DEPARTMENT OF TAXATION
2015 Fiscal Impact Statement

1. Patron Glenn R. Davis

2. Bill Number HB 2233

House of Origin:

X **Introduced**

_____ **Substitute**

_____ **Engrossed**

Second House:

_____ **In Committee**

_____ **Substitute**

_____ **Enrolled**

3. Committee House Finance

4. Title Corporate Income Tax; Working Group to Evaluate Market-Based Sourcing.

5. Summary/Purpose:

This bill would direct the Tax Commissioner to convene a working group to examine (i) existing laws concerning the allocation of sales of nontangible personal property for purposes of the corporate income tax and (ii) the desirability and feasibility of adopting a market-based sourcing model. The Tax Commissioner would be required to report the findings and any recommendations of the working group to the Chairmen of the House Committee on Finance and the Senate Committee on Finance by December 1, 2015.

The effective date of this bill is not specified.

6. Budget amendment necessary: No.

7. No Fiscal Impact.

8. Fiscal implications:

<u>Administrative Costs</u>

The Department of Taxation ("the Department") considers implementation of this bill as routine, and does not require additional funding.

<u>Revenue Impact</u>

This bill would have no impact on revenues.

9. Specific agency or political subdivisions affected:

Department of Taxation

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.

In 2010 JLARC published "Review of Virginia's Corporate Income Tax Structure" (2010 H. Doc 3). Market-based sourcing was one of the alternatives discussed in the report. JLARC estimated that as much as $248 million additional revenue might eventually be generated after market-based sourcing was fully phased in. However, further discussion indicated that other policy changes would also need to be made, and there was substantial doubt that the full $248 million could be realized. In fact, In the initial years JLARC estimated that there would be a revenue loss.

Since the JLARC report four bills have been introduced to adopt market-based sourcing:

- House Bill 1604 (2011) would have adopted market-based sourcing and dedicate revenue generated by the bill to the Highway Maintenance and Operating Fund.

- Senate Bill 1006 (2011) would have adopted market-based sourcing.
- House Bill 2253 (2013) would have adopted market-based sourcing as part of an omnibus bill revising rates and tax preferences for several state and local taxes.
- House Bill 442 (2014) would have adopted market-based sourcing.

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.

The **District of Columbia** adopted market-based sourcing effective for taxable years beginning after December 31, 2014. Services will be sourced based on the location of service delivery. There are detailed rules for other types of income. If a sale cannot be assigned to a state based on the detailed rules, or the taxpayer is not taxable in the state where the sale is assigned, then the sale will be thrown out of the numerator and denominator.

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 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 sources sales of services to Illinois if the services are received in Illinois, effective for taxable years ending on or after December 31, 2008. 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 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 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 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.

Massachusetts law states that o include service receipts in the numerator
of the sales factor to the extent the service is delivered to a location in Massachusetts. If taxpayers cannot determine or reasonably approximate the location where a service is delivered, its sales will be thrown out of the numerator and denominator. Sales will also be thrown out if the sale would be assigned to a state in which the taxpayer is not taxable.

Massachusetts issued lengthy and complex draft regulations, and revised them in November 2014.

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 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.

Multistate Tax Commission ("MTC"): The MTC amended its version of the Uniform Division of Income For Tax Purposes Act to provide that services and intangibles would sourced to the state in which the taxpayers market for the sale exists. In the case of services, a taxpayer's market for sales is in the state "if and to the extent the service is delivered to a location in the state." Taxpayers may make reasonable approximations if sufficient data is not available. No further guidance is available. The provisions have no effect unless one or more member states of the MTC enact conforming laws.

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. This rule applies for purposes of the Ohio franchise tax. 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 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 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.

<u>Proposal</u>

The bill would require the Tax Commissioner to convene a working group to study the desirability and feasibility of amending existing law that sources sale of other than tangible personal property based on costs of performance to adopt a market-based sourcing approach to sales and the desirability and feasibility of adopting a bifurcated approach to sales that would allow some businesses to use a market-based sourcing approach and other businesses with significant property and payroll in the Commonwealth to continue to use the existing model. Any recommendation would include an estimate of the potential fiscal impact on the Commonwealth.

The working group would consist of telecommunications providers, data centers, other technology service providers and any other entity as the Tax Commissioner deems necessary. The working group may, at the Tax Commissioner's discretion, include out-of-state businesses with a significant portion of sales in the Commonwealth.

The Tax Commissioner would be required to provide a report of the working group and any recommendations to the Chairmen of the House Committee on Finance and the Senate Committee on Finance by December 1, 2015.

cc : Secretary of Finance

Date: 1/27/2015 JPJ
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