Testimony of Navjeet K. Bal

Commissioner of Revenue

Senate Post-Audit and Oversight Committee Hearing

March 29, 2011

Good morning Chairman Montigny and members of the Committee. My name is Navjeet Bal and I am the Commissioner of Revenue for the Commonwealth. Let me preface my remarks by reminding you that State law prevents me from providing any tax returns or other information with respect to a particular taxpayer. Taxpayer confidentiality is a fundamental principle of both federal and state tax administration, and is vital to encouraging taxpayer compliance with the Commonwealth's state tax laws. Both business and individual taxpayers have every expectation that their tax returns, which may contain sensitive business or personal information, will be kept confidential by the DOR in accordance with state law. Any disclosure of tax return information can only be done in accordance with explicit statutory authorization.

In order to understand how the single sales factor benefits in-state corporations that qualify for such treatment, it is helpful to understand how corporate income is apportioned or shared amongst the states for tax purposes.

- Apportionment is a process that applies only to corporations or other taxpayers who do business in more than one state. In such a situation, each state in which the taxpayer is doing business cannot tax 100% of the entity's income, or multiple taxation would result.

- For the better part of fifty years, states and businesses have used the **three-factor apportionment formula** originally developed here in MA back in the 1920's and 30's, to apportion corporate income amongst the states. The formula takes three factors into account – property, payroll and sales – as proxies for the amount of capital, labor and markets that a business has within a state.

Let's take each factor, one at a time:

- The Property factor is determined by taking the cost of real property and tangible personal property (owned and rented) by a corporation here in MA, divided by the cost of such property that such corporation has everywhere else. This ratio provides an approximation of the amount of capital a corporation has here, compared to the amount of capital it has everywhere else.

- Similarly, the Payroll factor is determined by taking the amount of compensation paid by a corporation to its employees in MA, divided by the amount of compensation paid everywhere else, which provides a proxy for the amount of labor a company has here compared to everywhere else.

- The Sales factor is determined by comparing the amount of sales a corporation has to customers here in MA, compared to the amount of sales it has everywhere else, as a proxy for the size of its market here in MA compared to everywhere else.

- The three-factor apportionment formula then adds all three factors together, divides them by three and then multiplies the resulting fraction against the corporation's taxable net income to determine how much of that net income is subject to taxation here in Massachusetts.

Let me give you an example to illustrate how the formula works:

- Let's say there is a company that makes chairs, with its factory and most of its workers in North Carolina. It also has a sales office and a couple of sales agents here in Massachusetts, and it sells chairs here. In this scenario, the three-factor apportionment formula would reflect the fact that most of the company's property and people are in NC (say 90% in my example), although it does have a small presence here in MA. Assuming that the corporation sold an equal number of chairs here in MA as it did in NC, then you would expect the apportionment formula to apportion more of its income to NC, as that is where the greater proportion of its property and people are, whereas only half of its sales are here in MA.

- Conversely, if that company's factory and related employees were here in MA, then you would expect the three-factor formula to apportion more of its income to MA, reflecting the greater presence of the company here in MA.

The three-factor apportionment formula was developed in the first half of the 20th Century, when the American economy consisted mostly of manufacturing and mercantile businesses, and the production and sale of tangible goods, and it gave equal weight to each of the three factors.

- The property and payroll factors represented the contribution of the so-called "production" states where a taxpayer's manufacturing plant or retail store would be located.

- The sales factor was meant to recognize the contribution of the so-called "market" states in providing a market for a taxpayer's goods and thereby generating income for that taxpayer.

- Over time, many states, including Massachusetts, have moved to a double-weighted sales factor or even a single sales factor to place a greater emphasis on the importance of a taxpayer's market in the generation of its income. Large, industrial states such as NY, Illinois and CA use single sales factor. Many other states, including most NE states use double-weighted sales factor. Some, like MA, use Single Sales Factor for certain industries and double-weighted sales factor for everyone else.

Now that I have provided some background on how three-factor apportionment works, I will cover the rise of single sales factor here in MA and how it is designed to benefit particular types of companies that are located here but that sell their goods or services outside the state.

- Back in the mid-1990's, there was a legislative change to the MA corporate tax code that required, first, defense companies and then all manufacturers to use only the sales factor in determining the amount of tax owed here in the Commonwealth.

- The single sales factor approach ignores the amount of property and payroll of an eligible corporation here in MA in determining how much of that corporation's income is subject to tax here, and only looks to the amount of sales of that company here in MA compared to its sales everywhere else. This benefits manufacturers that are located here and are making substantial sales out of state, and has the opposite effect for manufacturers that are located outside of MA but that have a substantial market for their goods here.
- In my example from before, for a chair-making company that had its factory and related employees here in MA, but that sold its chairs in N.C., the application of the single-sales factor would significantly benefit that company because it would not have to take into account any of its property or employees (payroll) here in MA in determining the portion of its income that should be attributed to MA. All it has to do is look at the sales of chairs it makes in MA compared to the sales of chairs it makes everywhere else.
- You can see how this would create a benefit for manufacturers that are located here and sell their products out of state.
- On the other hand, a chair-making corporation with its factory and related employees in NC would only be able to take into account its sales in MA in determining how much of its income to apportion to MA, and would not be able to dilute its apportionment percentage in MA by the amount of property or payroll it had in NC.

The DOR estimates that in 2011, anywhere from 1500 to 2600 manufacturers saved approximately $111 million in state corporate taxes, due to the Single Sales factor. This does not take into account the larger apportionment percentages applicable to out of state manufacturers that are selling their goods in MA which are also subject to single sales factor.

Then, in 1996, Governor Weld and the Massachusetts Legislature changed the Commonwealth's tax laws to provide that (similar to manufacturers) mutual fund service corporations **had** to use "single sales factor" in determining the amount of corporate income taxes they owed here in the state. Furthermore, in the case of mutual fund service corporations, Governor Weld and the Legislature also changed the way their sales were sourced by looking through to where a mutual fund's investors were located, as opposed to where the mutual fund service corporation was providing services. In the case of mutual fund service corporations located here in Massachusetts, these twin changes in tax law served to lower their corporate taxes.

- A mutual fund service corporation is defined in Massachusetts law as a corporation that derives more than 50% of its gross income from providing management, distribution or administrative services to a mutual fund.
- Starting in 1997, mutual fund services corporations that grew their MA workforce by at least five percent each year through 2002, were required to use Single Sales Factor. Failure to meet the job growth percentages meant that such mutual fund service corporation had to use the normal apportionment formula, with double-weighted sales factor.
- Starting in 2003, all mutual fund service corporations, regardless of job growth or retention, or indeed, when they started doing business here in MA, are required to use Single Sales Factor. They don't have a choice; it is mandatory.
- The shift to the single sales factor meant that property and payroll in MA were no longer part of the calculation of determining how much of their income was taxable here, a change designed to encourage mutual fund service corporations to locate in Massachusetts.

Furthermore, as I mentioned earlier, the way such mutual fund service corporations sourced their sales also changed in 1997.

- Under this change, sales by the mutual fund service corporation to one or more mutual funds were sourced based on where the shareholders (or investors) in those mutual funds were located, as opposed to where the mutual fund service corporation performed its services for such mutual funds.

- This legislative change allowed mutual fund services corporations to "look through" to where the mutual fund company's shareholders were located. This had the further effect of reducing the Massachusetts sales factor by spreading those sales around the country, and thus the Massachusetts apportionment percentage for mutual fund service corporations located here.

The DOR estimates that in 2011, anywhere from 60 to 120 mutual fund service corporations saved approximately $136 million in Massachusetts corporate taxes, due to Single Sales factor apportionment and the particular sourcing rules applicable to them. Again, these numbers do not take into account the larger apportionment percentages applicable to out of state mutual fund service corporations with shareholders here in MA. It should also be noted that more than a dozen other states have similar single sales factor apportionment for the mutual fund industry, including Maine, New York, Colorado, California, Minnesota, Connecticut, Rhode Island and New Jersey and several others.

That is a quick summary of what three-factor Apportionment is, the rise of single sales factor apportionment for selected industries here in Massachusetts and how they were designed to encourage such industries to locate here.

It is important to remember that companies that qualify under the law and DOR regulations as manufacturers or mutual fund service corporations **must** use single sales factor. This is a benefit to such types of corporations that are located here in Massachusetts, but results in a larger apportionment percentage for such types of corporations that do not have a substantial amount of property or payroll here in the Commonwealth, but that do have sales here.

In order to protect the Commonwealth's revenues, it is important to remember that any application of single sales factor to a particular industry or indeed more broadly should be mandatory and not elective.