCommittee/August302016Meeting/TRACFinalReport.pdf>.

135 National Conference of State Legislatures, "Specific Statewide Taxes on Lodging - By State," Oct. 1, 2017, <http://www.ncsl.org/research/fiscal-policy/state-lodging-taxes.aspx>.

TABLE 5.7.

State Accommodations (Lodging) Taxes in the Southeastern United States

State	State Lodging Tax Rate	Sales Tax on Lodging	Total State Tax
Alabama	4.0%	0%	4%
Arkansas	2.0%	6.5%	8.5%
Florida	n/a	6.0%	6.0%
Georgia	\$5 per room	4.0%	4.0% + \$5
Kentucky	1.0%	6.0%	7.0%
Louisiana	n/a	5.0%	5.0%
Maryland	n/a	6.0%	6.0%
Mississippi	n/a	7.0%	7.0%
Missouri	n/a	4.225%	4.225%
North Carolina	n/a	4.75%	4.75%
South Carolina	2.0%	5.0%	7.0%
Tennessee	n/a	7.0%	7.0%
Virginia	2.0%	4.3%	6.3%

Source: National Conference of State Legislatures.

In addition to South Carolina, five other southeastern states impose state lodging taxes ranging from 1 percent in Kentucky to 4 percent in Alabama (which does not impose its sales tax on hotel rooms). It should be noted that the above table only considers *state* sales tax rates. Like many other states (particularly southern states), South Carolina has local option sales taxes which increase the overall tax burden on lodging. Significantly, the state's variety of specific purpose local sales taxes (discussed elsewhere) can lead to particularly high rates in tourism-heavy communities.

Counties and municipalities in South Carolina are authorized to impose their own local accommodations taxes by ordinance. The cumulative rate cannot exceed 3.0 percent, which is achieved by restricting the county to 1.5 percent unless the municipal council accedes to a higher county rate with the knowledge that it will limit what the municipality can impose.¹³⁶ For instance, a room in Isle of Palms is subject to the 5 percent state sales tax, the 2 percent state accommodations tax, a 2 percent county accommodations tax, a 1 percent city accommodations tax, a 1 percent local option sales tax, a 1 percent county transportation tax, a 1 percent county school tax, and a 1 percent beach preservation fee, yielding a 14 percent tax rate on a hotel room in the city.¹³⁷

Notably, the "Robin Hood" provision is not a transfer from affluent to financially distressed counties. The determination is solely based on tourism revenue, so a well-to-do county with little tourism is eligible for redistributed moneys from the accommodations tax. Historically, this system arose because, when the legislature was considering the establishment of an accommodations tax in the 1980s, it was resisted by the 30 counties (of 46) with limited tourism activity. Officials in these counties objected to a tax that would be imposed on their residents when they visited coastal communities, but for which their own government would receive no additional revenue.¹³⁸

136 Municipal Association of South Carolina, "Handbook for Municipal Officials," 42.

137 City of Isle of Palms, "Accommodation Licensing & Tax Information: Short-Term Rentals of Residential Property," 2018, <https://www.iop.net/accommodation-licensing-tax-information>.

138 South Carolina Tourism Expenditure Review Committee, "A Brief History of the South Carolina Accommodations Tax Bill," <http://www.atax.sc.gov/history.htm>.

Local hospitality taxes are imposed by counties and municipalities as well, with a maximum cumulative rate of 2 percent. Counties may not exceed 1 percent within a municipality without the consent of the municipal council. These hospitality taxes are on the sale of prepared food and beverages, and despite the seemingly more expansive name, are the equivalent of what are called “meals taxes” or “prepared food taxes” in other states.¹³⁹

TABLE 5.8.
Hospitality (Meals) Taxes in the Southeastern United States

State	Taxing Authorities	Method of Adoption	Authorized Rate
Arkansas	Select cities and counties, incorporated towns	Ordinance	Up to 3%*
Florida	Counties, select resort cities and towns	Ordinance	1%
Kentucky	Select cities	Ordinance	Up to 3%
Louisiana	Two specified taxing districts	State Statute	0.5 – 0.75%
Maryland	Select resort areas	Ordinance	Up to 1%
South Carolina	All counties and municipalities	Ordinance	Up to 2%
Virginia	All counties Cities and towns with general tax authority	Referendum Ordinance	Up to 4% No cap

* Four percent in the city of Little Rock.
Source: Tax Foundation research.

Finally, the local option tourism development fee is really a 1 percent local option sales tax only available to municipalities in a county with at least \$14 million in state accommodations tax revenues. It is discussed separately in the sales tax chapter.¹⁴⁰

Each of these taxes comes with restrictions on the use of revenues. For instance, the first \$25,000 in state accommodations tax revenues distributed to any locality are to be deposited in the general fund, but for any additional revenue, 65 percent is dedicated to a special fund for tourism-related expenditures, 30 percent is earmarked for advertising and promotion of tourism, and only 5 percent goes to the general fund.¹⁴¹ Revenues deposited into the tourism fund must be spent within two years of receipt or committed to a specific project with prior approval of the state’s Tourism Expenditure Review Committee (TERC).¹⁴²

What constitutes a tourism-related expenditure is a recurring, and often difficult, question. The Tourism Expenditure Review Committee used to publish a newsletter featuring answers to some of the more common funding questions they received, such as whether tourism dollars could go to web design, fireworks, historical markers, highway exits, and sporting events. In some cases, where a municipality is overwhelmingly tourism-oriented, TERC has gone so far as to permit the funding of local services (like police, fire, water, and sewer) as tourism-related expenditures.¹⁴³

139 Jared Walczak, “Punching the Meal Ticket: Local Option Meals Taxes in the States,” Jan. 26, 2017, 3, <https://taxfoundation.org/punching-meal-ticket-local-option-meals-taxes-states/>.

140 Municipal Association of South Carolina, “Handbook for Municipal Officials,” 42.

141 South Carolina Tourism Expenditure Review Committee, “County and Municipal Governments Accommodations Tax Guidelines,” 2010, 2, https://www.state.sc.us/atax/forms/ATAX_GUIDELINES_10.pdf.

142 Id., 2.

143 South Carolina Tourism Expenditure Review Committee, “The A-Tax Newsletter,” multiple issues, <http://www.atax.sc.gov/newsletter.htm>.

Even where such broad latitude is not granted, there is reason to believe that local governments engage in widespread fiscal substitution. In an academic review of Accommodations Tax Reporting forms submitted by local governments, involving two teams of trained reviewers, 43 percent of all disbursements in fiscal year 2002 were flagged as potentially noncompliant by at least one of the two teams.¹⁴⁴ If TERC judges an expenditure noncompliant, it can request that the state Department of Revenue withhold additional state accommodations tax revenues until the funds are replaced, but no further penalty is imposed.¹⁴⁵

144 Calvin Blackwell, John C. Crotts, Stephen W. Litvin, and Alan K. Styles, "Local Government Compliance with Earmarked Tax Regulation," *Public Finance Review* 34:2 (March 1, 2006), 221-222.

145 *Id.*, 217.

Sales and Accommodations Tax Solutions

South Carolina's sales tax begins with a narrow base which excludes a significant number of tangible goods and applies to very few services. A "max cap" of \$500 on the purchase of a vehicle also carves out the sales tax base. As a result, the base is too narrow to grow with today's service-oriented economy, with carveouts for select goods further reducing revenue stability and requiring higher rates than might otherwise be required. The state may also be insufficiently prepared to take advantage of the Supreme Court's green light for the taxation of remote sales.

Base-Broadening Options

A well-structured sales tax applies to all final consumer purchases, both goods and services, while exempting business inputs. Currently, the South Carolina sales tax specifically exempts a significant number of consumer transactions which, if included in the base, would permit substantial rate reductions or reductions to the rates of other taxes.

In the base-broadening options that follow these tables, we augment the tax expenditure report with estimates (again, adjusted for comparability) from Dr. Rebecca Gunnlaugsson,¹⁴⁶ an economist who has done extensive tax and revenue modeling work in South Carolina. This allows us to break down the base into more discrete categories for consideration by policymakers.

Among existing exemptions of consumer goods, the largest are for motor fuel (which is already subject to its own excise tax), pharmaceuticals, and unprepared foods (groceries). Of these, the grocery exemption is by far the newest, only phased out about a decade ago. Exempting groceries is often viewed as a progressive measure, since purchases of food represent an outsized share of consumption for lower-income individuals, but the reality is more complicated. Since food purchased with federal assistance is inherently exempt and prepared foods are taxable, the actual incidence is much more complicated. High-end ingredients purchased at an upscale grocery store are tax-exempt, while a rotisserie chicken is taxed.

This is, moreover, a sizable exemption: just adding food back into the sales tax base would permit a revenue neutral rate reduction to 5.3 percent. (A partial rate could also be significant.) Alternatively, revenue from base broadening could be used to pay down income tax relief or transfers to allow localities to address some of the inequities in their property tax structures.

Lawmakers should consider expanding the sales tax base to include additional consumer goods and services, while exempting business inputs. Table 5.9 shows three options for base broadening, where Option A is the broadest, adding a wide range of goods and services to the sales tax base, while Option C is the most modest, adding a few additional consumer transactions to the base.

146 Rebecca Gunnlaugsson, "Methodology Notes: South Carolina Tax Model," 2016.

When services could constitute either a final consumer transaction or a business input, depending on the identity of the final purchasers, the state should either define the categories in such a way as to exclude business inputs or, preferably, provide a mechanism by which business purchases are exempted, in much the same way as purchases by nonprofits are exempted in many states. For purposes of these calculations, services which frequently constitute business-to-business transactions have their value prorated based on estimates of the business share of purchases in given industry categories.¹⁴⁷ For instance, the exemption for legal services forgoes an estimated \$149.9 million, but only 29 percent of that value is associated with final transactions, yielding \$43.5 million potentially available under sales tax base broadening.

Below, we provide a few base-broadening options that allows lawmakers to decide how broad they would like to make the sales tax base, while still accounting for other policy considerations. Sales tax base broadening could be used to pay down sales tax rate reductions or other reforms elsewhere in the tax code, or both. We also list several other, larger untaxed segments of the economy (like health care) for informational purposes, though they would not be taxed under any of the options delineated below.

Eliminating Impediments to Remote Sales Tax Collections

Although South Carolina has opted to move forward with remote collections without adopting all the reforms suggested by the Supreme Court's decision in *Wayfair*, this is a legally precarious and economically undesirable outcome. Policymakers should prioritize establishing the *de minimis* threshold in statute, providing free sales tax compliance software to remote sellers, and conforming sales tax definitions to emerging national standards. Joining the Streamlined Sales and Use Tax Agreement, though not necessarily required, is the most efficient and straightforward way to accomplish these latter aims.

Excluding Business Inputs

South Carolina policymakers have long recognized the importance of excluding business inputs from the sales tax base to avoid tax pyramiding, but efforts to expand the scope of these important exemptions have been piecemeal, targeted at specific industries, and sometimes only made available to particularly large purchasers.

Either specific exemptions should be written for goods and services likely to constitute business inputs or businesses should be granted the ability to claim an exemption from the sales tax for all business purchases. Many states allow nonprofit organizations to make sales tax-exempt purchases. Similar provision could be made for business purchases to avoid taxation of business inputs without attempting to ascertain which goods and services are likely to constitute business-to-business transactions. Certainly, with any broadening of the sales tax base, care should be taken to avoid including any additional predominantly business-oriented transactions in the base.

¹⁴⁷ Robert Cline, John Mikesell, Tom Neubig, and Andrew Phillips, *Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Inputs*, Council on State Taxation, Jan. 25, 2005, 10, <http://www.ncsl.org/documents/standcomm/sccomf/Business-Inputs-Study.pdf>.

TABLE 5.9.

Sales Tax Base Expansion Options (revenue in millions of dollars)

Good or Service	Revenue	A	B	C
Recreation Services, Clubs, and Admissions	\$306.0	✓	✓	✓
Personal Care Services	\$102.8	✓	✓	✓
Household Maintenance	\$52.9	✓	✓	✓
Barber and Cosmetology Services	\$13.7	✓	✓	✓
Newspapers and Periodicals	\$13.5	✓	✓	✓
Tax Preparation Services	\$7.1	✓	✓	✓
Consumer Repairs	\$6.0	✓	✓	✓
Parking Lots and Garages	\$1.0	✓	✓	✓
Max Cap on Vehicle Sales	\$173.5	✓	✓	
Motor Vehicle Maintenance and Repairs	\$148.5	✓	✓	
Telephone Toll Charges	\$59.4	✓	✓	
Internet Access	\$50.1	✓	✓	
Lottery Ticket Sales	\$39.6	✓	✓	
Car Rental and Leasing	\$32.0	✓	✓	
Veterinary Services	\$29.4	✓	✓	
Interior Design Services	\$5.7	✓	✓	
Taxi, Limo, and Charter Bus	\$2.9	✓	✓	
Gasoline and Motor Fuels	\$717.5	✓		
Food	\$446.8	✓		
Financial Institution Fees	\$227.6	✓		
Public Transportation	\$77.2	✓		
Investment Management	\$55.8	✓		
Accounting	\$45.6	✓		
Legal Services	\$43.5	✓		
Water Sold by Public Utilities	\$20.2	✓		
Funeral and Burial Services	\$17.6	✓		
Sale of Manufactured Homes	\$5.2	✓		
Vacation Time Sharing and Multiple Ownership	\$3.4	✓		
Motor Vehicle Extended Warranties	\$3.3	✓		
Hospitals	\$826.3			
Outpatient Physician and Paramedical Service	\$706.7			
Pharmaceuticals and Medical Devices	\$460.7			
Residential Electricity and Heating	\$284.1			
Nursing Care	\$276.7			
Private Education Tuition	\$201.9			
Gambling	\$102.6			
Totals	\$5,566.8	\$2,707.8	\$1,044.1	\$503.0

Sources: South Carolina Comptroller General; South Carolina Department of Revenue; Dr. Rebecca Gunnlaugsson; Tax Foundation calculations.



CHAPTER 6

**PROPERTY AND
RELATED TAXES**

Introduction

Adopted in 2006, Act 388 was supposed to be South Carolina's big stab at property tax reform. In hindsight, the bill served to make local property taxes more complex and inequitable, and to force local governments to scramble to find ways to keep taxes competitive for targeted businesses and industries. Some of the features of Act 388 are undeniably popular, as the legislation drove down effective rates for many homeowners and implemented safeguards to keep those taxes from rising. The distortions it introduced into the tax code, however, are not easily dismissed. South Carolinians want to keep their residential property taxes low—but increasingly, there's also an understanding that the current system is flawed and unsustainable.

That understanding is taking hold despite the fact that few taxpayers can be expected to understand just how property taxes work in the state. Base-narrowing exemptions, formula-driven adjustments, and divergent assessment ratios on different classes of property combine to produce a property tax structure that few understand, but most understand to be broken. Some businesses have the ability to abate their own burdens through negotiated agreements, while others—including, perhaps, their rivals—obtain no such relief from South Carolina's anomalously high commercial property taxes.

In this chapter, we provide an overview of the property tax system in South Carolina and then provide ideas for improvement.

A General Overview of South Carolina Property Taxes

Property taxes are among the oldest forms of taxation and remain a significant source of local government revenue in many states, South Carolina included. Until a century ago, property taxes formed the basis of the state's tax system. Relinquished to localities, the property tax is now a major funding source for local government and education, though policy choices in recent decades have shifted some of the responsibility for funding education away from homeowners and onto other taxpayers.

Property taxes tend to be justified on both economic and practical grounds: economically, as a generally efficient form of taxation which raises revenue with a minimal effect on economic decision-making and consistent with widely accepted principles of taxation, and practically, as a well-established source of funding that is both familiar and not easily replaced.

Because real property is an immobile asset, tax competition and tax avoidance activities arising from its taxation are less pronounced than they would be from other available tax options.¹³⁶ At the margin, income taxes discourage labor and investment and may induce inefficient efforts at avoidance. Many other taxes pick winners and losers by favoring or disfavoring a range of economic activities. Property taxes, by contrast, tend to be more economically neutral,¹³⁷ though South Carolina's system sometimes tests that proposition.

Property taxes also come closer than most taxes to passing the benefit test, whereby taxes paid roughly correlates with benefits received. However imperfect, the value of one's property is a better proxy for the value of local services received than most alternative tax bases. More than at other levels of government, local services often align closely with property and property values. Roads, utilities, police and fire protection, and local public amenities all increase or preserve the value of property, and, if supplied privately, would likely increase in worth with higher property values.¹³⁸ If, therefore, aggressive property tax limitations drive localities to shift to alternative revenue options, the net economic effect may be negative.

Unfortunately, South Carolina's property tax code is one of extremes. It features enviably low effective rates for many homeowners, particularly those who remain in one home for many years, at the expense of renters and commercial property owners, who can face remarkably high property tax burdens.

South Carolina ranks slightly below average on its property tax structure on our *State Business Tax Climate Index*, though this does not capture the full burden of a lopsided tax code on many businesses and individuals. Contributing favorably to its ranking, the state forgoes taxes on inventory or intangible property and does not impose an inheritance or estate tax. Overall property tax collections, moreover, are low both per capita and as a percentage of personal income. However, the state's highly divergent assessment ratios for different classes of property, combined with its preferential treatment of owner-occupied residential property (all discussed in detail in the subsequent pages), yield a considerably less attractive environment for renters and businesses.

136 For a discussion of strategic competition in property tax regimes, see Jan K. Brueckner and Luz A. Saavedra, "Do Local Governments Engage in Strategic Property-Tax Competition?" *National Tax Journal* 54:2 (June 2001), <https://www.ntanet.org/NTJ/54/2/ntj-v54n02p203-30-local-governments-engage-strategic.pdf?v=%CE%B1&r=03589733876287937>.

137 Bruce Wallin and Jeffrey Zabel, "Property Tax Limitations and Local Fiscal Conditions: The Impact of Proposition 2½ in Massachusetts," Lincoln Institute of Land Policy Working Paper, 2010, 4, http://www.lincolnst.edu/sites/default/files/pubfiles/1885_1200_wallin_zabel_wp11bw1.pdf.

138 *Id.*, 4-5.

TABLE 6.1.
State Business Tax Climate Index Property
Tax Component Rankings

South Carolina and Select Regional Competitors (2018)

State	Component Ranking
South Carolina	27th
Florida	11th
Georgia	24th
North Carolina	33rd
Tennessee	29th
Virginia	30th

Property Tax Rates and Collections

In fiscal year 2016, property taxes made up 76.7 percent of local tax collections in South Carolina, making them by far the most significant source of local collections.¹³⁹ While significant local government reliance on property taxes is a fact of life throughout the country, South Carolina leans on property taxes slightly more heavily than the nation as a whole, and certainly more than some of its regional peers, since some states give relatively higher priority to local sales taxes.

On average, 72.0 percent of local revenue derives from property taxation. Regional differences, however, can be significant. Among Southeastern states (as broadly classified by the Bureau of Economic Analysis), only Mississippi (93.5 percent) and West Virginia (81.9 percent) rely more heavily on property taxes as a source of local revenue. The regional average is 69.1 percent (7.6 percentage points below South Carolina's level of reliance), with three states—Alabama (40.8 percent), Arkansas (42.4 percent), and Louisiana (45.9 percent)—generating less than half of their local revenue from property taxes.¹⁴⁰

This relatively lower reliance on property taxes in the Southeastern United States is offset by the region's high reliance on local option sales taxes. South Carolina provides a wide range of local sales tax add-on options to localities, mostly as dedicated revenue for specific purposes, but on the whole, local governments rely less on sales tax revenue—and thus, more on property taxes—than their peers in surrounding states.

Intriguingly, legislation (Act 388) designed to reduce property tax burdens seems to have had little effect on overall local government reliance on property taxes as a percentage of revenue. The property tax share of local tax collections has been falling since the early 1990s, when local governments began receiving local sales tax authority, but the adoption of Act 388 in 2006 did not noticeably accelerate the trend, nor did property tax collections drop off. Burdens shifted within the property tax; they were not reduced overall.

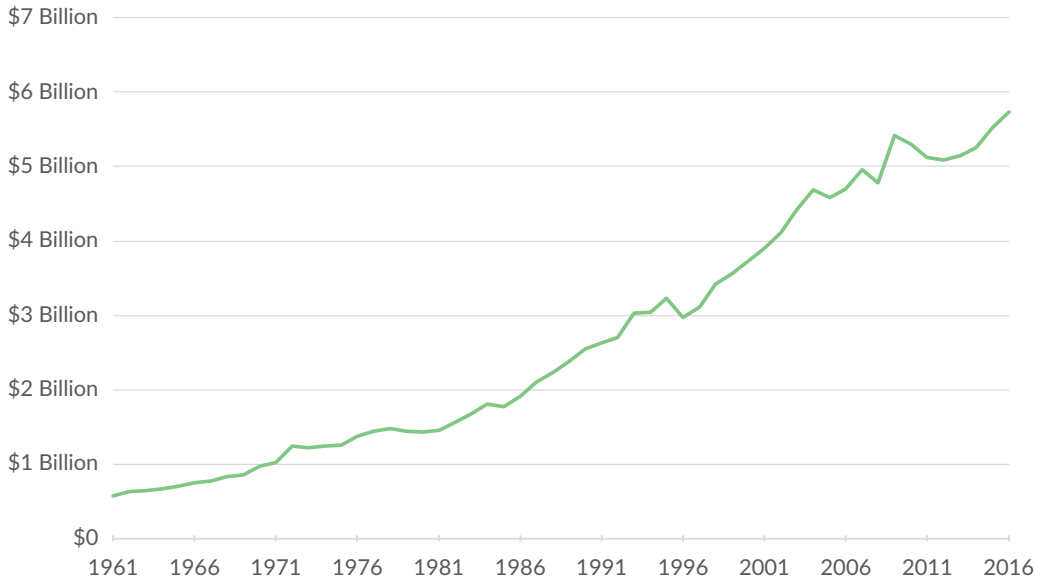
Like most taxes, property taxes have become higher over time. In inflation-adjusted

139 U.S. Census Bureau, "2016 State & Local Government Finance Historical Datasets and Tables," <http://www.census.gov/govs/local/>.

140 Id.

terms, property tax collections in 1961 were \$574 million, almost exactly one-tenth of the \$5.7 billion local property taxes raised in 2016. In the figure below, note that collections continued to rise after the implementation of Act 388 in 2006, only dipping once the Great Recession hit.

FIGURE 6.1.
**South Carolina Property Tax Collections,
Inflation-Adjusted, 1961-2016**



Source: U.S. Census Bureau.

Per capita state and local property tax collections were \$1,157 in fiscal year 2016, ranking 22nd-lowest nationwide. However, property taxes paid as a percentage of owner-occupied housing value in South Carolina are remarkably low at 0.55 percent of housing value, about half the national average of 1.08 percent and significantly less than regional peers that rely less on the property tax overall.¹⁴¹ These figures reflect effective rates, not millages. As will be discussed in detail later, different assessment rates on different classes of property, an exemption from the school property millage for primary residences, the homestead credit, and other tax preferences yield an effective tax rate significantly lower than the published property tax rates.

TABLE 6.2.
Property Taxes Paid as a Percentage of Owner-Occupied Housing Value

South Carolina and Select Regional Competitors (2017)

State	Effective Rate
South Carolina	0.55%
Florida	0.87%
Georgia	0.91%
North Carolina	0.84%
Tennessee	0.70%
Virginia	0.80%
National Average	1.08%

Source: U.S. Census Bureau.

Property Tax Structure

Overview

In South Carolina, property taxes are applied against certain percentages of fair market value, known as assessment ratios. Fair market value was established as the basis of property tax assessment in 1975, along with a classification schedule for real property, with different assessment ratios for each class of property.¹⁴² Agricultural real property is assessed on use value—the one exception to the rule—which often provides a substantial discount for agricultural land.¹⁴³

Property is reassessed on a five-year cycle, though counties have the authority by ordinance to delay a reassessment by one year. Reappraisals are also triggered by the completion of improvements or additions or the sale or transfer of interest in the property. Assessed value may increase by no more than 15 percent over a five-year period, however, under the terms of an assessment limitation discussed later. Improvements are outside the assessment limitation, and transfers of ownership trigger an uncapped reappraisal.¹⁴⁴

142 South Carolina Taxation Realignment Commission, “Final Report,” December 2010, 186, <https://www.scstatehouse.gov/CommitteeInfo/HouseTaxPolicyReviewCommittee/August302016Meeting/TRACFinalReport.pdf>.

143 *Id.*, 201.

144 South Carolina Department of Commerce, “Property Tax: Statewide Economic Growth and Taxation Issues in South Carolina,” 2010, 2.

Calculating Property Tax Liability

Calculating property tax involves multiplying the assessed value of a property by the assessment ratio for that class of property, then multiplying the resultant by the property tax rate (millage). Imagine, for instance, a property valued at \$250,000 with an assessment ratio of 4.0 percent, against which a property tax of 250 mills (\$250 per \$1,000 in taxable value) is levied. The calculation would look like this:

$$\begin{array}{r}
 \$250,000 \text{ (fair market value)} \\
 \times .04 \text{ (assessment ratio)} \\
 \times 0.25 \text{ (rate)} \\
 \hline
 =\$2,500 \text{ (1.0\% effective rate)}
 \end{array}$$

A 250-mill rate seems incredibly high, and would be in some states, but combined with an assessment ratio that only subjects 4 percent of fair market value to tax, the result is an effective tax rate of 1 percent on this example property. Without taking assessment ratios into account, millage rates are not comparable across states.

TABLE 6.3.
Assessment Ratios by Class of Property

Property Classification	Assessment Ratio	Percent of Assessed Value
Owner Occupied	4.0%	33.4%
Agricultural (Private)	4.0%	0.5%
Agricultural (Corporate)	6.0%	0.1%
Commercial/Rental	6.0%	35.6%
Vehicular Personal Property	6.0%	9.6%
Other Personal Property	10.5%	1.3%
Manufacturing	10.5%	3.3%
Utility	10.5%	7.2%
Business Personal Property	10.5%	3.3%
Motor Carrier	9.5%	0.3%
Fee-in-Lieu Projects	4.0 - 6.0%	5.4%

Source: South Carolina Department of Revenue.

Beginning this year, the assessment ratio on manufacturing property will begin a phasedown to 9 percent in practice, if not in name. The assessment ratio is set in the state constitution, but a newly-enacted 14.2857 percent deduction from the value of manufacturing property, to be phased in over five years, will have the effect of granting these properties a 9 percent assessment ratio—better, but still remarkably high.¹⁴⁵ For 2018, the “real” assessment ratio for manufacturing property is 10.2 percent, even though the constitution still says 10.5 percent.

The system of property taxation in South Carolina yields radically different tax burdens on similarly valued properties. It does so in three ways: (1) using different assessment ratios for distinct classes of property, (2) providing a range of exemptions and deductions only available to select property owners, and (3) exempting owner-occupied housing from the portion of the millage dedicated to school operating expenses, which is typically the single largest component of a local millage by a significant margin.

Let's look at that \$250,000 property again, but this time, let's assume it's an owner-occupied residential property and that 120 of the 250 mills on the property tax are dedicated to school operating expenses, leaving only 130 mills still applied.

$$\begin{aligned}
 & \$250,000 \text{ (fair market value)} \\
 & \times .04 \text{ (assessment ratio)} \\
 & \times 0.13 \text{ (rate)} \\
 & = \mathbf{\$1,300 \text{ (0.5\% effective rate)}}
 \end{aligned}$$

Now assume that same property is owned by senior citizens eligible for a \$50,000 homestead exemption, which reduces fair market value by that amount prior to application of the assessment ratio.

$$\begin{aligned}
 & \$250,000 \text{ (fair market value)} \\
 & - \$50,000 \text{ (homestead exemption)} \\
 & \times .04 \text{ (assessment ratio)} \\
 & \times 0.13 \text{ (rate)} \\
 & = \mathbf{\$1,040 \text{ (0.4\% effective rate)}}
 \end{aligned}$$

But what if, by contrast, this was a manufacturing property, subject to (functionally) a 10.2 percent assessment ratio and not eligible for the homestead exemption or the exclusion from the school operating portion of the property tax millage? (Overlook, for the moment, the fact that few manufacturing properties are valued at a mere \$250,000.) Suddenly, the effective rate is massively higher.

$$\begin{aligned}
 & \$250,000 \text{ (fair market value)} \\
 & \times .102 \text{ (assessment ratio)} \\
 & \times 0.25 \text{ (rate)} \\
 & = \mathbf{\$6,375 \text{ (2.6\% effective rate)}}
 \end{aligned}$$

The manufacturer is paying five times what a homeowner pays for a property with the same assessed value (more than six times if compared to seniors). It's not uncommon for business taxpayers to face higher rates or assessment ratios, a system known as "split roll taxation," but the magnitude is massively out of proportion to what businesses experience elsewhere and makes property taxes deeply uncompetitive for many of those who would like to invest in the state.

Every year, the Lincoln Institute of Land Policy calculates effective rates of taxation for different classes of property in the largest city in each state. In 2017, the effective rate on industrial property in Charleston, South Carolina was 2.28 percent, fifth highest in the nation and substantially higher than the national average of 1.50 percent. Two of the four states with higher effective rates—Tennessee and Texas—forgo taxes on wage income, whereas South Carolina imposes an individual income tax with a top marginal rate of 7 percent.

TABLE 6.4.

Effective Property Tax Rates on \$1 Million in Industrial Property

State	City	Effective Rate
South Carolina	Charleston	2.28%
Florida	Jacksonville	1.36%
Georgia	Atlanta	1.47%
North Carolina	Charlotte	0.91%
Tennessee	Memphis	2.58%
Virginia	Virginia Beach	0.50%
U.S. Average	n.a.	1.50%

Source: Lincoln Institute of Land Policy.

And it's not just manufacturers feeling the sting. Other real property faces a 6 percent assessment ratio and, even more importantly, the full millage—a category that includes not only most commercial establishments, but also rental properties. While the landlord is responsible for paying the tax, ultimately it's the tenant who bears most of the cost, and it can be a steep one: following the assumptions of the above examples, the burden on a \$250,000 rental property would be \$3,750, or nearly three times the property taxes owed if the same property were owned rather than rented. (That may be an expensive rental property, but the same differential holds for less expensive units as well.)¹⁴⁶

This creates a bias against renting, which affects people in all income ranges, but can be particularly burdensome for lower-income South Carolinians. These higher taxes on rental properties show up for tenants in the form of higher rent, lower maintenance standards, and a reduced rental housing stock. The 6 percent assessment ratio also applies to second homes (that is, homes other than one's primary residence, whether or not one has another in-state property), which can make beachfront property in South Carolina less attractive than similar properties across the border in North Carolina or in other coastal states. Immigrants on work visas, meanwhile, may have difficulty establishing their (only) home as a primary residence, and be hit with the higher assessment ratio.

For manufacturers, meanwhile, effective tax rates are exorbitant to the point of making it exceedingly difficult to operate in the state—at least, not without a patch. That patch is South Carolina's system of fees in lieu of taxes (FILOTs), which reduces property tax burdens to more reasonable levels for many manufacturers, but in the process increases the system's overall complexity and contributes to significant inequities, since not all

146 Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence, "50-State Property Tax Comparison Study for Taxes Paid in 2017," April 2018, 80-81, https://www.lincolinst.edu/sites/default/files/pubfiles/50-state-property-tax-comparison-for-2017-full_1.pdf.

manufacturers are eligible for this brand of relief. Properties entering into a FILOT deal receive additional perquisites protecting them against increases in tax liability.

Fees in Lieu of Taxes

South Carolina's FILOTs are a breed of their own, scarcely analogous with the practices of other states. Certainly, localities in other states offer property tax abatements to select businesses. Indisputably, they use property tax incentives to encourage relocations or tax increment financing (which South Carolina also has) to spur development. What other states do not have: a system designed to award a lower assessment ratio to larger businesses by replacing the company's property tax burden with a (smaller) fee which operates under its own special rules, impervious to rate changes or increases in assessed value applicable to other properties.

Fees in lieu are available to industries investing at least \$2.5 million—or as little as \$1 million in less developed counties—and result in a tax savings of about 43 percent in most cases, by reducing the assessment ratio from 10.5 (in practice, currently 10.2) to 6.0 percent.¹⁴⁷ (In the case of “Super Fee Projects,” discussed later, they can reduce the assessment ratio to 4 percent for a savings of about 62 percent.) The target investment amount must be reached within a five-year period, though the alternative fee arrangement lasts for 20 to 30 years, depending on the nature of the agreement.¹⁴⁸

South Carolina's FILOTs come in three flavors, each governed by a separate statute: the Original FILOT Act, the Streamlined FILOT Act, and the Simplified FILOT Act. Although these subsequent approaches have eclipsed the original in popularity, they do not supersede it, and businesses may take their pick of structures when negotiating a fee-in-lieu deal with a receptive county government.¹⁴⁹

The Original FILOT Act is the most arduous in its requirements, only available upon a commitment to invest at least \$45 million. Worse, it requires a convoluted maneuver by which the company conveys title to its land to the county in exchange for a lease-purchase agreement under which it gradually resumes ownership of the land, all underwritten by the issuance of industrial revenue bonds which are frequently purchased by the company itself. The effect is circular and largely intended to circumvent potential constitutional impediments, but it entails a real risk for companies: if, for whatever reason, they are unable to make their lease-purchase payments, the county could take the property out from under them.¹⁵⁰

147 South Carolina Taxation Realignment Commission, “Final Report,” 190.

148 *Id.*

149 April C. Lucas, “Negotiated Fees In Lieu of Taxes and Special Source Revenue Bonds/Credits in South Carolina – 2010,” Nexsen Pruet, LLC, 2010, 1.

150 S.C. Code Ann. § 4-29-10.

The Streamlined approach eliminates the bonding requirement but still involves a transfer of title, while the Simplified fee-in-lieu system replaces the transfer with a contract. Both these latter options also cut the eligibility threshold to \$2.5 million worth of investment, or \$1 million for counties with average annual unemployment rates of at least twice the state average for the two preceding years.¹⁵¹ Super Fee Projects, which have higher qualifying thresholds of either a \$400 million investment or \$150 million and 125 new full-time jobs at the project site, can receive a 4.0 percent assessment ratio for 30 years, and have eight years to reach the target investment amount.¹⁵²

The reasons a company might still elect the Streamlined or Original FILOT structures over the Simplified option are unnecessary to go into here, other than to note that a measure of legal uncertainty surrounds the Simplified and Streamlined options. Suffice it to say, though, that what began as tax relief for a relatively small subset of large projects has grown to encompass a much broader range of investment. As of tax year 2016, 5.6 percent of the assessed value of all property in South Carolina was in a fee-in-lieu deal—a considerable amount, given that manufacturing properties not operating under a FILOT agreement only account for 3.3 percent.¹⁵³

Businesses with property in a fee-in-lieu arrangement receive the added advantage of ensuring that the assessed value of their real property remains constant for the duration of the agreement—not even subject to the capped assessment increases permitted for owner-occupied property. In some cases, moreover, companies can negotiate to lock the millage rate in place throughout the entirety of the FILOT deal.

These agreements make property taxes more competitive for qualifying businesses but are unavailable to business taxpayers who cannot meet the investment threshold or may not capture the interest of the local governing body. Their prominence is a reflection of an uncompetitive tax environment, and lower reliance on them—and more equitable treatment across all businesses—would be possible if reforms were made to the taxation of properties other than primary residences.

Property Tax Limitation Regimes

South Carolina offers both assessment and rate limits, designed to keep property tax burdens from growing too rapidly. These property tax limitations, though popular with taxpayers, impose heavy constraints on localities, which can create fiscal stress and force localities to increase taxes elsewhere in the system. They can also create substantial inequities for homeowners and discourage people from improving their property, or up- or downsizing as their family circumstances change.

151 S.C. Code Ann. § 4-12-10; § 12-44-10.

152 April C. Lucas, "Negotiated Fees In Lieu of Taxes and Special Source Revenue Bonds/Credits in South Carolina - 2010," 3.

153 South Carolina Department of Revenue, "Index of Taxpaying Ability 2018," May 11, 2018.

Assessment limits are meant to constrain incidental tax increases, driven not by conscious policy but by rising home values. Even if assessments rose uniformly across a given tax district, increased tax burdens might arise if local government officials are inattentive, or if they consciously choose to collect more revenue through inaction on rate reductions. In practice, however, assessed values may rise heterogeneously, such that some property owners experience significant tax increases even if overall collections remain flat.

Assessment limits are often understood as a way to avoid inadvertently pricing someone out of their home when assessed values (and thus tax burdens) rise. While the owner may be wealthier on paper due to the appreciation of their property value, their income flows and ability to pay higher taxes may not have risen proportionately. To critics, restrictions on assessment growth create sizable inequities over time and may adversely affect location decisions. To proponents, they help align the property tax with the taxpayer's ability to pay. In South Carolina, the increase in fair market value is capped at 15 percent over a five-year period provided the property does not change ownership.¹⁵⁴

Rate limits, conversely, function largely as a policy constraint. Whereas assessment limits are concerned with tax burdens which rise in the absence of any intervention, rate limits are designed to restrict the authority of local government officials to adopt a tax increase. South Carolina law limits millage rate increases to population and inflation adjustments,¹⁵⁵ though this limitation can be superseded under certain circumstances.

By a vote of two-thirds of council members, the millage rate limitation can be suspended to offset a budget shortfall from the previous year, to cover the costs of coping with a natural disaster, to comply with a court order, or to cope with losing a major taxpayer large enough to decimate property tax revenues—quite literally, to reduce collections by 10 percent or more.¹⁵⁶ Any suspension of the rate cap must be temporary, and each taxpayer's bill must list the surcharge as a separate charge and account for its imposition.¹⁵⁷

The millage limitation is best understood as a structural impediment to the growth of government. Revenues may rise if property values do—subject to the state's assessment limits—or if new property is placed into service, but under rate caps, local government officials are limited in their ability to engineer a conscious tax increase. Some view such limitations as a hallmark of good government, forcing governments to live within their means; others see such caps as artificial constraints which strip authority from the people's elected representatives and channel revenue generation efforts into other, often less efficient, taxes and fees.

Taken together, South Carolina's assessment and millage limits lead to the gradual erosion of residential property taxes as a source of local revenue. The assessment limit, moreover, can lead to highly unequal outcomes—what those in the policy community refer to as “horizontal inequity”—where nearly identical properties can face massively different property tax burdens. They also increase the cost of newly purchased homes and of new

154 S.C. Code Ann. § 12-37-3140(B).

155 South Carolina Department of Commerce, “Property Tax: Statewide Economic Growth and Taxation Issues in South Carolina,” 3.

156 Municipal Association of South Carolina, “Handbook for Municipal Officials in South Carolina,” 2017, 36.

157 *Id.*

construction, both relative to existing housing stock and in absolute terms.

Because the limit in assessment growth does not apply if an ownership interest in the property changes, moving from one home to another generally involves surrendering preferential tax treatment built up over years of undervaluation, creating a “lock-in effect” where homeowners have a disincentive to relocate.

Due to assessment limits, an ever-increasing share of property tax revenue must be generated from newer properties, or those which have changed ownership more recently. This often (but not exclusively) penalizes younger and lower-income homeowners, even though property tax limitations are often designed to benefit those with limited resources.

Assessment limits may also injure these classes of homeowners or would-be homeowners in another, more subtle way. Over the course of their lives, people frequently upgrade to larger and more expensive homes as they gain additional financial security, in the process selling their old, more affordable homes. When the lock-in effect keeps such individuals in their more modest homes longer, this decreases the stock of starter homes and other more affordable housing on the market, to the detriment of those with fewer financial resources.

Meanwhile, older homeowners who wish to downsize may face a higher tax burden imposed on a more affordable property. Additionally, homeowners in all stages of life are disincentivized from improving their properties, which can cause their assessed value to increase beyond the cap.

All of South Carolina’s notable policies on the taxation of real property—the assessment ratios, the tax limitations, and the exclusion of primary residences from the school operating costs millage—point in a single direction, toward the evisceration of the owner-occupied property tax base. Homeowners undoubtedly appreciate these preferences for now, but their long-term ramifications are unsettling.

Already, property taxes are disconcertingly high on rental properties, commercial properties, and second homes. Renters, who ultimately bear most of the burden of higher property taxes on rental properties, are taxed much more heavily than homeowners, even though many tenants are lower-income and often seek more affordable dwellings. A business taxpayer ineligible for a FILOT will have to think long and hard about the costs of locating or expanding her business in South Carolina, and such businesses will find themselves at a competitive disadvantage against their peers in other states and against competitors eligible for targeted abatements in South Carolina.

Over time, property tax limitations will make these effects even more pronounced, as revenue from owner-occupied property stagnates and localities are forced to rely even more heavily on other properties, a trend which is economically unsustainable. Perhaps of greater consequence for homeowners, though, these constraints have the potential to place a strain on public education funding, and while homeowners may appreciate their very low property tax liability, the families occupying those homes are also very invested

in a quality school system.

Property Tax Exemptions and Offsets

While some states provide a homestead exemption for all primary residences, South Carolina's is limited to the primary residences of taxpayers who are 65 or older, legally blind, or permanently disabled. Originally a \$20,000 exemption, it now exempts the first \$50,000 per eligible individual, and local governments are fully reimbursed by the state for the forgone revenue.¹⁵⁸

Meanwhile, manufacturing businesses are eligible for a five-year moratorium on the nonschool portion of the property tax, almost a mirror image of the exclusion available to homeowners, who are not subject to the school operating costs portion of the millage (though they do pay the portion devoted to capital costs). Companies entering into a fee-in-lieu deal waive the moratorium.¹⁵⁹

Finally, when the local option sales tax was adopted in 1990, permitting local governments to tack an additional percentage point on retail transactions, the intended purpose was the reduction of property taxes. By law, at least 71 percent of the proceeds of any local option sales tax must be used to offset property tax burdens through a property tax credit in proportion to fair market value. (Some localities have adopted offsets higher than 71 percent, with several implementing a 100 percent tax shift.) The credit appears on the property owner's bill as a deduction from taxes owed.¹⁶⁰

Because the offset is applied against fair market value, it disproportionately favors primary residences, which have the largest differential between fair market value and tax liability.¹⁶¹ Unsurprisingly, the share of local revenue generated from property taxes fell for cities adopting a local option income tax, but that decline was the most dramatic in smaller cities.¹⁶²

Personal Property Taxes

In the parlance of property taxes, *real* property is land, structures, and mineral estate, whereas *personal* property encompasses physical objects, including business equipment—often colloquially defined as property that can be touched and moved. In South Carolina, household goods are generally exempt, but individuals owe a personal property tax on automobiles, while businesses have the tax assessed on machinery, equipment, and other tangible property. Business inventory, however, is exempted, as is intangible property like stocks, bonds, and promissory notes.¹⁶³

Tangible personal property taxes reduce capital investment, particularly when the tax burden is heavy, as it is in South Carolina. Vehicles are subject to a 6.0 percent assessment

158 South Carolina Department of Commerce, "Property Tax: Statewide Economic Growth and Taxation Issues in South Carolina," 5.

159 April C. Lucas, "Negotiated Fees In Lieu of Taxes and Special Source Revenue Bonds/Credits in South Carolina - 2010," 1.

160 Municipal Association of South Carolina, "Handbook for Municipal Officials in South Carolina," 43.

161 South Carolina Taxation Realignment Commission, "Final Report," 188.

162 See Holley H. Ulbrich, "Local Option Sales Taxes and Municipal Finance in South Carolina: A Look at the First Few Years," Municipal Association of South Carolina, October 1996.

163 South Carolina Department of Commerce, "Business Incentives," January 2005, 13.

ratio, while business personal property is exposed to a 10.5 percent ratio, with none of the relief available to residential property.

In addition to the actual tax burden, tangible personal property taxes impose substantial compliance and administration costs because the tax levy is “taxpayer active.” This means that businesses must fill out forms identifying all their personal property subject to taxation and detailing relevant attributes including, but not limited to, a physical description, the year of purchase, the purchase price, and any identifying information (e.g., serial numbers). The tax is to be remitted upon the depreciated value of each article of personal property.

The direct and indirect costs of tangible personal property taxes have made such taxes a target for reduction or elimination in a growing number of states, as they are a barrier to economic growth. According to the Council on State Taxation, 48 percent of state and local business taxes remitted in South Carolina are property taxes,¹⁶⁴ and a not-insignificant share of that total is due to personal property taxes. A direct tax on capital formation, tangible personal property taxes are also distortionary, as they apply to some business inputs but not to others. Taxes and machinery and equipment create incentives for mobile capital to flow out of high-tax areas into low-tax areas.

The South Carolina Department of Revenue assesses business personal property, but does not collect it, leaving that task to county governments. Such property is valued at historical cost less a straight-line depreciation allowance.¹⁶⁵ In the 1990s, the state accelerated the depreciation of manufacturing personal property and increased the amount permitted to be depreciated, a change for which it reimburses localities.¹⁶⁶ Nevertheless, tangible property continues to face high and distortionary taxes in the state.

Implications of Act 388

Many of the biggest issues in South Carolina property taxation can be traced to the adoption of Act 388, known colloquially as the “tax swap,” in 2006. That legislation removed the school operating portion of a primary homeowner’s property tax bill—replacing a \$100,000 exclusion¹⁶⁷—in exchange for a one-cent increase (to 6 percent) in the sales tax while introducing a reduced rate for groceries, at 3 percent. (Groceries were later exempted from the sales tax altogether.) It also imposed South Carolina’s assessment and rate limitations.¹⁶⁸

Lawmakers concurrently passed the South Carolina Real Property Valuation Reform Act of 2006, mandating reappraisals after a transfer of interest, ensuring that, assessment limitations notwithstanding, a property *would* be reappraised upon sale.¹⁶⁹ As is often the

164 Council on State Taxation and State Tax Research Institute, “Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2016,” August 2017, 22, [https://www.ey.com/Publication/vwLUAssets/ey-total-state-and-local-business-taxes-2016/\\$File/ey-total-state-and-local-business-taxes-2016.pdf](https://www.ey.com/Publication/vwLUAssets/ey-total-state-and-local-business-taxes-2016/$File/ey-total-state-and-local-business-taxes-2016.pdf).

165 South Carolina Department of Commerce, “Property Tax: Statewide Economic Growth and Taxation Issues in South Carolina,” 2.

166 *Id.*, 4.

167 *Id.*, 1.

168 South Carolina Taxation Realignment Commission, “Final Report,” 187.

169 South Carolina Department of Commerce, “Property Tax: Statewide Economic Growth and Taxation Issues in South Carolina,” 6.

case, however, that legislation produced more questions than answers, precipitating a series of questions as to which sort of transfers, beyond the sale of a property, resulted in a new tax appraisal.

As we spoke with South Carolinians in researching this book, nothing was more certain than the prospect that every interviewee would bring up Act 388. It is, without a doubt, the biggest, most contentious, and most consequential tax change South Carolina has implemented in many years. Some of those we interviewed expressed satisfaction with Act 388, but most—including many who supported it at the time—lamented its consequences, believing that it has skewed the property tax code too much.

It is not, however, easily unraveled. Some of our interviewees contended that Act 388 is the third rail of South Carolina politics, while others were more optimistic about prospects for its reform. There is no denying that reform would be difficult, but things worth doing often are. As this chapter comes to a close, we will explore several ways to address the inequities and challenges created by Act 388, along with proposed reforms to elements of the state's system of property taxation.

Property Tax Solutions

Our property tax solutions would improve South Carolina's competitiveness by enhancing property tax neutrality and stability and reducing the need for targeted abatements.

Narrow Disparities in Assessment Ratios

South Carolina's current property classification schedule imposes widely disparate assessment ratios on different classes of property, then exempts select property owners from feeling the brunt of those disparities. All residences should face the same assessment ratio, and, at the very least, the manufacturing and business personal property ratios require a downward adjustment. The recent enactment of a phased-in deduction for manufacturing property establishes a framework for achieving this aim without amending the constitution, and should be used to get the manufacturing rate lower than 9 percent and offer a deduction for non-primary residences to bring them, functionally, to 4 percent. An ultimate goal of equalizing assessment ratios might be funded by additional local sales tax authority.

Reform Property Tax Limitations

Assessment limitations create serious inequities, tie the hands of local governments, and influence decisions about whether to improve or sell a property. Furthermore, if property taxes are understood as being closely related to the services one receives, then they ought to be assessed in relation to market value, without a preference for properties held unaltered for long periods. Because the millage limits implemented under Act 388 impose a strict limitation on the growth of property tax collections overall, assessment limits should be unnecessary.

Optimal policy, therefore, would be repeal of the assessment limitations, allowing taxes to rise and fall on property in tandem with its increases or decreases in value. If desired, policymakers could adopt a circuit breaker for elderly, disabled, or low-income taxpayers in its stead, though seniors and disabled taxpayers already receive a generous homestead exemption.

Short of the repeal of the assessment limitation, it might be relaxed, and a provision could be added to avoid a downward ratchet effect when assessed values fall. The current assessment limit caps *increases* in appraised values, but not *decreases*. If a property's fair market value plummets during a recession, and that lower value is captured in a reappraisal, a recovery of the property's prior value is still limited by the cap. At the very least, a property should be allowed to regain its prior value without regard to the cap.

The rate limitation, meanwhile, has no catch-up provision if localities elect not to increase the property tax rate the allowable amount a given year, and unlike many rate limitations, lacks a voter override, only allowing an exception to the rate limitation for limited purposes. Should policymakers wish to give localities additional flexibility, they could modify these provisions to allow rates to "catch up" or to grant local governments an appeal to the voters.

The exclusion of the millage associated with school operating costs from taxes on primary residences yields extremely attractive effective rates for those properties, but at a cost in overall state competitiveness and, ultimately, in the ability to ensure appropriate levels of school funding. Reversing this provision of Act 388 in one fell swoop may be difficult, but policymakers should prioritize phasing it out. They could do so over time, perhaps by phasing it back into the base in increments of 20 percent a year, reducing the exclusion from 100 percent to 80 percent, then 60 percent, and so on until the exemption is eliminated.

Eliminate the School Operating Costs Differential

In its place, policymakers might well leave a dollar-denominated exclusion (functionally a homestead exemption for all taxpayers) similar to the \$100,000 exclusion which predated Act 388. Optimally, however, this exclusion would be less than \$100,000. It is worth noting here that the median value of owner-occupied property in South Carolina is \$161,800, meaning that an exclusion at that level would exempt 62 percent of the median owner-occupied residential property from tax. The phasedown could be accompanied by mandatory rate reductions, keeping owners' property tax liability from rising rapidly while beginning to rebalance some of the inequities between different classes of property.. Sales Tax base broadening could yield some additional revenue to assist with such a transition. Any such restoration of the school operating costs millage should be paired with broader tax relief.”

Replace School Operating Costs Millage with a Statewide Tax

As an alternative to phasing the school operating costs millage back onto owner-occupied properties, parity could be achieved by removing school operating costs from *all* property taxes to eliminate the disparity while preserving current treatment of primary residences and replacing it with a statewide millage or other statewide tax for school operating costs. This would address the disparities within an individual jurisdiction and address the growing differentials between funding for high- and low-growth school districts.

State government often invests heavily in large economic development projects which expand the property tax base for a particular community, without similar growth in the surrounding jurisdictions where employees' children actually attend school. Enhancing the state's equalization efforts by imposing a statewide millage in lieu of the existing local school operating cost millages is one way to address inequities in the property tax and disparities in school finance simultaneously

Reduce Reliance on Business Personal Property Taxes

South Carolina could follow the lead of other states and adopt a *de minimis* exemption to reduce compliance costs for smaller businesses with a minimal loss of local revenue. Under this approach, the state might exempt the first \$25,000, \$50,000, or \$100,000 of business personal property from taxation, and not require businesses or individuals to file if the value falls below that threshold.

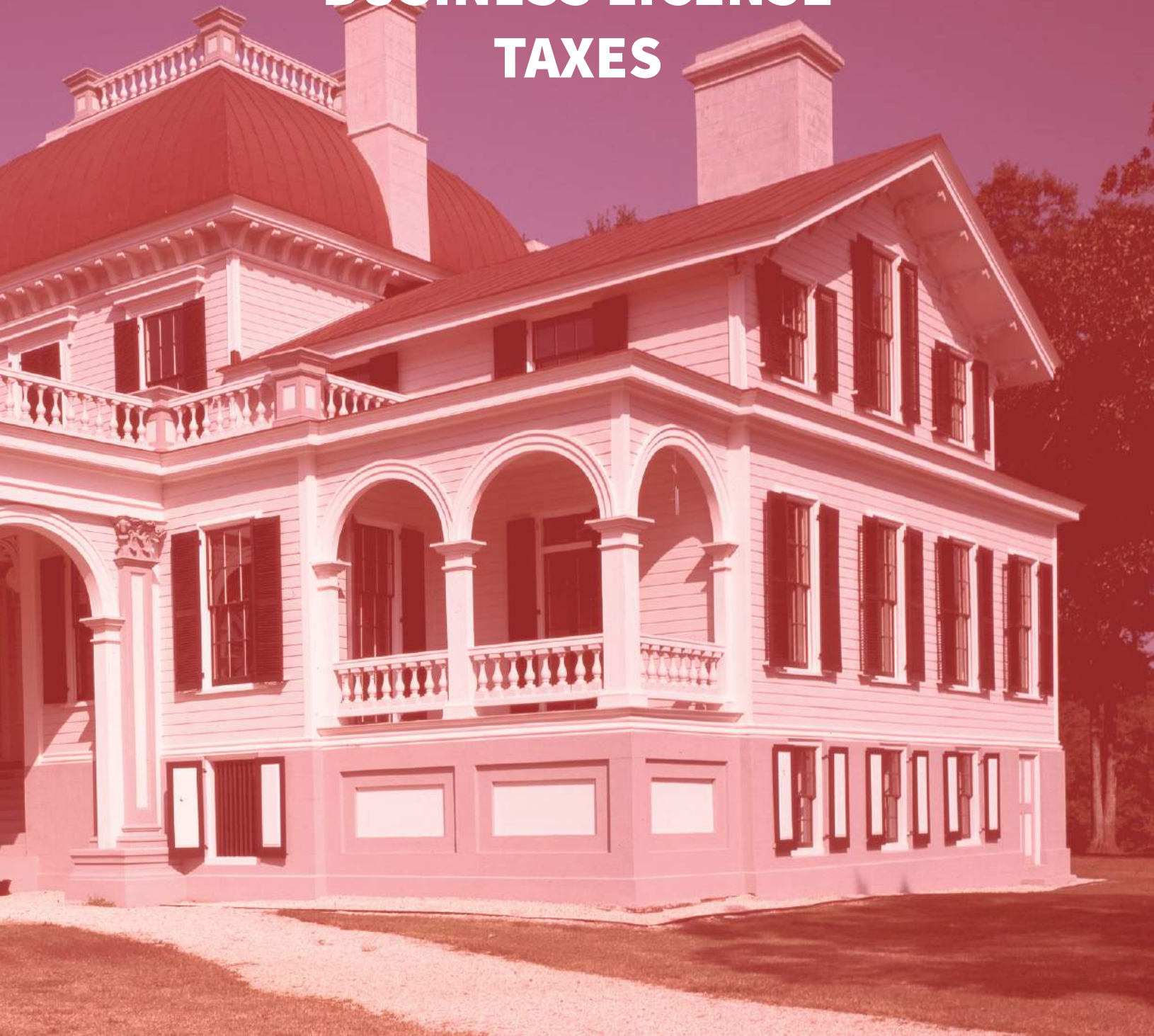
The state could also phase out the tax over time by exempting new property from taxation, as Maine and Kansas have done.¹⁷⁰ This has the advantage of limiting the immediate impact on local bases, while encouraging economic growth by keeping new and expanding business from entering the system in the future. Over time, taxable old equipment is replaced with new equipment that is exempt from the tax, while local governments avoid steep and sudden reductions in tax revenue, instead relying on gradual cuts that could be absorbed by real property or other taxes over time without large rate increases.

Alternatively, South Carolina could promote greater tax competition within the state by enacting an option for localities to make these exemptions more generous or to repeal them outright within their borders. In the absence of a move toward statewide repeal, a local option, either standing alone or coupled with other reforms, would help reduce reliance on an antiquated tax without statutorily restricting local property tax bases.

170 Joyce Errecart, Ed Gerrish, and Scott Drenkard, "States Moving Away from Taxes on Tangible Personal Property," Tax Foundation, Oct. 4, 2012, <https://taxfoundation.org/article/states-moving-away-taxes-tangible-personal-property>.

CHAPTER 7

**BUSINESS LICENSE
TAXES**



Introduction

While property and sales taxes together form the lion's share of local tax revenue, South Carolina also leans heavily on business license taxes, which can impose very high compliance costs on some businesses. Actual tax burdens vary widely, with the tax structured so poorly that some businesses find themselves at the mercy of local governments to avoid tax liability massively out of proportion with their economic activity within a given jurisdiction. These taxes constitute a serious impediment to the state's overall competitiveness.

Overview of a Burdensome Tax

South Carolina's business license taxes have evolved over the years, but the adaptations that have taken hold are far from a case of survival of the fittest. The legislature first adopted a license tax law in 1872, but repealed it almost immediately as legal challenges mounted.¹⁶⁹ That tax, administered by county treasurers, generated revenue for the state government. Under the 1895 constitution, license taxes were specifically authorized for the first time, for both state and local governments, and granted an exception to the constitution's tax uniformity requirements. Subsequently, a series of court cases over the course of nearly a century gradually defined the parameters for business license taxes.¹⁷⁰

Today, municipalities may levy business and occupational license taxes on the gross income of any business operating within their geographic boundaries unless expressly prohibited by state or federal law.¹⁷¹ Because businesses frequently operate in many jurisdictions, this can require them to maintain licenses and remit tax to a large number of local governments, even if their contact with a given jurisdiction is limited—in some cases, even a single delivery, installation, or service call. In practice, according to government officials with whom we spoke, compliance tends to be low among businesses with limited dealings in a given jurisdiction.

The compliance costs of dealing with many jurisdictions can be high. Localities use different forms, have different filing deadlines, and use different classification systems for businesses. Each jurisdiction collects separately; businesses cannot file or remit in one place or carry over information from one form to another.

The complexity is almost comic. In Columbia—which is no worse than many of its peers—there's one rate for wholesale food sales, and a separate rate for wholesale *sandwich* sales. There's a standard retail rate, but that doesn't prevent the ordinance from having special rates for particular kinds of retail stores, including harness shops, presumably frequented by the owners of the horse-drawn carriage businesses that also come in for their own unique rate.¹⁷² (There *are* still horse-drawn carriage establishments in the city, of course.)

169 William Quirk, "Nature of a Business License Tax," *South Carolina Law Review* 32 (1981), 473.

170 *Id.*, 478-479.

171 Municipal Association of South Carolina, "Handbook for Municipal Officials in South Carolina," 2017, 37.

172 Columbia, South Carolina, Municipal Code § 11-49.

If you're in the donut business, it's pretty simple: retail sales of donuts are subject to the general retail rate, and wholesale donut sales fall under the general wholesale schedule. Not so for ice cream, though: while retail ice cream sales get the regular retail rate, ice cream wholesalers have their own special category, which is itself distinct from the rate schedules for creameries and dairies. There's a rate schedule for sales of peanut and popcorn roasting machines, and for pumpkin stands, and for itinerant photographers. Some businesses, like taxicabs and event organizers, face taxes based on additional factors other than gross income, like the number of cars in service or the number of functions held.¹⁷³

And that's just one city. What constitutes general retail in Columbia might have its own special category in Sumter, or vice versa. The system is hopelessly complex.

These separate rates are intended to address the inequities inherent in a tax on gross receipts. Once common, gross receipts taxes are now rare because they are widely (and correctly) regarded as nonneutral and economically damaging.

Because they are levied on gross income, these taxes are indifferent to profitability and thus to ability to pay. Gross receipts taxes heavily penalize new firms, those with narrow profit margins, and those posting actual losses. When they are imposed at multiple stages of the production process, moreover, they lead to what is called "tax pyramiding," the result being that the final product contains multiple layers of taxation. Under gross receipts taxes, businesses experience vastly different effective tax rates. The same statutory tax rate might be inconsequential for a high-margin boutique shop but devastating for a low-margin convenience store. Hence the differential rates—but that's a patch, not a real solution.

Consider, for instance, the fact that artists, attorneys, caterers, engineers, accountants, auditors, osteopaths, and veterinarians, among others, all pay the same "professional rate" under Columbia's business license tax. There's not enough granularity to distinguish between artists and attorneys in an ordinance that has its own rate for sales of popcorn roasting machines. And this can be a problem not just because the margins can be radically different across professions, but also because of how much they can vary within them. Corporate litigators, criminal defense attorneys, lawyers who primarily practice in traffic court, or provide will-drafting services, or represent indigent defendants—all these practitioners, likely with extremely different profit margins, face the same rate on their gross income. Whatever set of categories policymakers create, they can never capture variation across firms—an inherent flaw of gross receipts taxation.

Only five states impose statewide gross receipts taxes (all but Delaware forgo a corporate income tax), and only a smattering of states (like Pennsylvania, Virginia, and West Virginia, in addition to South Carolina) authorize them at the local level. South Carolina is unique—and not in a good way—in allowing each locality to create its own complex rate schedule, with its own business classifications. By contrast, Pennsylvania only allows local governments to choose between one or two categories (and no longer allows the creation of new gross receipts taxes), and Virginia and West Virginia have uniform classification schedules that apply to all local jurisdictions.

Under Virginia's Business, Professional and Occupational Licensing (BPOL) tax, for instance, there are separate categories for contractors, retailers, wholesalers, financial and professional services providers, and other service providers, but a given business's classification will be the same in all jurisdictions that impose the BPOL. Not so under South Carolina's business license tax.

The result is costly and inequitable tax for some, and a headache for many. In recent years, policymakers have explored a number of options for streamlining the process, such as mandating a uniform collection cycle, requiring all localities to use the same classification system (though not the same rates on those classifications), creating a single form that can be submitted to all localities, establishing a filing and payment portal, or consolidating the filing and payment process in a central location, under the auspices of state government or, under one proposal, the Municipal Association of South Carolina. These proposals have met with varying levels of local resistance and have not, to date, taken hold.

Local Authority to Impose Business License Taxes

Under South Carolina law, local governments have considerable latitude in imposing business license taxes. Statutorily, they must be levied on gross income, though the term is not defined by the state and historically, definitions have varied from jurisdiction to jurisdiction.¹⁷⁴ A recently decided lawsuit may change that, as the state supreme court sided with a taxpayer who objected when two overlapping jurisdictions applied conflicting definitions of gross income.¹⁷⁵ Thus far, however, minimum tax obligations, though not actually based on gross income, have been allowed to stand.

Nothing in state law prohibits county and municipal governments from establishing whatever classifications and rate schedules they wish, and rates across classes need not be—indeed, are not—uniform. The judiciary may require a showing that a rational basis exists for particularly wide disparities in rates between classes,¹⁷⁶ but in practice, courts have been extremely reluctant to interfere with local governments' rate-setting authority, and aggrieved taxpayers face a nearly insurmountable burden of proving that the disparity is unconstitutional beyond a reasonable doubt.¹⁷⁷ The courts have expressly established,

174 S.C. Code Ann. § 5-7-30.

175 *Todd Olds v. City of Goose Creek*, Op. No. 27829 (S.C. Sup. Ct. filed Aug. 8, 2018).

176 *Carter v. Linder*, 303 SC 119, 399 S.E.2d 423 (1001).

177 Russell S. Sobel, "Reforming South Carolina's System of Business Licensing," Baker School of Business at The Citadel, May 2015, 10-11, <http://faculty.citadel.edu/sobel/UC/SC%20Business%20Licensing%20Study%20Sobel%20Edit.pdf>.

moreover, that localities can impose higher rates on nonresidents.¹⁷⁸ And while there technically may be a reasonableness standard, the fact of a business's unprofitability does not render the imposition of a tax on that business unreasonable, according to multiple court decisions.¹⁷⁹

Similarly, while the Municipal Association of South Carolina offers a model business license ordinance tied to nationally-recognized industry classifications, localities are free to come up with just about any method of classification they want. They can, moreover, impose a business license tax for the privilege of doing business in the county or municipality regardless of whether a company has established a place of business within local limits,¹⁸⁰ and perhaps most astonishingly, the tax can reach income earned elsewhere—even in other countries.¹⁸¹

Determination of Taxable Gross Income

Apportionment of business license taxes is a matter of great importance for some businesses. Local governments have the right to tax any outside income on which business license taxes have not been paid to another municipality, including gross income earned in other states or across the world, with no connection to any activity in a South Carolina jurisdiction other than that it is earned by an entity also doing business in South Carolina.¹⁸² This is in marked contrast to practices in other states, most of which forgo local taxation of business income altogether. Even when local governments do tax business income—on a gross or net basis—other states are more constrained in their reach. By contrast, a multinational's entire global income can fall under a South Carolina business license tax because of one local transaction.

This result is clearly absurd, and untenable for many businesses, which is why another policy has arisen: the handshake agreement. Although not sanctioned by any law, it is a matter of common knowledge that many businesses have reached informal agreements with cities and counties to pay far less than they ostensibly owe under business license taxes, and for the jurisdiction to accept that lower payment without protest. This is, however, an inherently dicey proposition, as the reduced burden is never formally agreed to, is not actually permitted under law, and is accepted only as a matter of local governmental forbearance. It could be withdrawn at any time, and theoretically nothing would prevent a local government from going after a business which had been chronically underpaying, even if that underpayment was done with the support of local government officials.

178 See *American Bakeries Co. v. Sumter*, 173 S.C. 94, 174 S.E. 919 (1934).

179 Municipal Association of South Carolina, "Business License Handbook," 2013, 11.

180 *Id.*, 9.

181 *Eli Witt Co. v. City and West Columbia*, 309 SC 555, 425 S.E.2d 16 (1992).

182 Municipal Association of South Carolina, "Business License Handbook," 15.

All taxes on gross income have a tendency to pyramid, but sometimes the double taxation is exceedingly obvious. A contractor, for instance, owes business license tax on the entirety of the income earned from a particular job—and all the subcontractors owe business license tax on the entirety of their income as well, even though much of the contractor's gross income is dedicated to paying those subcontractors.

The Municipal Association of South Carolina defends this result in its handbook on business license taxes, arguing that it does not actually constitute double taxation because the tax is imposed on the privilege of doing business, not on the income from doing business, even though the tax on that privilege is assessed according to income. This conclusion is economically perplexing, but there is no doubt that this double taxation is permissible in South Carolina as a matter of law:

Subcontractors are not exempt from a business license tax even though the general contractor may pay a tax on the full contract price of a project. A general contractor cannot deduct the amount paid to a subcontractor from the gross income upon which he computes his license tax. The contractor and subcontractor are two different people or entities engaged in two different business activities. Each is subject to a license tax based upon the gross income received. The tax is levied upon the privilege of doing business not on the income. Therefore, there is no double taxation, as is frequently argued.¹⁸³

Notably, local governments frequently lean on contractors to serve as unofficial enforcement and collection agents, refusing to issue occupancy permits to a general contractor until every subcontractor has remitted his or her business license tax. This puts immense pressure on the contractor to monitor subcontractors' tax payments and punishes the contractor for any failure or insufficiency on the part of entirely different companies.

Nor is pyramiding the only way that business license taxes lead to double taxation. In addition to this tax on gross income, businesses are of course subject to taxes on net income, and employees are taxed on wage income. To the extent that business license taxes are understood as funding the services local governments provide to businesses, this is duplicative of the intent of the state's already high commercial, industrial, and manufacturing property taxes.

South Carolina's business licenses taxes are highly atypical. Localities in other states often levy modest taxes on incorporation. A smaller number of states permit localities to impose taxes on business income—gross or net. South Carolina, however, not only taxes on gross income but, by failing to adopt any limits on apportionment, potentially allows local governments to capture the entirety of a company's worldwide income within their tax base. Such a system is unique to South Carolina.

¹⁸³ Id., 26.

Compliance with Business License Taxes

According to Dr. Russell Sobel, a professor of economics at The Citadel, government administration of business license taxes consumes about 6.5 percent of the revenue collected, a fairly high amount, but it pales in comparison to the compliance costs imposed on businesses.¹⁸⁴ While a brick-and-mortar establishment that doesn't make deliveries may only have to worry about one or two business license taxes (at most, a city and a county tax), it is not uncommon for service providers or companies with a delivery model to be subject to dozens of local business license taxes, nearly all of which are administered independently of each other. As Sobel observed, to serve all the towns within a short drive of Charleston, a business would need three county and a minimum of 28 municipal business licenses.¹⁸⁵

Some municipalities allow online filing; many do not. Some adopt the Municipal Association's model ordinance and thus use a common classification schedule; others don't. Forms vary, as do filing periods. While the occasional municipal government allows counties to administer the tax on its behalf, most governments administer the tax independently, requiring businesses to register, file returns, and remit tax separately in each relevant jurisdiction. For a small business, dealing with tax compliance in dozens of jurisdictions is often far costlier than its actual liability.

The tax imposes burdens on consumers too, some less obvious than others. The most straightforward cost is, of course, the share of the tax and compliance burden that is passed onto consumers in the form of higher prices. But prices may be higher, and options fewer, for another reason as well: reduced competition. The burdens associated with serving a potential customer in a new town may be too high to justify it; businesses may artificially circumscribe their service area to avoid needing to comply with additional license requirements.

Reform Considerations

The complexity, inequity, and high compliance costs of business license taxes have made them a target of reformers for many years, but their importance as a local revenue source has made reform difficult. As South Carolina's economy grows and evolves, however, the business license tax structure must change with it.

The menu of possible reforms is not new. Modest tweaks would include requiring all municipalities to adopt the same filing cycle or establishing a standard form that could be returned to all jurisdictions. Slightly more ambitious changes might include lodging responsibility for administration with counties rather than each individual municipality to facilitate simplified filing, or adopting a uniform classification schedule (to which local governments could attach their own locally-adopted rates) for all jurisdictions, as the state has already done for other taxes.

¹⁸⁴ Russell S. Sobel, "Reforming South Carolina's System of Business Licensing," 19.

¹⁸⁵ Id., 15.

Serious efforts to tackle simplification would centralize administration, collections, and auditing functions in a single entity, either through the office of the Secretary of State or the Department of Revenue. The former might be more palatable to local governments, as the Secretary's office could serve as a central payment processor without ever receiving or depositing the revenue into a state fund for local disbursement, as the Department of Revenue would do. Truly comprehensive business license tax reform would restrict the ability to tax income earned elsewhere and might even revisit the tax base of gross income, instead taxing businesses on net income, reflecting ability to pay.

Some of these options are ambitious. Several have been considered in the past and gained little traction. This does not, however, lessen their importance, and should not permit them to be dismissed as pipe dreams. The current system is broken. What, really, are local governments giving up by adopting a responsible method of apportionment if, for large multistate and multinational firms, they are already entering into handshake agreements which waive most tax liability? Businesses crave certainty, and localities need ways to impose the tax in a more neutral and equitable manner.

Business License Tax Solutions

Our business license tax solutions would enhance South Carolina’s competitiveness by reducing compliance costs and increasing tax neutrality.

While acknowledging that license tax reform is a heavy lift, we do not believe that minimalist reform recommendations are appropriate for a tax this dysfunctional. Tackling business license taxes is necessary to improve the state’s business climate. In the course of our research, we heard about contractors and real estate agencies which have to devote a full-time staffer to deal with business license taxes. We met business owners who spoke of wasted days, and of running up against competitors who evade the tax.

Government officials told us of chronic underpayment, frequently smiled upon by municipalities which recognize that full enforcement would put localities and businesses alike at a competitive disadvantage. We heard of handshake deals which all but eliminated liability for some companies while others paid full freight. Even the ostensible winners in this arrangement, the companies with their own deals with municipal officials, dislike the current system, because they know that their arrangements could be suspended at any point, with impractical results—like subjecting the worldwide income of a multinational corporation to a local business license tax in South Carolina.

If ever a tax demanded meaningful reform, it is this one. While getting all jurisdictions on a uniform tax cycle is worthwhile—indeed, it should have been done long ago—real reform must tackle central administration (with a uniform classification schedule), apportionment requirements, and the tax base itself. State government could operate as a payment processor, not a tax collector, administering the tax on behalf of local governments without ever receiving the revenue.

Taxpayers should be able to enter their details in one place and obtain additional business licenses with minimal effort. Were a state agency to maintain a web portal, a taxpayer requiring an additional license could simply log on, select the locality, and approve a payment, without the need to worry about differing definitions or waste time on duplicative paperwork. Local governments would still be free to set their own rates for each class of business and could accept paper returns from businesses which still wished to file that way.

This would mean an end to handshake deals, and some businesses would wind up paying substantially more, though some in the business community told us that this greater certainty and predictability would be well worth the trade. For most businesses, moreover, there would be a substantial reduction in tax compliance, which should be a top priority. Compliance costs are deadweight losses which leave the taxpayer worse off without enhancing local revenues.

That would make it even more vital, however, to simultaneously tackle the issue of apportionment and to reconsider the tax's base of gross income. If businesses are paying the statutorily indicated amount—which they should—then it is necessary to ensure that businesses are being taxed on economic activity reasonably associated with the county or municipality to which they are remitting taxes.

To avoid double taxation, most other business taxes—at the federal, state, and local levels—are apportioned based on factors like sales, payroll, and property. (At the state level, the corporate income tax in South Carolina is based entirely on where a sale takes place.) While the overlap of different apportionment methods can lead to some amount of double taxation, it is almost unheard of for one taxing jurisdiction to claim a right to tax all of the economic activity of a company, wherever it takes place—but that is exactly what is claimed under the Business License Tax. But for handshake deals, it would be incredibly difficult for any large multistate, to say nothing of multinational, firm to ever locate in South Carolina.

Broad-based reform would also shift from gross to net income, taxing on the basis of profitability, not revenue. Although local governments could accomplish this by providing deductions for cost of goods sold, compensation, and other core costs of doing business, a better solution would be to eliminate the business license tax as it currently exists, replacing it with (1) a flat annual license fee for the privilege of doing business in a locality, and (2) local authority to “piggyback” on the state corporate income tax, which would solve both apportionment and definition of income. A full revenue offset might not be necessary within the context of a broader tax reform plan which includes sales tax base broadening, since local governments would enjoy additional sales tax revenue as well.

ABOUT THE TAX FOUNDATION

The Tax Foundation is the nation's leading independent tax policy research organization. Since 1937, our research, analysis, and experts have informed smarter tax policy at the federal, state, and local levels. Our Center for State Tax Policy uses research to foster competition among the states and advises policymakers on how to improve their tax systems.

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ABOUT THE SOUTH CAROLINA CHAMBER

The South Carolina Chamber Foundation's mission is to advance the long-term welfare of South Carolina and her citizens by identifying, researching and analyzing policies that are key to improving the business climate, workforce readiness, and quality of life in the Palmetto State. The Foundation is affiliated with the South Carolina Chamber of Commerce which strives to make South Carolina the best place in the nation to live, work and do business.

South Carolina policymakers have worked hard to position the state for success, but an outmoded and inefficient tax code stands in the way of the state achieving its full potential. The individual income tax features the highest top marginal rate in the Southeast and the highest effective rates in the region for many wage earners. A byzantine system of fees in lieu of taxes has emerged to offset an otherwise deeply uncompetitive property tax system for many businesses. The sales tax has failed to keep pace with today's economy. Compliance with local business license fees is complex and time-consuming.

Some of these challenges are unique to South Carolina, while others are more widespread. In many cases, systems developed over time, more by accident than design. And they're holding South Carolina back.

The problems with South Carolina's tax code are not, ultimately, questions of revenue. South Carolina is by no means a high tax state, though it can feel that way for certain taxpayers. The problems come down to questions of tax structure. This book seeks to identify what South Carolina does well and to point out opportunities for improvement. It is our hope that this book will help inform a robust and much needed debate about the future of the state's tax code.



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