

## When Do Taxes “Move the Needle” in the Location Process?

Certain industry sectors are more sensitive to specific taxes, and companies in those sectors need to know what to avoid.

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**T**axes receive their fair share of scrutiny in site selection — and rightfully so. The broad assortment of fees adds up to a significant cost for most businesses. Surveys of companies and site selection consultants frequently rank tax burden as an important factor in the location decision.

It is standard practice for business location consultants to explore tax climate in every analysis. Information considered ranges from company-specific tax liability to a third-party tax environment index, depending on the specific needs of the company.

Yet, despite their large potential cost burden, taxes alone seldom dictate where a company locates. The goal of location analysis is to properly balance a multitude of factors impacting a company’s operations. Normally, operation-critical attributes — like labor pool characteristics and access to customers — drive the location decision. Tax considerations join labor, utility, and transportation costs as part of the overall cost of doing business. Most of the time this method is appropriate.

However, certain industries are disproportionately sensitive to taxation based on the nature of their sales, investments, or overall operations. In these cases, increasing the weight or significance of a specific tax is appropriate when ranking locations. Let’s examine specific taxes and situations that create hurdles or even eliminate locations from the site search.

### Personal Property Tax

Data centers were one of few sectors to see growth during the recession. Changing means of communication, entertainment, and access to medical data all drive growth.

Communities want these projects because they attract skilled IT workers and capital investment, while creating a relatively small drain on services. Yet

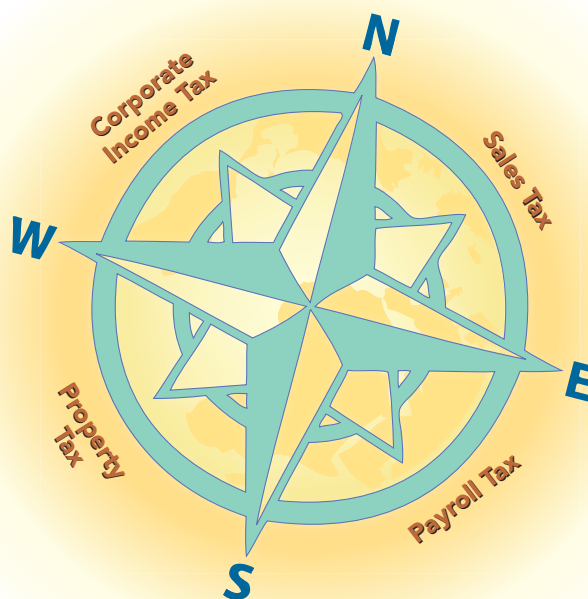
the massive investment in personal property that is usually involved can force site selectors to place a state’s personal property tax structure at the top of a list of evaluation criteria. States are beginning to take notice.

Personal property tax is assessed and collected locally, and primarily used to fund education and services. Though rates are determined locally, the existence of tax on personal property is a state-level decision. This creates vastly different tax burdens across state borders.

It can be the largest tax levied on companies with substantive investment in equipment. For data centers, the value of personal property — including servers, cooling systems, and infrastructure — is often twice the value of the building shell, which is assessed as real property.

Thus the absence of personal property tax joins the list of criteria for a data center site, along with low risk of natural disasters and favorable electric rates.

A recent client, who was in a national site search for a mission-criti-



cal data center, selected personal property tax as a criterion in its first-level location filter. (In searches for less capital-intensive industries, overall tax climate is usually included in the first round of filtering.) The addition of this specific tax to the location assessment eliminated many locations that were otherwise suitable for the facility. Since the first filter is data-driven, the eliminated cities and states were never told that they hadn't made the cut — but other locations that survived this first filter were asked to submit information about available real estate and took a step closer to landing the project.

Savvy economic development groups now promote the statutory absence of personal property tax on data center equipment as a significant advantage over neighboring states. States including Illinois and Wisconsin have traditionally been havens for equipment-intensive industry such as manufacturing, and they apply this concept to data centers as well. Others such as Indiana have recently addressed data centers specifically, creating personal property tax exemption for data centers to level the playing field with neighboring states.

### **Apportionment**

Though not a tax, a state's apportionment formula can play a role in attracting and retaining manufacturers. Apportionment makes part of a multi-state company's profit subject to state corporate income tax, traditionally weighting property, payroll, and in-state sales equally. Significant in-state manufacturing operations equate to a higher proportion of employees and investment subject to corporate income tax.

Most states, realizing the inherent benefits of attracting and retaining basic manufacturing industries, have converted to an apportionment that double-weights sales (50 percent of total), reducing the influence of employment and investment on corporate income tax. Some have gone a step further to only consider in-state sales. Twelve states have adopted the single-sales apportionment and another four are in the process of converting.

From a business attraction perspective, the rationale is immediately evi-

dent. Projects with significant levels of employment and investment will lean toward states that minimize or eliminate the influence of jobs and investment on corporate income tax. Those seeing the greatest benefit have large concentrations of production in a few states and high out-of-state sales. Conversely, companies with low employment and investment but sizeable in-state sales could be hurt.<sup>1</sup>

Opponents to a single-sales factor argue that it reduces state revenue during a period of historic budget deficits, and unfairly transfers the tax burden to out-of-state firms. Lawmakers continue to weigh the tradeoffs between enhanced competitiveness and deteriorating state finances.

### **Sales Tax**

Business location analysis uses multiple filters to narrow down many potential locations into a smaller, more manageable list. The first filter is based on readily available data, and seeks an efficient path to eliminating inappropriate markets. After the first screen, the additional factors applied are subtler and require higher effort to discern the differences between locations within the same region. Sales tax is often included in this second filter.

Retail users have a much tighter geographic focus than other sectors. The right mix of demographics, complementary businesses, and visibility will drive the success of the project. Typically, retailers will first emphasize overall growth and income trends when selecting a metropolitan area for expansion. Within the metropolitan area, retailers enter a world of fragmented jurisdictions and drastically different cost environments.

Sales tax is location-specific, as it often combines state, county, and municipal tax. For consumers, sales tax is levied at the point of purchase for goods and services, whether at a restaurant or big-box store.

From a retailer's point of view, a variety of location choices can serve the same consumer base, especially if the business draws from a large area. Different sales tax levels within a small geographic area make a difference in the final cost to a consumer, and can enhance or jeopardize sales.

This can lend an advantage to low-tax sites just outside the boundaries of large metropolitan areas or across county lines. This is particularly true for large-ticket items such as cars.

Even in high-tax areas, a solution in the form of economic incentives is unlikely. Economic developers understand retail is demographics-driven and incentives will not overcome the pull of a better location. Additionally, retail is perceived as low-wage, and has little economic impact in the form of supplier businesses. An exception pertains to destination big-box retail. Some communities have attracted a new generation of destination retailers, like Cabela's or IKEA, to anchor downtown revitalization plans or establish a new area. These tend to attract buyers from a large geography and have a larger economic impact than the typical retail project.

This issue is not limited to attracting retail customers. Sales tax rates affect businesses making large or frequent capital purchases. Data centers or capital-intensive manufacturers often seek and obtain exemptions from sales tax due to perceived economic benefit to the community. Exemptions can be granted on the property's use or by crossing investment and employment thresholds. Regardless of industry sector, determining the scale of purchases eligible for exemption is a critical step when evaluating locations.

### **Best Practice Location Selection**

In general, the drag of a specific tax will not override a strong location's ample labor pool, transportation access, customer base, or other assets. Even locations with serious tax disadvantages can be ideal for companies if the location offers access to these key inputs.

Locations near one or more borders are an exception. These are much more susceptible to scrutiny because tax rates and policies are the sole differentiator between markets with identical labor, resources, and access. On an otherwise level playing field, an enhanced tax environment could push a company over a line.

In response to this, economic developers and lawmakers create incentives that exempt targeted industries or provide credits to lessen tax liability.

Nationwide, communities target a remarkably similar list of industries, offering incentives for emerging industries such as clean energy and biotech. In addition to the usual list, smaller niche industries are now being targeted. For example, Louisiana's Digital Media Incentive promises to reduce the cost of doing business for qualifying gaming and animation companies. A thorough examination of applicable incentives can identify areas of the country aggressively pursuing niche industries.

The best way to avoid getting stuck in a tough tax environment is to consider the elements of your operation and prepare an actual tax estimate to calculate the total cost of doing business in each location. A genuine assessment of a company's needs and a careful balancing of locational attributes will cut through the rhetoric and identify a location that best matches the needs of a company. ■

<sup>1</sup> McKenna, Jon, ed. "Winners, Losers When States Tilt Apportionment Toward Sales." *Tax Incentives Alert*, Vol. 9, Number 11, November 2010

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## DATA CENTER INPUTS

Data centers will remain strong economic drivers around the country in the coming years. Data center construction is expected to double in just five years, far exceeding levels prior to the financial crisis. And while communities and economic developers may have been slow to respond to this rising need, they are quickly catching up, developing strategies to attract and support data center growth in their communities. The challenge now is for companies to find suitable sites that meet their complex infrastructure and security requirements among a growing list of competitive locations.

### Identify the Right Site

Data center site selection starts with a keen understanding of your company's most critical needs matched against a state's ability to meet those needs. Critical factors that your organization should seek in a potential community include:

- 1. Infrastructure to support data centers:** Determine whether the community provides a reliable electric distribution system, significant and cost-effective energy supply, and multiple communication services that offer reliable conductivity and latency through their fiber networks. Besides the obvious service characteristics — voltage, redundant supply, and capacity needs — a review of the load buildup and commissioning schedule is also extremely important. Keep in mind that while a site may not meet your energy needs now, utility companies can upgrade services and provide additional capacity over time. Communicate effectively with local utility professionals to minimize duplicate service charges, high demand costs of commissioning, and reserve capacity fees.
- 2. A secure environment to minimize risk:** Resiliency and security are two top data center site selection criteria. Determine if the region is prone to natural disasters such as flooding, hurricanes, and earthquakes, or if it is near hazardous locations such as airports, oil reserves, natural gas pipelines, or freight rail lines.
- 3. Technical support to navigate complex needs:** The support you can expect on-site improves a potential location's value. In many states, economic developers and utility professionals can identify areas and buildings that meet your needs. In particular, utility economic developers have the technical expertise to work with your engineers and consultants to quickly refine your search and streamline the process, reducing unnecessary time and expense.
- 4. Incentives to offset costs:** Many communities offer targeted economic development incentives that reward companies for capital expenditures (if not large employment gains) associated with data center construction. These include sales tax exemptions, energy rebates, and property tax abatements. These programs provide companies with a greater — and quicker — return on investment.

Secondary considerations may include labor availability, proximity of water for cooling, and availability of renewable energy.

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