The Importance of Corporate Taxes and Incentives in Site Selection

Corporations use various tools in selecting locations for capital investment and consider numerous factors in determining the optimal sites for such investment. These factors will vary from industry to industry, but several factors are key among most companies, these include labor availability, energy availability and costs, and corporate tax burden. Increasingly, state and local incentive programs are added to this list of top factors because of the impact incentives have upon the other factors. For example, employee training grants upon labor costs, electric and natural gas riders upon energy costs, tax exemptions and credits upon tax burden. As advisors to companies conducting location studies (and their desire in securing state and local incentives) this article will provide some insight into the importance of corporate tax burden and economic incentives upon site selection.

Enhanced transportation modes and the internet have tremendously changed the landscape for commerce in the U.S. and indeed globally. Certain U.S. based companies that once depended upon close proximity to markets, such as manufacturers and providers of information services, can now serve customers from locations greatly remote from these customers where they can gain advantages from lower labor, energy, and tax costs. Yet other U.S. businesses, such as distributors, service companies, and retailers still rely heavily upon proximity to markets. Although location factors such as highway access and distance to customers play a greater role in site selection for many of these companies, the importance of the other key factors of labor availability, energy availability, and tax burden become even more critical as these companies can not necessarily serve customers from lower cost, remote locations.

On the cost side of location analysis, as operating costs such as labor costs and energy costs have begun to align more closely among regions across the U.S., one of the remaining areas where there is greater disparity of costs is tax. The primary state and local corporate taxes including income/franchise tax, sales and use tax, and property tax vary widely between states and municipalities. Such variations exist both in tax rates and in how the taxes are applied. In the case of the latter, differences are found between states in the types of taxes that are levied on corporations. While most states have a corporate income/franchise tax many states have eliminated personal property taxes making these states much more competitive in attracting production capital.

For companies, where location options are restricted to the continental U.S., state and local tax burden plays an important role in site selection. There are several primary reasons for the importance of tax burden in corporate location decision-making.

First, the level of business taxes generated in a state is one factor to consider when determining the states level of competitiveness as compared to the level of economic activity that is being taxed. In general businesses usually base their location decision primarily on the origin based taxes such as property tax and sales tax as compared to destination based taxes. For example, there are a few states such as Texas, Indiana and Arizona which generate the majority of business related taxes from sales tax and property taxes. These states generate a significant portion of their taxes base on business capital located in the state thereby reducing their competitiveness as compare to other states.

Second, state and local taxes, as a portion of operating costs have increased over the past ten years. In general, income taxes have increased three times faster than all state taxes. The primary reason for these increases is that states have become more aggressive in raising revenue from the business sector. When the economy is in a recession the amount of tax revenue generation is greatly reduced. Many states experience revenue loss in relation to growing costs and incur deficits resulting in the need for additional sources of revenue. These sources often include changes in business tax structures and alternative taxing methods.

For example, the states of Ohio and Texas have recently under gone tax restructuring that shift corporate tax burden away from production based companies to consumer based companies. Ohio tax restructuring replaced the state corporate income tax with a corporate activity tax or a modified gross receipts tax which moved the basis for corporate taxes from productive assets to out of state sales. Texas has also expanded its definition of a taxable corporation doing business within the sate and now the tax is based on gross revenues based on the privilege of doing business within the state. Additionally, Ohio has phased out its personal property tax as a means of shifting tax away from productive assets. This has relieved the tax burden on manufacturers for one and is equally of value to companies that export goods from Ohio either to other states or globally.

Next, states are becoming more sophisticated with interpreting and drafting new tax law which may result in incremental tax liabilities for some industries rather than others. For example, Michigan has revamped the SBT tax which was once a gross receipts tax to a modified gross receipts tax and income tax. Although, this change will affect business in different ways, the states overall revenue collection will impact the state favorably.

Finally, with businesses downsizing in various sectors, states have also looked for other ways to increase revenue. Some states have increased the definition of “taxpayer” to include entities which were not previously subject to tax in those states. States have also modified the state tax base by disallowing exemptions and deductions which were once allowed as part of the overall tax structure.

The Impact of Tax Incentives

The rising impact of taxes upon location decision making has increased the importance of tax incentives in site selection. Tax incentives are used both by public authorities and companies to accomplish different objectives. The objective is attracting operations in the case of the former and to aid in choosing sites in that of the latter.

> Tax incentives serve as a way to equalize tax burden between states and municipalities. To this point, property tax abatement in one community may be no more valuable than no abatement in a second community due to higher property tax rates in the first locality. However, the tax abatement may be necessary to make the first location competitive in attracting investment. For example, communities in states such as Michigan that levy personal property tax on manufacturing assets need to offer personal property tax abatement to remain competitive with communities in states with no personal property tax.
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> Tax incentives are looked at as a means to reduce the long term impact of taxes upon operating costs. Effective location analysis models estimate and evaluate key operating costs such as labor costs, transportation costs, energy costs, and tax costs over the long term (typically between ten and twenty years). Many tax incentives provide benefits for ten years or longer including income tax credits based upon job creation, property tax exemptions and refunds, and employee withholdings refunds. Even in cases of non-refundable tax credits, where a company may not have immediate tax liability to apply the credits against, many times such benefits may be carried forward for future use over ten or more years.
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> Taxes generated by new or expanded operations may be used as a method to finance the start-up costs of the operations. As an example, many states use a tool known as Tax Increment Financing to support certain costs incurred by companies in establishing or expanding operations within the jurisdiction. The incremental taxes generated by the operations over an extended period (typically 20 or more years) are used to service bonds the proceeds of which are used for the benefit of the project. These taxes vary from state to state, but often include property taxes, sales taxes, and special assessments. In some cases, future incremental taxes generated by unrelated operations are used to support the costs of a single operation.

Each of these objectives is key to companies when determining the optimal location for new investment. Whether the impact of incentives is short term in off-setting the up-front costs of an investment or longer term in reducing operating costs, the effects of inducements can have a significant impact upon the competitiveness of operations between alternative sites. We have seen numerous occasions where a company's initial preferable location for investment was upended by the impact of incentives upon start-up and operational costs. In some cases the impact has been significant enough to reverse decisions that were far along in the corporate approval process.

Incentives not only influence decisions regarding alternate locations for investment, but may also be the determining factor regarding whether an investment with a single location option goes forward. We have seen instances in which the return on investment required by an approving corporate board has been substantially influenced by incentives. In other words, the shorter term return on the investment does not enable management to justify an investment without the financial benefit of incentives.

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State and local taxes and tax incentives will continue to be a key factor in location decision making. Taxes will likely grow as a component of operating costs, while incentives will be viewed by corporations as a viable means to reduce these costs and increase return on investment. To states and communities, tax structures and tax incentives will both be scrutinized to determine the fiscal and economic impacts upon their economies and upon the competitiveness of these jurisdictions in attracting new investment.