Center on Budget and Policy Priorities

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Summary of Oral Testimony of Michael Mazerov, Senior Fellow
On House Amendments to S. 53
Vermont Senate Committee on Finance
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Chair Cummings and Members of the Committee, I appreciated the opportunity to present testimony on the House-approved amendments to S. 53 on October 15th. Per the request of Senator Brock during the hearing, I am submitting this summary of my oral testimony on the five principal amendments affecting Vermont's corporate income tax that the House approved.

I recommend approval of the three amendments that would expand Vermont's corporate minimum tax, switch Vermont's method of combined reporting from the "Joyce" to "Finnigan" approach, and eliminate the exclusion from Vermont "water's edge" combined reports of affiliated U.S.-incorporated subsidiaries with more than 80 percent of their property and payroll abroad. I recommend rejection of the amendments that would eliminate Vermont's "throwback rule" and switch its corporate income tax apportionment formula from its current property/payroll/sales formula to a single sales factor (sales-only) formula.

Expansion of the corporate minimum tax

- Profitable corporations doing business in the state and benefitting from services it provides have many opportunities to zero-out their Vermont corporate income tax liabilities by claiming multiple tax incentives and exploiting weaknesses in Vermont' corporate tax structure – in particular, its vulnerability to international income-shifting.[1] There will be even more profitable corporations reporting no Vermont income tax liability if the throwback rule is eliminated and/or the state switches to a sales-only apportionment formula.

- It is therefore entirely fair that the state put in place a more robust minimum tax than the very limited $300 flat-dollar tax it currently levies to ensure that corporations pay something meaningful each year to support the skilled workforce, public safety, and other services the state helps to provide. Even for a corporation with more than $300 million in Vermont sales this tax would be limited to $100,000 (which would also be deductible in calculating its federal income tax liability, thereby reducing it).

- New Jersey, New York, and Oregon levy the type of tiered, gross receipt-based minimum taxes created by the House amendment; the latter two top out at $200,000 and $100,000 respectively. Connecticut and New Hampshire levy net worth and value-added taxes, respectively, that also serve as significant corporate minimum taxes. Connecticut's tax can

be as high as $1 million annually, and New Hampshire's Business Enterprise Tax is not capped at all.[2]

Switching from the "Joyce" to "Finnigan" method of combined reporting

- "Joyce" and "Finnigan" refer to California state tax cases where the issue was first raised of how combined reporting should be implemented when some members of the unitary group are taxable ("have nexus") in California and other unitary members are not. The Joyce approach treats every individual parent and subsidiary member of a commonly owned corporate group as an individual taxpayer, requiring the state to establish legal taxing jurisdiction over each individual member. The Finnigan approach effectively treats the entire unitary corporate group as a single taxpayer; if one member of the corporate group is taxable in a state, then the profits and apportionment factors of all members of the group are included in the calculation of the group's tax liability. One ancillary implication of switching to the Joyce method is that the throwback rule does not apply if another member of the group is taxable in a state from which sales would otherwise be thrown back.

- The fundamental goal of combined reporting is to ensure that a corporation's income tax liability to a state does not depend in any way on how that corporation chooses to divide itself up into different corporate subsidiaries. That goal cannot be fully achieved under the Joyce approach, because while the *profit* of subsidiaries not taxable in Vermont will be included in the corporate group's total profit that will be apportioned to the state, the Vermont *sales* of those subsidiaries will not be included in the *apportionment* calculation. This reduces corporate income tax revenue and provides opportunities and incentives for corporations to place most of their income-producing activities in subsidiaries that do not have independent nexus in Vermont.

- For these reasons, most of the states that have adopted combined reporting in recent years have started out with the Finnigan approach, and several other Joyce states have switched to Finnigan as the House amendment would do. (Colorado enacted legislation to switch just a few months ago.) Some states were initially reluctant to switch to the Finnigan method because of a lingering question as to whether it violated a federal law governing state corporate income taxation, but litigation challenging Finnigan on that basis has failed.[3]

- It would be even more important for Vermont to switch to the Finnigan method if the House amendment to adopt a single sales factor apportionment formula were accepted. Such a change reflects a policy choice to reduce taxation of in-state corporations with substantial sales outside the state and increase the tax liability of corporations with little property and payroll in the state but substantial sales. The latter cannot be maximally achieved unless the state switches to the Finnigan approach.

Including domestic "80/20" corporations in unitary combined groups

- One of the main goals of combined reporting is to prevent corporations from shifting profits out of a state by engaging in artificial or artificially priced transactions with related corporations in other (low- or no-tax) states. Even if a corporation engages in such transactions, the tax avoidance is nullified in a combined reporting state because the profits

of those out-of-state entities are added back to the profit of the in-state corporation in calculating the latter's tax liability.

- That goal is undercut, however, if corporations are allowed to exclude commonly owned and controlled corporations from the combined report. That is precisely what the 80/20 exclusion does. It allows other subsidiaries incorporated in the United States but having at least 80 percent of their property and payroll abroad to be excluded from the combined group.

- This has proven to be a loophole that corporations have been able to "drive a truck through," because a subsidiary with just a single foreign employee supplied with a company computer could qualify as an 80/20 corporation under this definition. There have been many documented cases of corporations using domestic 80/20 corporations as tax shelters, and states such as Illinois, Colorado, and Minnesota have enacted legislation to nullify this tax avoidance.[4] Vermont should do the same, as the House proposes.

Repealing Vermont's "throwback rule"

- The "throwback rule" deems sales of goods ("tangible personal property") made by Vermont manufacturers, wholesalers, and retailers to be Vermont sales for corporate income tax apportionment purposes if they are delivered from Vermont into a state in which the seller does not have enough physical presence to be subject to its corporate income tax. A 1959 federal law, Public Law 86-272, decrees that a seller of tangible personal property cannot be subjected to a state's corporate income tax if it has no physical presence in the state or if its physical presence is limited to salespeople who do no more than solicit orders.

- The goal of the throwback rule is to prevent corporations from having "nowhere income" – profit that can't be taxed by any state. Under Vermont's current apportionment formula, a Vermont manufacturer organized as a corporation with all its property and employees in Vermont but no physical presence in any other state would pay no taxes anywhere on 50 percent of its profit. Were Vermont to switch to a single sales factor apportionment formula as proposed by the House, that corporation would owe *no* state income taxes *anywhere*.

- Public Law 87-272 enshrines bad public policy. Just as the Supreme Court finally recognized in the 2018 *Wayfair* decision that physical presence shouldn't be a requirement for sales taxation, it shouldn't be a requirement for income taxation either. Nonetheless, states are stuck with Public Law 86-272 for now. The creation of the throwback rule and its inclusion in the "Uniform Division of Income for Tax Purposes Act" reflected an agreement among the states to collectively address limits on their ability to impose income taxes on corporations with no physical presence within their borders and the "nowhere income" resulting from those limits. States essentially said: "Let's make a deal. You'll tax the profits of your corporations selling into my state without a physical presence, and I'll tax the profits of my corporations selling into your state. We should roughly get the same amount of revenue, and corporations won't avoid taxes they should legitimately be paying to one of us."

- Repealing the throwback rule would break that agreement, one that more than half the states with corporate income taxes continue to sustain – including Massachusetts, Maine, New Hampshire, and Rhode Island. (Maine's rule is a variation of the throwback rule.)

- Individual taxpayers subject to personal income taxes can't have "nowhere income." If a resident of Vermont works entirely in New Hampshire, a state without an income tax, Vermont will tax their entire income. Repealing the throwback rule would therefore be unfair; other taxpayers will pay higher taxes or suffer reduced services to compensate for the revenue lost on nowhere income.

Switching to a single sales factor apportionment formula

- A single sales factor apportionment formula represents a violation of why we tax corporate profits to begin with. We tax them (effectively, their owners) to ensure they make a financial contribution toward the state services that benefit them and help them earn a profit – a skilled workforce, roads and bridges, a court system to adjudicate their commercial disputes, police and fire protection for their employees and facilities, and so forth. The more physical presence a corporation has in a state, the more it is likely benefitting from those services. It therefore makes sense to tax corporate profits to some extent in proportion to that physical footprint. A single sales factor formula breaks that connection entirely.

- The single sales factor formula has, of course, been touted as an economic development incentive, because it means that corporations don't pay more income tax if they increase their property or employment in a state. But it simply hasn't worked out that way in practice, because the state corporate income tax is too small and too small a share of a corporation's total state and local tax liability in a state to be a significant driver of business location decisions. The attached table ranks the states with corporate income taxes according to their retention of manufacturing jobs over the past 20 years. (Every state except Utah and North Dakota has lost manufacturing jobs on net during that period.) If a single sales factor formula were a major factor in where manufacturing jobs are located, the eight states that had single sales factor throughout this period would be bunched toward the top of this ranking, and the five states with the lowest weight on sales in their formula (a one-third weight) would be bunched toward the bottom. But neither of these patterns are evident in the table. Moreover, a more sophisticated version of this analysis, which looked at the job creation record of all the states that switched to single sales factor at any point during the study period, similarly found no significant effects of the formula on job creation – disproving earlier research.[5]

- Accordingly (and notwithstanding that many other states have adopted it), Vermont should reject adoption of a single sales factor formula. It would result in an unnecessary revenue loss (estimated by the Legislative Joint Fiscal Office to equal 15 percent of corporate income tax revenues when fully phased in), and the state would have little to nothing to show for it with respect to job creation. Adopting this formula simply provides a tax cut windfall to corporations with a disproportionate share of their sales out of state; the tax cut is not contingent in any way on their creation or retention of jobs in the state. If legislators believe they can afford to forgo $20 million in corporate income tax revenue for economic

development objectives, they can likely find much more cost-effective ways to achieve them than by adopting such a no-strings-attached "incentive."

Percent Change in Manufacturing Employment, Dec. 2000-Dec. 2020
In States with Corporate Income Taxes (data not seasonally-adjusted)
States with Single Sales Factor Formula in Effect Throughout Period in Bold
States with Equally-Weighted 3-Factor Formula in Effect Throughout Period in Italic

If greater weighting of the sales factor encouraged manufacturing job growth/retention, states shown in bold would be clustered toward the top, and states in italic would be clustered toward the bottom.

Utah	11.9%		
North Dakota	0.4%		
Idaho	-0.6%		
Iowa	**-9.5%**	**Single sales**	
Montana	*11.2%*		*Equally weighted 3-factor*
Nebraska	**13.4%**	**Single sales**	
Alaska	*17.7%*		*Equally weighted 3-factor*
Arizona	18.6%		
Florida	19.3%		
Oregon	19.5%		
Colorado	19.6%		
Wisconsin	20.3%		
Kansas	*20.5%*		*Equally weighted 3-factor*
Kentucky	21.1%		
Minnesota	22.2%		
South Carolina	22.2%		
Indiana	22.4%		
Alabama	22.7%		
Missouri	**25.5%**	**Single sales**	
Georgia	26.2%		

Louisiana	26.5%		
Tennessee (median)	30.9%		
Oklahoma	*31.7%*		*Equally weighted 3-factor*
Mississippi	31.8%		
Connecticut	**32.7%**	**Single sales**	
Hawaii	*33.9%*		*Equally weighted 3-factor*
California	35.0%		
Illinois	**35.3%**	**Single sales**	
Virginia	35.5%		
Maryland	**36.8%**	**Single sales**	
Pennsylvania	37.3%		
Maine	**37.3%**	**Single sales**	
West Virginia	37.4%		
New Mexico	37.6%		
Arkansas	37.8%		
New Hampshire	38.2%		
Delaware	39.1%		
Vermont	39.7%		
North Carolina	40.1%		
Massachusetts	**41.9%**	**Single sales**	
New Jersey	42.1%		
Rhode Island	45.8%		
New York	46.2%		

Notes

[1] I summarized some of the recent evidence on the extent of international income shifting in "Legislators: Don't Feel Guilty about Taxing GILTI," presentation to the NCSL Task Force on State and Local Taxation, November 17, 2018, pp. 8-10.

[2] See the endnotes to the Federation of Tax Administrators' annual compilation of state corporate tax rates, available at https://www.taxadmin.org/assets/docs/Research/Rates/corp_inc.pdf.

[3] See: In the Matter of Disney Enterprises, Inc., et al. v Tax Appeals Tribunal of the State of New York et al., March 25, 2008; https://www.law.cornell.edu/nyctap/I08_0049.htm.

[4] See: Jesse Drucker, "Why Walmart Set Up Shop in Italy," *Wall Street Journal*, November 4, 2007 (appended to this statement). See also: Bruce Fort, "Anatomy of a Domestic Tax Shelter," State Tax Notes, May 17, 2021; https://www.mtc.gov/getattachment/The-Commission/News/Anatomy-of-a-Domestic-Tax-Shelter/AnatomyofDTS.pdf.aspx.

[5] See: David Merriman, "A Replication of 'Coveting Thy Neighbor's Manufacturing: The Dilemma of State Income Apportionment'," *Journal of Public Economics,* 2014; available on request.