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"Single Sales Factor" Would Cost Substantial Revenue Kentucky Needs for Investments that Work

By Jason Bailey

Summary

A proposal to change the way Kentucky calculates state corporate income taxes for big multistate corporations would wipe out one-third of the corporate income tax revenue Kentucky needs for investments that will grow the state's economy. Claims about the economic development benefits of such a change—which would base corporate income taxes solely on a company's sales in Kentucky, ignoring its other assets—are unsubstantiated. Using this "single sales factor," as proposed in Governor Beshear's tax reform plan, would reduce the revenue needed for schools, health and other public investments that are crucial to moving Kentucky forward. Rather than more corporate tax cuts, Kentucky should spur stronger growth by increasing the fairness and adequacy of the state's tax system.

Moving away from a more balanced approach to corporate taxes

For large multistate corporations, states like Kentucky use formulas to determine the share of a company's income that is taxable in their state. This formula usually includes three factors: the portion of a corporation's property, payroll (employee compensation) and sales that are located in a state. The formula was established in the 1950s as a way to allocate taxable income fairly and reflect the share of a company's profits that result from doing business in each state.

Traditionally, most states have equally weighted these three factors. In recent years, many states—including Kentucky—have moved to "double-counting" the sales factor in the formula, weighting sales twice in the hopes that lower taxes for companies that tend to sell their products out of Kentucky will attract more such businesses to locate here.

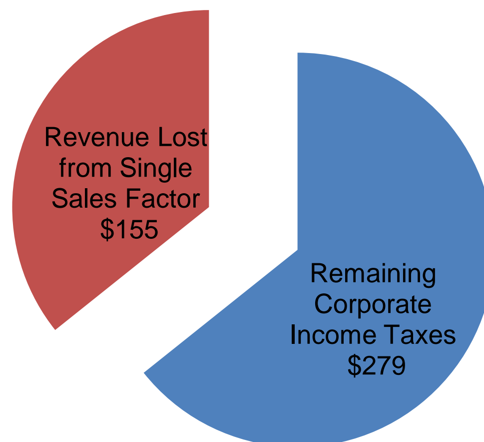
Single sales factor takes that idea much further by completely eliminating property and payroll from the formula. Only the in-state share of a corporation's total sales determine what portion of its income is taxable in a state.

Proponents claim such a switch would attract corporate investment and create jobs since corporations would no longer be taxed on their workforce or property ownership. Twenty-one states have adopted single sales factor and three more are phasing it in, largely because of lobbying by coalitions of large multistate corporations that would benefit from the change.[1]

Single sales factor reduces revenues that Kentucky needs

Enacting single sales factor in Kentucky would raise taxes for some corporations and lower them for others. But the net result would be a loss of $155 million in revenue.[2] That equals 36 percent of the $434 million in corporate income tax revenue Kentucky expects to collect in 2016. Such a loss would be a substantial blow to Kentucky, especially given the depth of recent budget cuts and other longstanding problems with Kentucky's budget and revenue system.

Single Sales Factor Would Eliminate One-Third of KY's Corporate Income Taxes
(Graph in Millions of Dollars)



Source: KCEP analysis of Office of the state Budget Director data. Uses 2016 estimate for corporate income tax revenues and revenue loss at full implementation of single sales factor.

A shift to single sales factor could also create opportunities and incentives for tax avoidance that would result in even more revenue loss than estimated.[3] Corporations facing higher tax bills could take advantage of strategies to lessen or even completely avoid their corporate income taxes.

For example, a federal law says that a corporation that only solicits sales in a state does not necessarily have enough presence in that state to be subject to its corporate income tax.[4] Single sales factor presents an incentive for out-of-state corporations with significant sales in Kentucky to restructure their operations in ways that substantially reduce the tax increase that single sales factor would otherwise cause. Even a company with employees in a state can avoid paying corporate income taxes if they are engaged only in sales and work out of their homes or commute from another state. This loophole could lead some businesses to remove property and eliminate jobs from Kentucky in order to avoid a tax increase from single sales factor.

A company facing higher corporate income taxes under single sales factor could also create a subsidiary in another state to house whatever activities would otherwise be subject to the corporate income tax and then use a variety of bookkeeping methods to transfer profits to that subsidiary. This method of tax avoidance, called transfer pricing, is possible because Kentucky allows subsidiaries of the same corporation to generally report their earnings separately rather than as a combined unit.[5]

Economic development benefits are highly questionable

Proponents of single sales factor claim it would boost Kentucky's economy by giving multistate corporations an incentive to invest here. However, the evidence from other states suggests that single sales factor would likely be ineffective at creating jobs, possibly counterproductive and certainly not cost-effective.

The reasons to question the economic benefits of single sales factor include:

Business taxes have relatively little impact on economic development.

State taxes are a very small part of the cost of doing business, and in fact differ little between states compared to other important differences in location factors. State corporate income taxes overall make up less than 0.3 percent of total business costs.[6]

In a survey of 33 studies on the role of business taxes in economic development, 24 found only a very modest impact and nine found no impact. The studies that looked at manufacturing found that a 10 percent reduction in business taxes was only associated with a 2 percent increase in the number of manufacturers—before taking into account the negative economic impact of a loss of public services due to decreased revenue.[7]

Revenue losses from lower taxes would harm public services businesses rely on.

Any possible economic benefit from tax cuts must be weighed against the harm done to public services from decreased revenue. Research suggests a positive association between economic development and investment in vital public structures and services. Businesses tend to thrive where roads, sewers and other infrastructure are in good repair. They rely on sound transportation to import raw materials, ship their goods and bring in customers. They need police and fire protection, and an efficient court system to handle contract disputes. They depend on schools and colleges to turn out skilled, well-trained workers. All of that is impossible without adequate revenue. [8]

Corporations should help pay for the public services that benefit them. Businesses with significant property and employees in Kentucky that largely ship their goods to other states clearly benefit from state roads, schools, public safety and other services. Yet adopting single sales factor would ensure that they pay little or no corporate income tax.

Because some businesses pay higher taxes as a result of single sales factor, the overall economic impact could be negative.

Even in those rare instances where corporate income taxes make a difference in location decisions, single sales factor could just as easily cause job losses as job gains. As mentioned earlier, corporations that would pay higher taxes might remove jobs and facilities from the state in order to avoid taxation. Those corporations with a high percentage of their sales in the state but no current taxability (because they have not established adequate presence, or “nexus”) may choose not to invest and create jobs in Kentucky in the future in order to avoid paying the higher taxes they would incur under single sales factor.

Single sales factor provides large windfalls to some major corporations with no accompanying requirements for job creation and investment.

Single sales factor rewards businesses for investments they have already made by eliminating property and payroll considerations when their taxes are calculated. It would thus be a windfall for those businesses that wouldn’t necessarily result in any new jobs. Companies can lay off workers and close plants in a state yet still receive tax benefits from a single sales factor formula so long as they are selling most of their goods and services outside of the state. That is what happened with Raytheon in Massachusetts; Motorola in Illinois; and Black & Decker in Maryland.[9]

Corporations in Kentucky are already eligible for 10-15 years of state tax incentives that provide credits against corporate income taxes and other subsidies if the companies create jobs and make investments. Single sales factor will provide corporate income tax breaks to companies with no expectation of additional job creation, retention or investment.

Proposal would reduce tax fairness

By reducing corporate income tax revenues overall, single sales factor would shift even more of the costs of schools, health care and other public services to families and individuals. This would continue a troubling trend in Kentucky. Despite corporate profits being at record highs, corporate tax revenue made up only 6.9 percent of state tax collections in 2013, down from 11.6 percent in 1989. [10] Over the last couple of decades, the state has substantially reduced corporate tax rates and introduced a variety of aggressive corporate tax incentives.

As mentioned previously, single sales factor would raise taxes for some businesses and lower them for others. Because state corporate income tax payments are not disclosed, it is unclear how many Kentucky businesses would pay less because of the change and how many would pay more. But based on the experience of other states it is possible that more corporations would see tax increases than tax cuts—and that a relatively small number of large corporations would get major benefits.[11] A study in Pennsylvania estimated that nearly two corporations would pay more in taxes for every one that got a tax cut if that state enacted single sales factor.[12]

Few small businesses would benefit because many make all of their sales in the state. Wisconsin reported that 79 percent of its profitable corporations were only taxable in Wisconsin in 1997 and thus would not have benefitted if the state had single sales factor that year. In Kentucky the Legislative Research Commission reports that a coalition made up of 15 large businesses is the major voice for single sales factor in the state.[13]

Conclusion

Single sales factor would cost the state more revenue as it struggles to pay for schools, public safety, health care and other necessities. It would create greater inequity in the tax system. Claims that it would benefit the economy are unfounded. Instead of identifying new ways for corporations to avoid paying taxes in Kentucky, the state should increase the fairness and adequacy of the state tax system. That would help Kentucky afford the investments in fundamental public services that are essential to long-term prosperity.

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[1] Federation of Tax Administrators, “State Apportionment of Corporate Income,” http://www.taxadmin.org/fta/rate/apport.pdf.
[2] “Kentucky Competes: Estimated Fiscal Impact,” http://migration.kentucky.gov/NR/rdonlyres/6D84D0C3-1826-4738-A573-6317263CE8DE/314368/FiscalImpact2414FINAL.pdf.
[3] Mazerov, “The “Single Sales Factor” Formula for State Corporate Taxes;” Institute on Taxation and Economic Policy, “Corporate Income Tax Apportionment and the “Single Sales Factor,”” August 2012, http://itepnet.org/pdf/pb11ssf.pdf; William F. Fox, Matthew N. Murray and LeAnn Luna, “How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?” *National Tax Journal*, March 2005.
[4] If a corporate meets a minimum threshold of activity to be considered taxable in a state, it is said to have “nexus” in that state.
[5] Institute on Taxation and Economic Policy, “Combined Reporting of State Corporate Income Taxes: A Primer,” August 2011, http://itepnet.org/pdf/pb24comb.pdf.
[6] Mazerov, “The “Single Sales Factor” Formula for State Corporate Taxes.”
[7] Mazerov, “The “Single Sales Factor” Formula for State Corporate Taxes.”
[8] For the role of public services in economic development see Robert G. Lynch, *Do State and Local Tax Incentives Work?* Economic Policy Institute, 1996; Michael Mazerov, “Cutting State Corporate Income Taxes is Unlikely to Create Many Jobs,” Center on Budget and Policy Priorities, September 14, 2010, http://www.cbpp.org/files/9-14-10sfp.pdf. Institute on Taxation and Economic Policy, “Taxes and Economic Development 101,” September 2011, http://www.itep.org/pdf/pb42.pdf.
[9] Mazerov, “Single Sales Factor.”
[10] Calculation includes revenue from the corporate income tax, corporate license tax (until it was abolished), and limited liability entity tax and is presented as a share of General Fund revenue.
[11] Mazerov, “Single Sales Factor.”
[12] C. D. Hassell, “The Revenue Effects of a Single Sales Factor Formula on the Pennsylvania Corporate Net Income Tax,” Pennsylvania Department of Revenue, 2004, http://www.taxadmin.org/fta/meet/re_pres04/hassell.pdf.
[13] Jennifer C. Hays, “Apportionment of Income for Tax Purposes,” *Issues Confronting the 2011 Kentucky General Assembly*, November 2010, http://www.lrc.ky.gov/lrcpubs/ib233.pdf.