

## **Market-Based Sourcing Working Group Meeting**

**June 4, 2015**

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# Meeting Agenda

# *Meeting Agenda*

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- Explanation of Apportionment and the Cost of Performance Method
- Overview of Market-Based Sourcing
- Fiscal Estimates
- Plan for the Report
- Questions and Open Discussion

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# Purpose of this Meeting

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### **Request to Study Market-Based Sourcing**

- The Chairman of the Virginia House Finance Committee requested that the Department convene a working group to study market-based sourcing, and publish a report regarding such study.
- The working group is required to include tax practitioners, representatives from telecommunications providers, data centers, cyber technology entities, other technology service providers, out-of-state businesses with a significant portion of their sales in Virginia, in-state businesses with a significant portion of their sales outside Virginia, and other principal stakeholders.

## *Purpose of this Meeting*

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### **Study and Report Requirements**

- Study the feasibility and desirability of changing Virginia's method of apportionment to market-based sourcing.
- Study the feasibility and desirability of changing Virginia's method of apportionment to a bifurcated method.
  - Under such method, all companies would be required to use market-based sourcing unless they exceed certain thresholds related to, but not limited to, property and payroll.
  - Any companies exceeding such thresholds would be allowed to elect to use market-based sourcing;
- Submit a report to the House Finance Committee regarding the study that is required to contain:
  - Recommendations regarding the results of the study and a draft bill.

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# Conflict of Interest Policy

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# Background: Explanation of Apportionment

# *Virginia's Statutory Apportionment Method*

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## **Three-Factor Apportionment Method**

- Most corporations that conduct business both within and without Virginia are required to use Virginia's statutory method of apportionment to determine the amount of income that is subject to Virginia income taxation.
- The statutory method of apportionment consists of three factors:
  - Property;
  - Payroll; and
  - Sales (double weighted)

# *Virginia's Statutory Apportionment Method*

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## **Computing the Factors**

- **Property**
  - The value of property in Virginia divided by the value of property everywhere.
- **Payroll**
  - The compensation paid to employees in Virginia divided by compensation paid everywhere.
- **Sales**
  - Sales (gross receipts) made in Virginia divided by sales everywhere (the sales factor is double-weighted).

# *Virginia's Statutory Apportionment Method*

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## **Determining How Sales Are Assigned**

- Sales of tangible personal property are in Virginia if delivered to a location in Virginia.
- Sales of tangible personal property are outside Virginia if delivered to a location outside of Virginia.
- Sales of services or intangible property are in Virginia if the greater portion of income producing activity (measured by costs of performance) is in Virginia.
- Sales of services or intangible property are outside Virginia if the greater portion of income producing activity (measured by costs of performance) is outside of Virginia.

# *Virginia's Statutory Apportionment Method*

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## **Cost of Performance Method**

- “Costs of performance” is an all-or-nothing determination for purposes of sourcing sales of services and intangible property.
  - For example, a company with facilities in all 50 states and only 5% of its costs in Virginia would assign 100% of its sales of services and intangible property to Virginia if no other state had more than 5%.
  - The income producing activity and costs of performance are deemed performed at the location of the corporation’s real and tangible property and its employees.

# *Virginia's Statutory Apportionment Method*

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## **Origin of Virginia's Use of Cost of Performance**

- Virginia's statutory definition of the sales factor for services and intangible property is virtually identical to § 17 of the Uniform Division of Income for Tax Purposes Act ("UDITPA")
- Virginia's regulatory definition of income producing activity and costs of performance is similar to regulations promulgated by the Multistate Tax Commission and many states.
- Until recently, the majority of states used the cost of performance method.

# *Virginia's Statutory Apportionment Method*

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## **Other Virginia Methods of Apportionment**

- Since 1972 the General Assembly has enacted several special methods for specific industries:
  - Financial corporations (1976, amended 1981)
  - Construction contractors (1976)
  - Railway companies (1979)
  - Manufacturing companies (2009)
  - Retail companies (2012)
- Virginia also allows companies to request an alternative method of apportionment in situations where the statutory method is inapplicable or inequitable.

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# Market-Based Sourcing

# *Overview of Market-Based Sourcing*

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## **Market-Based Sourcing**

- An alternative method for determining the sales factor for sales other than sales of tangible personal property (services and intangible property).
- Under market-based sourcing, sales of services and intangible property are sourced to a state if the taxpayer's market for such sales is in that state.
  - The method for determining a taxpayer's market for a sale of services or intangible property varies between the states.
- Georgia, Iowa, Maryland, and Minnesota were the first states to adopt market-based sourcing.

# *Market-Based Sourcing Methods*

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## **Market for Sales of Services**

- There are four differing methods states have adopted for determining a taxpayer's market for sales of services.
  - Where the benefit of the service is received.
  - Where the service is received.
  - Where the service is delivered.
  - Where the customer is located.
- The method adopted in the Multistate Tax Commission's model statute sources sales based on where the service is delivered.
- The actual rules adopted by each state are much more complicated.

# Market-Based Sourcing Methods

Benefit of the Service is Received	Service is Received	Service is Delivered	Customer is Located
Arizona California Georgia Iowa Michigan Missouri New York Ohio Rhode Island Utah Washington Wisconsin	Illinois Maine Minnesota	Alabama District of Columbia Massachusetts New York* Pennsylvania Tennessee	Maryland Nebraska Oklahoma

\*If where the benefit was received cannot be determined.

# *Market-Based Sourcing Methods*

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## **Market for Sales of Intangible Property**

- General rule is to source intangible property to a state to the extent such property was used in that state, but the specific rules for each state may be much more complicated.
- Some states have specific rules for sourcing certain types of intangible property and that allow a taxpayer to reasonably approximate where to source sales of intangible property when the statutory method is inadequate (see Massachusetts).
- Many states exclude sales of intangible property from the sales factor to some degree (see Missouri).
- Some states utilize market-based sourcing for services, but the cost of performance method for intangible property (see Pennsylvania).

## *Market-Based Sourcing Methods*

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- The rules for sourcing services and intangible property may be much more complicated.
- For example, Massachusetts permits a taxpayer to reasonably approximate the state to which a service or item of intangible property should be sourced when the state where the service or item of intangible property was delivered cannot be determined.
- Massachusetts has specific rules for reasonably approximating services and intangible property including, but not limited to:
  - In-person services;
  - Transportation and delivery services;
  - Professional services;
  - Services delivered by physical means;
  - A license or sale of software; and
  - A sale or license of digital goods or services.

# *Trend Toward Market-Based Sourcing*

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## **Market-Based Sourcing in Other States**

- Recently, a number of states have changed their method of apportionment to market-based sourcing.
- 22 states and the District of Columbia now utilize some form of market-based sourcing.
- Tennessee and Missouri recently enacted market-based sourcing.
- The Multistate Tax Commission recently adopted a model statute incorporating market-based sourcing, and is currently working on regulations regarding such model statute.

# *Trend Toward Market-Based Sourcing*

## Market-Based Sourcing States

Alabama	Missouri
Arizona	Nebraska
California	New York
District of Columbia	Ohio
Georgia	Oklahoma
Illinois	Pennsylvania
Iowa	Rhode Island
Maine	Tennessee
Maryland	Utah
Massachusetts	Washington
Michigan	Wisconsin
Minnesota	

## *VA Market-Based Sourcing Legislation*

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- Over the past five years, a number of bills have been considered by the General Assembly that would have changed Virginia's method from cost of performance to market-based sourcing:
  - 2011 House Bill 1604
  - 2011 Senate Bill 1006
  - 2013 House Bill 2253
  - 2014 House Bill 442
- 2015 House Bill 2233 would have required a study regarding market-based sourcing similar to the current study.

## *VA Market-Based Sourcing Legislation*

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- All of the Virginia market-based sourcing legislation proposed in 2011, 2013, and 2014 would have generally required a taxpayer to source sales, other than sales of tangible personal property, to Virginia if the taxpayer exploited the Virginia market to the extent that any benefit or use of such sale is to a person or location in Virginia.
- However, these bills would have required the Department to promulgate guidelines setting forth the detailed rules of how market-based sourcing would apply to such sales.

## *Additional Policy Changes*

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### **Extension of 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 the taxpayer's representative for the sale of tangible personal property.
- Virginia has historically extended the protection afforded under P.L. 86-272 to sales of services and intangible property.
- Virginia would need to amend this long-standing policy if it adopts market-based sourcing to avoid a significant negative revenue impact.

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# Previous Fiscal Estimates

## *2010 JLARC Study on Market-Based Sourcing*

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- 2009 House Joint Resolution 681 required JLARC to study Virginia's corporate income tax system.
- As part of that study, JLARC analyzed the impact market-based sourcing would have on corporations that file and pay the Virginia income tax.
- JLARC's study consisted of two components:
  - The impact market-based sourcing would have on corporations that file and pay the Virginia income tax; and
  - The impact market-based sourcing would have on corporations that do not pay the Virginia income tax under cost of performance, but would pay under market-based sourcing.

## *2010 JLARC Study: Current VA Taxpayers*

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- JLARC reported a negative revenue impact of \$16.6 million from corporations that file the Virginia income tax return under cost of performance.
- Assumptions in the JLARC report:
  - Taxable Year 2006 sample data of 857 corporate income tax returns.
  - Corporations sell both tangible goods and services.
  - New estimated sales factor under MBS was based on:
    - Virginia proportion of U.S GDP for services in 2009 (3.08 percent).
    - Current physical presence in Virginia - Higher sales factor for corporate filers with high property and high payroll factors.
  - Same logic was applied to all corporations regardless the nature of their business.

# 2010 JLARC Study: Current VA Taxpayers

2010 JLARC Study on Current VA Taxpayers - Estimate Examples				
	Small Presence in VA		High Presence in VA	
	Standard	MBS	Standard	MBS
Property	22.0%	22.0%	80.0%	80.0%
Payroll	1.0%	1.0%	87.0%	87.0%
Old Sales Factor	4.0%		92.0%	
Goods		2.1%		47.8%
Services		2.0%		20.3%
New MBS Sales Factor		4.1%		68.2%
Apportionment factor	7.8%	6.5%	87.8%	37.0%
<i>Virginia Proportion of U.S. GDP for Services 3.08%</i>				
<i>Share of Goods (52%) and Services (48%) in Virginia</i>				

## *2010 JLARC Study: New VA Taxpayers*

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- JLARC reported a positive revenue impact of \$171.5 million from such corporations that do not pay Virginia income tax under cost of performance, but would pay under market-based sourcing if those corporations are fully compliant.
- Assumptions in the JLARC report:
  - Estimate based on the Federal Taxable Income (FTI) attributable to Virginia.
  - No available data for this estimate.
  - Lack of information on tax planning and non-compliance that may result if market-based sourcing is adopted.

## *Market-Based Sourcing-Other MBS bills*

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- The same approach was used by the Department in its fiscal impact statements to estimate the revenue impact of enacting market-based sourcing.
- The estimates for such bills are as follows:
  - In 2011, the revenue loss for Senate Bill 1006 and House Bill 1604 was estimated at \$16.6 million.
  - In 2013, the revenue loss for House Bill 2253 was estimated at \$19.3 million and included financial corporations.
  - In 2014, the revenue loss for House Bill 442 was estimated at \$16.6 million and excluded financial corporations.
- In each of these estimates, it was assumed that the revenue gain attributable to out-of-state corporations is unknown given the lack of information. As a result, the revenue loss is provided only for the first two fiscal years.
- The compliance of out-of-state corporations, the volatility of the corporate income tax revenue, and guidelines could alter the estimate in the out years.
- For each of these bills, corporations would be required to use market-based sourcing to apportion services and intangible assets.

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# Methodology for the Working Group Estimate

## *Methodology for the Working Group Estimate*

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- The study will include two groups of taxpayers:
  - Virginia-based and out-of-state taxpayers that are currently filing a Virginia Corporate Income tax return.
  - Out-of-state taxpayers that are not currently filing a Virginia Corporate Income tax return.
- It is important to note that market-based sourcing would not affect:
  - Taxpayers selling Tangible Personal Property
  - Taxpayers already subject to a special apportionment method (e.g., financial corporations)
- Market-based sourcing will instead affect taxpayers that provide services and sell intangible property.

## *Data Limitations*

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- The Department of Taxation's corporate income tax return data is limited for purposes of analyzing market-based sourcing:
  - Although the corporate income tax return has data on each taxpayer's United States sales and sales in Virginia, there is no data available that breaks down whether a sale consisted of a sale of tangible goods, intangible property, or services.
  - The destination of sales of services or intangible property is not available.
  - Affiliates' primary activities are not listed.
  - There is no available data on out-of-state taxpayers that are not currently filing a Virginia corporate income tax return that would be required to file a Virginia corporate income tax return if market-based sourcing is adopted.
  - Because corporate income tax revenue is very volatile, the estimates for purposes of this study will be based on data from one taxable year. This makes it difficult to gauge taxpayers' behavior.

## *Market-Based Sourcing - Impact*

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- Market-based sourcing estimates are not available yet, as the Department is gathering data and determining its assumptions. However, the following examples illustrate the likely decrease and increase in the sales factor under MBS.
  - Virginia income tax revenues may be slightly reduced for corporations filing Virginia income tax returns with a small sales factor.
  - Virginia income tax revenues may be significantly reduced for corporations filing Virginia income tax returns with a higher sales factor.
  - Virginia income tax revenues may be increased for corporations filing Virginia income tax returns that currently have 0 sales factor.
  - Virginia income tax revenues may be increased for out-of-state corporations that are not currently filing Virginia corporate income tax returns.

# Examples of Potential Revenue Decrease

Examples of a Decrease in Corporate Income Tax Revenue				
	Small Presence in VA		High Presence in VA	
	Current Law	Market Based Sourcing	Current Law	Market Based Sourcing
Total Sales	\$600,000	\$600,000	\$600,000	\$600,000
VA Sales	\$24,000	\$15,600	\$552,000	\$15,600
Property factor	22%	22%	80%	80%
Payroll factor	1%	1%	87%	87%
<b>Sales Factor</b>	<b>4%</b>	<b>3%</b>	<b>92%</b>	<b>3%</b>
Apportionment factor (Double Weighted)	8%	7%	88%	43%
Virginia Taxable Income	\$100,000	\$100,000	\$100,000	\$100,000
Virginia Taxable Income Subject to Tax	\$7,750	\$7,050	\$87,750	\$43,050
<b>Virginia Income Tax</b>	<b>\$465</b>	<b>\$423</b>	<b>\$5,265</b>	<b>\$2,583</b>

*In this case, it is assumed that all sales are services and intangibles. VA income tax slightly decreased by 9% for a corporation with a small presence in VA whereas VA income tax significantly decreased by 51% for a corporation with a high presence in VA. The portion of services and intangibles goods delivered to Virginia is a key factor and may vary from one company to another.*

# Examples of Potential Revenue Increase

Examples of an Increase in Corporate Income Tax Revenue				
	Small Presence in VA with \$0 Sales in VA		Not filing in VA	
	Current Law	Market Based Sourcing	Current Law	Market Based Sourcing
Total Sales	\$600,000	\$600,000	\$600,000	\$600,000
VA Sales	\$0	\$15,600	\$0	\$15,600
Property factor	22%	22%	0%	0%
Payroll factor	1%	1%	0%	0%
<b>Sales Factor</b>	<b>0%</b>	<b>3%</b>	<b>0%</b>	<b>3%</b>
Apportionment factor (Double Weighted)	6%	7%	0%	1%
Virginia Taxable Income	\$100,000	\$100,000	\$0	\$100,000
Virginia Taxable Income Subject to Tax	\$5,750	\$7,050	\$0	\$1,300
Virginia Income Tax	\$345	\$423	\$0	\$78

*In this case, it is assumed that all sales are services and intangibles. In both cases, the MBS sales factor increased leading to an increase in corporate income tax revenue.*

## *Options for Bifurcated Methods*

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- For purposes of analyzing the bifurcated method of market-based, the Department proposes the following options:
  1. 50% of Services and Intangible Property as Cost of Performance and 50% of Services and Intangible Property as Market-Based Sourcing.
  2. Graduated Model (Arizona):
    - 85% of Services MBS/15% as COP;
    - 90% of Services MBS/10% as COP;
    - 95% of Services MBS/5% as COP;
    - 100% of Services MBS.
  3. Allow Certain Corporations to Elect Which Method of Apportionment to Use for Sourcing Services and Intangible Property.
    - Market-Based Sourcing would be the default method;
    - Corporations with property and payroll apportionment factors that exceed certain thresholds would be allowed to elect to use the cost of performance method.

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# Plan for the Report

# *Plan for the Report*

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## **Outline for the Report**

- Background information regarding the cost of performance method, market-based sourcing, and the trend toward market-based sourcing in other states.
- Fiscal impact and data analysis regarding market-based sourcing and the bifurcated method.
- Recommendations regarding the findings of the study.
- Draft legislation regarding market-based sourcing.

# *Plan for the Report*

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## **First Meeting**

- Please submit any comments you have regarding the report to the Department in writing by emailing such comments to Matthew Huntley at [tax-studies@tax.virginia.gov](mailto:tax-studies@tax.virginia.gov).

## **Draft Report**

- Will be published during Summer 2015.
- 60 days to submit comments to the Department in writing regarding the draft report.

## **Additional Meeting**

- We may hold an additional working group meeting after the publication of the draft report.

## **Final Report**

- Will be published in November of 2015

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# Questions and Open Discussion

# *Department of Taxation Contacts*

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- Mark Haskins, Director of Policy Development
- Stuart Carter, Chief Economist
- John Josephs, Lead Expert Policy Analyst
- Kristin Collins, Lead Tax Policy Analyst
- Aisha Yededji, Senior Economist
- Matthew Huntley, Tax Policy Analyst