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# OPPOSITION TO HB 11

Dennis C. McCoy

Madam Chairman and Members of the Committee:

Good Afternoon. I am Dennis McCoy appearing before you today representing Kraft Foods and Philip Morris Management Corporation in opposition to HB 11.

Before expressing our opposition to this particular legislation, it is necessary to consider corporate income tax from an historical perspective. According to an evaluation report written for the US Department of the Treasury by Joann M. Weiner, corporate income taxes were first introduced in the then territory of Hawaii in 1901. The first state to adopt a corporate income tax was Wisconsin in 1911. Since that time, almost all states that have adopted corporate income tax have adopted some type of calculating formula based upon property, cost of manufacturing, and sales (44 of 46 in 1999) to apportion the income subject to tax for multi-state corporations. The alternative to "formula apportionment" is "unitary apportionment" which does not consider multiple factors but looks only at one aspect of the business to arrive at the portion of income to be taxed by a particular state. It appears that while either method is acceptable under various court rulings, arriving at a consistent method should be the most important consideration since not more than 100% of the corporate income will be taxed by all states combined. In 1957, a major breakthrough in the confusing array of income apportionment for state tax purposes occurred when a group of state legislators crafted the Uniform Division of Income for Tax Purposes Act (UDITPA) which not only defined a common formula but also adopted common rules for measuring the components of the formula. Further, in the mid-1960's, most states subscribed to the Multi-State Tax Compact and the Multi-State Tax Commission, which, taken together, incorporate the income division rules outlined in UDITPA and provide for further regulations to carry out that apportionment. In general, these provisions provide that an enterprise doing business in multiple states may be subject to income tax in any state (other than the one in which it is domiciled) if its activities in that other state exceed a threshold "nexus" or contact with the other state by doing something more than soliciting orders for sales and shipment of the goods ordered to that other state. Once that threshold is exceeded, in general, the income that arises from all its activities in the regular course of business or trade in a particular state is subject to taxation by that state. Over time, consideration of property, payroll and sales came to constitute the standard formula for that apportionment. It is interesting to note that most of the states eventually moved to that formula - property, payroll and sales. In fact by 1999, 44 of the 46 states imposing corporate income tax by 1999.

The questions then can be legitimately asked as to why a state would not use some formula other than this traditional three-part calculation to aid companies doing business under certain circumstances within that state's borders. Certainly, states may attempt to minimize the tax burden but to do so they must abandon logic. Would it be logical to apportion corporate income tax looking only at the relationship of payroll within the state as it relates to the total corporate payroll of the corporation? Obviously, it would be illogical because for a company to earn income it must combine property, labor, and marketing and because it would over burden corporate employers in the State. Moreover, each one of those components of a productive corporate effort have an impact on each state which varies depending upon the intensity of the use of that component.

For these reasons, the uniform act struck a balance and considered all factors as they relate to a particular type of corporate earnings. Maryland several years ago, in an attempt to provide a competitive advantage to companies that were producing products here, doubled the weight placed upon sales. To further distort the consideration by weighing only the amount of sales will provide an unfair advantage to certain corporations and, in some instances, will result in a larger portion of the corporate income tax not being subject to taxation in <u>any</u> state. Consider, for example, since Maryland does not have the "throw-back" rule, sales by a Maryland corporation in a state or country that does not tax corporate income, if this bill is adopted. That portion of the total corporate income representd by sales in a non-tax state will go completely untaxed. In a very simplistic situation, assume a company manufactures in Maryland and sells half of its product in Maryland and half in Delaware (where there is no corporated income tax). Using the sales factor alone only one-half of its corporate income would be taxed. That certainly is not a logical result.

For these reasons, **the proposal before you should NOT be enacted.**

We urge an unfavorable report.

*IN OPPOSITION TO SINGLE FACTOR APPORTIONMENT*

**A WHITE PAPER**

**Prepared For:**

Philip Morris Management Corp.

**Prepared By:**

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**Prepared:**

November 12, 1999

*In Opposition to Single Factor Apportionment*

- **Single Factor Apportionment can Harm Legitimate Taxpayers** - Whether large, small or medium sized, a business is harmed financially, by a policy that discriminates against a specific class of taxpayers.

- **Single Factor Apportionment creates Instability and Uncertainty in Revenue Forecasting** – The reliance on one variable factor that can fluctuate dramatically from year to year creates an uncertainty in a state's ability to forecast revenues. This causes instability to the state's annual budgeting process.

- **Single Factor Apportionment may Violate the Commerce Clause of the U.S. Constitution** - The commerce clause of the Constitution of the United States guarantees that all businesses operating within a state, either domestic or foreign, will be treated equally. A single apportionment factor consisting exclusively of sales could discriminate against interstate commerce.

- **The Potential Economic Benefits of Single Factor Apportionment are a Fabrication** - The move to single factor apportionment may damage the economy of the state by negatively impacting a significant portion of the population while benefiting only a small number of firms.

(11/12/99)

## Single Factor Apportionment

### Background

Most businesses whether large or small engage in transactions that extend beyond the borders of a single state. When a business operates within a multi-state environment, it is required to distribute its taxable income among the states by means of an apportionment formula. Although not a precise or exact measurement, three-factor apportionment based on sales, employment and property has historically been the preferred method. The United States Supreme Court has not only ratified the use of the three-factor formula, but uses it as the benchmark against which all other apportionment methods are judged.[1]

Forty-four of the forty-seven states that impose a corporate income tax use some variation of a three-factor apportionment formula to distribute the income of multijurisdictional companies. The standard apportionment rules are set forth in the Uniform Division of Income for Tax Purposes Act ("UDITPA"), a model apportionment scheme first promulgated in 1957 by the National Conference of Commissioners on Uniform State Laws.[2] Under this methodology, the portion of a corporation's income that is deemed to have been earned in a state is determined by applying an average of three equally weighed fractions to a business' total income. The standard factors are the corporation's in-state property divided by its total property, its in-state payroll divided by its total payroll, and its in- state sales divided by its total sales.[3]

The overall idea behind a standardized apportionment formula is that certain operating elements of a business – those that are representative of the company's income producing activities – are used as a basis for distributing taxable income to the states in which the company does business. Thus, it is necessary to select or use a variety of elements to reflect all aspects of a business's operations. To select or use just one single factor or element would be both inappropriate and distortive.

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1 *Container Corp. of America v. Franchise Tax Board*, 103 S. Ct. (1983)

2 Simafranca, Ryan "The Double-Weighted Sales Formula – A Plague on Interstate Commerce," Number 95 STN 243-37, December 11 1995.

3 Joseph X. Donovan, *Radical Apportionment Reform Comes to Massachusetts*, 95STN 243-12, (Dec. 19, 1995)

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## The Three Factors

- **Payroll**

The payroll factor consists of the amount paid by a company to its employees as compensation during the tax period.

- **Property**

The property factor includes only property regularly used by a company in its regular trade or business, includes real and tangible property owned or rented by the company. UDITA prescribes specific rules on how to value such property.

- **Sales**

The sales factor includes all gross receipts derived by a company in the regular course of its trade or business. "*Sales*" include both the sale of tangible personal property and the sale of services and other income producing activities.

## Current Activity

The traditional formula is not well suited for taxing certain types of non-manufacturing activities. To accommodate the evolution of the United States economy from manufacturing to service, it has become commonplace for states to use specially developed formulas for the taxation of specialized industries such as banking, insurance, financial services, communications, transportation, natural resources, construction, and utilities. Provided the same formula is applied to the same types of activities, the goal of uniformity is furthered.

Over time, the support underlying the three-factor formula to generate corporate taxes has been evaporating, providing inducements for corporations to take advantage of differences among the states. The first inroad was made when the states started to deviate from the traditional formula by double-weighting the sales factor. At present, a substantial number of states double count the sales factor.

The second inroad on the traditional apportionment formula results from a "more must be better" philosophy. From the perspective of those who support a double-weighted sales factor, there is no reason not to weight it even more heavily. If double-weighting is good, triple-weighting must be even better. Or, carried to the extreme, why not use just the sales factor for apportioning income? Indeed, many states seem receptive to exactly this thinking. Nebraska and Texas have recently adopted single-factor sales formulas, as has Massachusetts for certain industries. Unlike these recent converts, Connecticut has used a single-factor sales formula for non-manufacturing activities for many years[4].

Compared with an evenly weighted three-factor formula, a single sales factor increases the tax on some corporations, decreases it on others, and has no effect on corporations that conduct all of their activities in one single state. The exact effect depends on the mathematical relationship between the sales factor and the property and payroll factors of each business impacted by the change. Specifically, businesses whose sales factors are less than the average of their property and payroll factors benefit from a move to a single sales factor; corporations whose sales factors are greater than the average of their property and payroll factors are disadvantaged.[5]

**How do Advocates Justify the Single Sales Factor?**

The motivation for moving to a single sales factor is typically twofold. First, replacing an equally weighted formula with a single sales factor reduces the tax on corporations that have a substantial amount of their physical production activities in a state. Such corporations often have easy access to the state legislature and can threaten to move their facilities and jobs elsewhere. Consequently, they have the political leverage to lobby for what might seem to legislators to be an esoteric change in a technical aspect of the tax.[6]

Moreover, the change will increase the tax on corporations that primarily produce goods out of state and sell to residents of the taxing state. Without any substantial in-state activities, these corporations cannot assert a credible threat to leave the state. Legislators might feel that such corporations would continue to sell in the state notwithstanding a change in the apportionment formula.

Second, a shift to a single sales factor is often packaged as an economic development tool. Legislators may view the shift to a single sales factor as an incentive for corporations with production activities already in the state to expand those activities, similarly, legislature might feel that they have provided an incentive to out-of-state corporations to shift their production activities to the state.

**Problems with the Standard Justifications**

What legislators do not appreciate is that no serious analytical support exists for the proposition that changes in the apportionment formula will affect a corporation's locational decisions.[7] Furthermore, even assuming that it does, a single factor may actually work to undermine a state's economic development. That is, if changing the apportionment formula can affect a business's locational decision making, then a single sales factor could actually be counterproductive, by encouraging certain corporations to

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4 The grandfather of the single sales factor is the state of Iowa, which adopted the method in the 1930's

5 Richard D. Pomp, *The Future of the State Corporate Income Tax*, 1999 STT 54-33.

6 Pomp, *id*

7 Pomp, *id*

move their operations out of state. The loss of a lot of small and mid-sized operations can outweigh the gain to larger in-state firms.

For example, consider a corporation that sells a substantial amount of its products into a state in which it has a small operation. If that state moves from an evenly weighted three-factor formula to a single factor of sales, the corporation has a greater incentive than previously to move its operational activities out of the state. This will eliminate its "nexus" with the state, terminating the state's ability to levy a corporate income tax on the firm.

A nationwide shift to a single sales factor can erode the aggregate state tax base. A state that is predominantly a market state will gain revenue, and a predominantly manufacturing state will lose revenue. If all states moved from an evenly weighted three-factor formula to a single sales factor, and if all states had comparable rates, the aggregate revenue effect would be minimal, as the revenue lost by one state would be offset by the revenue gained by another state.

### Constitutionality

Although the U.S. Supreme Court has accorded the states considerable leeway in designing and implementing formulas for apportioning a multijurisdictional business's tax base, it has also insisted that an apportionment formula not be "inherently" or "intrinsically" arbitrary. This means, that the "factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." There must be a reasonable fit between the tax base being apportioned and the factors used to apportion it. An apportionment formula inconsistent with this fundamental principle might not survive constitutional scrutiny. [8]

The use of a single-factor sales formula to apportion the tax base could violate this fundamental principle because it does not reflect a reasonable sense of how the tax base is generated. Thus, it could violate the commerce clause of the U.S. Constitution. A sales factor, which reflects the market for a taxpayer's product but nothing else, fails to account for the lion's share of the tax base, namely, the payroll and property that add to the value of the output. There is no reasonable relationship between the location of a business's sales and the location of its payroll and property that would warrant the geographical assignment of the property and payroll exclusively by reference to the geographical situs of sales. [9]

The use of a single-factor sales formula could be struck down as unconstitutional if – when is applied to a particular taxpayer - it attributes to the state income that is "out of all appropriate proportion" to the taxpayer's activities in the state, if it "project[s] the taxing power of the state beyond the borders of the state", or if it leads to "a grossly distorted result." The application of a state's income tax using only a single-factor sales formula to multi-state enterprises could violate these norms.

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8 Walter Hellerstein," *On the Proposed Single Factor Formula in Michigan*", 95 STN 191-23.

9 Hellerstein; *supra*.

**Policy Concerns**

In addition to the constitutional difficulties, single factor apportionment suffers from policy defects as well. The purpose of an apportionment formula is to spread the tax base fairly among those states in which the tax base is generated. The overwhelming majority of states impose a three-factor formula of property, payroll, and sales to apportion income among the states for tax purposes. The economic justification for two of the three factors – property and payroll -- is clear enough. Income may be defined as the gain derived from capital, from labor, or from both combined. Capital and labor largely generate income, and the property and payroll factors reflect these essential income-producing elements. The sales factor was designed to recognize the contribution of the states in which a firm's products are marketed to the generation of the firm's income. With the nearly universal use of a destination test to assign sales of tangible personal property, the sales factor assigns income to states in which goods are consumed. It serves as a counterbalance to the property and payroll factors that tend to attribute income to states in which goods are produced.

From a tax policy standpoint, the very idea a state would even consider disregarding payroll and property altogether in a formula designed to apportion a tax base comprised largely of payroll and property is unsupportable. There is simply no justification as a matter of sound tax policy for the deliberate omission of two of the critical factors that contribute to the creation of the tax base in determining where that tax base should be assigned on a geographic basis. The states clearly enjoy flexibility in designing formulas for dividing a tax base among taxing jurisdictions. But that flexibility should not be viewed as a license to design a formula that ignores the essential components of the base. [10]

A business' in-state property and payroll are a significant indicator of the measure of the benefits that the business derives from the state, as well as the social costs it imposes upon the state. By contrast, the geographic distribution of a corporation's sales alone is a dubious measure of the protections and benefits provided by the state.

Using only a single factor of sales could significantly impair a state's ability to forecast its revenue. Total reliance on just one factor that is highly volatile and that can fluctuate dramatically from one year to the next can lead to distortive and unreliable forecasts negatively impacting a states budgeting process.

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[10] Hellerstein, *supra.*

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