★ Chapter Four ★

"Single Sales Factor" and the Corporate Assault on the Income Tax

Suppose you're a manufacturing company executive and you don't like paying corporate income tax to your home base state. How'd you like to get an 80 or 90 percent tax cut? All you have to do is file your tax return, using a special new formula. No conditions, no strings attached. Just file your return and pay a tiny fraction of what you used to pay. Oh, just one more thing: be sure your state manufacturers' association keeps saying over and over again that this gigantic tax cut will create jobs, jobs, jobs. Maybe have it rent an economist to issue a rosy study. Remember, you're for jobs, so anyone who opposes this giveaway scheme must be against jobs.

Welcome to the magical world of "Single Sales Factor" (SSF), in which manufacturing lobbyists have gotten some state legislatures to radically rewrite their corporate income tax codes, sometimes under the threat of losing a major employer. The fact that several states have considered SSF in the past decade reflects the mutation of subsidies from their originally stated purpose—of job attraction and multistate competitions for specific projects—to job retention and multistate rewriting of entire corporate tax codes.

SSF is the special deal, recounted in chapter 1, that Raytheon and other manufacturers won in Massachusetts. As we learned, rewriting the formula that multistate corporations use to allocate their taxable income among the states can radically cut their income tax bills. To date, ten states have enacted SSF. Iowa and Missouri have had it for decades, plus Connecticut, Illinois, Maryland, Massachusetts, Nebraska, and Texas. Wisconsin will start in 2006 and Oregon is phasing it in. (In some of these states, the formula applies only to manufacturers.)[1]

Here is how Single Sales Factor works. Historically, the states agreed upon a system using three factors to divvy up—the technical word is "apportion"—the taxable income of multistate corporations among different states. One factor is the share of its payroll that the company has in a state; another is the share of its property in a state; and the third is the share of its sales that occur in a state.

Here's a quick hypothetical to show how it works. Imagine you own the Rapid Razor Company and you sell your razors in all 50 states. Your company is headquartered in a medium-sized state, and you have half your payroll and 40 percent of your property in that state, since your main office and biggest factory are there. But you sell only 2 percent of your products there, since a medium-sized state has only 2 percent of the population. Your annual profits are $10 million.

Before your headquarters state adopts SSF, your state corporate income tax computation would be as follows:

$$\$10{,}000{,}000 \times \frac{0.5\ (\text{payroll}) + 0.4\ (\text{property}) + 0.02\ (\text{sales})}{3} = \$3{,}066{,}667$$

So about $3.07 million of your income would be apportioned to that state for tax purposes.

But after your state enacts SSF for manufacturers, you use only one factor, sales, to determine how much of your income gets taxed there. So your new calculation looks like this:

$$\$10{,}000{,}000 \times 0.02\ (\text{sales}) = \$200{,}000$$

So now only $200,000 of your income gets taxed by your headquarters state. Assuming the same tax rate, your tax bill just shrank by *more than 93 percent.*

Can you say "windfall with no strings attached"?

Theory versus Reality

The theory behind SSF says that if your state adopts a tax formula based on the single factor of sales that gives manufacturers like Rapid Razor a big tax cut for having a lot of payroll and property but not a lot of sales in your state, and competing states do not adopt the same tax formula, such companies will relocate to or grow in your state.

In the real world, this theory presents many problems, including the slippery slope (that's a scientific term) and what economists call "declining marginal utility." The pro-SSF theory assumes that SSF will give your state an advantage because it creates a difference between your state's tax formula and those of the states you compete with. But then comes the slippery slope. If you accept the (implausible) argument that Wisconsin needed to enact SSF because Illinois did it after Iowa did it (a really long time ago), then the only logical thing for Indiana to do is follow suit, and then Minnesota, and so forth down the slippery slope. Every time this happens, for every state that went to SSF the earliest, the value gets diluted, because a competing state has the same tax break.

Declining marginal utility means that every time you do something again, it becomes less useful or effective or enjoyable. If Indiana or Minnesota goes to SSF, from day one the state will never enjoy as big a theoretical advantage as Iowa used to, because so many states it competes with already have SSF. So for every state that goes to SSF later on, the initial value also keeps shrinking.

As the *Wall Street Journal* put it, it's "a classic race to the bottom, in which states compete with tit-for-tat responses until nearly all impose the same low level of tax liability. At that point, the economic advantage of lowering corporate taxes vanishes, leaving as the ultimate winner the companies that pocketed millions in tax breaks."[2]

The pro-SSF theory also ignores the reality of why companies pay taxes. Using a tax formula that ignores payroll and property is like saying the company doesn't physically *exist* in a state. If a company has a lot of payroll in a state, that means the state has a lot of families with future workers to educate, a lot of roads to maintain, a lot of public safety and sanitation services to provide. Likewise, if a company has a lot of property in a state, that indicates it has a lot of activity there and creates a lot of both wear and tear on infrastructure and demand for public services there. Property may also relate to how much pollution or other costs the company generates. On the other hand, it is fair to include sales as one of three factors, because it reflects the value of markets; that is, sales reflect where the buying power came from to create the profits being taxed.

Basing taxes only on sales is also unfair because it punishes most small companies and those that only sell in-state, while favoring manufacturers and other kinds of companies that "export" most of their sales to other states. If you own a small bakery in Baltimore, 100 percent of your payroll, property, and sales were in-state before Maryland enacted SSF. And they still are now, so your tax bill didn't change a bit. If you own an oyster-canning company headquartered in Delaware and you sell a third of your oysters in Maryland but only have a fifth of your payroll and property in Maryland, under SSF your Maryland tax bill goes *up*.

The theory justifying SSF also has a big problem with results: there is little compelling evidence that it works in the real world. For example, eight states had SSF fully in effect by fall 2001, when the rebound from the most recent recession began. The U.S. economy has continued to bleed manufacturing jobs since then, and SSF states have been among the hardest hit. Five of the eight SSF states had worse than average manufacturing job losses between November 2001 and November 2004; only three did better than average. Ironically, Massachusetts—whose 1995 enactment of SSF to benefit

Raytheon set off the latest wave of SSF adoptions—had the steepest manufacturing job loss of the eight SSF states in this period.[3]

That's not scientific proof that the formula doesn't stimulate job creation, but it does suggest that other forces—especially globalization—are the real issue in manufacturing today. Occasionally, a company will say as much. The year after Maryland enacted SSF, one of its major manufacturers, Black & Decker, announced it would lay off 450 workers in Easton, moving production to Mexico. Pressed by a *Baltimore Sun* columnist about why SSF didn't work its promised magic of saving the jobs, a company spokesperson said the move was "part of a comprehensive restructuring of our entire global manufacturing network, and, thus, is based on a range of considerations well beyond Maryland tax law." That's exactly the point for manufacturing jobs today: as a location issue, state taxes are more microscopic than ever. *The* issue is globalization.[4]

More Corporate Losers Than Winners

Besides being ineffective, SSF is unfair to most companies. At least six states have estimated how many winners and losers there would be if SSF were adopted. In every single case, the states concluded that more companies—in some cases almost twice as many—would pay higher taxes than would get tax cuts. Winners get bigger tax cuts than the tax hikes suffered by the losers, so overall revenue goes down.[5]

In Pennsylvania, for example, the average winner would get a tax cut almost three times bigger than the tax hike imposed on the average loser, so the state would be out $63 million overall. Big companies would get the lion's share: those with more than $10 million in capital stock value would get the vast majority of the tax cuts.[6]

The Pennsylvania study included another ominous finding that suggests SSF could cause even worse damage—to both jobs and revenue. It finds that those companies with a very small physical presence in the state—just 4 percent or less of their property and payroll—would get stuck with more than 80 percent of the tax hikes. These are "national corporations primarily engaged in shipping products into Pennsylvania," such as, say, a national food company with a warehouse or a couple of sales offices in the state.[7]

If SSF were enacted, such a company would have a tax incentive to close the warehouse or sales offices, get rid of its Pennsylvania property, lay off those workers, and either truck its products in from surrounding states or contract out the sales work. They would still be able to sell as much and make as many profits in Pennsylvania, but they would no longer have nexus; that is, they would have so little physical presence in Pennsylvania, the state could no longer legally tax those profits. So instead of getting stuck with higher tax bills, these companies would avoid income tax altogether.

More than 8,300 taxpaying companies fit this profile of having a very small physical presence in the Keystone State. If they all restructured to dodge the tax hike, it would cost the state at least another $108 million in lost revenue—and untold thousands of jobs. Of course, SSF would also give these same companies a disincentive against ever investing in future job creation in Pennsylvania.[8]

Such distortions mean that some multistate companies would prefer to have it both ways: to have SSF in some states, but not in others. Usually they don't talk about it publicly. But Kraft Foods lobbied for SSF in Illinois (where it is headquartered) and then opposed it in Maryland. Ford Motor Company led a campaign for SSF in Michigan (where it is based) but then opposed it in Illinois.[9] And AT&T backed SSF in New Jersey but opposed it in Oregon.[10]

Flunking Every Measure of Accountability

It's not just the size of the Single Sales Factor tax cut that big manufacturers love; it's also the process. Cutting corporate income taxes by changing the *definition of taxable income* is the manufacturing lobbyists' coveted prize, because it flunks every measure of accountability. SSF includes no obligations such as job creation or decent wages; it is not at all transparent; and it does not provide for any kind of "clawback," or money-back guarantee if a company that gets a big tax break fails to deliver job creation benefits. Changing to SSF doesn't require a company to fill out any messy application paperwork, saying it is going to invest a certain number of dollars or create a specific number of jobs. It doesn't require any involvement at all by state or local economic development officials, so they have no clue about costs or benefits.

Indeed, Single Sales Factor does not create any paper trail for taxpayers to review—no records about outcomes at any specific company or industry at all. So no one has any way to see if specific companies are living up to the rhetoric of "jobs, jobs, jobs." And no one can see how big a tax windfall any specific company got. That's because state corporate income tax returns, like personal returns, are confidential. Once Single Sales Factor gets enacted into law, it becomes a secret matter between each corporation and the state revenue department.

In the end, the only thing the states can be sure of is that they will have less revenue for the public goods—like roads and education—that benefit all employers.

Massachusetts: The Slippery Slope on Steroids

For a prime example of the SSF slippery slope in action, we return to Massachusetts, where the original proposal had been SSF for defense contractors, which morphed into SSF for all manufacturers, and would soon become SSF for all mutual fund companies as well.

The financial press was impressed by Raytheon's 1995 tax coup. *CFO* magazine's January 1996 cover story blared: "There's No Place Like Home: How Companies Are Cashing in by Staying Put." Naively, the magazine claimed that the day of huge packages for multistate competitions was over. "Instead, the focus now is on retaining current businesses," it said. "As the Raytheon case illustrates, companies can force states to focus on retention. . . . Who can blame them? After years of seeing the goody bag opened for incoming businesses, in-state companies are asking 'What about us?'"[11]

Indeed, Boston-based mutual fund giant Fidelity Investments had started asking that very question in the summer of 1995 as the Raytheon battle heated up. Creating leverage on Massachusetts, Fidelity won SSF for mutual fund companies in Rhode Island in August 1995 and hinted that it was considering moving its fixed-income group to Providence.[12]

Massachusetts's Governor Weld proposed extending SSF to all corporations in September, but the legislature balked and proceeded only on the Raytheon/manufacturing part. After all, Fidelity was a growing, profitable company. And multibillionaire Ned Johnson and his family owned about half of the company. Through the fall, it was reported that the company was negotiating to buy property in New Hampshire and looking at space in Rhode Island. In December 1995, Fidelity announced that it planned to move as many as 900 Boston jobs to the two sites. The Rhode Island site might grow to 2,500 jobs, it said, and the New Hampshire facility might grow to 2,000. A Fidelity executive called the news "a kind of wake-up call" to Massachusetts.[13]

The mutual fund tax-break campaign reignited in April 1996 and succeeded by August. As in Raytheon's campaign, a study was commissioned, this one by Coopers & Lybrand, that made robust predictions for both jobs and tax benefits. In releasing the study, the Massachusetts Business Roundtable pointed out lower tax rates on mutual fund companies in Rhode Island and New Hampshire and quoted a Coopers & Lybrand partner: "Massachusetts is becoming an island relative to the surrounding New England states that are competing for this growth . . ." The study kicked off a lobbying campaign aided by Governor Weld. "If you think the textile industry moved south in a hurry over a weekend in the 1950s, watch what can happen in other industries," he told a legislative hearing.[14]

After wrangling between Massachusetts House and Senate versions, by August the mutual fund companies won both tax breaks they sought: the Single Sales Factor formula and a "destination test" that exempted sales to people outside of the state even though the sales were handled in-state. Together, a legislator had estimated, the cuts would reduce Fidelity's tax bill by nearly 90 percent. (Boston is also home to Putnam, Scudder, MFS, Pioneer, Wellington, State Street, Eaton Vance, and other funds.)[15]

Stung by layoffs that were already starting at Raytheon by the spring of 1996, Bay State legislators negotiated for jobs language in the mutual fund tax cut that was better than the language in the manufacturing law. It required a company to expand Massachusetts employment 5 percent a year for five years through 2001 and then maintain that many jobs in 2002, with the requirements expiring as of 2003. That was a modest goal, given that the industry had been growing by 19 percent a year in Massachusetts in recent years. The law allowed for exceptions in the event of adverse economic conditions, and Fidelity did have layoffs in 2001 and 2002 as U.S. stock markets declined. Despite the layoffs, the company exceeded the 25-percent job-creation requirement, reportedly growing jobs by 35 percent in the Bay State from 1996 through 2003.[16]

However, now that the job requirements have expired, mutual fund companies have no obligations to keep jobs in Massachusetts, even though they still get the big tax break. Who knows whether the industry will continue to grow jobs there? Fidelity did begin outsourcing to India in 2003 and rapidly became one of the largest customers of Mastek, a company in Mumbai that specializes in financial services. A securities trade journal cites Fidelity as an industry leader, along with Morgan Stanley, in offshore outsourcing of *front office* functions, not just processing.[17]

High Costs in Lost Revenues, Public Service Cuts

The DRI/McGraw-Hill study commissioned by Raytheon also made state revenue and spending forecasts about the SSF tax cuts for manufacturing.[18] Starting again from that dire assumption of 50,000 prime defense contractor jobs lost *without* the tax cuts and retention of all of those jobs *with* the cuts, it forecast only a one-year net budget loss for the state and cumulative gains of $534 million in 10 years. Even from the less dire "10,000 jobs saved" scenario, it forecast a $112 million net budget gain for the state "because it eliminates the need for defense industry relocation and stimulates job growth and new sources of tax revenue."[19]

But the state's revenue department makes it clear that no such thing ever happened. By FY 2005, the Raytheon and Fidelity SSF tax cuts for defense contractors, manufacturers, and mutual funds had cost the Bay State's treasury about *$1.5 billion* in reduced corporate taxes, with about two-thirds of that going to mutual fund companies.[20]

The Bay State has enacted so many tax breaks (and stayed linked to federal cuts) that for every $5 it collects in corporate income taxes, it forgoes $4 more in tax breaks.[21] It also enacted a raft of personal income tax cuts. With less revenue, between FY 2001 and FY 2005, the Commonwealth cut funding for higher education by 21 percent and for public health by 24 percent in real terms. Between FY 2002 and FY 2004, Massachusetts cut state aid per school pupil by a greater share than any other state.[22]

The bottom line: in less than one year between 1995 and 1996, under the duress of job threats, dire studies, and intense lobbying, Massachusetts radically rewrote its corporate income tax code in ways that would not ensure long-term job creation or even job security, but *would* cost the state treasury a billion and a half dollars over the following decade and shift the burden for public services away from a few favored industries and onto working families and small businesses.

Illinois: Losing Factory Jobs *and* State Revenue[23]

Illinois enacted SSF in 1998 at the insistence of the Illinois Manufacturers' Association and some of its biggest members. It was reportedly backed by Ameritech, Abbot Laboratories, Deere & Company, Duchossois Industries, Kraft USA, Nalco Chemical, and Quaker Oats. Caterpillar and Motorola were likely major beneficiaries, along with Archer Daniels Midland, RR Donnelley, and Amoco.

It was no secret that the deal would heavily favor a small number of big boys. During the debate on an early version of the bill, the Illinois Department of Revenue estimated that just five companies, unnamed, would receive 63 percent of the tax-cut dollars. That's five companies out of 133,769 that file income tax returns in Illinois.[24]

Of course, given how completely unaccountable SSF is, none of the companies getting the huge windfalls would ever be required to create—or even retain—one single job in Illinois. In fact, many did just the opposite. Since SSF began taking effect there, Abbott, SBC Ameritech, Kraft, Motorola, Nalco, Deere, and BP/Amoco have announced layoffs totaling more than 9,900 workers.[25]

As part of its campaign for SSF, the Illinois Manufacturers' Association hired two University of Chicago economists to perform a study. The study predicted that SSF would cause Illinois to gain 155,000 factory jobs and 130,000 other jobs within three years.[26] Officials at the Illinois Department of Revenue called the forecast "so absurd it's laughable"—but of course it was the rosy forecast, not the sober expertise of career state economists, that got the most attention.[27]

So did the hired guns' forecast pan out? Not quite. The Bureau of Labor Statistics reports that the Prairie State has *lost* a whopping 188,000 of its factory jobs—more than one in five—in the five and a half years since SSF began taking effect there. In other words, so far the lobbyists' economists are 343,000 jobs short of the promised factory jobs.[28]

The hired economists also made a rosy forecast for tax revenues. They predicted that all those new manufacturing and ripple-effect jobs were going to generate $200 million a year in new revenue—in the form of *personal* income taxes. They did not predict the impact on corporate tax revenues.[29]

Given that Illinois has lost 188,000 factory jobs instead of gaining 155,000 (not to mention lost ripple-effect jobs), the state has obviously *lost* a lot of personal income tax revenue. Dislocated factory workers, when they can find new jobs, take overall pay cuts. And on the *corporate* income tax side, SSF has also become a huge drain on the Illinois treasury. From FY 1999 through FY 2004, it cost the state an estimated $462 million in revenue and now costs the state about $90 million a year, according to the Illinois Department of Revenue. The share of state revenue from the corporate income tax has plummeted as a result. In FY 1998, before SSF, corporate income taxes supplied 7.3 percent of the state's revenues. By FY 2004, they had plunged to just 3.4 percent. The FY 2005 projection: just 3.0 percent.[30]

Given the weight of the evidence, the state's leaders considered repealing SSF, but the business lobby went to the mat over the issue. In one of the most bizarre statements ever made in defense of a giveaway, the Illinois Chamber of Commerce said that SSF "encourages job creation and capital investment," but that opponents "focus instead on estimates of state revenue loss that do not take into account increased economic investment and that cannot be backed up with actual data."[31]

In other words, trust us.

Georgia: Have It Your Way

Georgia came up with a unique answer to the apportionment issue: let companies choose their own formula! No kidding. In a low-profile bill that flew from legislative filing to Governor Zell Miller's desk in barely three weeks in 1998, the Peach State said to newly arriving or expanding companies: let's make a deal. The state revenue director is authorized to negotiate customized apportionment deals for your income tax. You get to propose you own formula; that is, you can use SSF or you can use property, payroll, and sales one third each, or variations thereof. Just tell us why you want it, and satisfy a few criteria—including the conveniently vague "significant beneficial economic effect" requirement—and we will slate it to run for an unspecified "limited period" of years. Then it will be reviewed for approval by a three-person board whose members are also appointed or nominated by the governor. It's a nice brief law, too; it doesn't set out any kind of monitoring or compliance systems.[32]

Subsequent press reports revealed that the deal was initiated to encourage General Electric to relocate 500 Power Systems jobs from Schenectady, New York. But in 2000 and 2001, when *State Tax Notes* magazine and the *Atlanta Business Chronicle* filed Open Records Act requests to get the names of all the companies that got the special deal, the revenue commissioner refused to divulge them, and the attorney general ruled in favor of keeping them secret.[33]

The *Business Chronicle* responded with a blizzard of investigative articles by reporter Meredith Jordan through fall 2001 and winter 2002, revealing that six companies had gotten tax breaks worth $98 million. The debate grew ugly, with aides to then-governor Roy Barnes (a self-described "open records" governor) stonewalling on the records requests, while the *Business Chronicle* ridiculed them for their outrageous position. Finally, in early 2002, the state legislature amended the law to provide some disclosure—of company names and their projected investments, jobs, and wages.[34]

Armed with the names of the other five companies, the *Business Chronicle* investigated and reported that Alltel Corp., a telecom company, had fallen far short of its job creation pledge. The company repaid $11.5 million to the state and agreed to forgo its special deal for the remaining three years, saving taxpayers an estimated $17.2 million more.[35]

The Long-Term Corporate Assault on State Corporate Income Taxes

How did we get into this chaotic mess with all these gimmicks? Why don't the states agree on a standard tax system? There is actually a little-known history to it all: the corporate lobbying drive to enact Single Sales Factor is just one part of a broad, multidecade campaign by multistate corporations to gut state corporate income taxes.

The story boils down to this: since the 1950s, the states have been trying to cooperate and set up a simple, uniform system so that all profits of multistate corporations are taxed somewhere, somehow. And since the 1950s, corporations have been relentlessly attacking the states' effort to cooperate—with litigation, lobbying, and creative accounting.

I have to get wonky for a few pages here. Stick with me. It's important.

Between 1955 and 1957, the tax commissioners of the states advised a committee of the American Bar Association on a model state tax law. Issued in 1957, it was called the Uniform Division of Income for Tax Purposes Act, or UDITPA ("you-DIT-puh").[36] This model law included the three-factor formula for apportioning corporate income already described: one third based on the share of payroll a company has in a state, one third on its property, and one third on its sales.

Some state commissioners sought this model law because companies had been complaining and even suing some states over allegedly unfair rules. Because states used different rules about how to apportion income, companies had to literally keep different records for different states. The only reasonable and fair solution was to devise a system that, if adopted by all the states, would make sure 100 percent of corporate income got taxed. That is the genius of UDITPA.[37]

A few states had already adopted the three-factor formula, most notably Massachusetts. In their deliberations, the commissioners sometimes referred to the "Massachusetts formula" when discussing the three-factor model.[38] It's especially tragic, then, that the Bay State was later one of the early states to abandon this fair system, in the Raytheon and Fidelity episodes.

Although this carefully negotiated system did not make everybody happy, it was about as close to a corporate-government consensus as there has ever been on the issue. But UDITPA failed to address one big issue: nexus. At what point does a state have the right to say a company has enough of a presence in the state to owe income taxes on profits it makes in the state? Many companies refused to pay taxes in states even though they solicited and made sales there.

In 1959, a U.S. Supreme Court decision threatened to expand the definition of nexus. In *Northwestern States Portland Cement Co. v. Minnesota,* the Court ruled that a state could tax an out-of-state company's profits even if the company's only activity in the state consisted of sales representatives soliciting business in the state.[39]

Corporate lobbyists, led by the Pennsylvania Manufacturers' Association, rushed to Congress in 1959 and within six months won Public Law 86-272. This obscure law restricts how the states can define nexus; that is, it enables companies to have certain activities in a state yet avoid paying income taxes there. Basically, it says a corporation can avoid being taxed on the profits it makes selling goods in a state if it does not also manufacture or warehouse the goods in that state. Public Law 86-272 says that if a company solicits sales using the U.S. mail, or telephones, or the Internet—or even traveling salespeople—and then delivers the product from a warehouse outside the state, the company has not established nexus. Therefore the state where those sales occurred cannot tax the profits.[40]

Congress also created a special select committee that held a series of hearings between 1959 and 1965 to explore how unfairly and unevenly states were taxing corporations. It recommended drastic federal controls on how states and cities could tax corporations.

In response to the threat of restrictive federal legislation, in 1966 a group of states convened as a committee of the Council of State Governments to create the Multistate Tax Compact—and the Multistate Tax Commission (MTC) to administer it. The Compact gathered steam through 1967; by the end of 1968 there were a dozen member states.

The MTC's main purpose was to help the states proactively address the issue of tax uniformity. It promoted the adoption of the model law, UDITPA, so that more states would use the three-factor formula, but whether a state did so was voluntary. UDITPA was one of 12 articles of the Multistate Tax Compact—the formal agreement among the states that guided the work of the Commission.

Besides pushing UDITPA, in the early 1970s the MTC also began performing multistate corporate income tax audits. Companies hated this. Before the MTC started these audits, state officials had widely suspected that companies gave different numbers to different states, creating "nowhere income," or profits that never got taxed anywhere (I'll have more to say about this soon). The MTC's first executive director, Eugene Corrigan, recalled how a company could no longer deal separately with State A and then State B; instead, the company heard the MTC say: "We are here for your figures on States A *and* B."[41] No longer could a company get away with telling different stories to different states.

Corrigan recalled one audit the MTC performed for several states. The auditor asked the company's tax manager for a 50-states-and-DC breakdown so he could verify that the corporation was attributing all of its income somewhere among the states. The tax manager denied that he had any such document or had ever prepared one. A couple of days later, the auditor was working in one of the corporation's offices when he needed a paper clip. When he opened the desk drawer, he noticed a piece of paper: the company's "nonexistent" fifty-one-state breakdown. It revealed that the corporation was systematically attributing to each state only a set percentage of the sales that it was actually making in the state. The auditor left the document in the drawer and diplomatically avoided mentioning it while he proceeded to perform the audit armed with the knowledge that he had inadvertently acquired.[42]

Seventeen of the nations' largest corporations sued in 1972, seeking to shut down the MTC and its multistate audits. The case is known as *U.S. Steel v. Multistate Tax Commission,* and the plaintiffs were United States Steel Corp., Standard Brands Inc., General Mills, Inc., Procter & Gamble Distributing Co., Bethlehem Steel Corp., Bristol Myers Co., Eltra Corp., Goodyear Tire & Rubber Co., Green Giant Co., International Business Machines Corp., International Harvester Co., International Paper Co., International Telephone & Telegraph Corp., McGraw-Hill, Inc., NL Industries, Inc., Union Carbide Corp., and Xerox Corp. (IBM and Xerox withdrew as intervenor plaintiffs before the decision.) The corporations alleged that, in creating the MTC, the states violated the Compact Clause of the U.S. Constitution.[43]

Corrigan described the companies' aggressive legal tactics. "The high-powered law firm of White & Case represented the plaintiffs, which were 16 of the nation's most powerful corporations. They inundated us with interrogatories," he said, referring to questionnaires each party in a lawsuit is allowed to serve upon its adversaries during the pretrial phase known as discovery. "One interrogatory might consist of as many as 200 questions. It would be served not only upon the MTC but upon each of our 17 member income tax states. We had to get each question answered and coordinate all the states' answers for accuracy. As soon as we finished one set, we would receive another. It amounted to nothing more nor less than harassment."

The case dragged on for three years, with no progress.[44] Determined to fight back, Corrigan and the MTC brought on new counsel, William Dexter, a former assistant attorney general in both Michigan and Washington state. Dexter quickly brought the case to a head. He filed a motion for summary judgment, asking the U.S. District Court in New York (where the case had been brought) to promptly rule in favor of the MTC, based on the evidence, and end the case without spending time on a trial. The Court granted the summary judgment for the MTC. Because the case involved many states, it went directly to the U.S. Supreme Court. In a landmark ruling for the states, the Supreme Court in 1978 saved the MTC, ruling that states are free to form compacts, even without specific federal approval, so long as they don't interfere with or reduce federal powers.[45]

The business lobby, unable to kill the MTC through federal litigation, responded to the *U.S. Steel* decision by centralizing its efforts through the Council on State Taxation (COST), the obscure but powerful coalition of multistate corporations that had been founded in 1969 (the year after the Multistate Tax Compact took root) for the apparent purpose of killing or at least thwarting the MTC. As COST's website says, its birth was "precipitated by the need of corporate taxpayers to be represented by a united voice on state tax issues—to counterbalance a number of organizations of state tax authorities."[46] Indeed, as Corrigan explains, the Multistate Tax Commission was COST's raison d'être. A colleague told Corrigan that more than two decades after the *U.S. Steel* decision, COST meetings still included lengthy sessions devoted to ranting against the MTC about that case and other long-ago events.

The 1970s were heady times for the MTC staff. Said Corrigan, "We felt we were on the frontier of effective auditing of the major corporations, of effective tax administration. We felt we were breaking new ground, that we would end up making the corporations admit their tax liability as it should have been."[47]

The MTC's multistate audits uncovered another kind of tax dodge. Some companies would game the system by creating multiple subsidiaries, to avoid nexus. An auditor for State A might be assigned to audit a business that had 12 closely related corporate subsidiaries. But if only three had nexus in the state, the audit would cover only those three corporations. An auditor for State B would be allowed to audit only the three or four subsidiaries that had nexus in State B. Neither auditor would see the entire picture, even though all 12 subsidiaries were actively helping to create income from both states. The solution was to take into account the activities of all 12 subsidiaries in determining the taxable income for States A and B. Looking at the companies in their "unitary" relationship in a "combination" auditing procedure meant treating all the entities as if they were one company. The MTC led the way in performing such audits and in encouraging member states to adopt what is now called "combined reporting."[48]

Corrigan's MTC also promoted the extension of combined reporting to foreign corporations; that is, requiring companies to include their foreign subsidiaries in their income statements. Corrigan cites this as "the first attempt in this country to cope with what has become a national scandal—the exporting of jobs and income to foreign nations so that businesses pay little or no income tax to either the federal government or the states."[49]

Worldwide combined reporting—also called the "unitary tax"—stood as a major threat to offshore tax dodges. COST went so far as to try to ban it through a tax treaty between the U.S. and the United Kingdom that was being renewed. The states blocked Senate ratification of the treaty. Finally, in 1983 in *Container Corp. vs. California Tax Board,* the U.S. Supreme Court upheld the states' right to require combined reporting—including worldwide reporting.[50]

Frustrated by *Container* and its failure to win a federal ban on worldwide combined reporting, COST turned its lobbying fire upon state legislatures. Claiming that combined reporting would jeopardize jobs, the corporate lobby succeeded in getting many states to prohibit or limit its use.[51]

Today, COST claims about 570 corporate members and continues to spearhead opposition to many state efforts to bolster their corporate income taxes. Besides orchestrating legislative action, it issues studies, files amicus briefs, keeps a database of tax regulations, and provides referrals to attorneys and consultants. COST often uses a series of studies it has commissioned from the Big Four accounting firm of Ernst & Young; these purport to show that corporations' state and local tax burden are unfairly high or rising. And it holds conferences, including the Fall Audit Session, with "optimal time to share tips, ideas and strategies for handling difficult state audits." In 2004 testimony, a COST official said combined reporting is "poorly defined" and "subject to endless litigation."[52]

At the federal level, corporate lobbyists keep trying to get the federal government to limit states' taxing rights. They seek to extend the federal restrictions on state nexus for physical goods (the notorious Public Law 86-272) to the entire *service economy*. The proposed "Business Activity Tax Simplification Act of 2003" would narrow the definition of nexus so that lots more corporate profit would never be taxed in any state. As Michael Mazerov of the Center on Budget and Policy Priorities explains, it would mean that "a television network would not be taxable in a state even if it had affiliate stations within the state relaying its programming and regularly sent employees into the state to cover sporting events and to solicit advertising purchases from in-state corporations . . . A restaurant franchisor like Subway or Dunkin' Donuts would not be taxable in a state no matter how many franchisees it had in the state and no matter how often its employees entered the state to solicit sales of supplies to the franchisees."[53]

By taxing companies for having employees and property in a state, the bill would create a perverse incentive that would be bad for jobs. The current chair of the MTC said it well: "If a company is subject to state and local taxes only when it creates jobs and facilities in a state, then many companies will choose not to create additional jobs and invest . . . Instead, many companies will choose to make sales into and earn income from the states without investing in them."[54]

The bill would likely reduce the revenue of 45 states and the District of Columbia and create a new wave of corporate tax-dodging gimmicks. The so-called Coalition for Rational and Fair Taxation (CRAFT) pushing the bill has not disclosed its corporate membership since 2001, and even then it omitted the names of six large members. The named members included media companies such as Viacom/CBS and Walt Disney/ABC, high-tech giants Microsoft and Cisco, and retailers such as J.Crew and The Limited.[55]

Finally, corporate lobbyists have continued their defense of two other loopholes: "nowhere income" and Delaware Holding Companies. I know, I know, I just used two new terms. Read on for the goods on two more amazing tax dodges.

Two More Corporate Income Tax Loopholes[56]

"Nowhere income" and Delaware Holding Company loopholes are not sold as "job, jobs, jobs" subsidies the way Single Sales Factor has been. But they are active examples of the lengths to which corporations will go to dodge state income taxes.

Nowhere income. Let's say you produce corn dogs in Iowa and you sell them to a vendor at Wrigley Field in Chicago. Under Public Law 86-272, because you don't have a factory or a warehouse in Illinois, and you used a traveling salesman who works out of his home to market the dogs to the vendor, you did not establish nexus in Illinois. So the Prairie State has no right to tax your profits on the sale. Iowa doesn't either, since the sale didn't occur there. That means the profits are "nowhere income"—they are never taxed anywhere. States have one possible solution, the "throwback rule"; when applied to cases such as this, the profits get "thrown back" to Iowa as taxable income there. But 20 states still lack a throwback rule: Arizona, Connecticut, Delaware, Florida, Georgia, Iowa, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, Nebraska, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Tennessee, and Virginia. Corporations have actively fought efforts in recent years to enact throwback rules in states such as Arizona, Maryland, North Carolina, and Massachusetts.[57]

Delaware Holding Company loophole. Now let's say you own a chain of clothing stores, with outlets in 20 states that have not adopted combined reporting. Don't like paying income taxes on your profits in those 20 states? No problem! Doesn't your store have a valuable logo, slogan, and/or character associated with it? (Think of certain companies' use of cartoon figures, animals, mottos, and the like.) Well, make sure you have that "intangible" property trademarked. Then, in either Delaware or Nevada, set up a wholly owned subsidiary shell (called a Passive Investment Company, or PIC) that owns that trademark. Now, have that PIC bill all of your stores, charging them "royalties" for the use of that trademark. The size of the royalty bill might even equal the stores' profits. That's a good thing, because the stores will then show no profits and therefore owe no income taxes in the 20 states. When the royalty checks arrive in Delaware or Nevada—presto!—no income tax there, either, since the Diamond State does not tax this "passive income" and the Sagebrush State has no corporate income tax. You can even lend those tax-free profits back to your company—and deduct the interest! Is this a great country or what?

Neither Delaware nor Nevada even requires that holding companies *publicly disclose their existence*, so no one knows how many thousands there are. A Delaware official said his state had 6,000 at the end of 1998 and was gaining 600 to 800 more each year. Thanks to some lawsuits, we have a peek behind the curtain. Toys "R" Us set up its Geoffrey Inc. subsidiary in Delaware; it took in $55 million in 1990 for the use of the company's name, trademarks, and "merchandising skills." The retail giant The Limited/Victoria's Secret/Lane Bryant/Express set up a Delaware PIC that collected $949 million between 1992 and 1994 from trademark licenses. Kmart set up a PIC that took in $1.25 billion from 1991 to 1995. Multiply these figures times thousands of companies. Since no one knows how many PICs there are, there is no estimate on how many dollars in corporate profits are dodging state income tax due to this scam. But it's obviously a lot.

The *Wall Street Journal* compiled a list of 50 companies with PICs, made public by litigation. The list includes ADP, Inc., American Greetings Corp., Budget Rent-A-Car Corp., Burger King, CompUSA, ConAgra Foods, Inc., Gap, Inc., Home Depot USA, J.P. Stevens and Co., Kohl's, Long John Silver's, May Department Stores, Payless Shoesource, Inc., Radio Shack Corp., Sherwin Williams, Snap-on, Inc., Stanley Works, Staples, Syms, Tyson Foods, Inc., Urban Outfitters, and Yellow Freight System.[58]

What's the best solution to this massive sidestepping of state corporate income taxes? Combined reporting, whereby a state requires a company to file a tax return as if all of its subsidiaries are one company and then apportion the income. But only 16 states require that. Nine more states prohibit companies from deducting royalties or interest paid to a related company. That leaves 20 states prey to the PIC scam: Arkansas, Delaware (!), Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Missouri, New Mexico, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Vermont, Virginia, West Virginia, and Wisconsin.[59]

What do all these scams cost the rest of us? The Multistate Tax Commission has estimated that corporate tax sheltering such as nowhere income, Delaware Holding Companies, incorporating offshore, and offshoring of profits cost the states $12.3 billion in 2001.[60]

"Why do we have less uniformity in state tax laws than we did in the early 1980s?" asks the MTC's current executive director Dan Bucks. "Because businesses don't support it. They undermine uniformity whenever they see it because they have learned [that] the lack of uniformity creates opportunity for tax shelters." He concludes that "[t]he multistate tax system is becoming a Swiss cheese income tax system . . ."[61]