JOINT SUBCOMMITTEE STUDYING THE SINGLE SALES FACTOR FOR CORPORATE INCOME APPORTIONMENT PURPOSES

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A History of the Corporate Income Tax in Virginia and the Apportionment of Income for Multi-state Corporations

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Virginia' Corporate Income Tax -- A History

Nineteenth Century --

The corporate income tax is an outgrowth of a license tax, which was a payment imposed for the privilege of doing business. The tax evolved from its earliest form when, in 1842-43, the Commonwealth imposed a 1.5 percent tax on all "dividends of profit." At that time many public service corporations had exemptions to encourage public works, and very few of the remaining corporations were profitable enough to pay dividends, with the result that very little tax revenue was generated. However, this tax formed the basis of our current net earnings tax.

Twentieth Century --

Corporate taxation in Virginia evolved through a number of different tax philosophies during the next 70 years, including the taxation of computed rent, of gross earnings, of bonded indebtedness as a measure of wealth, and attempts to tax the owners of a corporation. Since the early 1900s, however, Virginia has based its corporate income tax on net income and has focused on more accurately determining income.

From the early 1920's until the early 1960's, Virginia imposed the corporate income tax on the income from the portion of a corporation's interstate business that was shown on its books separately as being from Virginia. If no such separate accounting existed, the tax was apportioned using a two-factor formula. It was imposed on the portion of the entire net income of the corporation which the fair market value of the real estate and other physical assets (property factor) in Virginia and the amount of total gross receipts (sales factor) in Virginia bore to the aggregate of these factors inside and outside of Virginia.

In 1959, the Virginia Advisory Legislative Council studied and issued a report on the "Effect of Business Taxes on Industrial Development in Virginia and Apportionment of Income for Tax Purposes." That study recommended the adoption of the equally weighted three-factor formula consisting of a (i) property factor, (ii) payroll factor, and (iii) sales factor, that many other states had enacted at that time. Income was multiplied by a fraction, the numerator of which was the property factor plus the payroll factor plus the sales factor and the denominator was three. The difference in this new formula was the addition of the payroll factor (salary, wages and other compensation).

The Virginia Advisory Legislative Council recognized that the Commonwealth would suffer revenue losses from this change but that the industrial development that it would generate would be worth those initial losses.

This formula remained in effect until 1999, when the General Assembly adopted the double-weighted sales apportionment formula, which is still in use today. In 2003 there was a decrease of $12.2 million using the double-weighted sales formula rather than the equally weighted three factor formula, according to the Department of Taxation.

Corporate Tax Structure Today

The Virginia corporate income tax applies to all domestic (incorporated in Virginia) and foreign (incorporated outside Virginia) corporations doing business in the state except:

· Public service corporations other than telecommunications corporations;
· Electric utilities, as of January 1, 2001;
· Gas utilities as of January 1, 2002;
· Insurance companies;
· Inter-insurance exchanges;
· State and national banks;

· Banking associations;
· Electing small business corporations (S corporations);
· Any company that does business on a mutual basis;
· Credit unions; and
· Religious, educational, benevolent, and other nonprofit corporations.

Corporations exempt from the corporate income tax are either exempt or subject to other forms of taxation.

Virginia's six percent corporate income tax applies to a corporation's Virginia taxable income, which is computed by using federal taxable income as the base. Most states (39 of the 45 states that impose a corporate income tax) conform their corporate tax, in general, to the federal system for much the same reason most states conform their individual income tax. For Virginia tax returns, modifications are made to federal taxable income. These include the addition of (i) income taxes imposed by Virginia or any other taxing jurisdiction (because such income taxes are deductible when computing federal taxable income) and (ii) certain interest and dividends.

Virginia permits corporations engaged in multistate activities that have income taxable by Virginia and out-of-state political subdivisions to apportion their Virginia taxable income through the following three-factor formula, so that different states do not impose a tax on the same income:

1. **A Property Factor (25 percent):** A ratio of the average real and tangible personal property value of the firm in Virginia to the firm's total average real and tangible personal property value.
2. **A Payroll Factor (25 percent):** A ratio of the payroll in Virginia to the firm's total payroll.
3. **A Sales Factor (50 percent):** A ratio of the sales in Virginia to the firm's total sales.

These ratios are added together with the sales factor doubled and divided by a denominator of four to determine the portion of total taxable income subject to the Virginia corporate income tax. However, if there is no sales factor, then the denominator will be the number of existing factors and where there is a sales factor but no payroll or property factor, the denominator will be the existing factors plus one. All three factors do not necessarily pertain to all corporations, although this occurrence appears to be the exception rather than the rule. Also, a corporation can petition the Tax Commissioner to use a different allocation formula if the three-factor formula is inherently unfair to the particular corporation. Special apportionment factors exist for motor carriers, financial corporations, construction companies, and railway companies.

Example 1	Property	Payroll	Sales
In Virginia	25,000	40,000	100,000
Everywhere	100,000	120,000	1,000,000
Percentage	25.00%	33.33%	10.00%

Double-weight sales:

25.00% + 33.33% + (2 x 10.00%) = 78.33% ÷ 4 = **19.58%**

Single sales factor: **10.00%**

Example 2	Property	Payroll	Sales
In Virginia	5,000	9,000	100,000
Everywhere	100,000	120,000	1,000,000
Percentage	5.00%	7.50%	10.00%

Double-weight sales:

5.00% + 7.50% + (2 x 10.00%) = 32.50% ÷ 4 = **8.13%**

Single sales factor: **10.00%**