Testimony to Select Committee on Budget and Tax Reform
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I think it is important to situate my testimony on the Throwback Rule and the Single Sales Factor within the broader context of the role of taxes in business relocation decisionmaking. We routinely hear from business lobbyists that taxes are too high in New York. Too frequently our truly high property tax rate is conflated with other taxes (which in NY are more in the middle of the pack relative to other states) to create the shibboleth that NY is a "high tax environment." We are then led to believe that the state would benefit from lowering taxes and expanding corporate tax breaks for businesses. This oversimplification does not intelligently inform public policy decisionmaking. It is important to tease out the relevant taxes and it is even more important to assess the relative importance of these taxes in corporate investment decisions.

For his book "The Great American Jobs Scam: Corporate Tax Dodging and the Myth of Job Creation," Greg Leroy writes about Robert Ady, the president of Ady International. Ady's firm is one of the nation's leading site-consultant firms, and he is uniquely qualified to say what businesses consider when they're relocating. Taxes, Ady said, are a minor factor, accounting for about 4 to 5 percent of costs. The major factors businesses look at, Ady said, are labor costs, transportation, and utilities.

Study after study verifies this. In Robert Lynch's meta analysis of the research ("Do State & Local Tax Incentives Work?" published by the progressive think tank the Economic Policy Institute), Lynch identifies several other factors that businesses consider: labor productivity, the local cost of living, quality of education institutions, even proximity to the CEO's house.

The Center for Budget and Policy Priorities also refers to the research in this area. Robert Tannenwald, an economist with the Federal Reserve Bank of Boston, conducted studies of the effect of state tax policy on economic development. Tannenwald's study looked at the impact on manufacturing investment in five industries of total state business tax burdens, after controlling for other non-tax factors that seem likely to affect business location decisions. The study measured interstate variation in business tax burdens in a particularly careful and rigorous way. For the 22 states in the study — which included most of the major manufacturing states — Tannenwald found no statistically significant correlation between business tax burdens and the location of new investment.

If — as in Tannenwald's study — *total* business tax burdens do not seem to have a significant impact on business location decisions, policymakers should be even less concerned that closing a few loopholes in just one tax would adversely affect their state's economic development.

According to research by Ernst and Young economists Kevin Christensen, Robert Cline, and Thomas Neubig, state corporate income taxes account for only about 10 percent of total state and local taxes paid by corporations. Thus, even if one accepted the premise

that interstate differences in business tax burdens affect business location decisions, the corporate tax alone seems unlikely to be a major factor.

It is critical to look realistically at the relationship between taxes and economic development in New York. Clearly, as a factor, taxes have been overstated in the popular discourse.

New York State is currently missing out on collecting some tax revenues and the looming budget deficit for next year requires a careful consideration of all options. The Institute on Taxation and Economic Policy (ITEP) point to two possibilities, the Throwback Rule and the Single Sales Factor.

Nowhere Income and the Throwback Rule

Every state that levies a corporate income tax must determine, for each company doing business within its borders, how much of the company's profits it can tax. One factor that all such states use to make this determination is the percentage of the company's nationwide sales that can be attributed to the state. Ideally, all of a company's sales would be attributed to the states in which it operates, but, due to differences among states' corporate income tax rules, this is not always the case. In some instances, a portion of a business' sales are not attributed to any state, which means that a corresponding portion of its profits go untaxed, a phenomenon often referred to as "nowhere income."

Nowhere income arises when a company is not subject to a corporate income tax in one of the states into which it makes sales, either because that state does not levy such a tax or because the company doesn't have a sufficient level of activity in the state to be subject to the tax, a concept known as "nexus". Having property or payroll in a state is always sufficient to constitute nexus, but making sales into a state is not. A little known federal statute, Public Law 86-272, stipulates that making sales into a state is not sufficient to generate nexus if:

(1) the company's activities in the state are limited to soliciting sales of tangible personal property;
(2) the orders for the company's sales are taken outside of the state, and;
(3) all such sales are delivered from outside of the state.

Given these restrictions, companies may be able avoid establishing nexus in some of the states into which they make sales and thus generate nowhere income that is untaxed in any state.

A Simple Solution: "Throwback" Rule

The best state remedy for the problem of nowhere income is enacting a "throwback rule," which mandates that sales into other states or to the federal government that are not taxable will be "thrown back" into the state of origin for tax purposes. In other words, the throwback rule is a backup for the destination rule: when the destination rule assigns a

sale to a state that can't tax that sale, the sale is re-assigned back to the state that is the source of the sale. When legal reformers sought to create a uniform and fair system of state corporate taxation in the 1950s, they included the throwback rule in their recommendations, known as the Uniform Division of Income for Tax Purposes Act (UDITPA).

About half of the states with corporate income taxes have now created a throwback rule in keeping with the UDITPA recommendations—but half of the states have yet to enact this important reform.

Not surprisingly, the multistate corporate community generally opposes the throwback rule. Its spokespersons assert that through the enactment of Public Law 86-272, Congress has implicitly decreed that corporations should not be subject to taxation in states in which they have no or limited physical presence. Corporate representatives argue that it therefore is unfair of states to seek to counteract this result by arbitrarily deeming the profits earned from such sales to be earned in the states to which the sales are "thrown back." The state counter-argument is that the throwback rule predates Congress' 1959 enactment of Public Law 86-272 and that Congress neither prohibited the throwback rule in P.L. 86-272 nor has acted to block states from implementing the rule in subsequent years. State representatives also argue that corporations are not entitled to have "nowhere income," and that the throwback rule is a reasonable, second-best solution to unfair restrictions on their ability to impose taxes on corporations that are, in fact, earning profits by selling to their residents. While P.L. 86-272 may prevent states from taxing the profits of some out-of-state corporations making sales to their residents, states can tax profits attributable to sales made in other states by in-state corporations. If all states had the throwback rule in effect, the partial "swap" of corporate tax bases the throwback rule effectuates would be roughly equivalent.

Why Throwback Rules Are Necessary

The existence of states without throwback rules creates a clear tax avoidance opportunity for multi-state corporations. These companies can reduce their state taxes by locating their property and payroll in states that don't have a throwback rule and then making sales to customers in states in which the company does not have nexus. Companies aggressively pursuing this "nowhere income" tax avoidance strategy can reduce their state tax bill far below what they ought to pay — and far below the taxes paid by competing companies.

Allowing companies to minimize their tax liability through these strategies distorts the economic incentives they face, puts other businesses at a disadvantage, and drains away tax revenue that could be used to finance vitally important long-term public investments.

Throwback rules can help to level the economic playing field among all businesses and to reduce state fiscal stress, just by simply ensuring that all of the profits companies earn are subject to taxation in the states in which they do business.

Corporate Income Tax Apportionment and the "Single Sales Factor"

One of the thorniest problems in administering state corporate income taxes is how to distribute the profits of multi-state corporations among the states in which they operate. Ultimately, each corporation's profits should be taxed in their entirety, but many corporations pay no tax at all on a portion of their profits. This problem has emerged, in part, due to recent state efforts to manipulate the "apportionment rules" that distribute such profits.

Why Apportionment is Necessary

Most large corporations do business in more than one state and, as a result, are typically subject to the corporate income tax in multiple states. However, each state faces two important limits on how much of these corporations' profits it can tax.

First, if a corporation does not conduct at least a minimal amount of business in a particular state, that state is not allowed to tax the corporation at all. Corporations that have suffi cient contact in a state to be taxable are said to have "nexus" with that state.

Second, each state with which a corporation has nexus must devise rules for dividing the corporation's profi ts into an in-state portion and an out-of-state portion — a process known as "apportionment." The state can then only tax the in-state portion.

These limits exist for a good reason: if every state taxed all of the income of all corporations operating within the state's borders, businesses could find their profits taxed multiple times. Indeed, when state corporate income taxes were first adopted, there were no agreedupon rules for dividing corporate profits among states. As a result, some businesses found that nationally, more than 100 percent of their profits were subject to state taxes. In the 1950s, legal reformers worked to set up a fair, uniform way of allocating income among states that would result in multi-state businesses' profits being taxed exactly once. The result was the Uniform Division of Income for Tax Purposes Act (UDITPA), a piece of model legislation that about half the states with a corporate income tax have adopted.

How States Apportion Income

UDITPA recommends an apportionment rule that relies equally on three different factors in determining the share of a corporation's profits that can be taxed by a state. These factors are:

- ⇒ The percentage of a corporation's nationwide property that is located in a state.
- ⇒ The percentage of a corporation's nationwide sales made to residents of a state.
- ⇒ The percentage of a corporation's nationwide payroll paid to residents of a state.

The main rationale for using these three factors to determine taxable income is that companies benefit from a state's public services in a variety of ways, including owning property in a state, making sales within a state, and having an in-state employee base. The three-factor formula ensures that corporate tax liability reflects the benefits received by each type of corporation.

If every state used the apportionment rule UDITPA recommends, it would be an important step towards ensuring that all corporate profits are subject to taxation.

However, over the past twenty years, many states have chosen to reduce the importance of the property and payroll factors and increase the importance of the sales factor. The majority of states now use apportionment formulas that give "double-weight" or greater to the sales factor; in such formulae, a corporation's in-state sales are at least twice as important as each of the other factors. At the extreme, more than a dozen states now rely entirely on the sales factor (and therefore do not use the property or payroll factors at all) in determining at least some corporations' tax liabilities. This approach is known as the "single sales factor" or SSF.

Single sales factor is typically enacted for two reasons. First, it is argued that SSF makes a state a more attractive place for businesses to expand their property and payroll: if the property and payroll factors are ignored in calculating a state's corporate tax, then a business can hire employees or build a plant in a state without incurring any additional corporate profits tax. Second, SSF is sometimes enacted in response to threats from companies that already have substantial in-state employment and property. For example, Massachusetts adopted SSF in response to threats from Raytheon that it would reduce its employment in the state unless it was adopted.

These arguments overlook several disadvantages of heavily weighting the sales factor:

⇒ While some companies will benefi t from SSF, other companies will actually pay taxes under SSF. Manufacturing companies that have more of their property and payroll in-state (and sell more of their products to customers in other states) will benefit from SSF, but companies with little in-state employment and property that sell proportionately more of their products in-state will be hurt by SSF. Whether SSF will reduce, or increase, a state's corporate income tax revenue depends on the importance of the state for the purposes of producing goods and services relative to its importance as a market for those goods and services.

⇒ When SSF is enacted in response to the threats of in-state corporations to relocate in other states, there is no guarantee that these corporations will not "take the money and run." For example, after the passage of SSF, Raytheon cut thousands of Massachusetts jobs.

⇒ SSF creates harmful incentives for some businesses. A company that sells products in an SSF state, but does so only by shipping products into the state (and therefore has no nexus) will not have to pay any income tax to the state. But if such a company makes even a small investment of employees or property in the state, it will immediately have much of its income apportioned to the state because the sales factor counts so heavily.

Thus, SSF gives these companies a clear incentive not to invest in the state. Even worse, SSF gives companies with in-state employees an incentive to move all of

their employees out of state to eliminate their nexus with the state—thus zeroing out their tax.

- ⇒ By discriminating against some companies and in favor of others, SSF makes corporate income taxes less fair—and can result in profi table companies paying no state income tax. For example, under the Illinois SSF rules, a corporation that has all of its employees and property in Illinois—but makes all of its sales to customers in other states—will pay no Illinois income tax, no matter how profi table it is. This unfairness reduces public confidence in the tax system.

The use of SSF has created a lack of uniformity in corporate tax rules. As a result, corporations now face the same inequitable treatment that prompted the UDITPA rules fifty years ago: some multi-state businesses find their income taxed more than once, while others are not taxed at all. This inequitable treatment undermines the perceived legitimacy of the tax system by arbitrarily discriminating in favor of certain corporations and creates perverse tax incentives that can deter corporations from moving to, or remaining in, some states.

Returning to a more uniform set of apportionment rules is an important first step in preventing widespread tax avoidance and ensuring that state corporate income taxes are applied fairly.

The states levying corporate income taxes can be broken down into three groups with respect to their treatment of business and nonbusiness income:

- ⇒ Six states — Florida, Iowa, Minnesota, North Carolina, Pennsylvania, and Texas — have statutes that explicitly or effectively define apportionable business income as all income that may be apportioned under U.S. Supreme Court standards, and define allocable nonbusiness income as all other income of a corporation. These states are already maximizing their ability to tax their fair share of profits arising from irregular corporate transactions.
- ⇒ Some 26 states — Alabama, Alaska, Arizona, Arkansas, California, Colorado, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Mississippi, Missouri, Montana, New Mexico, New Jersey, New York, North Dakota, Ohio, Oregon, Tennessee, Utah, West Virginia, and Wisconsin and the District of Columbia could ensure that they obtain their fair share of corporate income tax revenues from irregular corporate transactions by amending their statutes to define as apportionable income all income that they are permitted to apportion under U.S. Supreme Court standards.
- ⇒ Finally, 13 states — Connecticut, Delaware, Georgia, Maine, Maryland, Massachusetts, Nebraska, New Hampshire, Oklahoma, Rhode Island, South Carolina, Vermont, and Virginia — define all corporate income as apportionable. This ensures that they are able to tax profits realized on most irregular transactions by out-of-state corporations. These 13 states could realize additional revenues if they restored a distinction in their statutes between apportionable business income and allocable nonbusiness income, defined apportionable income and defined allocable income as all other income of a taxable corporation.

The Throwback Rule and closing the Single Sales Factor loophole would provide New York significant revenue and help level the playing field among businesses located in New York.