Testimony: Corporate and Other Tax Changes in House Amendments to Senate Bill 53

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Testimony before the Senate Committee on Finance

Chairperson Cummings, Vice-Chairperson MacDonald, Members of the Committee:

My name is Janelle Cammenga, and I'm a policy analyst with the Tax Foundation. For those unfamiliar with us, we are a non-partisan tax policy research organization. Since 1937, we've advocated for tax codes that are simple, neutral, transparent, and stable. I'm glad to be able to speak to you today on senate bill 53.

Some of the proposed changes, like eliminating the throwback rule, are worth considering because they are pro-growth, but other parts of the bill reduce the efficiency of the tax code, like the increase in the alternative minimum tax. Because there's so much to discuss, I will just be addressing the parts that were added after the initial Senate bill was passed.

Increasing Vermont's Alternative Minimum Tax

One of the bill's components is an increase in the number of brackets in the AMT and an increase in the dollar amounts for required payments. This is problematic for a number of reasons. It is the very nature of corporate income taxes to land on corporate income. There are naturally going to be some years where companies do not owe any taxes because they post loss or are carrying forward net operating losses from previous years. An alternative minimum tax undermines this purpose because it applies to businesses even when they have a limited ability to pay. The required payments in the bill are relatively small in order to keep the burden moderate, but it is important to be careful about leaning too heavily on taxes that don't have any connection to profits.

Losses aren't the only reason companies might not owe corporate income taxes. Certain tax incentives can cause also tax burdens to dip to zero or even result in refunds. If those credits are accomplishing what the state wants to accomplish, then it's counterproductive to work against them with an AMT. If those credits aren't delivering the results Vermont is looking for, then the real answer—instead of an AMT—is to reform or repeal them.

Single Sales Factor Apportionment

Another provision in the bill is the change from three-factor to single sales factor apportionment.

This is a topic that has gained a lot of traction in states in recent years. As you all probably know, states can use three factors in their apportionment formulas: property, sales, and payroll, but may choose what weight these factors have, as long as they are internally consistent. This means that states need to set up their system so that, if every state were to adopt that same apportionment formula, it wouldn't result in double taxation. That leaves states freedom in how they want to address apportionment.

Historically, states weighted the three factors evenly, but there's been a big shift to relying only on the sales factor in recent years. Three-factor apportionment provides a greater connection between the taxes paid by companies and the benefits that those same companies receive from the state. But single sales factor has the pretty attractive effect of outsourcing some of the tax burden to companies with less of a physical footprint in the state. This happens because, under single sales factor apportionment,

businesses can increase their in-state investment without seeing their tax burden rise, and thus it doesn't discourage in-state operations. As more and more states have shifted to this treatment, it is understandable that Vermont would want to make this policy choice in order to compete with the rest of the country.

Repealing the Throwback Rule

Even more impactful is the provision to eliminate the state's throwback rule.

We've just discussed how states have the freedom to apportion corporate income based on sales, property, and payroll, but Public Law 86-272 adds another stipulation: a business must have some kind of physical presence in the state in order to be taxed. Just making sales into a state is not enough. But under this system, if there's a company that has all of its marketing and sales offices in one state and only ships its products to customers in another state using a common carrier, they won't have nexus. This creates what's called "nowhere income," and this is where throwback rules come in.

If a company is located in Vermont and sells into another state where it doesn't have nexus, then those sales are "thrown back" into the numerator of Vermont's sales factor. It's important to note that throwback rules only ask whether a business is *taxable* in another state, and not whether it's actually *taxed.* If a Vermont company sells into a state without a corporate income tax—like South Dakota—the throwback rule does not apply, since South Dakota had the legal ability to tax the company, but chose not to do so. That also holds true if a company has no liability in a destination state because of incentives—that income cannot be thrown back just because the destination state decided to forgo taxation.

All this sounds attractive to states looking for revenue, but throwback rules can create an uncompetitive business environment for certain types of businesses. In some cases, throwback rules can create levels of taxation that are so high and unattractive to businesses that the outmigration they generate can more than offset any revenue gains they received from capturing that "nowhere income."

To illustrate how this works itself out, we can picture a company that is located in Vermont and sells into two additional states where it doesn't have nexus. If the sales income is equally distributed between the three states, the company's VT tax burden would be three times what it would be if the state did not have a throwback rule. Throwback rules try to consolidate tax burdens from many states into a single state, but this can be avoided by shifting operations. If our company suddenly picked up and moved to one of those two states instead, or even adjusted its distribution process, its tax burden would reduce by about two-thirds. It's easy to see why companies are willing to make changes like this for significant tax reductions.

This isn't just a hypothetical situation. Businesses take note of throwback rules. In one study,[1] profit sensitivity rates to throwback rules were shown to be about double the response to property tax abatements and investment subsidies. That means throwback rules tend to reverse any benefits provided by tax incentive packages—and then some.

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[1] James A. Papke, "The Convergence of State-Local Business Tax Costs: Evidence of De Facto Collaboration," Proceedings from the Annual Conference on Taxation Held under the Auspices of the National Tax Association-Tax Institute of America 88 (1995), 203.

The economic literature also suggests that throwback rules don't expand corporate tax bases in any meaningful way and do not increase overall state revenue, even though they significantly increase burdens for specific taxpayers.[23] In fact, in states with high enough taxes, the imposition of a throwback rule can actually reduce revenues.[4]

Those in support of throwback rules see them as a way to correct the problem of taxing anything less than 100 percent of business income, but there's no clear reason why, if a business has untaxed activity in one state, another state should be able to tax that activity.

Throwback rules are also inequitable, as they ultimately land on a relatively small number of businesses, and small-sized businesses. Bigger businesses with more resources will be able to restructure themselves to avoid the tax burden, but businesses without that flexibility will be stuck footing the bill.

To sum all that up: Throwback rules are nonneutral, uncompetitive, and ultimately counterproductive. They can lead to double taxation, often land on small businesses, and don't actually increase state revenue significantly, if at all.

As a rule, tax cuts do not pay for themselves. But repealing throwback rules may very well be the exception. There would of course be short term transition costs, but because of the outsized effect that throwback rules have on business decisions, the small revenue loss would be absorbed into future growth from new or retained businesses. Vermont would see no long-term loss, and could even see a long-term gain by becoming a more attractive business destination.

Taxing Software as a Service

Including software as a service in the sales tax base is worth discussing. At the Tax Foundation, we are generally supportive of expanding the sales tax base to include services; after all, an ideal sales tax is one that falls on all final consumption. States are far from this ideal, mostly through historical accident—their sales taxes were created in the 1930s, when goods made up the majority of the economy, leaving services mostly untaxed. As services make up a larger share of the modern economy, moving towards a broader sales tax base is important, but it's even more important that the base be the *right* size—and that means taking care to avoid taxing business inputs. The definition of software as a service in this bill is broad enough run into that issue because it levies a tax on all use of software as a service, regardless of who's paying for it. Many individuals certainly take advantage of cloud services, but a significant portion of these services are intermediate business transactions.

Taxing inputs like this increase costs for businesses, and that cost has to be made up somewhere. If the company is mostly competing with businesses in Vermont, they may pass those costs on to consumers. If they are mostly competing with out-of-state businesses that are not facing the same cost increase, they will have to absorb the costs themselves, possibly by slower wage growth for workers or less

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[2] Teresa A. Lightner, "The Effect of the Formulary Apportionment System on State-Level Economic Development and Multijurisdictional Tax Planning," Journal of the American Taxation Association 21 (January 1999).
[3] Donald Bruce, John Deskins, and William F. Fox, "On the Extent, Growth, and Efficiency Consequences of State Business Tax Planning," in Alan J. Auerbach, James R. Hines Jr., and Joel Slemrod, eds., Taxing Corporate Income in the 21st Century (Cambridge: Cambridge University Press, 2007).
[4] Harley Duncan and William F. Fox, "State Strategies for Dealing with Tax Sheltering and Planning," The State and Local Tax Lawyer 11:2 (2006), 90-91.

investment. In that way, in-state companies are penalized. This would undermine the state’s competitiveness when compared to states that do not tax software as a service.

Conclusion

In its amended form, Senate Bill 53 makes several changes to business taxation, some of which are more attractive than others. As the legislature deliberates on these issues, and potentially makes changes to the legislation, I would encourage lawmakers to focus on repeal of the throwback rule, which undermines Vermont’s tax competitiveness and drives away businesses without doing much to generate revenue for the state. Two states repealed their own rules earlier this year, and that’s a trend we’re likely to see continue in the coming years.