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To: The Honorable Donovan M. Dela Cruz, Chair
and Members of the Senate Committee on Ways and Means

Date: Wednesday, February 6, 2019
Time: 10:00 A.M.
Place: Conference Room 211, State Capitol

From: Linda Chu Takayama, Director
Department of Taxation

Re: S.B. 394, Relating to Taxation

The Department of Taxation (Department) offers the following comments on S.B. 394 for the Committee's consideration.

S.B. 394 amends the way Hawaii taxes multistate businesses by apportioning income using only the taxpayer's sales factor rather than the average of the taxpayer's property, payroll, and sales factors. The measure is effective upon approval and applied to taxable years beginning after December 31, 2018.

Apportionment by single sales factor is popular across the country; 24 states and the District of Columbia have adopted the single sales factor. Nonetheless, the change to a single sales factor is a radical change from the current equally weighted three-factor formula and may not be appropriate at this time.

First, the Department believes single sales factor apportionment may not properly reflect a taxpayer's activity in the State. Apportionment of the income of a multistate business is done by formula. In Hawaii, that formula is the average of the taxpayer's sales in the State, its property in the State, and its payroll (employees) in the State (an equally weighted three-factor formula).

Apportioning income using an equally weighted three-factor formula takes proper account of the taxpayer's business activity in the State. The use of the property and payroll factors in apportioning income takes account of the basic economic inputs of production, i.e., capital and labor. The inclusion of the sales factor complements this by taking account of the taxpayer's market through a measure of its actual sales.

In contrast, apportionment by single sales factor ignores a taxpayer's capital and labor and thus ignores its physical presence in the State. Sales of tangible personal property are

sourced based on the market, or destination, for purposes of the sales factor. This means that with single sales factor apportionment, a business whose sales are made to customers outside Hawaii will not be subject to any Hawaii income tax, even if that taxpayer has significant property and payroll in the State.

Under the current equally weighted three-factor formula, even a taxpayer whose sales are all sourced outside of Hawaii will be subject to Hawaii income tax based on its property and payroll factors. Conversely, a taxpayer with no property or payroll in the State will be subject to tax in this State if its sales are sourced to this State. This is the case, though to differing degrees, regardless of whether Hawaii has a single sales factor or a three-factor formula.

Second, the Department notes that the Department is proposing market-based sourcing for the sales factor. S.B. 1270, an administration measure, proposes to amend the sales factor by adopting market-based sourcing for sales of services and intangibles. Tangible personal property is already sourced using market-based sourcing. Sourcing for services and intangibles has historically been based on the performance of the services or production of the intangibles. As stated above, the role of the sales factor is to take account of the taxpayer's market for its goods. Transitioning to market sourcing for all sales will enhance the sales factor as a measure of a taxpayer's market. Thus, the Department believes that market-based sourcing of the sales factor together with the property and payroll factors, will better reflect taxpayers' activities in Hawaii.

Third, the change to market sourcing for all sales will match the sourcing law and rules applicable under Hawaii's general excise tax (GET). This will make the GET and income tax less burdensome for taxpayers to comply with and less complicated for the Department to administer.

For the above reasons, the Department believes that at this time it is more appropriate to adjust the sales factor by adopting market-based sourcing than to make the more radical change of adopting single sales factor apportionment.

Thank you for the opportunity to provide comments.

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SUBJECT: INCOME, Adopt Single Sales Factor Apportionment

BILL NUMBER: SB 394

INTRODUCED BY: DELA CRUZ

EXECUTIVE SUMMARY:

SYNOPSIS: Amends section 235-29, HRS, to provide that all business income shall be apportioned to the state by multiplying the income by the sales factor.

EFFECTIVE DATE: Taxable years beginning after December 31, 2018.

STAFF COMMENTS: Many businesses have income from and operations in more than one state. States are permitted to tax these businesses if they have nexus with the taxing state, and the question then becomes how much income each state may tax.

For income tax purposes, most states including Hawaii have adopted the Uniform Division of Income for Tax Purposes Act (UDITPA). Under UDITPA as it exists today, a taxpayer is required to compute a property factor, which is a fraction representing the amount of property in Hawaii versus elsewhere; a payroll factor, which is a fraction measuring Hawaii payroll; and a sales factor, a fraction which measures Hawaii sales. The amount of net income apportioned to Hawaii is then the net income from operations everywhere multiplied by the average of the property, payroll, and sales factors. This three-factor formula once had nearly universal application in the states that had an income tax, and it was referred to by the U.S. Supreme Court in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), as a “benchmark against which other apportionment formulas are judged.”

Recently, the formula has undergone significant modifications in adopting states. Many states started by double-weighting the sales factor, so the state’s share of net income is computed by multiplying it by the sum of two times the sales factor, the property factor, and the payroll factor, all divided by 4. Over time, many states upweighted the sales factor even further, and some took the step of disregarding the property and payroll factors, leading to single sales factor apportionment, which is the system proposed to be adopted by this bill.

An excellent analysis of the issue comes from *Forbes*, Sept. 8, 2014:

The problem with single-sales-factor apportionment is that it is questionable whether the formula presents an accurate depiction of a company’s activity in a state. A strong argument can be made that the sales factor is a poor indicator of a company’s activity and should be minimized and that property and payroll would be better indicators.

The move away from three factor apportionment is happening because it can be seen as penalizing increases in property and payroll investments, thereby discouraging

investment and job creation in the state. By contrast, single sales factor apportionment deemphasizes property and payroll factors and is therefore seen as an aid when states compete with each other for jobs. Many states reasoned that moving to single sales factor apportionment or increasing the weight of the sales factor could reduce the tax liabilities of businesses that have significant property and payroll in the state, thereby rewarding those businesses. Then, given the choice between a state with three factor apportionment and one with single sales factor apportionment, businesses would choose to locate additional capital in the state with single sales factor apportionment.

Unquestionably, single sales factor apportionment can benefit some taxpayers (typically in-state businesses) while burdening others (typically out-of-state businesses). What is worrying is that the motive for states making the switch from a three factor formula to a single sales factor formula is not that the latter is a more accurate representation of “fair apportionment” but that states are seeking to encourage job creation and investment within their borders and shift some of the tax burden to out-of-state companies.

Unfortunately, there is little empirical evidence to prove a connection between the adoption of single sales factor apportionment and increased in-state jobs or investment. There is evidence to show that because single sales factor apportionment disregards property and payroll, it will have the effect of increasing the tax liability of out-of-state companies (assuming they have nexus with the state) that have little property and payroll in the taxing state but make substantial sales into the state. In other words, single sales factor apportionment can provide a more favorable taxing environment for in-state businesses than for out-of-state businesses.

Whether taxpayers are in favor of or against a move to single sales factor will depend on individual taxpayer circumstances. Because the effect of single sales factor apportionment depends largely on the nature of a taxpayer's business, there will always be companies on both sides of the equation.

The rise of single sales factor apportionment is interesting, though it should come as no surprise. Once one state adopted single-sales-factor apportionment seeking to create jobs and increase investments, other states followed suit not to miss out. They did so not because single sales factor apportionment produced more accurate results, but because it was perceived as making a state's tax laws more competitive or business friendly. While single sales factor apportionment may benefit some businesses, it is far from being universally beneficial for taxpayers. In the end, if state officials are truly concerned with making their state more attractive to businesses, perhaps they should consider retaining (or returning to) the three factor apportionment method and focus on a less burdensome corporate tax system overall.

Griffith, Cara, *Single Sales Factor Apportionment May Be Inevitable, But Is It Fair?* in Forbes (Sept. 18, 2014), available at <https://www.forbes.com/sites/taxanalysts/2014/09/18/single-sales-factor-apportionment-may-be-inevitable-but-is-it-fair/>

Although single sales factor apportionment has been adopted in several states, there are disadvantages that the Committee should consider:

- Although some companies might be better off under SSF, others will be hurt. Companies with little in-state employment and property that sell proportionately more products or services in Hawaii will pay more tax.
- SSF could be perceived as unfair. A corporation that has all of its employees and property in Hawaii but makes all of its sales to customers in other states will pay no Hawaii income tax, no matter how profitable it is. This unfairness reduces public confidence in the tax system.

Digested 2/1/2019