The Revenue Effects of a Single Sales Factor Formula on the Pennsylvania Corporate Net Income Tax

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Computation of SSFF

Current Law:

- PA requires corporations to use three factor apportionment with the sales factor weighted 60 percent – triple-weighted sales factor formula.
  In the numerator of the formula, the sales factor is multiplied by three and the payroll and property factors are multiplied by one. The sum of the numerator is then divided by five.

Single Sales Factor Formula (SSFF):

- The sales factor is weighted 100% and there are no payroll or property components in the apportionment formula.

The Effect of SSFF

What companies are affected?

- An increased weight in the sales factor rewards companies exporting products from the state
- … and taxes more heavily those that produce products elsewhere and sell into the state.
- Companies that do not sell across state boundaries, use special apportionment, or do not have a profit in a particular year, would not be affected by changing to the SSFF.

Policy Discussion

Policy Rationale

- The policy rationale for increasing the sales factor weight is that it will reduce tax liabilities for corporations that have significant property and payroll in the state.
- Under the SSFF, if a PA corporation builds a new factory in the state, the company's apportionment percentage does not increase due to the new facility.

Policy Discussion - (cont.)

<u>Studies on SSFF</u>

- Studies by Austan Goolsbee and Edward Maydew find a positive economic benefit for states adopting a higher sales factor weight. Moving from equally-weighted factors to double- weighted sales factor increased manufacturing employment by more than 1%.

- Other studies dispute these findings. Michael Mazerov of CBPP has found that the model gives widely varying and implausible results. SSFF makes the penalty for creating nexus in a market state very significant. A company can cut its tax burden by closing a small sales office and doing business remotely, thus reducing jobs.

Policy Discussion – (cont.)

<u>Other Issues</u>

- The SSFF violates the benefits principle of taxation. Equally weighed apportionment ensures that a business with a larger physical presence in a state pays a higher income tax to pay for their greater use of benefits. With a SSFF a large company that exports 100% of its sales from the state pays no income tax, despite being a significant user of state benefits.

Policy Discussion – (cont.)

Other Issues

- DOR recommends that if a SSFF is adopted it should be accompanied by statutory changes to strengthen the definition of the sales factor. Under current law, all sales other than tangible personal property are sourced to where the income-producing activity is performed, based on cost of performance.
- This rule is a compliance burden for taxpayers and an administrative burden for DOR.

Revenue Effect Summary

Important Facts

- SSFF causes a revenue loss of $64 million for tax year 2000.
- SSFF affects 32,000 corporations, about half of whom pay CNIT. It does not affect 91,000 corporations that either don't apportion or use special factor apportionment.
- Though the net impact on CNIT revenues is a loss, the SSFF causes both tax increases and tax decreases for taxpayers. 10,400 corporations pay an additional $131 million, while 5,500 corporations pay $195 million less in CNIT.

Detailed Summary of Revenue Effects

Single Sales Factor Impact by SIC

- Manufacturers have the largest tax decrease of any group, $90 million. The average benefit is $110,000 per corporation.
- Combined with the largest tax increase of $30 million, manufacturers have a combined net tax decrease of $60 million.
- Manufacturers receive 95% of the benefits of SSFF though they only pay 21% of the affected CNIT. Manufacturing facilities tend to have a small number of plants, while serving markets in many remote locations.
- All other industries in the SIC breakdown show a net impact that is between ± $5 million. The SSFF redistributes CNIT among taxpayers but has a relatively small impact in the aggregate.

Detailed Summary – (Cont.)

Single Sales Factor Impact by Capital Stock Value

- A significant amount of the tax reduction is for corporations that have a capital stock value greater than $10 million.
- Large corporations that do business in every state are more likely to have a gap between their physical presence percentage and their sales percentage. They are more likely to have large CNIT changes when the sales factor weighting of their apportionment percentage changes.
- The percentage of losers is between 62% and 65% in all categories. In general, the larger the corporation, the larger the impact from the SSFF will be, for both winners and losers.

Detailed Summary – (Cont.)

Single Sales Factor Impact by Physical Presence

- Physical presence is the average of the property and payroll factor for those corporations that use three-factor apportionment.
- For the unaffected corporations, physical presence is either 100% or based on special factor apportionment.
- Corporations with physical presence between 0% and 4% have the largest net tax increase under the SSFF, $93 million. Because these corporations have a relatively small presence in PA, it is possible that they could restructure to avoid a tax increase from SSFF.
- All other groups have an overall tax reduction, with the 75% to < 100% group having the largest tax reduction ($61 million). Even in this category, 18% of corporation pay more under SSFF, though the CNIT increase is small.

Detailed Summary – (Cont.)

Single Sales Factor Impact by PA Payroll

- As the level of PA payroll increases, so does the benefit received from the switch to a SSFF.
- 37 corporations that have more than $50 million in PA payroll would have a tax increase. The average increase would be about $140,000.
- In contrast, 154 corporations with more than $50 million in PA payroll would see a tax decrease of $59 million (more than $1.0 million per taxpayer).
- Taxpayers with less than $1 million in PA payroll have a net CNIT increase of $53 million. More than half the taxpayers in this category pay more tax.

Conclusions

- The SSFF has the overall effect of reducing CNIT revenue by $64 million for tax year 2000. 10,000 corporations will pay more CNIT, while about 5,500 affected corporations pay less CNIT.
- The policy rationale for the SSFF is that it removes the tax penalty for a corporation that locates a new plant or expands into the state. At least one study suggests that weighting the sales factor does increase manufacturing employment. Other studies argue that the SSFF may actually create an incentive for a corporation to locate outside the state and avoid nexus.
- 90,000 corporations are not affected by the SSFF. However, since overall CNIT revenues will decrease, these corporations will now pay a higher percentage of CNIT.
- Manufacturers, companies with a capital stock value greater than $10 million, and companies with significant physical presence in PA tend to have the biggest tax benefit from the SSFF.