Corporate Sales Factor Report

This report responds to the requirements in Laws 2005, Chapter 289 for a JLBC Staff analysis of the corporate sales factor.

- Laws 2005, Chapter 289 provided businesses with an alternative method of calculating their corporate income tax liability. The new method emphasized in-state sales compared to their employment and property holdings. By 2009, Chapter 289 allowed companies to apportion 80% of their income to their level of sales in the state.
- Chapter 289 also required JLBC Staff to report by July 1, 2011 on the number of corporations using the enhanced sales factor option, their level of capital investments, and the related economic impact.
- In tax year 2008, the Department of Revenue reports that 183 corporations reduced their tax liability by $64 million by using the enhanced sales factor option. Another 1,817 companies could have lowered their tax liability but chose not to use the enhanced sales factor. If they had, the overall tax reduction would have been $91 million rather than $64 million.
- In terms of investments of enhanced sales factor companies, Intel Corporation reported that it spent $3 billion for plant expansion and improvements. Intel's report was in response to a Chapter 289 requirement that companies cumulatively report at least $1 billion in investments before the enhanced sales factor became effective.
- Beyond Intel's report, JLBC Staff did not attempt to gather additional information on capital investments and related economic activity. Such a large scale study of 183 corporations would have required considerable resources and would have produced questionable results.
- The broader economic impacts of the enhanced sales factor would have been difficult to assess, especially in this time period. While the legislation was being implemented, the state was experiencing a historic downturn in its economy and capital investment declined for reasons unrelated to the sales factor. In addition, business investment decisions can be tied to a host of factors and it is challenging to isolate the impacts of a single variable.
- Laws 2011, 2nd Special Session, Chapter 1 enacted further changes in the sales factor option and will phase it up to 100% over 4 years starting in Tax Year 2014.

Description of the Corporate Income Tax Apportionment Formula

Multi-state corporations have operations in several states or countries. If a multi-state corporation has business activity in Arizona, a share of the corporation's total business income, referred to as Arizona Taxable Income, is subject to the state's corporate income tax. That share is determined by the apportionment formula, which computes the percentage of a corporation's total business income that is allocated to Arizona for tax purposes (Corporations may have another type of income, called nonbusiness income, which is allocated to Arizona based on criteria other than the apportionment formula).

The apportionment formula defines a corporation's Arizona Taxable Income based on the proportion of payroll, property, and sales the corporation has within the state. The percentage of a corporation's Arizona payroll is referred to as the payroll factor. Likewise, the percentage of a corporation's property value located in Arizona is referred to as its property factor and the percentage of a corporation's sales occurring in Arizona is referred to as its sales factor.

Prior to the enactment of Chapter 289, Arizona used a 50% sales factor formula, meaning it was a weighted average of the 3 factors with the sales factor contributing 50% to the average and the payroll and property factors contributing 25% each. With the enactment of Chapter 289, Arizona added an additional apportionment formula that put even greater emphasis on sales. The enhanced sales factor formula was phased in over 3 years, with the sales factor reaching 80% in January 2009. With an 80% sales factor, property and payroll account for 10% each in the apportionment formula. The purpose of this legislation was to reduce the tax liability of corporations who employ high proportions of labor and capital in the state but export a large share of their product elsewhere.

Corporations may choose between the 50% and 80% sales factor formulas. For example, a business with 2% of its sales and 5% of its property and payroll in Arizona would benefit from the 80% sales factor. In calculating the proportion of its multi-state income to Arizona, the 2% sales factor would receive an 80% weight and the 5% property and payroll factors would receive a 10% weight. After applying the weights, 2.6% of the business' multi-state income would be applied in Arizona. Under the 50/25/25% formula, alternatively, the business would have to apply 3.5% of its income to Arizona.

A Brief History of the Corporate Sales Factor

In addition to Chapter 289's additional 80% sales factor, Laws 2011, 2nd Special Session, Chapter 1 further modified the enhanced sales factor formula by phasing in a 100% sales factor in 5% increments beginning in tax year 2014. A timeline of recent events explains changes relating to the apportionment formula below:

January 2001	Arizona moves from an equal weighted to a double weighted sales factor for the corporate income tax apportionment formula.
May 2005	Chapter 289 is passed and signed into law on May 20, 2005. The bill has a conditional enactment, contingent on capital investment in the state of $1 billion, and phases in an additional apportionment formula with an enhanced sales factor.
July 2005	Intel Corporation announces plans to invest $3 billion to expand in the Chandler market, which met the conditional enactment provisions and triggered the new apportionment formula.
January 2007	Optional 60% apportionment formula sales factor takes effect.

January 2008 Optional 70% apportionment formula sales factor takes effect.

January 2009 Optional 80% apportionment formula sales factor takes effect.

February 2011 Laws 2011, 2nd Special Session, Chapter 1 is passed and signed into law on February 17, 2011. The bill includes a provision to increase the optional enhanced sales factor apportionment formula to 100% over a 4-year phase-in beginning in Tax Year 2014.

January 2014 Optional 85% apportionment formula sales factor takes effect.

January 2015 Optional 90% apportionment formula sales factor takes effect.

January 2016 Optional 95% apportionment formula sales factor takes effect.

January 2017 Optional 100% apportionment formula sales factor takes effect.

Department of Revenue Statistics

The Arizona Department of Revenue has released aggregate information for the first 2 years of the enhanced sales factor formula. Data for additional tax years will be made public by DOR as the information is processed.

In tax year 2007 there were 121 corporations that elected the 60% enhanced sales factor formula. On net, these corporations reduced their tax liability by $22.8 million in that year. By tax year 2008 the number of corporations electing the 70% enhanced sales factor formula increased to 183 and, on net, these corporations reduced their tax liability by $63.6 million in that year *(See Table 1).*

Table 1

Enhanced Sales Factor Apportionment Formula Statistics

	Tax Year 2007	**Tax Year 2008**
Optional Enhanced Sales Factor	60%	70%
Corporations Electing Enhanced Sales Factor	121	183
Tax Liability Reduction from Electing Enhanced Sales Factor	$22.8 million	$63.6 million
Maximum Tax Liability Reduction	$45.9 million	$90.9 million

However, in each year there were corporations who did not minimize their tax liability. These companies fall into 2 categories:

- Companies that elected the 80% sales factor formula but would have reduced their tax liability by selecting the 50% sales factor formula, and
- Corporations that elected the 50% formula but would have reduced their tax liability by selecting the 80% formula.

Most of the companies that did not minimize their tax liability were in the second category. Had every corporation selected the apportionment formula that minimized their liability, the result would have been a $45.9 million decrease in corporate income tax collections in tax year 2007, as opposed to $22.8 million, and a $90.9 million decrease in corporate income tax collections in tax year 2008, as opposed to $63.6 million.

There are several reasons that a company may choose an apportionment formula that does not minimize their tax liability, including being unaware of an alternative formula. At least for some firms, the choice between alternative apportionment formulas may only change their tax liability by a small amount. Alternatively, some corporations may have not wanted to release their identities to the JLBC, which was a requirement of selecting the optional enhanced sales factor formula during this time period.

With each successive year, corporations may take greater advantage of the enhanced sales factor option. Knowledge of the option is likely to increase and associated tax savings will increase as the sales factor grows to 100% by tax year 2017. This trend already started to occur in tax year 2008. In tax year 2007 the $22.8 million reduction in tax liability was 49.7% of the maximum reduction possible in that year. By tax year 2008, however, the $63.6 million reduction in tax liability was 70.0% of the maximum reduction possible in that year.

Western States Sales Factor Policy

Table 2 compares the sales factor policy of Western states. While more than just Corporate Income Tax policy will affect the competitiveness of the state, it is useful to see how our tax policy compares to surrounding states.

In comparing the apportionment formulas of states in the western United States, 3 of the 12 western states (Nevada, Washington, and Wyoming) have no state corporate income tax and 4 other states (California, Colorado, Oregon, and Texas) offer 100% sales factors, either as a choice or as their only apportionment option. There are 4 other states (Idaho, Montana, New Mexico, and Utah) that have less weight on their sales factors than Arizona.

Table 2

State Apportionment of Corporate Income

State	Apportionment Formula		
Arizona [1/]	3 Factor – 50% Sales Factor	**OR**	3 Factor – 80% Sales Factor
California	3 Factor – 50% Sales Factor	**OR**	100% Sales Factor
Colorado	100% Sales Factor		
Idaho	3 Factor – 50% Sales Factor		
Montana	3 Factor – Equally Weighted		
Nevada	No State Income Tax		
New Mexico	3 Factor – Equally Weighted	**OR**	3 Factor – 50% Sales Factor
Oregon	100% Sales Factor		
Texas	100% Sales Factor		
Utah	3 Factor – Equally Weighted	**OR**	3 Factor – 50% Sales Factor
Washington	No State Income Tax		
Wyoming	No State Income Tax		

1/ Arizona will phase-in a 100% Sales Factor option from TY 2014 – 2017 in place of their current 80% Sales Factor.

Investment Related to the Corporate Sales Factor

Chapter 289 requires JLBC Staff to report on the number and value of investments made by corporations electing the enhanced sales factor. Based on public information, Intel Corporation spent $3 billion in new investments. These investments had the effect of triggering the legislation that phased-in an enhanced sales factor.

Pursuant to Chapter 289, enactment of the optional enhanced sales factor formula was conditional on at least $1 billion of capital investment in the state by a corporation. On July 25, 2005 Intel Corporation publicly announced and reported to the JLBC and OSPB their intent to trigger the enhanced sales factor legislation by investing approximately $3 billion for a new manufacturing facility in Chandler. Intel also provided progress reports to the JLBC on the status and expected completion of the investment per Chapter 289. Construction concluded in 2007 and the factory began production in October of that year.

Beyond Intel's report, JLBC Staff did not attempt to gather additional information on capital investments and related economic activity. Such a large scale study of 183 corporations would have required considerable resources and produced questionable results.

Evaluating the State's Economic Performance

Chapter 289 requires JLBC Staff to evaluate the state's performance in attracting and retaining high wage industries, investments, and employment since the enhanced sales factor option was made available. It would be difficult, however, to draw any meaningful results from such an analysis.

The state experienced a historic economic downturn as the enhanced sales factor was being phased in. *Table 3* below illustrates the volatility of corporate income tax collections in recent years. Between FY 2007 and FY 2010, corporate income taxes declined by (58.1)%. Given this high level of economic instability, an evaluation of the state's performance in attracting and retaining high wage industries, investments, and employment would not be meaningful. Corporate investment likely declined during this same time period for reasons unrelated to the implementation of the corporate sales factor.

Table 3

Corporate Income Tax Collections

	Net Collections	Annual Percent Change
FY 04	$ 494,044,869	
FY 05	$ 701,859,285	42.1%
FY 06	$ 874,219,472	24.6%
FY 07	$ 986,169,564	12.8%
FY 08	$ 784,510,885	-20.4%
FY 09	$ 592,157,255	-24.5%
FY 10	$ 413,193,306	-30.2%

In addition, an effective evaluation of the state's business attraction and retention policies would require insight into the corporate decision-making process. *Site Selection Magazine* annually surveys corporate executives from different industries. Executives are asked to list the main factors they consider when choosing a location. According to *Site Selection Magazine*, location decisions are based on many factors, including state and local tax policy, transportation and utility infrastructure, existing workforce skills, the cost of land or property, regulatory factors, and incentive programs.