DEPARTMENT OF TAXATION
2012 Fiscal Impact Statement

1. Patron John C. Watkins

2. Bill Number SB 78

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

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

3. Committee Senate Finance

4. Title Income Tax: Tax Credit for Corporate Income Tax Paid in Another State

5. Summary/Purpose:

This bill would allow a multistate corporation that pays Virginia corporate income tax based upon 100% of its sales to claim a credit against the amount of corporate income tax paid to another state based upon its sales in that state.

This bill would be effective for taxable years beginning on or after January 1, 2012.

6. Budget amendment necessary: Yes.
Page 1, Revenue Estimates

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

8. Fiscal implications:

Administrative Costs

The Department has not assigned any administrative costs to this bill because the changes required by a single bill such as this can be implemented as part of the annual changes to our systems and forms. As stand-alone legislation, the Department considers implementation of this bill as "routine," and does not require additional funding.

The Department will provide specific administrative costs on any legislation that is not "routine." Additionally, the Department will review all state tax legislation likely to be enacted prior to the passage by each house. If the aggregate number of routine bills likely to pass either house is unusually large, it is possible that additional resources will be required. If so, the Department will identify the costs at that time.

Revenue Impact

This bill would have an unknown negative impact on General Fund revenue beginning in FY 2013. The Department could not assess an order of magnitude to the revenue loss because data on what taxes corporations pay to other states is not available. This tax credit would be available to those corporations with a greater proportion of its income-producing activities and costs of performing an activity or intangible in Virginia, but are taxed on its sales in multiple states for its service or intangibles. Thus, a multistate corporation that has a greater proportion of its operations in Virginia, but does most of its sales in other states and is taxed on income from those sales, would be eligible to qualify for the tax credit.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes.

In order for this bill to be properly administered, the Department suggests the following technical amendments:

Line 15, after sales
Insert: in the Commonwealth for purposes of § 58.1-414

Line 16, after equal to
Strike: the amount of taxes
Insert: six percent of the amount on which income taxes were

Line 16, after state that
Strike: collects tax
Insert: apportioned the taxpayer's income

Line 17, after state.
Insert: The amount of credit with respect to any state shall not exceed the amount of income taxes paid to such states.

11. Other comments:

<u>Background</u>

For corporate income tax purposes, multistate corporations are 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, and the "all or nothing" approach for other corporations.

<u>Current Virginia Law</u>

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 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.

In Virginia, when corporations sell services and intangibles in multiple states, income is assigned to the state with the greater proportion of the income-producing activity and costs of performing or providing such activity or intangible. This means that some corporations with most of their offices and employees in Virginia must assign their income to Virginia even though a majority of its customers are outside of the state. In some circumstances, even though 100% of a corporation's sales are assigned to Virginia, it may pay income tax to other states that rely on market-based sourcing, which sources income related to services and intangibles to where the customer is located.

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.

Proposal

This bill would allow a corporation that pays Virginia corporate income tax based upon 100% of its sales to claim a credit against the amount of corporate income tax paid to another state based upon its sales in that state.

This bill would be effective for taxable years beginning on or after January 1, 2012.

Impact of this Proposal

Virginia and virtually all states imposing a corporate income tax use apportionment to assign income for tax purposes. The Department is not aware of any states that currently use a credit mechanism to assign income. Therefore, this appears to be unique among the states.

The fact that the credit is limited to multistate corporations with a 100% Virginia sales factor may potentially create a constitutional issue. Anytime a tax preference is limited to in-state businesses there can be an issue as to whether it violates the Commerce Clause of the U.S. Constitution because it discriminates against out-of-state businesses. The Department believes that there are arguments to support the constitutionality of such a credit, but because this is unique among states, there are no court cases that provide guidance. Therefore, the Department cannot provide assurance that the proposed credit would survive a court challenge by an out-of-state business.

Other Bills

House Bill 811 is identical to this bill.

House Bill 154 and **Senate Bill 49** would modify the corporate apportionment formula by allowing retail companies to use a similar single factor apportionment method based on sales to determine their Virginia taxable income.

cc : Secretary of Finance