

SENATE OF VIRGINIA

Senate Finance Committee

Corporate Income Tax: Overview of Market-Based Sourcing

June 23, 2016



What is Market-Based Sourcing?

- “Market-based sourcing” refers to methods of apportioning income for purposes of the state corporate income tax that, as a general rule, sources sales of services and intangibles to the jurisdiction where the corporation’s market for such sales is located.
- Market-based sourcing is an alternative to the current “cost of performance” method.



Trend Toward State Adoption

- A clear trend toward state adoption has emerged: 23 states and D.C. now use some form of market-based sourcing.
- States recognize that MBS reduces the tax burden on service-providers that have a large physical presence in the state — a way to “export” the tax burden out-of-state and potentially capture more revenue.
- Several states have recently considered adopting MBS, including: Indiana, Kentucky, New Mexico, North Carolina, Oregon and **Virginia**.
- A 2015 bill in North Carolina requires multistate corporations with taxable income of \$10 million or more to file an informational report.
- Language in SB 30 would have required multi-state corporate taxpayers with VA taxable income of \$50 million or more to file an informational return using the market-based sourcing method (not adopted in the final budget).



Corporate Apportionment

- A corporation that does business in more than one state must apportion income among the states where it does business to determine the amount of taxes due in each state.

EXAMPLE

Corporate income	\$10 million
VA apportionment %	2%
Income subject to VA income tax	\$200,000

- Most multi-state corporations that conduct business in Virginia are required to use the statutory three-factor apportionment method to determine the amount of income that is subject to Virginia corporate income tax.



Three-Factor Apportionment Method



$$\left[\frac{Va \text{ Property}}{\text{Property Everywhere}} + \frac{Va \text{ Payroll}}{\text{Payroll Everywhere}} + \left(2 \times \frac{Va \text{ Sales}}{\text{Sales Everywhere}} \right) \right] \div 4$$



Corporate Apportionment

How Sales Are Assigned Currently:

- Sales of tangible personal property (“goods”) are sourced to Virginia if the goods are delivered to a location in Virginia.
- Sales of services or intangibles are sourced to Virginia if the greater portion of income producing activity is in Virginia (i.e., the “cost of performance”).



Cost of Performance

- Of the 45 jurisdictions that impose a corporate income tax, 25 use the cost of performance method.
 - Includes Arizona and Missouri which also allow certain taxpayers the option of using market-based sourcing.
- Texas has no corporate income tax but applies the cost of performance method to its gross receipts tax.
- In 17 states including Virginia, the cost of performance method is an all-or-nothing determination.
- In nine states, a proportionate method is used.
- The method dates back to UDITPA, adopted by states beginning in the mid-1960's.



Market-Based Sourcing

- Under market-based sourcing, sales are sourced to a state if the taxpayer's market for the service is in that state.
 - Consistent with how sales of tangible property are assigned.
- Intangibles (licenses, leases, patents, trademarks, etc.) are typically sourced to the location of use.
- An increasing number of states are abandoning cost of performance in favor of market-based sourcing.
- 23 states and the District of Columbia now utilize some form of market-based sourcing.



Potential Fiscal Impact

- Definitive estimates of revenue impact are not available.
- Taxpayers are not required to provide the kind of information needed to calculate the impact of changing to market-based sourcing.
- Three groups of taxpayers would be impacted:
 - Service-providers with a large physical presence in Virginia that sell services or intangibles outside of Virginia would see a reduction in tax liability (negative revenue impact).
 - Some existing Virginia taxpayers would see their tax liability increase if they have a relatively small physical presence but a large amount of sales in the Commonwealth (positive revenue impact).
 - Some out-of-state corporations that do not currently file Virginia income tax returns may be required to file and pay taxes in Virginia if they have sales of services or intangibles in Virginia (positive revenue impact).*

* *If Virginia changes current administrative policy and makes sales of services and intangibles by out-of-state corporations subject to income tax.*

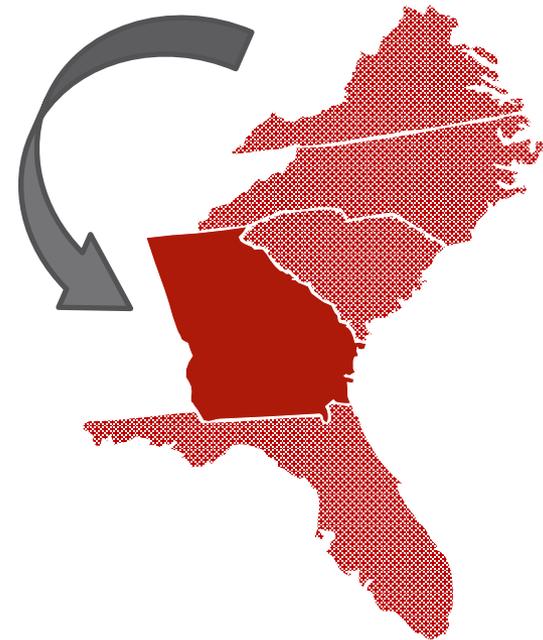


Virginia Companies May Face Double Taxation

A Virginia corporation may be taxed twice currently under Cost of Performance if...

- It sells services into a market-based sourcing state, and
- The greater portion of income generating activity takes place in Virginia.
- Sales are sourced to both:
 - Virginia (for VA Corporate Income Tax), and
 - Georgia (for GA Corporate Income Tax).

Sale of Services



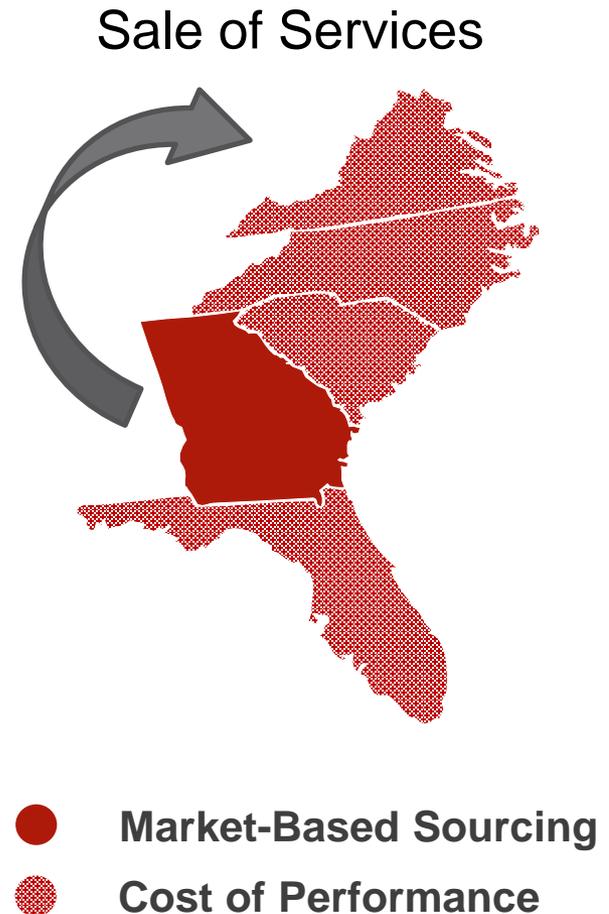
- Market-Based Sourcing
- Cost of Performance



Virginia Loses Tax Revenue

No corporate income tax is collected on the sale when ...

- A company in a market-based sourcing state sells services into Virginia, which is a cost of performance state.



Practical Concerns

- For purposes of sourcing sales of services, the definition of “market” varies among states.
 - Where the benefit of the service is received (12 states).
 - Where the service is received (three states).
 - Where the service is delivered (four states and DC).
 - Where the customer is located (three states).
 - Where the service is used (one state).
- Other terms are ambiguous or used inconsistently.
- Implementation requires additional statutory and/or regulatory rules that provide guidance. These rules tend to be lengthy and complex.
- Fiscal impact is unknown.



Summary

- Market-based sourcing is an alternative to the current “cost of performance” method for determining corporate income tax liability for companies selling services and intangibles.
- A clear trend toward state adoption has emerged: 24 jurisdictions now use some form of market-based sourcing.
- May improve Virginia’s competitiveness by removing the disincentive for large service-providers to locate in the Commonwealth.
- Market-based sourcing may increase revenues (*but not immediately*).
- Rules and regulations governing market-based sourcing are complicated and inconsistent across states.
- Some Virginia taxpayers would see their tax liability increase under market-based sourcing while others would see a reduction.



Looking Ahead

- Department of Taxation to issue report on the Study of Market-Based Sourcing.
- Additional proposals to adopt market-based sourcing are likely.
- Should the General Assembly impose an informational return requirement?
- Should it be adopted, to what extent should the General Assembly prescribe the method and rules governing market-based sourcing?

