

Single Sales Factor Election for Manufacturers Guidelines

Introduction

These guidelines provide guidance to manufacturing companies regarding the modification to Virginia's corporate apportionment formula for manufacturers under *Va. Code* § 58.1-422. Pursuant to Acts of Assembly, Chapter 821 (House Bill 2437), enacted by the 2009 General Assembly, the development and publication of these guidelines is exempt from the provisions of the Administrative Process Act (§ 2.2-4000 *et seq.*). These guidelines complement the Department's existing Corporate Apportionment Formula Regulations (23 *Virginia Administrative Code* ("VAC") 10-210-10, *et seq.*). To the extent that there is a conflict between the existing regulations and § 58.1-422, the provisions of § 58.1-422, as interpreted by these guidelines, supersede the existing regulations.

The Department has worked with affected manufacturers and other interested parties to develop these guidelines and rules. As necessary, additional information will be published and posted on the Department's website, at www.tax.virginia.gov.

Definitions

Terms used throughout these guidelines have the same meaning as those used for Corporate Income Tax, unless defined otherwise, as follows:

"Affiliated group" has the same meaning as provided in *Va. Code* § 58.1-3700.1.

"Base year employment" has the same meaning as provided in *Va. Code* § 58.1-422 D.

"Full-time employee" has the same meaning as provided in *Va. Code* § 58.1-422 D.

"Manufacturing company" has the same meaning as provided in *Va. Code* § 58.1-422 D. For purposes of these guidelines, "primarily engaged" means that either fifty percent or more of the gross receipts are derived from the sale of goods that are manufactured in Virginia, or fifty percent or more of the employees are engaged in manufacturing activities within Virginia.

"Pass-through entity" has the same meaning as provided in *Va. Code* § 58.1-390.1.

Overview of Modified Apportionment Method for Manufacturing Companies

During the 2009 Session, the Virginia General Assembly passed legislation (HB 2437) that modifies the corporate apportionment formula by allowing manufacturing companies to use a single factor apportionment based on sales, phased-in over three years, to determine their Virginia taxable income. A multistate manufacturing company is allowed to continue apportioning income using a three-factor formula consisting of property, payroll and double-weighted sales, as provided under *Va. Code* § 58.1-408, or elect a modified method of apportionment (hereinafter "modified apportionment

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method”), as provided under *Va. Code* § 58.1-422. The modified apportionment method election is phased-in as follows:

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

Once a manufacturing company elects the modified apportionment method, the method of apportionment may not be changed for three taxable years.

After the due date, as extended, of the return in which the election is made, the election may not be revoked for three taxable years. Therefore, a manufacturing company may not file an amended separate, consolidated or combined return to change its modified apportionment method election because it will not be able to meet the base year employment level or wage requirements in the second or third taxable year of the modified apportionment method election.

Modified Apportionment Method Formulas

For taxable years beginning on and after July 1, 2011, through June 30, 2013, a qualifying manufacturing company that apportions income using the triple-weighted sales factor will use the following apportionment formula:

$$\frac{\text{Property Factor} + \text{Payroll Factor} + 3(\text{Sales Factor})}{5}$$

For taxable years beginning on and after July 1, 2013, through June 30, 2014, a qualifying manufacturing company that apportions income using the quadruple-weighted sales factor will use the following apportionment formula:

$$\frac{\text{Property Factor} + \text{Payroll Factor} + 4(\text{Sales Factor})}{6}$$

For taxable years beginning on July 1, 2014, and thereafter, a qualifying manufacturing company that apportions income using the single sales factor method will use the following apportionment formula:

$$\frac{\text{Sales}_{VA}}{\text{Sales}_{\text{Everywhere}}}$$

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Example 1. A multistate manufacturing company's Virginia apportionment factors are as follows:

	<u>Property</u>	<u>Payroll</u>	<u>Sales</u>
Virginia	25,000	40,000	100,000
Everywhere	<u>100,000</u>	<u>120,000</u>	<u>1,000,000</u>
Percentage	25%	33.33%	10%

The manufacturing company decides to make the apportionment method election. Its Virginia taxable income would be apportioned as follows:

For taxable years beginning before July 1, 2011:

Under the standard three-factor formula with double-weighted sales, the apportionment factor is 19.58% ($[25\% + 33.33\% + 2(10\%)] / [3]$).

For taxable years beginning on and after July 1, 2011, through June 30, 2013:

The manufacturing company would use the triple-weighted sales factor apportionment method. The apportionment factor would be 17.76% ($[25\% + 33.33\% + 3(10\%)] / [5]$).

For taxable years beginning on and after July 1, 2013, through June 30, 2014:

The manufacturing company would use the quadruple-weighted sales factor apportionment method. The apportionment factor would be 16.39% ($[25\% + 33.33\% + 4(10\%)] / [6]$).

For taxable years beginning on and after July 1, 2014:

The manufacturing company would use the single sales factor apportionment method. The single sales factor only apportionment factor would be 10%.

A multistate manufacturing company that elects the modified apportionment method and files its income tax return on a calendar year basis must use the apportionment formula that is effective at the time of the election. The manufacturing company is prohibited from using two different apportionment methods in any calendar year in which the election is made.

Example 2. A multistate manufacturing company files its Virginia corporate income tax return on a calendar year basis, and elects the modified apportionment method in July 2011. The manufacturing company will use the regular double-weighted sales factor for its 2011 Virginia return. The modified apportionment method is effective for the manufacturing company's 2012 Virginia return, in which it will use the triple-weighted sales factor method. The manufacturing company must continue using the applicable modified apportionment method for its 2013 and 2014 corporate income tax returns.

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Electing to Use the Modified Apportionment Method

The modified apportionment method for manufacturing companies is an election made by the taxpayer. A qualified manufacturing company that elects the modified apportionment method under *Va. Code* § 58.1-422 will make one election, and may not revoke that election for three taxable years. The manufacturing company will be required to use the apportionment factor that is effective at the time the modified apportionment method election is made, and any apportionment factor that becomes effective in the first three taxable years of the election.

Example 3. A manufacturing company is currently using Virginia's double-weighted sales factor apportionment method, and has decided to elect the modified apportionment method beginning January 1, 2013. The manufacturing company must not use two different apportionment methods for the 2013, 2014 and 2015 calendar years. After December 31, 2015, the manufacturing company may continue using the single sales factor method of apportionment, or revoke the election and apportion income according to the standard double-weighted sales factor apportionment method.

Example 4. A manufacturing company is currently using Virginia's double weighted sales factor apportionment method, and has decided to elect the modified apportionment method beginning January 1, 2014. The manufacturing company decides to make the election under the quadruple-weighted sales factor apportionment methods. The manufacturing company, therefore, will apportion income using the quadruple-weighted sales factor method for 2014 and the single sales factor method for 2015 and after. The manufacturing company is prohibited from revoking the modified apportionment method election for three years, until January 1, 2017. The manufacturing company must not use two different apportionment methods for the 2014, 2015 and 2016 calendar years.

Mixed Apportionment Factors

If a manufacturing company is part of an affiliated group consisting of non-manufacturing entities or manufacturing entities that have not elected the modified apportionment method and files a Virginia consolidated return, then the affiliated group must follow the mixed apportionment factors method under 23 VAC 10-120-326.

Treatment of Pass-through Entities

Pass-through entities ("PTE") are required to use corporate apportionment to determine the portion of their income that is from Virginia sources for purposes of allocating a share of that income to nonresident individuals. This will affect the amount that the nonresident individuals report on their Form 763 or that the PTE reports on behalf of its nonresident owners on Form 765, and the amount for which the PTE may be required to withhold Virginia income. See the PTE Guidelines (Public Document ("P.D.") 07-150) for more information.

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A corporate owner of a PTE may be required to include its share of the PTE's property, payroll, and sales in the corporation's own apportionment factors. (See P.D. 95-19, 95-263, and 99-76.) If the PTE meets the requirements of a manufacturing company it may elect to use the modified apportionment method for this purpose under the same conditions applicable to corporations. If elected, the corporate owners would include in their factors only their share of the PTE's factors for the applicable taxable year.

Employment and Wage Requirements: Recapture

A manufacturing company will be subject to additional tax and incur a penalty and interest if its number of full-time equivalent employees (hereinafter "full-time employees") do not equal or exceed its base year employment level, as provided in *Va. Code* § 58.1-422 C.

Additional tax will be assessed if the average annual number of Full-time employees of a manufacturing company for any of the three taxable years of the modified apportionment method election is below the base year employment level. The additional tax (hereinafter "recapture") is equal to the difference between the taxes that would have been due under the standard apportionment method (*Va. Code* § 58.1-408) and the amount of taxes that was due using the modified apportionment method.

Failure to meet the base the year employment level in any of the first three years of the modified apportionment method election will also incur a penalty that is equal to 10% of the recapture amount that is assessed. The Department will assess interest, at a rate prescribed under *Va. Code* § 58.1-15, which will begin accruing from the original due date of the appropriate Virginia income tax return until the date of the payment of the recaptured amount.

A manufacturing company is required to certify to the Department, on the appropriate Virginia income tax form, each of the first three years that the modified apportionment method election is used that the average weekly wage of its Full-time employees is greater than the lower of the state or local average weekly wages for the taxpayer's industry.

At a minimum, a manufacturing company must be able to, upon request, demonstrate to the Department that the average weekly wage of its full-time employees is greater than the lower of the state and local average weekly wages according to labor market data provided by the Virginia Employment Commission ("VEC"). The Department will rely on VEC data unless the manufacturing company can provide the Department with other labor market data sources that show an average state or local weekly wage for its industry that is lower than the Virginia state or local average weekly wages.

A qualified manufacturing company's average annual number of full-time employees in Virginia during the first three taxable years of the modified apportionment method election must equal or exceed the base year employment level. The manufacturing

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company is required to certify to the Department each of the three years that the modified apportionment method election is used that the average annual number of Virginia full-time equivalent employees has not fallen below the base year employment level.

Example 5. A manufacturing company elects to use the modified apportionment method on January 1, 2012, beginning with the triple-weighted sales factor apportionment method. The manufacturing company has 100 Full-time employees for taxable year 2011, which is its base year employment level. The manufacturing company must maintain 100 Full-time employees for three taxable years, until December 31, 2015.

After the first three taxable years in which a manufacturing company has used a modified apportionment method as provided under *Va. Code* § 58.1-422 A, the manufacturing company is no longer required to satisfy the employment requirements.

Example 6. A manufacturing company elects to use the modified apportionment method for taxable year beginning July 1, 2014, beginning with the single sales factor apportionment method. The manufacturing company has 100 Full-time employees for taxable year 2013, which is its base year employment level and maintains that number of employees for three taxable years, until June 30, 2017. The manufacturing company eliminates 10 Full-time employees on January 1, 2018. Because the three year employment requirement was fulfilled, the manufacturing company is not subject to the additional taxes and penalties specified in *Va. Code* § 58.1-422 C.

Treatment of Employment Requirement for Affiliated Groups

A manufacturing company that is a member of an affiliated group consisting of more than one manufacturing company is permitted to aggregate the number of Full-time employees provided that the aggregate number of Full-time employees of the affiliated group members equals or exceeds the aggregate base year employment level of the manufacturing company members of the affiliated group. Aggregation, however, is limited to affiliates that are eligible to, and have elected, the modified apportionment method under *Va. Code* § 58.1-422. The affiliated group must file a combined or consolidated Virginia return in each of the relevant years in order to aggregate full-time employees.

Example 7. A Virginia affiliated group consists of three manufacturing companies with the following base year employment levels in the first taxable year of the modified apportionment method election: Company A has 50 Full-time employees; Company B has 25 Full-time employees; and Company C has 25 Full-time employees. All affiliates elect the modified apportionment method. In the second taxable year of the modified apportionment method election, Company A experienced a decline of 25 jobs from its base year FTE level, while Company B and Company C remained constant with a base year FTE level of 25

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jobs. The aggregate number of Full-time employees for the affiliated group increased to 150 jobs. The affiliated group will be subject to recapture, a penalty and interest because the employment gains the affiliates cannot be used to offset the losses for Company A. The recapture will be computed solely with reference to Company A's failure to maintain the base year employment level.

Example 8. A Virginia affiliated group consists of three manufacturing companies with the following base year employment levels in the first taxable year of the modified apportionment method election: Company A has 50 Full-time employees; Company B has 25 Full-time employees; and Company C has 25 Full-time employees. All of the affiliates elect the modified apportionment method. In the second taxable year of the modified apportionment method election, Company A experienced a decline of 25 jobs from its base year FTE level, while Company B remained constant with its base year FTE of 25 jobs and Company C increased its employment to 100 Full-time employees. The aggregate number of Full-time employees for the affiliated group increased to 150 jobs. No recapture is required of Company A because the aggregate employment level of the manufacturing affiliates is at least equal to the aggregate base year employment level.

Application of the Employment Requirement during Corporate Restructuring

Internal Revenue Code ("IRC") § 368, establishes the federal tax treatment of various forms of corporate restructuring transactions. Virginia law provides that when a corporation merges with other corporations, all liabilities of parties to the merger become the liabilities of the surviving corporation. (See *Va. Code* § 13.1-721.) Therefore, when there is corporate restructuring, any recapture, penalty and interest for failure to maintain the base year employment level requirement under *Va. Code* § 58.1-422 C will remain with the manufacturing company or the survivor into which the manufacturing company was merged.

If, after the merger, the survivor does not qualify as a manufacturer it may not use the modified apportionment method under *Va. Code* § 58.1-422 for taxable years beginning on or after the date of the merger. However, the survivor will not be subject to recapture provided that the survivor's employment level remains at or above the merged manufacturing company's base year employment level for the remainder of the three year election period.

A manufacturing company that is acquired by a corporation or an affiliated group of manufacturing companies will be allowed to maintain its modified apportionment method election, if one was made, and fulfill the requirement that the modified apportionment method be maintained for three taxable years. The affiliated group may include as part of the aggregation the acquired manufacturing company's Full-time employees for purposes of satisfying the employment requirement. If the acquired manufacturing company's number of Full-time employees does not equal or exceed the base year employment level, resulting in recapture, a penalty and interest, then the affiliated group

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will need to use the acquired manufacturing company's income while it existed under the selling affiliated group to compute recapture.

Example 9. A Virginia affiliated group consisting of one non-manufacturing company ("Company A") and one manufacturing company ("Company B") acquires a manufacturing company ("Company C"). Companies B and C made the election January 1, 2012 to use the modified apportionment method. Company C will still be required to maintain the use of the modified apportionment method election for the duration of the three year requirement. Companies B and C will be allowed to aggregate their number of employees in order to meet the base year employment level requirement.

Example 10. The facts are the same as Example 13, except Company C fails to maintain the base year employment level in the second taxable year that the modified apportionment method was elected and Company B maintained its base year employment level. Only Company C will be subject to the recapture, penalty and interest. In order to calculate the recapture, income attributable to Company C before its acquisition will be included in the apportionment formula.

When a multistate manufacturing company creates a new company, any recapture, penalty and interest will remain the liability of the manufacturing company from which the new entity was created. If the new entity created by the manufacturing company is another manufacturing company, any recapture, penalty and interest will still remain the liability of the manufacturing company that elected the modified apportionment method. Employees transferred to the new entity may cause employment to fall below the base year employment level unless the new entity also elects the modified apportionment method under *Va. Code § 58.1-422* and the employment of both entities is aggregated.

Example 11. Corporation A, a manufacturing company that has elected the modified apportionment method, creates Corporation B, another manufacturing company, and transfers some of its assets and employees to the new entity. After the first taxable year of the modified apportionment election, Corporation A fails to maintain the base year employment level and is subject to recapture, penalty and interest. Because the modified apportionment method was elected by Corporation A, which failed to satisfy the employment requirements, Corporation B will not be subject to the recapture, penalty and interest. However, if Companies A and B are included in a combined or consolidated Virginia return they may be able to avoid recapture by aggregating employment.

A Virginia affiliated group disposing of a manufacturing company that has elected the modified apportionment method will only be affected to the extent that it must calculate the tax liability for the year(s) the manufacturing company was a member of the affiliated group. Any recapture, penalty and interest will only be attributable to the manufacturing company that failed to maintain a base year employment level, and will follow such manufacturing company if it is part of a disposition by an affiliated group. A disposed manufacturing company that failed to meet the base year employment

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requirement and is subject to recapture, penalty and interest, will not become a tax liability for the selling group. However, a manufacturing company with an average number of employees below the base year employment level at the time of the disposition will carry any recapture, penalty and interest with it to the acquiring group.

Example 12. A Virginia affiliated group consists of three manufacturing companies (“Company A,” “Company B,” and “Company C”), all of which elected the modified apportionment method. Company A is sold during the second taxable year of the modified apportionment method election. During that period Company A also fails to maintain its base year employment level. Company A will be subject to the recapture, penalty and interest. The acquiring group will acquire any tax liabilities of Company A. Companies B and C of the affiliated group, however, will not be subject to recapture, and will compute their Virginia tax liability excluding Company A and the recapture, penalty and interest it has incurred.

A Virginia affiliated group acquiring a manufacturing company from an affiliated group that aggregated its number of employees in order to meet or exceed the base year employment level, must also aggregate its number of employees to meet the base year employment level. If the acquiring group is unable to aggregate its employees to calculate the employment level, then it may calculate the employment level for the manufacturing company separately. However, if upon the acquisition the manufacturing company fails to meet the base year employment level, then it will be subject to recapture, penalty and interest.

Example 13. A Virginia affiliated group consists of three manufacturing companies (“Company A,” “Company B,” and “Company C”), all of which elected the modified apportionment method and aggregate their employees to meet the base year employment level. Company A is sold during the second taxable year of the modified apportionment method election to another affiliated group, which consists of two non-manufacturing companies (“Company D” and “Company E”). At the time of the disposition, Company A had failed to maintain its base year employment level. Because Companies D and E are non-manufacturing companies they may not use their employees to compensate for the decrease in Company A’s base year employment level. The acquiring group will have to calculate Company A’s employment level separately. Company A will be subject to the recapture, penalty and interest.

If a manufacturing company is involved in a transaction that results in a change in ownership and a short year return, which trigger recapture, penalty and interest, then an exception is provided that would abate any recapture penalty and interest that has been incurred. The federal consolidated tax return regulations provide that the short-year tax period income for affiliate(s) that are sold is reported on a short-year tax return for the period that the entity was a member of the affiliated group from which it was disposed. (See I.R.C Regulation (“Reg.”) § 1.1502.) Under *Va. Code* § 58.1-422 C, recapture, penalty and interest is applied on a taxable year basis. As such, recapture, penalty and

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interest could be included in a short year tax return. In certain instances, due to seasonal fluctuations in employment, some manufacturing companies involved in corporate restructuring that result in a short year return may be subject to recapture, penalty and interest. Therefore, if a manufacturing company involved in a change in ownership resulting in a short year tax return has an employment level that is below the base year employment level for the short year period, but may not have fallen below the base year employment level for a regular twelve month tax return period, then any recapture, penalty and interest will be abated. If the employment level is below the base year employment level for the following twelve month tax year period, then the manufacturing company will be subject to recapture, penalty and interest.

Documentation and Filing Requirements

The taxpayer does not need to provide a separate statement or additional documents with the Virginia return. However, the taxpayer must maintain documentation that substantiates its qualification for, and calculation of, the modified apportionment method election and provide it to the Department upon request. In addition, a taxpayer must provide documentation that substantiates the wage and employment requirements upon request.

In order to elect the modified apportionment method under *Va. Code* § 58.1-422, a manufacturing company must be classified under Sector 11, 31, 32 or 33 of the North American Industrial Classification System (NAICS). The NAICS replaced the Standard Industrial Classification manual in 1997, and is the standard used by Federal statistical agencies in classifying business establishments. A parent corporation with multiple NAICS codes, or a holding company consisting of corporations with different NAICS codes, must be able to demonstrate, upon request, to the Department that a manufacturing company electing the modified apportionment method qualifies under Sector 11 or 31 through 33 of the NAICS. If the Department determines that a corporation does not qualify as a manufacturer under these NAICS code sections, then the corporation will be required to file an amended return and apportion Virginia income using the standard apportionment under *Va. Code* § 58.1-408. The corporation will also be subject to late filing penalties and interest as provided in *Va. Code* § 58.1-450.

Additional Information

These guidelines are available on-line under the Publications/Education and Tax Policy Library sections of the Department's website at www.tax.virginia.gov. For additional information, please contact the Department's Customer Service Section at **(804) 367-8037**, or use the "Live Chat" feature on the Department's website to communicate online in real time with a Department representative. Live Chat assistance is available at www.tax.virginia.gov or <https://www.business.tax.virginia.gov>. Additional information may also be obtained by writing to: **Department of Taxation, P.O. Box 1115, Richmond, VA 23218-1115.**

Approved:

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Craig M. Burns
Tax Commissioner
[INSERT DATE]

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