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Commentary: Federal, State Laws Helping Corporations Avoid State Income Taxes

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When making a purchase at your local big box store, you might assume that the item's manufacturer will owe tax to your state on its profit from the sale. But there's a pretty good chance it won't. And, maybe just as important, you have no way to find out.

One big reason these companies might not pay any income tax to your state is an obscure 1959 federal law that says they don't have to if they organize their activities in particular ways. Public Law 86-272 says that if an out-of-state company selling physical products limits its activities in a state to soliciting sales and delivering the goods, the state can't tax the company's profits from those sales.[1]

To be sure, the company will be taxable in any state in which it has an office building, warehouse, or assembly plant. (And the retail store that sells the item will be taxable on its profit.) But many manufacturers, wholesale distributors, and online retailers can limit their physical footprint to just a handful of states. And this law allows many of them to avoid income taxation in the states where many or even most of their customers live — even though these companies benefit from state services such as police protection (which assists their traveling salespeople) and their delivery trucks' use of local roads and bridges.

PL86-272, which Congress passed in just a few weeks and with little debate, was supposed to be temporary. But it's been in effect for six decades and Congress hasn't held a single hearing on its state impact since the early 1960s. We don't know how much revenue it costs states collectively, but it may well be in the billions of dollars annually — money that could help pay for schools, parks, public health clinics, and other critical services. The law also creates an unlevel playing field for small in-state manufacturers and wholesalers, which must pay tax on 100 percent of their profits.

This is bad enough. Worse, many corporations have figured out ways to exploit this tax break even when they shouldn't qualify for it. For example, let's say a manufacturer can't limit its activity in its customers' states to soliciting sales because it sells a complicated piece of equipment that it needs to set up at the customer's facility and teach the customer how to use. So the company incorporates a separate subsidiary to employ the people who do the set-up and training. The

[1] P.L. 86-272, Title I, §101, September 14, 1959, 73 Stat. 555.

subsidiary's profit is subject to tax by the buyers' states, but the company's out-of-state manufacturing arm — which earns most of the profit on the sale — remains protected from taxation in the states where the equipment is delivered. This strategy is known as "entity isolation."

"Nowhere Income" Goes Untaxed by Any State

But it gets worse still. A complementary change in state tax policy has supercharged the tax breaks from PL86-272 in ways that aren't widely understood. Here's how it works.

States have historically taxed the profit of a multistate corporation by taxing a share of its nationwide profit, not its profit from specific sales to the state's residents (which would be too difficult to track). That share is determined by an "apportionment formula" set out in state law. The traditional formula gives equal weight to how much of the company's nationwide property, employee payroll, and sales are in the state. But if companies make sales in states where they aren't subject to tax due to PL86-272, some of their profits will be "nowhere income" — profit not taxable by any state.

To see this, take the example of a company with 40 percent of its property, 30 percent of its payroll, and 5 percent of its sales in Connecticut. Under the traditional formula, 25 percent of its nationwide profit (the average of those three figures) would be subject to corporate income tax there. If the other 60 percent of its property and 70 percent of its payroll were in Pennsylvania, along with 20 percent of its sales, 50 percent of its profits would be taxable in Pennsylvania. Under this scenario, 75 percent of the company's nationwide profit would be taxable in Connecticut and Pennsylvania combined. Assuming PL86-272 protects the company from income taxation in every other state, the other 25 percent would be untaxed "nowhere income."

Compounding the problem, over the last 30 years corporate lobbyists have convinced most states to abandon the traditional apportionment formula and switch to one that looks only at the location of sales.[2] This change greatly boosts the amount of "nowhere income." Under the above scenario, for example, if Connecticut and Pennsylvania switched to a sales-only formula — which, in fact, both have — then only 25 percent of the company's nationwide profit would be taxed in those two states, and the share that's "nowhere income" would jump to 75 percent.

States Can Make Corporations Pay Fair Share of Tax

PL86-272 and sales-only apportionment formulas lead — both independently and together — to some extremely costly and unfair tax outcomes for states, taxpayers, and residents who rely on state services. They are big reasons why the state corporate income tax has seriously eroded as a state revenue source. They also illustrate the power of corporate lobbying at the federal and state levels to achieve favorable tax rules and the ways corporations then exploit the rules to reduce their taxes even further. But state policymakers and tax administrators can mitigate the damage.

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[2] Michael Mazerov, "The 'Single Sales Factor' Formula for State Corporate Taxes," Center on Budget and Policy Priorities, revised September 2005, https://www.cbpp.org/archiveSite/3-27-01sfp.pdf.

For example, about half the states have eliminated "nowhere income" through rules declaring that if an in-state corporation sells products in other states in which the company isn't taxable because of PL86-272, those sales are deemed to be made in the state and thus taxable there.[3]

A growing number of states are also trying to nullify the "entity isolation" scheme by enacting laws declaring that if even one subsidiary in a corporate group is taxable in the state, a share of the combined profit of the entire group is subject to tax. This reform is a variant of a tax accounting method known as "combined reporting."[4]

Although a handful have considered it, no state has yet adopted what could be states' most powerful weapon to protect their corporate income taxes: requiring corporations to report publicly how much income tax they pay each state. Publicly traded corporations have to include information in their annual reports about how much federal income tax they pay and their total state income tax, but not their income tax for individual states. In fact, corporations don't have to publicly disclose whether they even file a tax return in a given state.

It doesn't have to be that way. States should pass laws requiring company-specific public disclosure of the annual bottom-line corporate tax payment, together with a limited amount of additional information from the tax return to help the public understand how state tax laws affect the company's tax liability (such as its savings from economic development subsidies).[5] Hard evidence of how little state income tax many corporations pay might create political pressure for policy changes like adopting combined reporting.

States should also require companies making sales in the state but claiming PL86-272 protection to publicly report that fact, the level of sales, and the amount of corporate income tax they would pay if PL86-272 didn't exist. This concrete information on how much corporate tax revenue the law costs states would likely help spur debate over repealing it.

Fortunately, many of the tools to counteract tax avoidance from PL86-272 and sales-only apportionment would also address other corporate tax-sheltering schemes. These and other policy changes at the federal and state levels should be front and center as we work to make sure all corporations pay their fair share of state income taxes.

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[3] Institute on Taxation and Economic Policy, "'Nowhere Income' and the Throwback Rule," August 2011, https://itep.org/wp-content/uploads/pb39throw.pdf.

[4] Multistate Tax Commission, "Finnigan Briefing Book, Presented to Phil Skinner, Idaho," June 8, 2018, http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2018/Agenda-7-2018/Finnigan-Briefing-Book.pdf.aspx?lang=en-US.

[5] Michael Mazerov, "State Corporate Tax Disclosure: The Next Step in Corporate Tax Reform," Center on Budget and Policy Priorities, February 14, 2007, https://www.cbpp.org/research/state-corporate-tax-disclosure-the-next-step-in-corporate-tax-reform.