DEPARTMENT OF TAXATION
2018 Fiscal Impact Statement

1. Patron Glenn R. Davis

2. Bill Number HB 798
House of Origin:
_____ **Introduced**
_____ **Substitute**
_____ **Engrossed**

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

3. Committee Passed House and Senate

4. Title Income tax; apportionment of sales for debt buyers

5. Summary/Purpose:

This bill would require debt buyers to apportion their Virginia taxable income using a single factor method of apportionment based on sales. This bill would provide that, for debt buyers, only money recovered on debt that a debt buyer collected from a person who is a resident of Virginia or an entity that has its commercial domicile in Virginia would be apportioned to Virginia for income tax purposes.

This bill would also provide that, for debt buyers, sales other than sales of tangible personal property are in Virginia if they consist of money recovered on debt that a debt buyer collected from a person who is a resident of Virginia or an entity that has its commercial domicile in Virginia. Such rule would apply regardless of the location of a debt buyer's business.

This bill would be effective for taxable years beginning on and after January 1, 2019.

6. Budget amendment necessary: No.

7. Fiscal Impact Estimates are: Not available. (See Line 8.)

8. Fiscal implications:

Administrative Costs

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

Revenue Impact

This bill would have an unknown negative General Fund revenue impact beginning in Fiscal Year 2019. Generally, this bill would reduce the amount of Virginia income tax collected from debt buyers headquartered in Virginia while increasing the amount of Virginia income tax collected from debt buyers headquartered outside Virginia. Because the Department does not have sufficient information regarding out-of-state debt buyers, the net impact of this bill is unknown.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Virginia's Methods of Apportionment

Statutory Method of Apportionment

Virginia generally requires the Virginia taxable income of a multistate corporation to be apportioned to Virginia by multiplying the 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. The property factor is a fraction that consists of the average value of the corporation's real and tangible personal property owned or rented and used in Virginia over the like property located everywhere. The payroll factor is a fraction, the numerator being the total amount of compensation paid or accrued within Virginia during the taxable year by a taxpayer, and the denominator being the total compensation paid or accrued everywhere during the taxable year. 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.

Modified Method of Apportionment for Manufacturing Companies

During the 2009 Session, the General Assembly enacted legislation (House Bill 2437 (2009 *Acts of Assembly*, Chapter 821)) that allows manufacturing companies to elect whether to apportion Virginia taxable income using the statutory method of apportionment or using a single sales factor method of apportionment. This modification was phased in as follows:

- For taxable years beginning on or after July 1, 2011, but before July 1, 2013, qualifying corporations could elect to use a triple-weighted sales factor;
- For taxable years beginning on or after July 1, 2013, but before July 1, 2014, qualifying corporations could elect to use a quadruple-weighted sales factor; and
- For taxable years beginning on or after July 1, 2014, and thereafter, qualifying corporations may elect to use the single sales factor method to apportion Virginia taxable income.

A manufacturing company that elects to use the modified method of apportionment will be subject to additional taxes if such manufacturing company's average annual number of full-time employees for the first three taxable years that it used the modified method of apportionment is less than 90 percent of its base year employment, or if the average wages of the manufacturing company's full-time employees, as certified by the manufacturing company, is not greater than the lower of the state or local average weekly wage for its industry. "Base year employment" is defined as the average number of full-time employees employed by the manufacturing company in Virginia in the taxable year that ended immediately prior to the first taxable year in which the manufacturing company used the modified method of apportionment for manufacturing companies.

Modified Method of Apportionment for Retail Companies

During the 2012 Session, the General Assembly enacted legislation (House Bill 154 and Senate Bill 49 (2012 *Acts of Assembly*, Chapters 86 and 666)) that requires certain retail companies to apportion Virginia taxable income using a single sales factor method of apportionment. This modification was phased in as follows:

- For taxable years beginning on or after July 1, 2012, but before July 1, 2014, such corporations were required to use a triple-weighted sales factor;
- For taxable years beginning on or after July 1, 2014, but before July 1, 2015, such corporations were required to use a quadruple-weighted sales factor; and

For taxable years beginning on or after July 1, 2015, and thereafter, such corporations are required to use the single sales factor method to apportion Virginia taxable income.

Modified Method of Apportionment for Certain Enterprise Data Center Operations

During the 2015 Session, the General Assembly enacted legislation (House Bill 2162 and Senate Bill 1142 (2015 *Acts of Assembly*, Chapters 237 and 92)) that requires a taxpayer with an enterprise data center operation to apportion Virginia taxable income using single factor apportionment based on sales if such taxpayer enters into a memorandum of understanding with the Virginia Economic Development Partnership on or after July 1, 2015, to make a new capital investment of at least $150 million in an enterprise data center in Virginia on or after July 1, 2015. The modified method of apportionment applies beginning with the taxable year for which the Virginia Economic Development Partnership provides a written certification to such taxpayer that the new capital investment has been completed. The modification is being phased in as follows:

- From July 1, 2016 until July 1, 2017, qualifying corporations are required to use a quadruple-weighted sales factor; and
- From July 1, 2017, and thereafter, qualifying corporations are required to use the single sales factor method to apportion Virginia taxable income.

Alternative Method of Apportionment

If any corporation believes that the statutorily prescribed method of apportionment has operated or will operate as to subject it to taxation on a greater portion of its Virginia taxable income than is reasonably attributable to business or sources within Virginia, then it may submit a statement of objections to the Department and detail an alternative method of apportionment that it believes to be proper under the circumstances. If the Department concludes that the statutorily prescribed method of apportionment is inapplicable or inequitable, then it shall redetermine the corporation's taxable income by another method that best assigns to Virginia the portion of the income reasonably attributable to business and sources within Virginia. The amount assigned through an alternative method of apportionment may never exceed the amount that would have been assigned using the statutorily prescribed method.

The Department will not grant permission to use an alternative method of apportionment unless it determines that (a) the statutorily prescribed method of apportionment is inapplicable because it produces an unconstitutional result under the taxpayer's particular facts and circumstances; or (b) the statutorily prescribed method of apportionment is inequitable because (i) it results in double taxation of the income, or a class of income, of the taxpayer; and (ii) the inequity is attributable to Virginia, rather than to the fact that some other state has a unique method of allocation and apportionment.

Primary Methods of Apportionment in Other States

Twelve out of the 45 jurisdictions that impose a corporate income tax generally use a method of apportionment that is similar to Virginia's double-weighted sales factor formula. Seven jurisdictions generally utilize a method of apportionment that is similar to Virginia's, but do not double weight the sales factor. Tennessee generally employs a statutory method of apportionment that is similar to Virginia's, but triple weights the sales factor.

Three-Factor Methods of Apportionment (as of January 2017)		
Three-Factor, Evenly Weighted Factors	**Three-Factor, Double-Weighted Sales**	**Three-Factor, Triple-Weighted Sales**
Alaska Hawaii Kansas Missouri Montana North Dakota Oklahoma	Alabama Arkansas Arizona Florida Idaho Kentucky Massachusetts Maryland New Hampshire Virginia Vermont West Virginia	Tennessee

Twenty-five of the 45 jurisdictions that impose a corporate income tax primarily use the single sales factor method of apportionment, are currently phasing-in the use of such method, or will use the method for Taxable Year 2018 and thereafter. Mississippi uses a variety of industry specific methods of apportionment, but requires the use of the single sales factor method of apportionment if no specific formula is specified. In addition, Texas uses the single sales factor method of apportionment for its gross receipts tax. Therefore, 26 jurisdictions are considered to be single sales factor method of apportionment jurisdictions. Connecticut, Delaware, and North Carolina are the most recent states to enact the single sales factor method of apportionment.

Single Sales Factor Jurisdictions (as of January 2017)	
California	Minnesota
Colorado	Nebraska
Connecticut	New Jersey
Delaware	New Mexico
District of Columbia	New York
Georgia	North Carolina
Illinois	Oregon
Indiana	Pennsylvania
Iowa	Rhode Island
Louisiana	South Carolina
Maine	Texas
Michigan	Utah
Mississippi	Wisconsin

Determining the Sales Factor for Purposes of Apportionment

Virginia's Cost of Performance Method

For Virginia apportionment purposes, sales of tangible personal property are deemed in Virginia if the tangible personal property is delivered to a location in Virginia. In contrast, sales, other than sales of tangible personal property, are deemed in Virginia if:

- The income-producing activity is performed in Virginia; or
- The income-producing activity is performed both in and outside of Virginia and a greater proportion of the income producing activity is performed in Virginia than in any other state, based on costs of performance ("the cost of performance method").

An "income-producing activity" is an act or acts directly engaged in by the taxpayer for the ultimate purpose of producing a sale subject to apportionment. "Cost of performance" is defined as the cost of all activities directly performed by the taxpayer for the ultimate purpose of producing the sale to be apportioned.

When it is applied, Virginia's cost of performance method acts as an "all-or-nothing" sourcing rule because it sources a particular sale completely to one jurisdiction to the exclusion of all other jurisdictions. Under Virginia's cost of performance method, a sale may not be sourced to more than one jurisdiction.

Cost of Performance Method in Other Jurisdictions

Twenty-four out of the 49 jurisdictions that impose a corporate income tax or a gross receipts tax on businesses use the cost of performance method. Two of these jurisdictions (Arizona and Missouri) generally require taxpayers to use the cost of performance method, but allow certain taxpayers the option of using market-based sourcing. In addition, Texas applies the cost of performance method to its gross receipts tax. Therefore, 24 jurisdictions are considered to be cost of performance method jurisdictions.

Cost of Performance Jurisdictions (as of January 2018)	
Alaska	New Hampshire
Arizona	New Jersey
Arkansas	New Mexico
Colorado	North Carolina
Delaware	North Dakota
Florida	South Carolina
Hawaii	Texas
Idaho	Vermont
Indiana	Virginia
Kansas	West Virginia
Kentucky	
Mississippi	
Missouri	

Market-Based Sourcing

Until recently, the majority of jurisdictions utilized the cost of performance method to source sales of intangible property and services. However, the trend in state corporate income taxation over the past ten years has been for jurisdictions to adopt market-based sourcing. The term "market-based sourcing" encompasses several variations of an apportionment method that sources a sale to the jurisdiction in which the corporation's market for such sale is located. When providing guidance regarding how a corporation is to determine its market for sales, other than sales of tangible personal property, market-based sourcing jurisdictions have distinguished between sales of intangible property and services. All market-based sourcing jurisdictions generally source sales of intangible property to the jurisdiction where such property is used. Market-based sourcing jurisdictions have developed four general methods for sourcing sales of services:

- Where the benefit of the service is received by the customer;
- Where the service is delivered;
- Where the service is received;
- Where the customer is located; or
- Where the service is used.

Of the 45 jurisdictions that impose a corporate income tax, 25 jurisdictions have adopted market-based sourcing. The application of market-based sourcing is mandatory in 23 of these jurisdictions. Only Arizona and Missouri allow certain corporations to elect whether to apply either the cost of performance method or market-based sourcing. Ohio, Nevada, and Washington apply mandatory versions of market-based sourcing to their respective taxes on gross receipts that are imposed in lieu of a corporate income tax. Therefore, 28 jurisdictions are considered to be market-based sourcing jurisdictions. Montana and Oregon are the most recent states to adopt market-based sourcing.

Market-Based Sourcing Jurisdictions (as of January 2018)	
Alabama	Montana
Arizona	Nebraska
California	Nevada
Connecticut	New York
District of Columbia	Ohio
Georgia	Oklahoma
Illinois	Oregon
Iowa	Pennsylvania
Louisiana	Rhode Island
Maine	Tennessee
Maryland	Utah
Massachusetts	Washington
Michigan	Wisconsin
Minnesota	
Missouri	

Virginia's Study on Market-Based Sourcing

During the 2015 Session, the General Assembly considered House Bill 2233, which would have required the Department to form a working group to review and make recommendations concerning the desirability and feasibility of changing Virginia's method of sourcing a corporation's sales, other than sales of tangible personal property, to either market-based sourcing or to a bifurcated method that utilizes both the cost of performance method and market-based sourcing. Although, the General Assembly did not enact this legislation, the Chairman of the House Finance Committee requested that the Department form a working group of interested parties to:

- Study the desirability and feasibility of Virginia changing its method of sourcing a corporation's sales, other than sales of tangible personal property, from the cost of performance method to market-based sourcing;
- Study the desirability and feasibility of adopting a bifurcated approach to sourcing a corporation's sales that would allow certain corporations to elect to use market-based sourcing in lieu of the cost of performance method;
- Provide recommendations regarding the desirability and feasibility of implementing such changes; and
- Provide draft legislation based on the Department's recommendations for potential consideration by the General Assembly.

The results of such report were inconclusive, primarily because the Department does not currently have access to the data necessary to provide a concrete revenue estimate. To develop a definitive estimate regarding the impact of enacting market-based sourcing, it is critical for the Department to have data from corporations regarding the amount of sales that are sales of intangible property or services, and where such sales would be sourced under a particular version of market-based sourcing. Corporations do not currently report such information to the Department, and the Department does not have access to any other source of data that would let it ascertain such information.

Proposed Legislation

This bill would require debt buyers to apportion their Virginia taxable income using a single factor method of apportionment based on sales. This bill would provide that, for debt buyers, only money recovered on debt that a debt buyer collected from a person who is a resident of Virginia or an entity that has its commercial domicile in Virginia would be apportioned to Virginia for income tax purposes.

This bill would define "debt buyer" as an entity and its affiliated entities that purchase nonperforming loans from unaffiliated commercial entities that are in:

- Default for at least 120 days; or
- Bankruptcy proceedings.

The term "debt buyer" would not include an entity that provides debt collection services for unaffiliated entities.

This bill would provide that, for debt buyers, sales, other than sales of tangible personal property, are in Virginia if they consist of money recovered on debt that a debt buyer collected from a person who is a resident of the Commonwealth or an entity that has its commercial domicile in the Commonwealth. Such rule would apply regardless of the location of a debt buyer's business.

The corporate income tax on sales subject to these provisions would be imposed to the maximum extent permitted under the Virginia and United States Constitutions, and federal law. For the collection of such taxes on such sales, this bill would provide that it is the intent of the General Assembly that the Tax Commissioner and the Department assert the taxpayer’s nexus with Virginia to the maximum extent permitted under the Virginia and United States Constitutions, and federal law.

If the information necessary for the taxpayer to determine whether such a sale is in Virginia, the taxpayer would be permitted to estimate the dollar value or portion of such sale in Virginia, provided that the taxpayer can demonstrate to the satisfaction of the Tax Commissioner that:

- The estimate has been undertaken in good faith;
- The estimate is a reasonable approximation of the dollar value or portion of such sale in Virginia; and
- In using an estimate, the taxpayer did not have as a principal purpose the avoidance of any corporate income taxes due.

The Department would be permitted to implement procedures for obtaining its approval to use an estimate. The Department would be required to adopt remedies and corrective procedures for cases in which the Department has determined that the sourcing rules for sales other than sales of tangible personal property have been abused by the taxpayer, which may include reliance on the location of income-producing activity and direct costs of performance.

The Department would be required to develop and make publicly available guidelines implementing the provisions of this bill. In developing such guidelines, the Department would not be subject to the provisions of the Administrative Process Act for guidelines promulgated on or before December 31, 2021, but would be required to cooperate with and seek the counsel of interested groups and would not be permitted to promulgate any guidelines, preliminary or final, without first seeking such counsel and conducting a public hearing. Preliminary guidelines would be required to be promulgated and made publicly available no later than December 31, 2018, and final guidelines would be required to be promulgated and made publicly available no later than December 31, 2019. Subsequent to December 31, 2019, the guidelines would be required to next be updated by December 31, 2021, under the same procedures as required for the preliminary and final guidelines. After December 31, 2021, the guidelines would be required to be subject to the Administrative Process Act and accorded the weight of regulations.

This bill would be effective for taxable years beginning on and after January 1, 2019

cc: Secretary of Finance

Date: 3/5/2018 JJS
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