Origin Sourcing and Tax Incentive Programs: An Unholy Alliance

by Jennifer Carr

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Origin sourcing is a sales tax practice under which sales taxes for purchases of goods that are shipped to purchasers at locations different from that of the seller are sourced to the seller's location for tax purposes and not the purchaser's. Tax incentive economic development programs are programs in which state and local governments offer tax breaks to companies that agree to expand their operations in a specific location. Under those arrangements, the company generally agrees to make a specified amount of capital investment and create a specific number of jobs over a period of years in exchange for specified tax breaks, often property tax abatement or some sort of tax credit.

Both origin sourcing and economic development programs have their proponents and their detractors. For instance, in a situation unrelated to economic development, some have argued that origin-based sourcing could be a solution to the costs of compliance and other implementation they see on the horizon should the Marketplace Fairness Act become law.[1] And the merits of economic development programs have been thoroughly debated in the pages of this magazine and elsewhere. Proponents say they are an excellent way to create jobs and private investment and are well worth the initially forgone revenue.[2] Their detractors describe them as a classic "race to the bottom" in which states and local governments compete with each other using an increasingly attractive set of incentives without evidence the additional investment is worth the tax breaks or assurances the company will remain in place once the program has run its course.[3]

If tax incentives and economic development programs are indeed a race to the bottom, nothing greases the skids like origin-based sales tax sourcing. Unlike most economic development programs in which the local government and its citizens agree to bear the burden of forgoing some revenue in exchange for the corporation's additional investment, origin sourcing allows local governments to receive the benefits of increased investment, while purchasers in other localities foot a portion of the bill.

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Or, as seen in Illinois, origin-based sourcing can create an incentive for localities with lower tax rates to team up with companies to source their sales to the town, sometimes in a questionable manner, in exchange for a cut of the revenue. Both situations represent horrible tax policy. However, the situation is unlikely to change anytime soon because of the perverse incentives that crop up when origin sourcing and sales tax incentive programs combine and the desire of local governments to maintain control of that revenue.

Texas

The website for Round Rock, Texas, says it all — the city is home to the "Hardest Working Sales Tax in Texas."[4] Because of the city's sales tax, which provided 55 percent of its budget for fiscal 2012, the

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[1]National Taxpayers Union, "Senate's Latest Move Toward Internet Tax Scheme Threatens to Trample Economy, Constitution, Citizen Group Says," Apr. 23, 2013. Marketplace Fairness Act.

[2]*See* Billy Hamilton, "Oops: Texas and *The New York Times* Butt Heads Over Incentives," *State Tax Notes*, Dec. 24, 2012, p. 999.

[3]John Buhl, "Massachusetts Rep: States Should Cooperate to Avoid Incentive Bidding Wars," *State Tax Notes*, Aug. 13, 2012, p. 454.

[4]*See* http://www.roundrocktexas.gov/home/index.asp?page=1953.

average annual property tax for a residence in the city is just $732.[5] Without the sales tax, according to the city, that figure would be $1,067 — an increase of more than 40 percent. Texas has a sales tax of 6.25 percent and the city is maxed out legally with its local 2 percent tax, which goes directly to the city. When touting the benefits of the sales tax, the city urges its citizens to "shop in Round Rock . . . contribute to improving the city you live in . . . [and] put the hardest working sales tax in Texas to work for you!"

Clearly, the city has opted to emphasize its sales tax as a way of reducing the property tax burden on its citizens. But it hasn't done that simply by having its citizens spend money locally. It's done it largely by enticing Dell Inc. into the city. That is not something the city tries to hide — the city is clearly proud of its relationship with the company. The same Web page touting the effectiveness of the city's sales tax notes that it is able to collect so much sales tax revenue because Dell relocated its corporate headquarters to Round Rock in 1994. As a result, and because Texas has origin-based sales tax sourcing for property sold within the state, Round Rock collects all sales tax for Dell computers shipped to Texas customers. The impact is dramatic. Although the city ranked 31st in the state in population in 2010, according to the comptroller's most recent figures, the city is 11th in the state in year-to-date sales tax collection.[6]

This is not to criticize Round Rock — it did what any rational city in its situation would try to do, given the existence of two Texas statutes. First is the origin sourcing law. If a Texas business sells to a Texas purchaser and the order is not placed in person, the sale is considered consummated from the point where the retailer ships the item.[7] And the Texas Local Government Code allows local governments to establish programs "to stimulate business and commercial activity in the municipality."[8] Given that situation, it is no wonder that a city would try to lure large companies with largely mail-order business to its locality in exchange for a piece of the pie. That's exactly what Round Rock did.

In 1993 the city and Dell entered into an agreement under which Round Rock would make a monthly program payment to the company to "represent sharing of the tax benefits which inure to the city as a result of Dell's location in the city." That payment was calculated based on a percentage of the city's sales tax at the time, none of the additional 0.5 percent sales tax the city instituted then specifically for property tax reduction, and a percentage of property taxes owed by Dell for real and personal property owned or leased in the city.[9] The city's website indicates that the tax has been a rousing success for Round Rock and its citizens. That appears to be true. However, for good tax policy and for other Texas residents, it hasn't been so fantastic.

Illinois

Illinois, like Texas, uses origin-based sourcing for its sales taxes. According to the Department of Revenue's administrative code, "the seller's acceptance of the purchase order is the most important single factor in the occupation of selling."[10] Thus, absent indications to the contrary, the taxes from a sale will be sourced to the location where the purchase order is accepted. When combined with a wide variation in sales tax rates and a willingness of some local governments to let businesses get in on the action, the potential for shenanigans in sourcing is high. A recent lawsuit filed against one of Chicago's biggest corporations illustrates this point.

The suit, which was filed in January in Cook County Circuit Court, alleges that United Airlines has been improperly sourcing the sales of its aviation fuel through a subsidiary located in Sycamore, Ill., even though all the work associated with the sales actually occurs at the company's corporate headquarters in Chicago.[11] According to the complaint, which was filed by the area's regional transportation authority, United set up a subsidiary in Sycamore for the sole purpose of improperly sourcing its sales taxes there. The office for that subsidiary is on a shared floor with other businesses and, according to the complaint, the single employee who supposedly works there does not even have a computer. And even though United sources all of its fuel sales to that office, the transportation authority asserts that all the sales activities, negotiations, delivery scheduling, accounting, credit approval,

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[5]*See* http://www.roundrocktexas.gov/docs/fy12_annual_popular_report.pdf p. 4.

[6]*See* https://www.tsl.state.tx.us/ref/abouttx/popcity32010.html. Texas Comptroller of Public Accounts, "Top 20 City Sales and Use Tax Comparison Summary — May 2013," *available at* http://www.window.state.tx.us/taxinfo/allocsum/top20.html.

[7]Texas Tax Code section 321.203. SB 636, which was enacted in 2009 and is scheduled to expire in 2014, may affect sourcing in situations involving warehouses, in-person orders, and existing economic development agreements. That does not appear to affect Dell orders received online or by phone and shipped to Texas customers.

[8]Texas Local Government Code section 380.001.

[9]That amount started at 100 percent and is now at 50 percent.

[10]86 Ill. Admin. Code section 270.115(b)(1).

[11]*Regional Transportation Authority v. United Aviation Fuels Corp. et al.* For a similar case, see *Regional Transportation Authority v. City of Kankakee et al.*, 1CH29744, Cook County Circuit Court, Aug. 23, 2011. The authority has also asserted that American Airlines is engaged in a similar operation in Sycamore.

and other decisions actually occur at the company's main offices in downtown Chicago.

The sales tax savings for United are significant. Both Chicago and Sycamore have the state sales tax of 6.25 percent. The state sales tax contains a 1 percent local share that goes back to the cities. However, Chicago has an additional 1 percent Cook County tax, a 1 percent regional transportation authority tax, and a 1.25 percent city tax. Sycamore has only a 1.75 percent city tax for a difference of 1.5 percent. That's a significant savings for United. However, where things really get lucrative for the company is in the agreement it signed with Sycamore. In exchange for opening what is described in the city council minutes as a "modest operation housing several employees who would review, process, and approve" fuel purchase orders, the city agreed to give a significant portion of the sales tax levied on these deals back to the company. The deal called for the city to retain $300,000 every year with an annual 3 percent increase for the term of the 2001 contract, which was initially for 10 years and later extended to 25 years. Any additional sales tax goes back to United. The transportation authority asserts that as a result of that arrangement and the sham sales sourcing it alleges United is engaged in, it has been unlawfully deprived of sales tax revenue. Its suit seeks to recover that revenue and to require United to source its sales to Chicago.

Analysis

Origin sourcing for sales tax is not horrible on its own. Although arguably it's not optimal, it's a reasonable way to decide what sales get taxed where. And economic development programs with their tax breaks in exchange for job creation have their proponents. The purpose of this article is not to debate either of those policies. Instead, the purpose is to point out the horrible tax policy that can result when the two are combined. Mark Nebergall, president of the Software Finance and Tax Executives Council, went so far as to describe it as the "worst tax policy one can imagine." Although that sort of tone usually suggests at least some exaggeration, in this situation it's difficult to quibble with Nebergall's assessment.

The Texas and Illinois situations, though coming at the matter from different directions, illustrate the problems well. Unlike the property tax, which is tied to a definite location, the sales tax can be sourced to anyplace. The most common location is the purchaser's location, but there is a great deal of flexibility available for law and policymakers. In the case of Texas, that allows Round Rock to fund its sales tax miracle on the backs of other Texas residents. It isn't the city's sales tax that's working hard — it is citizens of other Texas towns. Sure, it's great for Round Rock citizens, but what about everybody else? There is something fundamentally unfair about a system that allows a city to outsource its sales tax burden and economic development plan payments to residents elsewhere just because the citizens happened to persuade Dell to move to their city. There are only so many Dells to go around.

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And, as seen in the Illinois case, the economic development programs and origin sourcing combination puts localities in the same area in competition with each other with little to no net gain for the entire area, which is highly problematic. Putting aside the question of whether United properly sourced its sales to Sycamore, it is clear the airline could have, and thus short-circuited any lawsuits, had it made its operations in Sycamore larger. What if the next town over offers United its next contract and office space for only a 2 percent annual increase instead of the 3 percent Sycamore is receiving? United, whose operations are highly mobile, would likely take it, and with no net benefit to the citizens in the area. Except for United, of course, which would be able to skim a larger portion of the cream off the top of the public fisc. And Chicago and its transportation authority, which is incurring the costs of hosting the most of United's income-generating operations, are missing out on needed revenue, while Sycamore, which incurs few costs associated with United's operations, reaps a huge windfall. The disconnect between government costs and revenue distribution is troubling.

That leaves the question how to fix this sort of situation. The biggest problems occur when there is a combination of origin sourcing and sales-tax-based economic development programs. It seems unlikely that states with origin sourcing will be moving away from it anytime soon. According to Billy Hamilton, the existence of these agreements and a desire for local control over these revenues was a serious impediment to Texas adopting destination sourcing in order to join the Streamlined Sales and Use Tax Agreement.[12] Another option would be for states with origin sourcing to prohibit local governments from entering into sales-tax-based economic development programs. Property tax would be limited to

[12]*See* Billy Hamilton, "Domaine Chicane," *State Tax Notes*, Nov. 17, 2008, p. 462.

where the property is located. The burdens of economic incentives would thus be limited to where the government with the program is located. That would prevent the problems associated with Round Rock's program and a significant portion of the Illinois issues as well.

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Although existing plans would probably have to be honored because of the federal Constitution's contracts clause, requiring future development plans to be property-tax-based would be a good start. Of course, the same interests that kept Texas from adopting destination sourcing would fight those changes as well. Unless there is recognition of the problems these policies create and a political will to change them, it is likely that Texas residents who buy Dell computers will continue to pay Round Rock sales tax at the expense of their own communities. ☆