Charlottesville
703 Concord Avenue
Charlottesville, VA 22903
(434) 984-4655 * (434) 984-2803 fax

Sally Bastian
Grassroots Fundraising Coord.
bastian@virginia-organizing.org

Harold Folley
Apprentice Organizer
harold@virginia-organizing.org

Michele Mattioli
Special Projects Coordinator
mattioli@virginia-organizing.org

Laura Ramirez
Office Manager
lramirez@virginia-organizing.org

Kevin Simowitz
Apprentice Organizer
kevin@virginia-organizing.org

Joe Szakos
Executive Director
szakos@virginia-organizing.org

Legislative Director
Ben Greenberg
bengreenberg@infionline.net
(804) 467-8212

Richmond/Petersburg
Cathy Woodson – Organizer
cwoodson@virginia-organizing.org
(804) 261-7497 office/fax

Salem
Sharon LaMar - Apprentice Organizer
lamarvop@aol.com
(540) 397-2379 work/cell

Roanoke
Ray Higgins – Organizer
ray@virginia-organizing.org
(540) 529-6428 work/cell

Shenandoah Valley
Larry Yates – Organizer
llyates@shentel.net
(540) 436-3432 office/fax

Southwest Virginia
Brian Johns – Organizer
bjohns@virginia-organizing.org
(276) 619-1920 office/cell

Lynchburg
Barry Butler – Organizer
bbutler@virginia-organizing.org
(434) 821-2157office/fax

Williamsburg/Peninsula
Ben Thacker-Gwaltney
Lead Organizer
ben@virginia-organizing.org
(757) 570-3005 work/cell

Virginia Organizing Project
www.virginia-organizing.org

M E M O R A N D U M

DATE: **September 26, 2008**

TO: **Members of the Joint Subcommittee Studying the Benefits of Adopting a Single Sales Factor for Taxing Multi-state Corporations**

FROM: **Janice "Jay" Johnson, Chairperson**

RE: **VIRGINIA ORGANIZING PROJECT RECOMMENDATIONS TO THE JOINT SUBCOMMITTEE**

The Virginia Organizing Project (VOP) is pleased to have the opportunity to share with the Joint Subcommittee our recommendations on this important issue. First, we would like to share with you some information about VOP and our Tax Reform Committee.

The Virginia Organizing Project is a statewide grassroots organization dedicated to challenging injustice by empowering people in local communities to address issues that affect the quality of their lives. The organization especially encourages the participation of those who have traditionally had little or no voice in our society. By building relationships with individuals and groups throughout the state, VOP strives to get them to work together, democratically and non-violently, for change.

The Tax Reform Committee of the Virginia Organizing Project has actively studied Virginia's tax laws for the past ten years. This Committee is comprised of tax experts and economists as well as average citizens with an interest in this vital area. Working closely with other groups and individuals in Virginia and the nation, the VOP Tax Reform Committee is committed to helping Virginia achieve a tax structure that is both equitable and adequate and based upon sound tax principles. The Committee is unequivocally opposed to regressive taxes (hidden or obvious) that are neither equitable nor adequate.

During the 2008 session of the General Assembly, VOP studied the legislative proposals that called for the introduction of a single sales factor apportionment formula for corporate income taxes. At that time, VOP's Legislative Director testified before the Senate Finance Committee to express the organization's concerns with the impact of this legislation. Specifically, we concurred with testimony that alerted the

Finance Committee to the adverse revenue impact of House Bill 1514, as indicated in the fiscal impact statement prepared for the bill. That document indicated that the Commonwealth would have lost an estimated $36 million in corporate income taxes in 2003 had this legislation been in place at that time. Since recorded Virginia corporate income tax revenue increased by approximately 256 percent between 2003 and 2007, the revenue loss from this proposed apportionment formula change is likely to be much greater than $36 million (approximately $92 million in 2007 if the loss remained a consistent fraction of total corporate income tax revenue).

While Virginia considers the adoption of a single-sales tax apportionment formula for the determination of state corporate income tax liability (outside of those industries already granted permission to use special apportionment factors, such as motor carriers, financial and construction companies and railroads), the Tax Reform Committee of the Virginia Organizing Project urges the joint subcommittee charged with studying its impact to consider three critical questions:

1. Would a single sales factor formula (optional or mandatory) represent a fairer and more accurate method of determining the apportionment of corporate income between Virginia and other states?
2. Will such a change promote aggregate investment and employment (either by shifting investment toward more productive enterprises or by advancing investment in manufacturing without depressing it elsewhere)?
3. What is the likely impact on revenue, and if negative, can we afford it?

We conclude that moving from the current double-weighted sales apportionment formula (adopted in 1999) to a single sales factor formula would create an apportionment formula that reflects less fairly and less accurately the connection of a given multi-state corporation and its business activities to Virginia, its resources, and its public investments—the most appropriate way of determining this ratio. As the Virginia Advisory Legislative Council recognized in its 1959 study of the matter, Virginia soon joined most other states in adopting the equally weighted three factor formula precisely because it helped to determine apportionment of income in the most equitable manner. In its very recent study (August 2008), the GAO confirmed this analysis as it examined similar questions related to international boundaries and *multi-national* companies. Their conclusion? Real business activity is best reflected by an equally weighted combination of property, sales, and wages. Any divergence from this formula, then, must be justified on grounds other than equity.

****

We conclude further that since the adoption of a single sales factor apportionment formula is a change that cannot produce a fairer or more accurate method of apportionment, its only possible benefit lies in its potential effect upon state economic development. If the revenue effects, addressed below, are not limiting in any significant way, and it can be shown that this change will spur investment and employment in the aggregate, then it can be recommended as a reform likely to confer some benefits upon the Commonwealth. Basing our conclusion on previous studies of both the adoption of the double-weighted sales factor formula and the now increasingly fashionable single sales factor variant, we find that such benefits are extremely small or negligible. If one were to properly account for both the deadweight losses incurred by state tax policy-induced shifts in investment—from one state to another—and for the marginal disinvestment effects on out-of-state corporations with significant Virginia sales, the aggregate impact may even be negative. The evidence is fairly clear: if this measure induces new investment and employment, it does so generally at the expense of other states.

It is also clear that the following factors have some bearing on the estimated extent of the induced investment that could potentially be attributed to a heavier weighting of sales in a state's apportionment formula, factors that would uniformly decrease the positive impact of such a change even more decidedly in a state such as Virginia:

a. **The unemployment rate, compared to the national mean**. The lower and more divergent is the Virginia rate, the more diminished is the positive impact of an apportionment formula change in which the weight of the sales factor is increased. Currently at one standard deviation below the national mean, Virginia stands to gain far less than other states closer to this mean. A prominent 1998 study (Goolsbee and Mayhew, 1998) suggests that such a divergence could approximately cut in half the potential positive impact of such an apportionment formula change.
b. **The prevailing corporate income tax rate, compared to the national mean**. Virginia's statutory corporate income tax rate is 6 percent. The national mean is approximately 7.3 percent. As with unemployment rates, the lower and more divergent from the mean, the more diminished is the positive investment impact of any income apportionment "reform." The amount by which this would reduce the impact in Virginia is significantly less than the unemployment rate effect, but it is not negligible.
c. **The difference between the statutory rate and the true marginal effective rate of corporate income taxation.** The broader the difference here, the more diminished the potential effect of an apportionment formula change. Virtually all studies that examine the impact of an apportionment formula change like that proposed in HB 1514 assume that the effective rate equals the statutory rate. There is little doubt; as in most other states, due to special credits, exemptions, and shelters (on the federal and state level, for Virginia conforms to federal taxable income), this difference in Virginia is significant.
d. **The difficult-to-measure role of the national economy**. Most studies indicate that this accounts for anywhere from 10-20 percent of the estimated induced investment stemming from this kind of an apportionment formula change. Where the evidence shows positive investment and employment effects, in other words, it shows a similar but smaller effect in the retail sector as well, where it would be expected to have the opposite impact. Where this pervasive measurement error has not been accounted for, we should discount the expected positive outcome here by the lower 10 percent rate, at minimum.
e. **The existence or non-existence of combined reporting requirements or the throwback rule.** Gupta and Hoffman (2006) found that in states without combined reporting requirements or the throwback rule, as is the case in Virginia, the potential effect of other corporate tax related inducements (heavier weighting of sales, lower tax rates) was diminished even further than in states with one or both of these laws (25 states currently with throwback rule; 16 states with combined reporting).

Taking into account these five factors, we conclude that Virginia's adoption of a single sales factor apportionment formula would have little or no positive effect on Virginia investment and employment.

****

We conclude, last of all, that the revenue impact of the proposed change to a single sales factor apportionment formula, is likely to be significantly negative, especially since we cannot attribute with any confidence any potential positive offsetting impact—through promised investment and employment changes—on personal income and associated revenue. Moreover, the joint subcommittee should make no mistake; a shift to a single sales factor apportionment formula implies a shift to a factor category much more easily manipulated with accounting devices (as opposed to changes derived from a genuine change in investment behavior) than either property or wages. As Gupta and Hoffman (2006), and Klassen and Shackleford (1998) have demonstrated, the most pronounced, and perhaps only significant effect of apportionment formula changes that increase the weight of the sales factor, is to reduce the amount of reported sales to that state—even during periods of significant economic expansion and vitality. There is little doubt that such an apportionment formula change serves at least partly as an invitation to "tax-planning opportunities" that allow companies to artificially shift sales to other states through transfer-pricing strategies. Keeping this in mind, we urge the subcommittee in this case to consider the negative impact on state revenue from both the proposed apportionment formula change, per se, *and* artificial shifts in reported sales.

****

After the conclusion of the 2008 General Assembly session, economic conditions in Virginia and across the nation have worsened. Faced with recessionary trends and a dramatic reduction in state revenues, Governor Kaine has informed the members of the General Assembly that state agencies should prepare for potential budget cuts of 5%, 10% or 15%. During such times, VOP and its Tax Reform Committee feel compelled to remind this subcommittee, and the General Assembly it represents, how these potential cuts, compounded by the effects of this proposed apportionment formula change, represent the withdrawal of significant demand for goods and services produced and delivered throughout the state. No change, particularly one with the limited or non-existent benefits of this proposal, should be judged favorably at any time, let alone during a fiscal crisis when it is likely to force a relatively small but additional contraction in the state's economic activity (and a further spiraling down of state revenue). At a time when rising unemployment and reduced health insurance coverage is likely to demand more and not fewer state resources, this is no time to further reduce our state's revenues or related economic activity.

These recommendations were developed by the following members of VOP's Tax Reform Committee: David Shreve, Bob Sack, Laura Granruth, Denise Smith and Toni Maxey. If the members of the Joint Subcommittee have any questions regarding the above recommendations, please feel free to contact Ben Greenberg, VOP's Legislative Director.