The “Single Sales Factor” Formula for State Corporate Taxes:

A Boon to New York Economic Development Or a Costly Giveaway?

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“As a businessman I never made an investment decision based on the tax code. If you give money away I will take it, but good business people don’t do things because of inducements.”

— Paul H. O’Neill, Secretary of the Treasury, January 17, 2001
• An enormous body of economic research supports O’Neill’s statement:

  ▶ State/local taxes are a very small share of business costs.

  ▶ Differences among states in business tax burdens are small and getting smaller.

  ▶ Differences among states in business tax burdens are swamped by differences in wage, transportation, energy, and other costs that vary much more among states than business taxes do.

  ▶ These other costs represent a much larger share of business costs than state/local taxes do and therefore affect business location decisions much more than state/local taxes do.
• Even granting that — all other things being equal — state/local taxes might tip the balance in favor or against a particular location for a business investment. . .

• The proposal for a “single sales factor” corporate income tax “apportionment” formula for manufacturers (SSFF) is likely to be cost-ineffective as an economic development incentive.

  ▶ It is likely to be far more costly in foregone state corporate income tax revenues than is being predicted.

  ▶ Tax breaks would be automatic for corporations receiving them and not tied in any way to new New York job creation/investment.

  ▶ SSFF would inherently create as many incentives to avoid creating jobs in New York or to remove existing jobs as it would to create new jobs in New York.
Part I:

How New York Taxes Multistate Corporations
It’s necessary to understand 3 basic concepts related to state taxation of multistate corporations to appreciate policy issues raised by single sales factor formula.

- **Corporate profit/net income** — what is taxed
- **Nexus** — what firms are taxable
- **Apportionment and apportionment formulas** — how much of a corporation’s profit is taxed by a particular state
Corporate profit

- Corporate profit equals sales (revenues) minus:
  - Cost of buying or making goods sold or Cost of providing services
  - Interest (wkg capital, mortgages, bonds)
  - Rent, royalties, licensing fees, etc.
  - Payroll & expenses for admin. overhead
  - Advertising & other marketing costs
  - R&D
  - Depreciation (annual pro-rata share of cost of equipment and real property)
Nexus

• Definition: having made sufficient contact with a state to be subject to tax in that state (in this case, subject to corp. income tax)

• Making profitable sales in a state does not automatically obligate an out-of-state corp. to pay a corporate income tax to that state

• Having a significant physical presence in a state (facilities and/or personnel) usually establishes nexus for corp. income tax

• But federal Public Law 86-272 provides that one kind of significant physical presence is not sufficient to establish state corp. income tax nexus
Nexus (continued)

• P.L. 86-272 provides that a corporation can have an unlimited number of salespeople in a state without establishing nexus for state corporate income tax, provided:

  ▶ the corporation is selling or reselling goods (not services)

  ▶ the salespeople work out of their homes or visit from out-of-state

  ▶ the orders are “accepted” out-of-state

  ▶ the goods are shipped into the state from an out-of-state origination point

• Thousands of wholesaling and manufacturing corporations are “immunized” from corporate income tax obligations in scores of states — including New York — by P.L. 86-272
Apportionment

Scenario:

Profitable oil company has:

- Oil fields in 2 states
- Refineries in 4 states
- Gas stations in these 6 states and 14 additional states

Dilemma: How do these 20 states decide how much of this corporation’s profit to tax?

Solution:

- These 20 states tax their pro-rata “fair share” of this corporation’s nationwide profit
- That share is determined by use of an “apportionment formula”
Apportionment (continued)

• Most states use variant of the “3-factor” formula — determining their taxable share of the corporation’s profit in relation to their in-state shares of its property, payroll & sales.

• Under traditional 3-factor formula, if

  ▶ 60% of Westchester Widget Co.’s property is located in NY; and

  ▶ 50% of its payroll is paid in NY; and

  ▶ 10% of its sales are to NY customers,

  then

the portion of Westchester Widget Co.’s nationwide profit subject to tax by New York would be the average of these 3 percentages:

\[
\frac{(60\% + 50\% + 10\%)}{3} = 40\%
\]
Apportionment (continued)

• Most states — including New York — now use “double-weighted” sales variant of 3-factor formula

• Under double-weighted sales variant, amount of Corporation X’s profit that is taxable by New York is equal to the average of 4 percentages:
  
  - NY share of total Corp. X property
  - NY share of total Corp. X payroll
  - NY share of total Corp. X sales
  - NY share of total Corp. X sales

For Westchester Widget Company, the share of its profit that would be taxable in NY would be 32.5% :

\[
(60\% \text{ property} + 50\% \text{ payroll} + 10\% \text{ sales} + 10\% \text{ sales}) \div 4 = 32.5\% 
\]
Better Boxes, Inc. (BBI) manufactures corrugated cardboard boxes in Georgia and sells them directly to customers in Georgia, Florida, and South Carolina. BBI’s total profit in 1998 was $2,000,000. The other financial statistics relevant to BBI’s apportionment calculation for 1998 were as follows:

<table>
<thead>
<tr>
<th>State</th>
<th>Property</th>
<th>Payroll</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Georgia</td>
<td>$25,000,000 (HQ and manufacturing plant)</td>
<td>$4,000,000 (HQ, sales force and manufacturing plant)</td>
<td>$6,000,000</td>
</tr>
<tr>
<td>S. Carolina</td>
<td>$5,000,000 (warehouse)</td>
<td>$1,500,000 (warehouse)</td>
<td>$13,000,000</td>
</tr>
<tr>
<td>Florida</td>
<td>$500,000 (sales office)</td>
<td>$500,000 (sales force)</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>TOTALS</td>
<td>$30,500,000</td>
<td>$6,000,000</td>
<td>$20,000,000</td>
</tr>
</tbody>
</table>

BBI’s profit taxable by Georgia:

\[
\text{BBI's profit taxable by Georgia: } \frac{\left( \frac{\text{Property of BBI in Georgia}}{\text{Property of BBI everywhere}} \right) + \left( \frac{\text{Payroll of BBI in Georgia}}{\text{Payroll of BBI everywhere}} \right) + 2 \times \left( \frac{\text{Sales of BBI in Georgia}}{\text{Sales of BBI everywhere}} \right)}{4} \times 2,000,000 = 2,000,000 \times \frac{.82 + .67 + 2 \times .3}{4} = 2,000,000 \times .52 = 1,040,000
\]

Fifty-two percent of BBI’s nationwide profit of $2 million — or $1.04 million — is taxable by Georgia.

BBI’s profit taxable by South Carolina:

\[
\text{BBI's profit taxable by South Carolina: } \frac{\left( \frac{\text{Property of BBI in S Carolina}}{\text{Property of BBI everywhere}} \right) + \left( \frac{\text{Payroll of BBI in S Carolina}}{\text{Payroll of BBI everywhere}} \right) + 2 \times \left( \frac{\text{Sales of BBI in S Carolina}}{\text{Sales of BBI everywhere}} \right)}{4} \times 2,000,000 = 2,000,000 \times \frac{.18 + .33 + 2 \times .7}{4} = 2,000,000 \times .52 = 1,040,000
\]
Forty-three percent of BBI’s nationwide profit of $2 million — or $860,000 — is taxable by South Carolina.

BBI’s profit taxable by Florida:

\[
\text{Total profit of BBI} = 2,000,000 \times \left[ \frac{.16 + .25 + 2 \times .65}{4} \right]
\]

\[
= 2,000,000 \times .43
\]

\[
= 860,000
\]

Note that all of BBI’s $2 million profit is assigned for tax purposes — “apportioned” — to one of the three states in which it does business. That is, $1,040,000+$860,000+ $100,000= $2,000,000. This results from the fact that all three states use the same formula. Had one or more of the three states used different formulas, more or less than 100 percent of BBI’s profit might have been apportioned to the three states in the aggregate.

Five percent of BBI’s nationwide profit of $2 million — or $100,000 — is taxable by Florida.
Part II:

What a Single Sales Factor Formula Does
“Single Sales Factor” Formula (SSFF)

• Under SSFF, share of a corporation’s profit taxable in a state is equal to share of its nationwide sales located in that state — property & payroll factors are not taken into consideration

• Why do corporations like the SSFF?

A state’s unilateral adoption of SSFF provides automatic corp. income tax cut to any corp. that is producing goods within the adopting state but selling a “disproportionate” share of those goods outside the state.
Recall Better Boxes, Inc. example:

- 82% of its property in Georgia
- 60% of its payroll in Georgia
- 70% of its sales outside Georgia (30% inside)

Under (double-weighted sales) 3-factor formula, BBI had 52% of its nationwide profit taxed in Georgia — but only 30% under SSFF

What happened to the 22% of BBI’s profit Georgia is no longer taxing?

As long as the other states in which BBI is taxable do not also adopt a SSFF, that 22% of BBI’s profit is “nowhere income” — profit that is not taxed anywhere.
• If all 3 states in which BBI is taxable adopted SSFF, shares of BBI’s profit taxable in each of them would be re-arranged, but would still total 100% — no “nowhere income”

• Lesson 1: NY’s unilateral adoption of SSFF will create “nowhere income” for many in-state corporations when they sell into states that have not adopted SSFF

Note: BBI’s Georgia tax cut was automatic — no new jobs had to be created or investments made
Why NY corporations want SSFF (II):

• Take NY manufacturer with 100 % of property and payroll in NY and 100% of sales in PA

• Assume NY corporation not taxable in PA due to protection of P.L. 86-172 (PA business solicited by traveling sales force)

• Under current NY formula, corporation subject to NY tax on 50% of its profit: 
  \[
  \frac{100\% \text{ NY property} + 100\% \text{ NY payroll} + 0\% \text{ NY sales} + 0\% \text{ NY sales}}{4}
  \]

• Since corporation not taxable in PA, 50% of its profit is “nowhere income”

• Under SSFF, none of corporation’s profit taxable in NY (0% NY sales); since not taxable in PA, 100% of its profit is “nowhere income”
• Lesson II: New York’s adoption of SSFF will vastly expand amount of untaxed profit received by NY manufacturers making sales in states in which they are not taxable
Does a state’s adoption of SSFF provide tax cut to all taxable corporations?

- Better Boxes, Inc. in South Carolina:
  - 16% of BBI’s property in SC
  - 25% of BBI’s payroll in SC
  - 65% of BBI’s sales in SC
  - 43% of BBI’s profit taxable in SC under 3-factor formula (with sales double-weighted)

- If it is SC, rather than GA, that shifts to SSFF, the share of BBI’s profit in SC will rise from 43% to 65% — a tax increase!

- GA will still tax 52% of BBI’s profit, FL will still tax 5%, and with SC now taxing 65%, 122% of BBI’s profit will be taxed by the 3 states in which it is taxable
Part III:

The SSFF Is a Costly Tax Giveaway
• In states switching from 3-factor formula to SSFF, thousands of corps. may experience corporate income tax increases and thousands may experience tax cuts

  ▶ IL estimated that adoption of SSFF would increase taxes of 7,586 corps. and cut them for 7,014 corps.

• Net impact on corp. income tax revenue of SSFF depends on state-specific balance of corps. receiving tax increases and tax cuts

• In theory, possible for tax increases to outweigh tax cuts and for switch to SSFF to result in net corporate income tax revenue gain — at least in short run

• Thus far, only states in which businesses have actively pushed SSFF are those in which net revenue effect would be negative
## Estimated Revenue Impact of Adopting a Sales-Only Apportionment Formula

<table>
<thead>
<tr>
<th>State</th>
<th>Eligible Corporations</th>
<th>Sales Factor Weight</th>
<th>Year Covered by Estimate</th>
<th>Top Corporate Tax Rate</th>
<th>Revenue Loss (millions)</th>
<th>Pre-loss Corp. Tax Revenues (millions)</th>
<th>Revenue Loss as % of Tax Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>CA</td>
<td>All</td>
<td>100 %</td>
<td>CY00</td>
<td>8.84 %</td>
<td>$96</td>
<td>$6,727.5</td>
<td>1.4 %</td>
</tr>
<tr>
<td>CT</td>
<td>Manufacturers Broadcasters</td>
<td>100 %</td>
<td>FY02</td>
<td>7.5 %</td>
<td>$28.1</td>
<td>$543.9</td>
<td>5.2 %</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>4.7 %</td>
</tr>
<tr>
<td>IL</td>
<td>All</td>
<td>100 %</td>
<td>CY00</td>
<td>4.8 %</td>
<td>$63</td>
<td>$1,128</td>
<td>5.6 %</td>
</tr>
<tr>
<td>ME</td>
<td>All</td>
<td>100 %</td>
<td>CY00</td>
<td>8.9 %</td>
<td>$5.7</td>
<td>$127</td>
<td>4.5 %</td>
</tr>
<tr>
<td>MA</td>
<td>Manufacturers Mutual funds</td>
<td>100 %</td>
<td>FY00</td>
<td>9.5 %</td>
<td>$84.8</td>
<td>$1,159.8</td>
<td>7.3 %</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>5.9 %</td>
</tr>
<tr>
<td>OR</td>
<td>All</td>
<td>80 %</td>
<td>CY03</td>
<td>6.6 %</td>
<td>$47.5</td>
<td>$505.4</td>
<td>9.4 %</td>
</tr>
<tr>
<td>WI</td>
<td>All</td>
<td>100 %</td>
<td>FY01</td>
<td>7.9 %</td>
<td>$80</td>
<td>$640</td>
<td>12.5 %</td>
</tr>
</tbody>
</table>

*Oregon: 80 percent sales factor.*
• NY appears to have implausibly optimistic forecast of how little SSFF would cost

• Estimated $38.6 million annual cost in foregone corporate tax revenue when fully phased in (FY06) is just 1.5% of estimated FY02 corporate tax receipts; likely to be even smaller share of FY06 revenue

• CT and MA have estimated proportionate losses 3-4 times larger

• NY Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law estimated that foregone corporate tax revenue from switch from standard 3-factor formula to current (double-weighted sales) formula — a much less significant change than switch to SSFF — was $71 million annually in 1982

  • granted, subsequent tax rate reduction
In fact, revenue losses likely to be underestimated even if NY weren’t being optimistic:

- Corps. experiencing large % tax increases when a state adopts SSFF are those with relatively large shares of their sales in such state but small shares of property/payroll

- Such corps. have incentive to remove property and payroll from state and eliminate taxability (nexus) entirely

- P.L.86-272 lets them “have their cake and eat it too” — maintain salespeople in state to preserve market but still eliminate nexus

- If corps. expected to pay higher taxes in NY when it shifts to SSFF can avoid this result, net revenue loss will be greater than NY forecasts
• New York especially vulnerable to unexpectedly large revenue losses in shift to SSFF because it allows multi-corporate groups to apportion on a corporation-by-corporation basis

• In “separate entity” apportionment states like NY, corporations that would suffer tax increases under shift to SSFF can largely nullify them without removing property and payroll by

  ▶ Forming a separate subsidiary to own the property and employ the people that establish nexus in NY

  ▶ Using income-shifting techniques to move taxable profit out of NY
E.g., PA manufacturer that needs to have NY sales office when NY switches to SSFF can:

- separately incorporate NY sales office as retailing subsidiary
- sell its goods to NY subsidiary at artificially-high price that shifts most profit out of NY and into PA
- have NY subsidiary resell goods to NY customers at nominal profit
- deliver goods directly from PA plant to NY customers like it has always done
To recap:

• NY forecasting very low corporate tax revenue loss from adoption of SSFF as compared with most other states that have prepared similar estimates.

• Adoption of SSFF formula likely to be even more costly than any state would predict, because corps. that would experience tax increases have motivation and means to nullify those tax increases by eliminating nexus

• PL 86-272 and NY’s use of “separate entity” apportionment enhance ability of companies to nullify tax increases from SSFF without crimping their ability to access their markets in NY
Part IV:

SSFF Is Unlikely to Be an Effective or Cost-Effective Economic Development Incentive
Proponents’ case for the SSFF:

• Adoption of SSFF eliminates disincentive for expanding employment and placing property in a state — doing so does not increase corporate tax liability in that state

• Adoption of SSFF creates positive incentives to locate new facilities in state
  ▶ especially “export-oriented” facilities whose production will be sold primarily outside state
  ▶ big manufacturing plants most likely to fit this profile
• Proponents’ logic has flaws
  ▶ If every state had same apportionment formula as NY, NY would be just as attractive a place to expand/invest as any other state — notwithstanding presence of property and payroll in formula
  ▶ In other words, property and payroll factors don’t inherently “penalize” investment in NY
• Nonetheless, it is true — in theory — that NY can make itself more attractive location for certain investments if it “jumps-out” ahead of other states to adopt SSFF

• A corporation contemplating expanding its production capacity would choose SSFF state over property-payroll-sales formula state

  ▶ when output will be sold largely outside the state where production occurs; and

  ▶ all other things being equal

BUT . . .
• Tax breaks have weak impact on state economic development in general because all other factors influencing location decisions are almost never equal

• Revenue losses can impair provision of public services needed by business — e.g., good schools, infrastructure

• More importantly, logic ignores countervailing effects of SSFF — SSFF can create incentives for out-of-state corps. to remove/forego investment and jobs in NY

• SSFF likely to have particularly low “bang for the buck”
Adoption of SSFF is a double-edged sword when it comes to economic development

- SSFF can create incentives for companies experiencing tax increases to remove jobs and property from NY to eliminate taxability (see previous discussion)

- Can also create disincentive for out-of-state companies not yet taxable in NY to place jobs and property in state for first time

- **No reason to assume that jobs/investments attracted by theoretical positive incentive effects of SSFF will exceed jobs/ investments repelled by equally inherent disincentive effects**
Adoption of SSFF can create an incentive for an out-of-state company to avoid placing jobs and investment in NY. E.g.:

- Pennsylvania manufacturer with 50% of its sales in NY, but no nexus (NY business solicited by out-of-state traveling sales force)

- PA manufacturer contemplating opening NY R&D facility; facility will constitute 10% of its nationwide property and payroll

- Under current NY double-weighted sales formula, PA manufacturer would have 30% of its profit taxed by NY if it made investment (10% NY property + 10% NY payroll + 50% NY sales + 50% NY sales) ÷ 4

- If NY adopts SSFF, PA manufacturer would have 50% of its profit taxed in NY
Why SSFF likely to have particularly low “bang for the buck” as economic development incentive (I):

• SSFF provides automatic tax cut to any corp. that has greater shares of its property and payroll in a state than share of sales
  
  ▶ companies get tax break even if they have no intention of expanding because demand for their product doesn’t warrant it
  
  ▶ companies get tax break even if they are laying off people and shutting down plants (see Raytheon Co., MA – 3,000 person job reduction in MA since Raytheon pressured state to adopt SSFF)
“Business leaders say the major winners [from Illinois’ adoption of SSFF] would be large corporations with headquarters and large work forces in Illinois, such as Caterpillar Inc. and Motorola Inc... [T]hey lobbied for the change.

— Chicago Tribune, 5/25/98

Motorola, Inc. is laying off 2,500 employees... The company said Monday that it plans to shut down its only U.S. cellphone manufacturing operation at its facility in Harvard, Ill. by June 30.

— Associated Press, 1/16/01

“As a businessman I never made an investment decision based on the tax code. If you give money away I will take it, but good business people don’t do things because of inducements.” — Treasury Secretary O’Neill
Why SSFF likely to have particularly low “bang for the buck” as economic development incentive (II):

• Main benefit of SSFF is creation of nowhere income; nowhere income disappears if many states also adopt SSFF. (Recall Better Boxes, Inc. example.) Adoption of SSFF stimulates other nearby states to adopt. Corp. execs won’t base location decisions on incentives whose longevity is highly uncertain.

• Deductibility of state corporate income tax payments from federal taxable income means that 35% of any tax savings provided to corp. from SSFF just flows to federal treasury in form of higher federal corp. income tax liability
The statistical record on SSFF:

Manufacturers most closely fit profile of business likely to receive tax cut from SSFF.

Yet:

- Iowa and Missouri have had SSFF for decades. In last 20 years, MO has lost 35,000 manufacturing jobs; IA ranked just 17th in manufacturing job growth.

- Since 1995, when it began phasing in SSFF, Massachusetts has lost 15,000 manufacturing jobs, rate of decline 8 times greater than national average.

- Since 1998, when it began phasing in SSFF, Illinois has lost 23,000 manufacturing jobs, which reversed a 6-year trend.
• IA, MA, and NE have not lured a single one of the new plant investments greater than $500 million made since 1995

• In short, states that have adopted SSFF so far do not have a great deal to show for it.
SSFF and tax equity

• SSFF imposes excessive tax burden on out-of-state corporations

  ▶ out-of-state corporation with virtually no NY property and workers could be subject to tax on 100% of profit while corporation with all of its property and employees in state could pay no tax

  ▶ violates “benefits received” principle of taxation

• SSFF unfair to small, family-owned corporations less likely than big corporations to reap tax savings because all property, payroll, and sales in NY

  ▶ inconsistent with economic development strategy focused on enhancing competitiveness of small businesses
Conclusion: Single Sales Factor Formula:

- A costly giveaway of corporate tax revenue

- Likely to be more expensive than forecasted (even if NY were doing it realistically) because some out-of-state manufacturers will take steps to nullify their tax increases

- Creates just as many incentives to avoid creating jobs in NY or remove them as it does to place jobs in NY

- Provides windfall tax savings to certain corporations not tied in any way to their job-creation behavior

- For all these reasons likely to be a very cost-ineffective economic development tax incentive