

6. Handout from Mr. John Williams, certified public accountant and shareholder, Henjes, Conner & Williams, P.C.

Tax Considerations of Companies in the Tri-State Area

Good morning. Thank you for the privilege of speaking with you this morning.

My name is John Williams. I'm a certified public accountant and shareholder in the firm, Henjes, Conner & Williams, P.C., a certified public accounting firm located here in Sioux City, Iowa. Our Company is fortunate to have clients located throughout the United States, as well as in Europe. As a result, we are familiar with the factors companies consider when they discuss locating their operations in a particular geographic area, and in fact, work with clients and explain the relative merits and costs of locating either their companies and/or families in different states in the US.

As you are aware, Sioux City is in a unique position geographically, sitting on the border of three states, Iowa, Nebraska and South Dakota. Border communities are not uncommon, but there are only a few that share more than one border, especially sharing a border with a State that has no business or personal income tax levies.

When a business reviews the costs associated with locating in a particular state, the income tax cost to the business is, obviously, a factor. However, it is not a major factor to companies choosing among Iowa, Nebraska and South Dakota. I know that sounds like a contradiction to our discussion today, but it is not. Both Iowa and Nebraska use the single factor of sales to determine the proportion of a business's net income subject to income taxes in their states, without a throwback provision.

Let me explain. Each state with a business income tax regime requires businesses to determine the portion of their business income subject to their state's income tax laws. It doesn't matter where the business is located physically. If the company is doing business in a state, and each state defines what "doing business" means, then the company is subject to the income tax laws of that state, if any. This requires the company to apportion their income among the states in which they are doing business.

About 30 years ago, nearly every state employed three factors to determine how much income should be allocated to their state. The portion of the company's property and equipment located in the state. The portion of a company's payroll earned in the state and the portion of a company's sales made in the state. You add up the three percentages, divide by three and the result is the factor used to apportion a business's income to each state. (Illustration I)

States made provisions in their tax laws for companies that had sales in a state where they didn't file an income tax return, either because the sales were so small that the cost of filing was greater than the tax liability, or because they did not levy an income tax on business income, to include those sales as if they were sales of their state of domicile. This is referred to as the throwback provision. (Illustration II)

So you can see from these illustrations, when a company was deciding where to locate, the tax rates of the various states had a big impact on their decision because most of their income would be taxed in their state of domicile. As a result, high tax rate states saw companies that were once located in their state, migrate to a lower tax state, and had difficulty attracting new business and industry to their state. Rather than sit back and watch their tax base erode, they fought back and changed their allocation method. Some started by eliminating the throwback provision. (Illustration III) Other states fiddled with their formulas, giving greater weight to the sales factor, in an attempt to keep the playing field level. But some, like Iowa, Illinois, Missouri, and Nebraska, changed to a single factor based only on sales and eliminated the throwback provision. (Illustration IV) As a result, a relatively high tax rate state could more than compete with a low tax rate state that used the old three factor method because where a company is physically located affects real estate tax revenues, personal income tax revenues, sales and use tax revenues, unemployment tax revenues and various service fee revenues paid to state and local governments.

Our neighbor, Minnesota still uses the three factor method but is phasing it out such that by 2013, they too will be using the single factor method. Remember those battles between then South Dakota Governor Bill Janklow and Minnesota Governor Rudy Perpich? South Dakota went after businesses located in Minnesota and convinced some of them to move to South Dakota by showing how a company could save Minnesota income taxes by moving out of Minnesota. (Illustration V)

But when the states use a single factor method, without a throwback provision, locating the business in South Dakota, or Iowa or Nebraska has no affect on the Income tax calculation. (Illustrations VI, VII and VIII) Each state's portion of the taxable income subject to its income tax laws stays the same.

So now the battle that was fought over business income tax rules to attract and keep jobs and businesses in a particular state has shifted. When Iowa goes up against a state with a three factor method, it's like the Minnesota - South Dakota battle. They don't have to sweeten the pot very much. But when Iowa goes up against a state with a single factor method, or no income tax, there is no advantage from the business income tax rules and the methods to attract and keep jobs and businesses shifts to other costs and incentives. South Dakota is using their lack of personal income tax levies plus specific incentive packages. Nebraska is using legislated business income tax credits to the businesses based on the amount of new investment in property and payroll plus specific incentive packages. Iowa is using specific incentive packages.

For those large companies that the states know are evaluating a decision to locate in either Iowa, Nebraska or South Dakota, each state is usually able to counteract another state's legislated benefits through an incentive package. But South Dakota's lack of a personal income tax is a large hurdle to overcome. (Illustration IX and X) This is especially true for highly paid management personnel, or business owners with substantial income from interest and dividends. (Illustration XI)

Although the benefit from South Dakota's lack of a personal income tax levy inures to the individual, from the business owner's perspective, moving the business to South Dakota is like giving everyone who lives and works in South Dakota a raise...at no cost to the business. For those businesses that can move with a minimum of disruption and cost, for example, service businesses, or for businesses who have outgrown their existing facilities and are going to have to move their facilities anyway, South Dakota presents a difficult hurdle to overcome especially when several of these businesses make the decision to move without seeking economic development funds or local government support.

We recognize that developing a tax district in Sioux City, Iowa similar to how people living and working in Texarkana, Arkansas are taxed, as an incentive to attract and retain businesses in Sioux City, Iowa, is not politically feasible. Instead, we are proposing the establishment of The Pilot Project Targeted Jobs Credit as a step toward leveling the playing field with South Dakota and Nebraska. We are proposing it as a pilot project so we can evaluate its costs and effectiveness in attracting and retaining businesses in Iowa before it is available to communities in rest of the state. Our position on the border with South Dakota gives us the opportunity to let companies compare the Project's merits with the advantages in South Dakota and Nebraska and learn directly from the companies themselves whether the Project is an effective incentive in convincing them to locate in Iowa.

Thank you for your time and attention. Does anyone have any questions?

Example of Apportioning Taxable Income

Assumptions: Company located in one state
 Sales in four states
 All states use the three factor method

	<u>Total</u>	<u>State of Domicile</u>		<u>State 2</u>		<u>State 3</u>		<u>State 4</u>	
		<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Property and Equipment	\$3,000,000	\$3,000,000	100.00%	\$0	0.00%	\$0	0.00%	\$0	0.00%
Payroll	\$2,000,000	\$2,000,000	100.00%	\$0	0.00%	\$0	0.00%	\$0	0.00%
Sales	\$11,000,000	\$1,000,000	9.09%	\$5,000,000	45.45%	\$3,000,000	27.27%	\$2,000,000	18.18%
Total of the three factors			<u>209.09%</u>		<u>45.45%</u>		<u>27.27%</u>		<u>18.18%</u>
Average of the three factors - Apportionment Factor Required			<u>69.70%</u>		<u>15.15%</u>		<u>9.09%</u>		<u>6.06%</u>
Total Income Subject to State Income Tax			<u>100.00%</u>						

Example of Apportioning Taxable Income

Assumptions: Company located in one state
 Sales in four states
 Three states use the three factor method
State 4 has no income tax levy

	<u>Total</u>	<u>State of Domicile</u>		<u>State 2</u>		<u>State 3</u>		<u>State 4</u>	
		<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Property and Equipment	\$3,000,000	\$3,000,000	100.00%	\$0	0.00%	\$0	0.00%	\$0	0.00%
Payroll	\$2,000,000	\$2,000,000	100.00%	\$0	0.00%	\$0	0.00%	\$0	0.00%
Sales	\$11,000,000	\$3,000,000	<u>27.27%</u>	\$5,000,000	<u>45.45%</u>	\$3,000,000	<u>27.27%</u>	\$0	<u>0.00%</u>
Total of the three factors			<u>227.27%</u>		<u>45.45%</u>		<u>27.27%</u>		<u>0.00%</u>
Average of the three factors - Apportionment Factor Required			<u>75.76%</u>		<u>15.15%</u>		<u>9.09%</u>		<u>0.00%</u>
Total Income Subject to State Income Tax			<u>100.00%</u>						

Example of Apportioning Taxable Income

Assumptions: Company located in one state
 Sales in four states
State of Domicile eliminates throwback provision
 Three states use the three factor method
 State 4 has no income tax levy

	<u>Total</u>	<u>State of Domicile</u>		<u>State 2</u>		<u>State 3</u>		<u>State 4</u>	
		<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Property and Equipment	\$3,000,000	\$3,000,000	100.00%	\$0	0.00%	\$0	0.00%	\$0	0.00%
Payroll	\$2,000,000	\$2,000,000	100.00%	\$0	0.00%	\$0	0.00%	\$0	0.00%
Sales	\$11,000,000	\$1,000,000	9.09%	\$5,000,000	45.45%	\$3,000,000	27.27%	\$0	0.00%
Total of the three factors			<u>209.09%</u>		<u>45.45%</u>		<u>27.27%</u>		<u>0.00%</u>
Average of the three factors - Apportionment Factor Required			<u>69.70%</u>		<u>15.15%</u>		<u>9.09%</u>		<u>0.00%</u>
Total Income Subject to State Income Tax			<u>93.94%</u>						

Example of Apportioning Taxable Income

Assumptions: Company located in one state
 Sales in four states
State of Domicile eliminates throwback provision, uses only sales factor
 Three states use the three factor method
 State 4 has no income tax levy

	<u>Total</u>	<u>State of Domicile</u>		<u>State 2</u>		<u>State 3</u>		<u>State 4</u>	
		<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Property and Equipment	\$3,000,000	\$3,000,000	n/a	\$0	0.00%	\$0	0.00%	\$0	0.00%
Payroll	\$2,000,000	\$2,000,000	n/a	\$0	0.00%	\$0	0.00%	\$0	0.00%
Sales	\$11,000,000	\$1,000,000	9.09%	\$5,000,000	45.45%	\$3,000,000	27.27%	\$0	0.00%
Total of the three factors			<u>9.09%</u>		<u>45.45%</u>		<u>27.27%</u>		<u>0.00%</u>
Average of the three factors - Apportionment Factor Required			<u>9.09%</u>		<u>15.15%</u>		<u>9.09%</u>		<u>0.00%</u>
Total Income Subject to State Income Tax			<u>33.33%</u>						

Illustration V

South Dakota and Minnesota Battle for Businesses

Assumptions: Company located in Minnesota
 Sales in four states
 Three states use the three factor method
 Minnesota has a throwback provision

	<u>Minnesota</u>			<u>State 2</u>		<u>State 3</u>		<u>South Dakota</u>	
	<u>Total</u>	<u>State of Domicile</u>		<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Property and Equipment	\$3,000,000	\$3,000,000	n/a	\$0	0.00%	\$0	0.00%	\$0	0.00%
Payroll	\$2,000,000	\$2,000,000	n/a	\$0	0.00%	\$0	0.00%	\$0	0.00%
Sales	\$11,000,000	\$3,000,000	<u>27.27%</u>	\$5,000,000	<u>45.45%</u>	\$3,000,000	<u>27.27%</u>	\$0	<u>0.00%</u>
Total of the three factors			<u>27.27%</u>		<u>45.45%</u>		<u>27.27%</u>		<u>0.00%</u>
Average of the three factors - Apportionment Factor Required			<u>27.27%</u>		<u>15.15%</u>		<u>9.09%</u>		<u>0.00%</u>
Total Income Subject to State Income Tax			<u>51.51%</u>						

Assumptions: Company located in South Dakota
 Sales in four states
 Three states use the three factor method

	<u>South Dakota</u>			<u>State 2</u>		<u>State 3</u>		<u>Minnesota</u>	
	<u>Total</u>	<u>State of Domicile</u>		<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Property and Equipment	\$3,000,000	\$3,000,000	n/a	\$0	0.00%	\$0	0.00%	\$0	0.00%
Payroll	\$2,000,000	\$2,000,000	n/a	\$0	0.00%	\$0	0.00%	\$0	0.00%
Sales	\$11,000,000	\$2,000,000	<u>n/a</u>	\$5,000,000	<u>45.45%</u>	\$3,000,000	<u>27.27%</u>	\$1,000,000	<u>9.09%</u>
Total of the three factors			<u>0.00%</u>		<u>45.45%</u>		<u>27.27%</u>		<u>9.09%</u>
Average of the three factors - Apportionment Factor Required			<u>0.00%</u>		<u>15.15%</u>		<u>9.09%</u>		<u>3.03%</u>
Total Income Subject to State Income Tax			<u>27.27%</u>						

Example of Apportioning Taxable Income

Assumptions: Company locates in Iowa
 Sales in Iowa, Nebraska, South Dakota and Minnesota
 Minnesota apportionment utilizing current weighting factors

	<u>Total</u>	<u>State of Domicile</u>		<u>Nebraska</u>		<u>South Dakota</u>		<u>Minnesota</u>	
		<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Property and Equipment	\$3,000,000	\$3,000,000	n/a	\$0	n/a	\$0	n/a	\$0	0.00%
Payroll	\$2,000,000	\$2,000,000	n/a	\$0	n/a	\$0	n/a	\$0	0.00%
Sales	\$11,000,000	\$1,000,000	9.09%	\$5,000,000	45.45%	\$3,000,000	n/a	\$2,000,000	18.18%
Total of the three factors			<u>9.09%</u>		<u>45.45%</u>		<u>0.00%</u>		<u>13.64%</u>
Average of the three factors - Apportionment Factor Required			<u>9.09%</u>		<u>45.45%</u>		<u>0.00%</u>		<u>4.55%</u>
Total Income Subject to State Income Tax			<u>59.09%</u>						

Example of Apportioning Taxable Income

Assumptions: Company locates in Nebraska
 Sales in Iowa, Nebraska, South Dakota and Minnesota
 Minnesota apportionment utilizing current weighting factors

	<u>Total</u>	<u>Iowa</u>		<u>State of Domicile Nebraska</u>		<u>South Dakota</u>		<u>Minnesota</u>	
		<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Property and Equipment	\$3,000,000	\$0	n/a	\$3,000,000	n/a	\$0	n/a	\$0	0.00%
Payroll	\$2,000,000	\$0	n/a	\$2,000,000	n/a	\$0	n/a	\$0	0.00%
Sales	\$11,000,000	\$1,000,000	9.09%	\$5,000,000	45.45%	\$3,000,000	n/a	\$2,000,000	18.18%
Total of the three factors			<u>9.09%</u>		<u>45.45%</u>		<u>0.00%</u>		<u>13.64%</u>
Average of the three factors - Apportionment Factor Required			<u>9.09%</u>		<u>45.45%</u>		<u>0.00%</u>		<u>4.55%</u>
Total Income Subject to State Income Tax			<u>59.09%</u>						

Example of Apportioning Taxable Income

Assumptions: Company locates in South Dakota
 Sales in Iowa, Nebraska, South Dakota and Minnesota
 Minnesota apportionment utilizing current weighting factors

	<u>Total</u>	<u>Iowa</u>		<u>Nebraska</u>		<u>State of Domicile South Dakota</u>		<u>Minnesota</u>	
		<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Property and Equipment	\$3,000,000	\$0	n/a	\$0	n/a	\$3,000,000	n/a	\$0	0.00%
Payroll	\$2,000,000	\$0	n/a	\$0	n/a	\$2,000,000	n/a	\$0	0.00%
Sales	\$11,000,000	\$1,000,000	9.09%	\$5,000,000	45.45%	\$3,000,000	n/a	\$2,000,000	18.18%
Total of the three factors			<u>9.09%</u>		<u>45.45%</u>		<u>0.00%</u>		<u>13.64%</u>
Average of the three factors - Apportionment Factor Required			<u>9.09%</u>		<u>45.45%</u>		<u>0.00%</u>		<u>4.55%</u>
Total Income Subject to State Income Tax			<u>59.09%</u>						

Illustration IX

Example of Savings to Employee of Home and Job in Different States

Assumptions: Employee's income and deductions:
 Married, 2 dependent children, owns a home
 Salary \$100,000
 Interest and dividend income 300
 Mortgage interest 7,500
 Car license 250
 Real estate taxes 2,800
 Contributions 1,000

If Business AND Employee Domiciled in	<u>Iowa</u>	<u>Nebraska</u>	<u>So. Dakota</u>
Federal Income Tax	\$11,063	\$11,228	\$12,318
Iowa Income Tax	5,337	0	0
Sioux City School District Surtax	320	0	0
Nebraska Income Tax	0	4,357	0
Total Income Taxes	<u>\$16,720</u>	<u>\$15,585</u>	<u>\$12,318</u>
Savings from Nebraska Location		<u>\$1,135</u>	
Savings from South Dakota Location			<u>\$4,402</u>

Illustration X

Example of Savings to Employee of Home and Job in Different States

Assumptions: Employee's income and deductions:
 Single, lives in an apartment

Salary	\$100,000
Interest and dividend income	300
Mortgage interest	0
Car license	250
Real estate taxes	0
Contributions	1,000

If Business AND Employee Domiciled in	<u>Iowa</u>	<u>Nebraska</u>	<u>So. Dakota</u>
Federal Income Tax	\$19,892	\$19,683	\$21,344
Iowa Income Tax	5,517	0	0
Sioux City School District Surtax	331	0	0
Nebraska Income Tax	0	5,931	0
Total Income Taxes	<u>\$25,740</u>	<u>\$25,614</u>	<u>\$21,344</u>
Savings from Nebraska Location		<u>\$126</u>	
Savings from South Dakota Location			<u>\$4,396</u>

Illustration XI

Example of Savings to Employee of Home and Job in Different States

Assumptions: Employee's income and deductions:
 Married, 2 dependent children, owns a home
 Salary \$250,000
 Interest and dividend income 3,500
 Mortgage interest 9,500
 Car license 250
 Real estate taxes 6,000
 Contributions 5,000

If Business AND Employee Domiciled in	<u>Iowa</u>	<u>Nebraska</u>	<u>So. Dakota</u>
Federal Income Tax	\$48,553	\$48,487	\$53,175
Iowa Income Tax	14,901	0	0
Sioux City School District Surtax	894	0	0
Nebraska Income Tax	0	14,207	0
Total Income Taxes	<u>\$64,348</u>	<u>\$62,694</u>	<u>\$53,175</u>
Savings from Nebraska Location		<u>\$1,654</u>	
Savings from South Dakota Location			<u>\$11,173</u>