DEPARTMENT OF TAXATION
2011 Fiscal Impact Statement

1. Patron David B. Albo

2. Bill Number HB 1604

House of Origin:
X **Introduced**
_____ **Substitute**
_____ **Engrossed**

Second House:
_____ **In Committee**
_____ **Substitute**
_____ **Enrolled**

3. Committee House Finance

4. Title Corporate income tax; market-based sourcing

5. Summary/Purpose:

This bill would change the method of determining the sales factor for corporate income tax purposes for sales other than sales of tangible personal property from the costs-of-performance method to market-based sourcing. Under this bill, sales, other than sales of tangible personal property, would be deemed in the Commonwealth if the taxpayer has exploited the market provided by the Commonwealth to the extent that any benefit or use of such sale is to a person or location in the Commonwealth.

This bill would require TAX to publish guidelines implementing its provisions. The bill would require the guidelines to assert to the maximum extent permitted by law Virginia's ability to include sales of services and intangible property in the calculation of taxable income from Virginia sources. Such guidelines would be exempt from the Administrative Process Act.

This bill would require that all revenues generated as a result of implementing market-based sourcing be non-general revenue funds dedicated to the Highway Maintenance and Operating Fund.

This bill would be effective for taxable years beginning on or after January 1 of the year after TAX publishes the mandated guidelines.

6. Budget amendment necessary: Yes.

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7. Fiscal Impact Estimates are: Preliminary. (See Line 8.)

7a. Expenditure Impact:

Fiscal Year	***Dollars***	***Positions***	***Fund***
2010-11	$0	0	GF
2011-12	$9,680.00	0	GF
2012-13	$65,196.00	0	GF
2013-14	$87,972.00	1	GF
2014-15	$365,247.00	3	GF
2015-16	$367,647.00	3	GF
2016-17	$376,447.00	3	GF

7b. Revenue Impact:

Fiscal Year	***Dollars***	***Fund***
2010-11	$0	GF
2011-12	($8.3 million)	GF
2012-13	($16.6 million)	GF
2013-14	Unknown	GF
2014-15	Unknown	GF
2015-16	Unknown	GF
2016-17	Unknown	GF

8. Fiscal implications:

Administrative Costs

Assuming that TAX completes and issues guidelines by December 31, 2011, the change to market-based sourcing would be effective for taxable years beginning on and after January 1, 2012. Assuming this effective date, the administrative costs associated with implementing this bill would be $1,272,189 from FY 2012 through FY 2017. These costs include those associated with updating existing TAX systems, as well as annual reconciliation process, to capture the data necessary for tracking revenues that are to be dedicated to the Highway Maintenance and Operating Fund; changing the existing corporate audit programs; and creating additional reports to track certain transactional data throughout the year. In addition to these costs, TAX would need to hire additional interstate audit staff to ensure compliance with the new rules, as well as an additional business analyst to assist in tracking the revenue stream resulting from this bill.

The administrative costs associated with this bill would be significantly lower if the revenues were not dedicated to the Highway Maintenance and Operating Fund. Without the dedication of the revenues to the Highway Maintenance and Operating Fund, the costs would be approximately one-third of the administrative costs of this bill from FY 2012 through FY 2017.

Revenue Impact

Assuming that TAX completes and issues guidelines by December 31, 2011, the change to market-based sourcing would be effective for taxable years beginning on and after January 1, 2012. This bill would impact two categories of corporations: those that already file Virginia income tax returns, and those that are not currently required to file a return. Based on information from corporations that already file Virginia income tax returns, TAX estimates a revenue loss of $8.3 million in FY 2012 and $16.6 million in FY 2013. TAX assumes that corporations whose tax is reduced by market-based sourcing would begin adjusting their estimated payments in FY 2012 to reflect the change in sourcing method. However, corporations whose tax is increased by market-based sourcing would not likely change their estimated payments until after they file their return for taxable year 2012 (due October 15, 2013, under extension).

The impact of out-of-state corporations that do not currently file Virginia income tax returns is unknown due to a lack of information about the level of activity in Virginia and potential compliance by these corporations. While out-of-state corporations would likely generate a significant revenue gain in the long-term, the amount is unknown. Because these corporations do not currently file Virginia returns, they are not likely to begin making estimated payments in FY 2012 or FY 2013. The revenue impact from these corporations would first occur in FY 2014 when they file their returns for the 2012 taxable year. Because of the compliance issues associated with multistate corporations that do not currently file income taxes in Virginia, it will likely take longer for these corporations to begin filing returns and sourcing sales of services to Virginia using market-based sourcing.

Accordingly, TAX estimates that this bill would result in a short-term loss in FY 2012 and FY 2013, but that the net effect of this bill is expected to generate a revenue gain over the long-term. However, the timing and extent of this gain is unknown and would depend on the impact to out-of-state corporations, as well as the amount of time it takes these corporations to comply with the new Virginia law.

JLARC Estimate

In House Document 3 (2010) entitled "Review of Virginia's Corporate Income Tax System", JLARC estimated the potential fiscal impact of adopting market-based sourcing while ceasing to extend protections to out-of-state providers of services and intangible goods. JLARC estimated that the fiscal impact from corporations that already file a Virginia income tax return would range from a slight revenue gain of $112,000 to a revenue loss of $2.7 million, based on 2006 data. This estimate is fairly consistent with the TAX estimate contained in this fiscal impact statement. (2010 H.D. 3, p. 90).

In addition, JLARC attempted to quantify the potential revenue impact from all corporations, including those that do not currently file an income tax return in Virginia. JLARC staff estimated that the long-term, total potential impact of the new policy could reach up to $248.7 million. This estimate is best described as a "tax gap" analysis. It compares a theoretical maximum Virginia corporate income tax revenue available (based on federal tax information) to actual collections. It does not purport to be an estimate of revenue that would actually be received after taking into account the timing of taxpayer actions, economic conditions, etc. (2010 H.D. 3, p. 91).

JLARC's estimate assumes that Virginia could capture its share of national income, using population as a proxy for the sales factor. However, there are at least three factors that would reduce this theoretical maximum revenue:

P.L. 86-272: Federal law prohibits Virginia from taxing certain corporations that sell tangible personal property to Virginia customers. This law, Public Law 86-272, prohibits states from subjecting the sale of tangible personal property to a net income tax where the taxpayer's only business activities within the sate during the taxable year are the solicitation of orders by the taxpayer or his representative for the sale of tangible personal property. Accordingly, Virginia does not subject the sale of tangible personal property to its corporate income tax if the only business activities within the state are the activities protected by P.L. 86-272.

In the early 1980's, Virginia voluntarily extended this policy to sales of services, and JLARC's estimate assumes that this policy will be revoked with the adoption of market-based sourcing. While Virginia may change its policy with respect to sales of services and intangible property, it cannot override federal law applicable to sales of tangible personal property, which are estimated to account for about half of the sales in Virginia. Because the national data used by JLARC staff could not accurately be segregated between sales of tangible personal property and those of services and intangible property, tax collections could be substantially less than the maximum JLARC estimate. Further, if the adoption of market-based sourcing makes a company's sales of services taxable in Virginia, it may make it more attractive for the corporation to adopt tax planning strategies, such as entity isolation, to preserve the application of P.L. 86-272 to its sales of tangible personal property.

Tax Planning: Entity isolation involves creating separate corporations to own certain property (e.g., an intangible holding company) or perform certain functions (e.g., marketing, transportation, manufacturing, etc.). By placing its sales of tangible personal property and sales of services into separate affiliates, a business may be able to preserve its exemption of sales of tangible property under P.L. 86-272.

There are many other tax planning strategies that reduce state income tax, and most of them would not be affected by the change to market-based sourcing. It is not known how much revenue Virginia is losing because of tax planning, so the actual revenue impact could therefore be lower than the maximum JLARC estimate.

Compliance: Some corporations believe that states cannot subject them to taxation unless they have physical presence in the state, and they are actively litigating this issue (and lobbying Congress for a law to this effect). So far, most court decisions have sustained state taxation of corporations that purposefully direct their marketing at customers in the state. The U.S. Supreme Court has refused to hear any of these cases, so litigation is likely to continue. Some of these corporations most likely will not voluntarily comply with a change to Virginia's sourcing and nexus rules but will litigate, either immediately or after an auditor discovers them. It is unknown how these issues will ultimately be resolved, and their potential negative effect would likely result in a lower revenue impact than JLARC's maximum estimate.

9. Specific agency or political subdivisions affected:

Department of Taxation
Department of Transportation

10. Technical amendment necessary: No.

11. Other comments:

Background

For corporate income tax purposes, multistate corporations are generally required to allocate and apportion income among the various states. Non-business income is generally allocated based on certain criteria, while all other income is generally apportioned among the states.

Most states apportion income by multiplying income by an apportionment factor, which is typically comprised of a payroll factor, a property factor, and a sales factor. The payroll factor is generally the amount of payroll in the state divided by total payroll everywhere. The property factor is generally the amount of property owned in the state divided by total property everywhere. The sales factor is the amount of sales or gross receipts sourced to the state divided by total sales or gross receipts everywhere. Some states (including Virginia) use a double-weighted sales factor, meaning that they multiply the sales factor by two, add it to the property and payroll factors, and divide by four.

The sourcing method involves a set of rules for determining when to source sales or gross receipts to the state for purposes of determining the sales factor. In Virginia, sales of tangible personal property are sourced to Virginia if the property is received in Virginia by the purchaser. The majority of states (including Virginia) use "costs of performance" to source sales from services to the state in which the income producing activity is performed. If the income producing activity is performed in two or more states, the sale is attributed to the state in which a greater proportion of the income producing activity is performed than in any other state, based on the costs of performance. Instead of an "all or nothing" approach, some states use a percentage of costs. Virginia uses this approach for financial corporations.

Federal and Constitutional Restrictions on State Income Taxation

The commerce clause of the United States Constitution provides that a state income tax may not discriminate against interstate commerce. To meet this requirement, a tax must be related to an activity that has substantial nexus within the taxing state; must be fairly apportioned; must not discriminate against interstate commerce; and must be fairly related to the services provided by the state. Some states require a taxpayer to have a physical presence in the state in order to satisfy the "substantial nexus" requirement. However, federal courts have held that an income tax satisfies this requirement if it has economic nexus with the state.

In addition to the constitutional requirements placed on states, federal Public Law 86-272 prohibits states from subjecting the sale of tangible personal property to a net income tax where the taxpayer's only business activities within the state during the taxable year are the solicitation of orders by the taxpayer or his representative for the sale of tangible personal property. Although this federal law only applies to the solicitation of sales of tangible personal property, several states (including Virginia) have extended the protection of P.L. 86-272 to the sale of services. Accordingly, Virginia does not currently subject the sale of tangible personal property or the sale of services to its income tax if the only business activities within the state are the protected activities included in P.L. 86-272.

Current Virginia Law

If a corporation's income is from activities that are taxable both in Virginia and outside Virginia, the corporation must allocate and apportion income. Dividends must be allocated to the commercial domicile of the corporation and all other income must be apportioned.

Apportionable income is calculated by multiplying Virginia taxable income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four. If there is no sales factor, the denominator will be the number of existing factors. If there is a sales factor but no property or payroll factor, the denominator will be the number of existing factors plus one.

The sales factor is a fraction, the numerator of which is the total sales of the corporation in Virginia during the taxable year, and the denominator of which is the total sales of the corporation everywhere during the taxable year, to the extent that such sales are used to produce Virginia taxable income and are effectively connected with the conduct of a trade or business within the United States, the income from which is includable in federal taxable income.

For purposes of computing the sales factor, *Va. Code* § 58.1-415 provides that sales of tangible personal property are deemed in Virginia if such property is received in Virginia by the purchaser. In the case of delivery by common carrier or other means of transportation, the place where property is ultimately received after all transportation is complete is considered the place where property is received by the purchaser. Direct delivery in Virginia, other than for purposes of transportation, to a person or firm designated by a purchaser constitutes delivery to the purchaser in Virginia and direct delivery outside Virginia to a person or firm designated by the purchaser does not constitute delivery to the purchaser in Virginia, regardless of where title passes or other conditions of sale.

Virginia Code § 58.1-416 currently provides that sales, other than sales of tangible personal property, are deemed in Virginia if the income-producing activity is performed in Virginia. If the income-producing activity is performed both in and outside of Virginia, such sales are deemed in Virginia if a greater proportion of the income-producing activity is performed in Virginia than in any other state, based on costs of performance.

Proposed Legislation

This bill would change the method of determining the sales factor for sales other than the sale of tangible personal property from the costs-of-performance method to market-based sourcing. Under this bill, sales, other than the sale of tangible personal property, would be deemed in the Commonwealth if the taxpayer has exploited the market provided by the Commonwealth to the extent that any benefit or use of such sale is to a person or location in the Commonwealth.

This bill would require TAX to publish guidelines implementing its provisions. These guidelines would be required to contain provisions that assert to the maximum extent permitted by law Virginia's authority to calculate and impose its income tax with respect to the sale of services, the benefits of which are received in Virginia, the sale of marketable securities when the customer is in Virginia, and the sale, lease, rental, or licensing or real, personal, or intangible property when such property, other than property subject to *Va. Code* § 58.1-415, is located in or used in Virginia. The guidelines would also be required to address the extent, if any, to which sourcing may be based upon estimates when necessary information is not in the possession of the taxpayer. Finally, the guidelines would be required to address the manner in which abuse of the sourcing rules may be remedied, which remedies may include reliance on the location of income-producing activity and direct costs of performance under prior law and regulations.

The development and publication of these guidelines would be exempt from the provisions of the Administrative Process Act.

This bill would require that all revenues generated as a result of implementing market-based sourcing be non-general revenue funds dedicated to the Highway Maintenance and Operating Fund.

This bill would be effective for taxable years beginning on or after January 1 of the year after TAX publishes the mandated guidelines.

Issues to be Addressed by the Guidelines

This bill would require TAX to publish guidelines implementing its provision. In addition to the provisions stated in the bill, these guidelines would need to address several constitutional and practical issues. For instance, the guidelines would need to ensure that Virginia's sourcing laws meet all constitutional requirements, particularly the economic nexus requirement. Additionally, the guidelines would need to address practical issues such as whether the requirements of P.L. 86-272 should continue to apply to the sourcing of services and whether taxpayers should be permitted to elect their method of sourcing. It is important to note that such decisions may affect the revenue impact of this bill.

Market-Based Sourcing in Other States

Market-based sourcing focuses on where the benefit of the service is received, rather than on where the income producing activity related to the services is performed. Eleven other states (California, Georgia, Illinois, Iowa, Maine, Maryland, Michigan, Minnesota, Ohio, Utah, and Wisconsin) currently use some form of market-based sourcing for sales of services and/or intangibles. Because of the complexity associated with market-based sourcing, several states (California, Georgia, Iowa, and Maryland) currently provide guidance for market-based sourcing primarily through regulations.

California

California is the most recent state to adopt market-based sourcing. California law provides that, for taxable years beginning on or after January 1, 2011, sales from services are in the state to the extent the purchaser of the service received the benefit of the service in the state. If services relating to a single item of income are performed partly in-state and partly out-of-state, gross receipts are attributable to California only if the greater portion of the services were performed in-state, based on the costs of performance. If the services in each state constitute a separate income-producing activity, gross receipts for the performance of services attributable to California are measured by the ratio of time spent in the performance of services in-state to the total time spent performing the services everywhere. Sales from intangible property are in the state to the extent the property is used in the state. In the case of marketable securities, sales are in the state if the customer is in the state.

Georgia

Georgia sources gross receipts from the performance of services within the state if the recipient of the service receives all of the benefit of the service in Georgia. If the recipient receives some of the benefit of the service in Georgia, gross receipts are sourced to the state in proportion to the extent the recipient receives the benefit of the service in Georgia. The Georgia regulations provide numerous examples of how this rule is applied, including examples of real estate development firms, contractors, computer software companies, and direct mail activities.

Illinois

Effective for taxable years ending on or after December 31, 2008, Illinois sources sales of services to Illinois if the services are received in Illinois. Gross receipts from the performance of services provided to a corporation, partnership, or trust may only be attributed to a state where that corporation, partnership, or trust has a fixed place of business. If the state where the services are received is not readily determinable or is a state where the corporation, partnership, or trust receiving the services does not have a fixed place of business, the services are deemed to be received at the location of the office of the customer from which the services were ordered in the regular course of the customer's trade or business. If the ordering office cannot be determined, the services are deemed to be received at the office of the customer to which the services are billed. If the taxpayer is not taxable in the state in which the services are received, the "throw-out" rule applies and the sale is excluded from both the numerator and the denominator of the sales factor. Illinois law provides that the Illinois Department of Revenue should adopt rules prescribing where specific types of services are received, but such rules have not yet been adopted.

Iowa

Iowa law provides that, where income is derived from business other than the manufacture or sale of tangible personal property, the income shall be allocated or apportioned under rules prescribed by the Iowa Department of Revenue. The Iowa Administrative Code states that gross receipts from the performance of services are sourced to Iowa if the recipient of the service receives all of the benefit of the service in Iowa. If the recipient of the service receives some of the benefit of the service in Iowa with respect to a specific contract or item of income, the gross receipts are includable in the numerator of the apportionment factor in proportion to the extent the recipient receives the benefit of the service in Iowa.

Maine

Maine sources receipts from the performance of services to the state where the services are received. If the state where the services are received is not readily determinable, the services are deemed to be received at the home of the customer or, in the case of a business, the office of the customer from which the services were ordered in the regular course of the customer's trade or business. If the ordering location cannot be determined, the services are deemed to be received at the home or office of the customer to which the services are billed. Gross receipts from the license, sale, or other disposition of patents, copyrights, trademarks, or similar items of intangible personal property are attributed to the state if the intangible property is used in the state by the licensee. If the intangible personal property is used by the licensee in more than one state, the income must be apportioned to Maine according to the portion used in the state. In cases where the purchaser of services or intangible property is the federal government, the receipts are attributable to Maine if a greater proportion of the income-producing activity is performed in Maine than in any other state based on costs of performance.

Maryland

Maryland sources gross receipts from contracting or service-related activities to Maryland if the receipts are derived from customers within the state. Both individuals and businesses are considered "customers within the state" if they are domiciled in Maryland. Sole proprietorships, partnerships, LLPs, LLCs, corporations, and other business entities are domiciled in the state where the office or place of business that provides the principal impetus for the sale is located. If an office or principal place of business cannot be identified as providing the principal impetus of the sale, then the domicile is the state in which the headquarters or principal place of business management of the customer is located.

Michigan

Effective January 1, 2008, Michigan law provides that sales from the performance of services are generally in the state if the recipient of the services receives all of the benefit of the services in Michigan. If the recipient of the services receives some of the benefit of the services in Michigan, the receipts are sourced to Michigan in proportion to the extent that the recipient receives the benefit of the services in the state. Special rules apply to the sourcing of sales derived from securities brokerage services; services related to regulated investment companies; the origination of loans secured by residential real property; interest from loans; gains from the sale of a loan not secured by real property; credit card receivables; loan serving fees; sale of securities; transportation services; telecommunications and mobile telecommunications services; private communication services; billing services and ancillary services for telecommunications; and live radio or television programming.

Minnesota

Minnesota sources receipts from the performance of services to the state where the services were received. Receipts from the performance of services provided to a corporation, partnership, or trust may only be attributed to a state where it has a fixed place of doing business. If the state where the services are received is not readily determinable or is a state where the corporation, partnership, or trust receiving the service does not have a fixed place of doing business, the services are deemed to be received at the location of the office of the customer from which the services were ordered in the regular course of the customer's trade or business. If the ordering office cannot be determined, the services shall be deemed to be received at the office of the customer to which the services are billed. Special rules apply to the sourcing of receipts from management, distribution, or administrative services for funds regulated under 15 U.S.C. § 80a-1 through § 80a-64; financial institutions; certain interest income; merchant discount income; receipts from the performance of fiduciary services; receipts from the issuance of travelers checks and money orders; receipts from investments of a financial institution in securities and from money market instruments; and financial institutions' interest in certain types of property.

Minnesota sources royalties and other income received for the use of or privilege of using intangible property to the state in which the property is used by the purchaser. If the property is used in more than one state, the income must be apportioned to Minnesota pro rata according to the portion of use in the state. If the portion of use in the state cannot be determined, the royalties or other income must be excluded from both the numerator and the denominator of the sales factor.

Ohio

For purposes of its franchise tax, Ohio sources receipts from the sale of services to Ohio in proportion to the purchaser's benefit, with respect to the sale, in Ohio to the purchaser's benefit, with respect to the sale, everywhere. The physical location where the purchaser ultimately uses or receives the benefit of what was purchased is paramount in determining the proportion of the benefit received in the state. Receipts from the sale, exchange, disposition, or other grant of the right to use trademarks, trade names, patents, copyrights, and similar intellectual property are sourced to Ohio to the extent that the receipts are based on the amount of use of that property in the state. If the receipts are based on the right to use the property, rather than on the amount of use of the property, and the payor has the right to use the property in the state, then the receipts are sourced to Ohio to the extent that the receipts are based on the right to use the property in the state.

For purposes of its commercial activity tax, Ohio applies the same general rules as the sourcing rules for purposes of its franchise tax. However, if a taxpayer's records do not allow the taxpayer to determine that location, the taxpayer may use an alternative method to source receipts if the alternative method is reasonable, is consistently and uniformly applied, and is supported by the taxpayer's records. Additionally, the Ohio Administrative Code provides specific examples of how the general sourcing rules are applied to fifty-four different types of services for purposes of the commercial activity tax.

Utah

Utah enacted market-based sourcing in 2008 (effective in for taxable years beginning on or after January 1, 2009). Receipts in connection with intangible property are sourced to Utah if the intangible property is used in the state. If intangible property is used both in the state and outside the state, the percentage of a receipt that is considered in the state is the percentage of use of intangible property that occurs in the state during the taxable year. Utah sources receipts from the performance of a service to the state if the purchaser of the service receives a greater benefit of the service in Utah than in any other state. The Utah Code provides that the Utah Tax Commission may prescribe the circumstances under which a purchaser of a service receives a greater benefit of the service in Utah than in any other state. However, such regulations have not yet been published.

Wisconsin

Wisconsin sources gross receipts from services to the state if the purchaser of the service received the benefit of the service in the state. The benefit of the service is received in the state if any of the following applies: the service relates to real property that is located in the state; the service relates to tangible personal property that is located in the state at the time the service is received or tangible personal property that is delivered directly or indirectly to customers in the state; the service is provided to an individual who is physically present in the state at the time the service was received; or the service is provided to a person engaged in a trade or business in the state and relates to that person's business in the state. If the purchaser of a service receives the benefit of a service in more than one state, the gross receipts from the performance of the service are included in the numerator of the sales factor according to the portion of the service received in Wisconsin.

Similar Legislation

Senate Bill 1006 is identical to this bill, except that it would have an effective date of January 1, 2012 and it would not require that revenues be dedicated to the Highway Maintenance and Operating Fund.

cc : Secretary of Finance

Date: 1/29/2011 KLC
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