Virginia’s Apportionment Formula

Presented to the:

Joint Subcommittee Studying the Benefits of Adopting a Single Sales Factor

Pursuant To 2008 HJR 177 and SJR 101

September 30, 2008

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Table of Contents

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I. Executive Summary

Virginia adopted its equally-weighted, three factor formula (property, payroll and sales) in 1960 shortly after the Uniform Division of Income for Tax Purposes Act ("UDITPA") was promulgated. Most states enacted a similar apportionment formula. Over the years states began increasing the weight of the sales factor for political and economic development reasons. Effective for taxable years 2000 and after the sales factor was double-weighted in Virginia. About a third of the states imposing an income tax now weight the sales factor at more than 50%, some use the sales factor exclusively.

The payroll and property factors represent the taxpayer's employment of labor and capital (physical assets), while the sales factor represents customer location or impact of the states in which goods and services are marketed. Some proponents believe that economic development and investment in Virginia will be encouraged if the apportionment of taxable income is based exclusively on market location rather than the location of employees and physical assets.

During the 2008 Session of the General Assembly, House Bill 1514 would have permitted manufacturers an option to use a single sales factor to apportion their income for Virginia income tax purposes. The bill was continued to the 2009 Session in the Senate Finance Committee. Instead, House Joint Resolution 177 and Senate Joint Resolution 101 created a joint subcommittee to study apportionment issues.

Today, Virginia's apportionment formula is in the mainstream. All of the states contiguous to Virginia (except D.C.) use the same apportionment formula as Virginia, but Maryland recently enacted a single sales factor applicable only to manufacturers. The District of Columbia uses an equally weighted three-factor formula. Of the 47 states that impose a corporate income tax, 15 primarily rely on an equally-weighted three-factor formula, 16 rely primarily on a formula that double-weights the sales factor, and 16 rely on a formula that weights the sales factor at more than 50% (9 of them are at 100%). There are exceptions for certain industries, especially manufacturers.

A single sales factor will increase the tax for some corporations, reduce it for others, and have little or no impact on most. The tax would be reduced for corporations with significant operations in Virginia that produce more here than they sell here. The tax would be increased for corporations with minor operations in Virginia that sell more here than they produce here. There would be little change in the tax for corporations with balanced operations and sales in Virginia and no change for returns filed by small corporations that do not operate outside Virginia. This is illustrated by the fact that as single sales factors were considered in other states, corporations headquartered in the state usually supported it, while those headquartered outside the state opposed it.

One option under consideration is allowing only manufacturers to use the single sales factor. The definition of a qualifying manufacturer will affect the revenue impact. The definition developed by the courts is clear: manufacturing is a process that transforms raw material into a new and different product. Applying this definition to specific taxpayers, however, is not clear cut.

The North American Industry Classification System ("NAICS") is a market-oriented, or demand-based, hierarchical classification system for products (goods and services). A numerical code is assigned to each establishment based upon the primary product or service produced at that establishment. While the NAICS definition of manufacturing is close to that of Virginia courts, it generally has a much broader application because it is focused on products and includes many non-manufacturing businesses that process or handle the same products. Some business that would be classified as a manufacturer by Virginia courts are not so classified under NAICS.

As shown in the table below, increasing the weight of the sales factor in Virginia's apportionment formula would produce an immediate and substantial revenue loss.

Revenue Estimates
Based on TY 2006 Returns

	Single Sales*	Optional Single Sales*
All Corporations	(47.4)	(122.7)
Manufacturers Only	(33.9)	(64.7)

* Amounts in $ millions.

II. Background

A. The Early Years

Virginia adopted a statutory apportionment method in 1926 that provided for apportionment by separate accounting if the books of the corporation showed where income was earned. Otherwise corporate income as apportioned based on a two-factor formula consisting of property (real and other physical assets) and gross receipts.[1]

In addition to the statutory method of apportionment, authority existed for alternative methods of allocation and apportionment.[2] By 1960 permission had been granted to numerous businesses to use alternative methods.

B. UDITPA

To promote uniformity and reduce the potential for multiple taxation of corporate income, the Uniform Division of Income for Tax Purposes Act ("UDITPA") was approved in 1957. Under UDITPA, business income is viewed as unitary, that is, all parts contribute to the whole. UDITPA required that the income of this unitary business be

[1] 1926 Acts of Assembly, p. 972. Subsequently codified as § 54 of the Tax Code of 1928, and § 58-131.1 of the Code of Virginia of 1950 without substantive change.
[2] 1926 Acts of Assembly, p. 973. Subsequently codified as § 54 of the Tax Code of 1928, and § 58-132 of the Code of Virginia of 1950 without substantive change.

divided among the states according to a three-factor formula giving equal weight to property, payroll and sales. Most states imposing an income tax adopted UDITPA or a similar apportionment formula. Virginia did not adopt UDITPA, but enacted a similar formula in 1960.[3]

No change was made to the statute authorizing alternative methods of apportionment, and they continued in effect. In 1972 the Tax Commissioner revoked all alternative methods of allocation and apportionment. All corporations were required to use the statutory method and alternative methods would be reserved for extraordinary situations where a clear need for relief had been demonstrated.[4] Since then very few requests for an alternative method have been granted.

When it appeared that the statutory method did not work well for an industry the Department of Taxation ("TAX") requested that new statutory methods be adopted. In 1976 new a formula was adopted for financial corporations and a provision was made for construction companies allowed to use the completed contract method of accounting for federal income tax purposes.[5] When railroads were switched from the public service corporation tax on gross receipts to the income tax in 1979 a special apportionment formula was adopted for them.[6]

C. Sales Weighting

> The gross receipts or sales factor . . . is designed to give weight in the apportionment to the states in which the taxpayer markets its goods. The sales factor—with the sales destination test—is justified as much by political as by economic considerations. The economic justification for the other two factors—property and payroll—is clear enough. "Income," we were told long ago, may be defined as the gain derived from capital, from labor, or from both combined. . . . The sales factor, by contrast, attributes income to states in which goods are consumed and serves as a counterbalance to the property and payroll factors which tend to attribute income to states in which goods are produced.[7]

Over the years states began shifting more weight to the sales factor for several reasons. One theory asserts that supply and demand contribute equally to corporate profits, while the formula emphasizes the supply side, or inputs, by giving two-thirds of the weight to property and payroll and only one-third to the demand side, or output. Double-weighting the sales factor equalizes the two sides. Other facts also influenced state tax policy decisions. In some states there is very little industry in relation to their population. They provide a market for producers in other states. These states may emphasize the sales

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[3] 1960 Acts of Assembly, c. 442.
[4] Income Tax Circular No. 1. (1971).
[5] 1976 Acts of Assembly, c. 436. The financial corporation factor was revised by Acts of Assembly 1979, c. 32 and 1981, c. 402.
[6] Acts of Assembly 1978, c. 784; 1979, c. 371; 1981, c. 402;
[7] Hellerstein, "State Taxation," Warren Gorham, & Lamont, ¶ 8.6[2], internal citations omitted. Retrieved from RIA Checkpoint 9/22/08.

factor because it reflects the value the state contributes to corporate profits by providing a market for the goods and services produced by the business.

Many states now weight the sales factor at 100% of the formula – a single sales factor – although such a formula has been criticized by commentators.

> There is no warrant in fiscal policy for attributing the entire net income from manufacturing in one state and selling and warehousing in another to the latter state. That formula cannot be justified on any of the bases customarily employed by the courts or by students of public finance for attributing the income of multistate businesses to the various states in which they carry on their businesses—the source of the income, the benefits or protection provided the business, its employees and its property, and the social costs to the state of the business. [8]

By 2000, when Virginia's double-weighted sales factor became effective, most states imposing an income tax gave at least 50% of the weight in their apportionment formula to the sales factor. But today, another policy consideration is influencing the choices in selecting a state income tax apportionment formula – economic development.

III. <u>Economic Development</u>

State and local taxes are one of many factors reviewed by businesses considering expanding or relocating facilities. Articles on the subject generally conclude that taxes are rarely a decisive factor, but are always considered. In the last 10 or 15 years Virginia has joined other states in using their tax system to offer incentives to encourage businesses to expand or relocate in Virginia. The major business facility job tax credit was Virginia's first major incentive of this type, and it clearly explains the rationale:

> The General Assembly of Virginia finds that modern business infrastructure allows businesses to locate their administrative or manufacturing facilities with minimal regard to the location of markets or the transportation of raw materials and finished goods, and that the economic vitality of the Commonwealth would be enhanced if such facilities were established in Virginia.
> § 58.1-439 T.

Increasing the weight of the sales factor has been suggested as another means of making Virginia more attractive for businesses, particularly manufacturers. If an established manufacturer needs to expand, it may compare adding on to an existing facility or building a new facility in another state. Assuming that the distribution of the expanded production will be the same as before the expansion, the state's apportionment formula could affect the manufacturer's tax liability.

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[8] Hellerstein, "State Taxation," Warren Gorham, & Lamont, ¶ 8.13[2][b][ii]

- If the new facility is placed in Maryland (which has a single sales factor for manufacturers), the expansion would have no impact on Maryland's corporate income tax liability because a manufacturer's property and payroll are ignored in apportioning its income.

- If the new facility is placed in Virginia, it would increase Virginia's corporate income tax liability because property and payroll constitute one-half of the apportionment formula.

To understand how the weight of the sales factor could affect economic development, one must understand how the apportionment formula works.

IV. The Apportionment Formula

After the business determines its income from the unitary business (usually federal taxable income with some adjustments), a formula is applied to determine the portion of that income attributable to the state. The formula starts with the percentages of the business' property, payroll and sales located in the state, and combines them into a single apportionment factor by giving varying weights to each factor.

For the 46 states and the District of Columbia that impose a corporate income tax, the apportionment formulas can be placed into three groups based on their primary formula:

- Equally-weighted factors. Sixteen states use this method, but three of them allow exceptions.

- Double-weighted sales factor. Sixteen states use this method, but four allow exceptions.

- Sales factor weighted 60% to 100%. Fifteen states weight the sales factor at more than 50% in the formula. Of the fifteen, nine are at 100% and one more is phasing in 100%.

Today, Virginia's apportionment formula is in the mainstream. All of the states contiguous to Virginia (except D.C.) use the same apportionment formula as Virginia, but Maryland recently enacted a single sales factor applicable only to manufacturers. The District of Columbia uses an equally weighted three-factor formula.

Nevertheless, eighteen states currently use a sales factor weighting of greater than 50% for manufacturers. Only nine states currently use a single sales factor for all businesses. Because several states have recently moved toward a single sales factor (whether for all multistate businesses or for selected industries) it has been suggested that Virginia should consider similarly changing its apportionment formula.

Virginia's Apportionment Formula

Sales Factor Weight in Apportionment Formula		
Sales factor only	**9**	GA,IL, IA, ME, NE, NY, OR, TX, WI
Three factors, sales weighted more than 50%	**6**	AZ (70%), MI (90%), IN (60%), MN (phase in 100%), OH (60%), PA (60%)
Three factors, sales weighted 50%, but 100% sales factor for certain industries	**4**	CT (100% for mfg.), FL (100% for citrus growers), MA (100% for mfg.), MD (100% for mfg.),
Three factors, sales weighted 50%	**12**	AR, CA, ID, KY, LA, NH, NJ, NC, SC, TN, VA, WV
Three factors, equally weighted, but with exceptions	**3**	CO (option to eliminate payroll); NM (50% for certain mfg.) OK (50% certain cases)
Three factors, equally weighted	**13**	AL, AK, DC, DE, HI, KA, MS, MO, MT, ND, RI, UT, VT
No income tax imposed	**4**	NV, SD, WA, WY

Source: 2008 Multistate Corporate Tax Guide, Vol. I, CCH Incorporated;

Such a change would increase the tax liability of some corporations while decreasing the liability of other corporations. The net impact on Virginia's corporation income tax revenue will be negative. Let's examine the impact on taxpayers first.

V. <u>Winners and Losers</u>

Who benefits when the weight of the sales factor is increased? Generally, increasing the weight of the sales factor will reduce the tax of any corporation that produces more in Virginia than it sells in Virginia, or that serves customers in several states from facilities in Virginia. Mathematically speaking, any corporation whose percentages of property and payroll in Virginia are greater than the percentage of sales (double-weighted) in Virginia will see their Virginia tax go down as the weight of the sales factor goes up. Set out below are three examples illustrating how changes in the weight of the sales factor would increase, decrease, or not substantially change the tax liability.

Virginia's Apportionment Formula

Examples of Winners and Losers

Example 1 - Significant Virginia Operations

Because its operations in Virginia are significantly greater than its sales, the sum of its property and payroll factors (58.33%) is significantly greater than the sales factor, doubled (20%). Therefore, increasing the weight of the sales factor reduces the business's Virginia apportionment factor and tax liability of this business.

	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%

Equally-weighted factors:
25.00% + 33.33% + 10.00% = 68.33% ÷ 3 = **22.78%**

Double-weight sales:
25.00% + 33.33% + (2 x 10.00%) = 78.33% ÷ 4 = **19.58%**

Single sales factor: **10.00%**

Example 2 - Minor Virginia Operations

Because its operations in Virginia are significantly less than its sales, its property and payroll factors (12.5%) are less than the doubled sales factor (20%). Therefore, increasing the weight of the sales factor will increase the apportionment factor and tax liability of this business.

	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%

Equally-weighted factors:
5.00% + 7.50% + 10.00% = 22.50% ÷ 3 = **7.50%**

Double-weight sales:
5.00% + 7.50% + (2 x 10.00%) = 32.50% ÷ 4 = **8.13%**

Single sales factor: **10.00%**

Example 3 - Balanced Operations

Because its operations in Virginia are roughly equivalent to its sales, the property, payroll and sales are relatively equal. Therefore, its tax liability will not be significantly affected by changes to the weight of the sales factor.

	Property	Payroll	Sales
In Virginia	8,000	14,400	100,000
Everywhere	100,000	120,000	1,000,000
Percentage	8.00%	12.00%	10.00%

Equally-weighted factors:
8.00% + 12.00% + 10.00% = 30.00% ÷ 3 = **10.00%**

Double-weight sales:
8.00% + 12.00% + (2 x 10.00%) = 40.00% ÷ 4 = **10.00%**

Single sales factor: **10.00%**

Any type of business can be in any of the situations represented by the three examples. Retail businesses are often set up as in Example 3 because their stores usually must be close to their customers. Manufacturers can ship their products anywhere and usually are not required to be close to their customers. They could fit Examples 1 or 2 depending on whether the manufacturing plant is located in Virginia or another state. But other businesses, even retailers, could fit the first two examples. Retail chains usually have central warehouses, headquarters and other administrative facilities that serve a wide region, and the location of these facilities could move a retailer from Example 3 to one of the first two examples.

These principles transcend all types of businesses. The following multistate businesses would benefit from an increase in the weight of the sales factor:

- A retail store chain with major warehouses in Virginia
- A regional service business with its parts warehouse in Virginia
- A professional service firm with its centralized administrative office in Virginia
- A manufacturing business with its factory in Virginia

A. Costs of Performance

The discussion above applies only to businesses that sell tangible personal property, or service business that primarily send their employees to the customer's location to render services. There are two versions of the sales factor:

- Sales of tangible personal property are assigned based on the destination.[9]
- Sales of other than tangible personal property are assigned based on where the greater portion of income-producing activities is performed, and the location of the activities is determined by the costs of performing those activities.[10]
- Financial corporations have a special statutory apportionment formula that is based solely on costs of performance in Virginia to costs of performance everywhere.
- Motor carriers, construction companies, and railroads have special statutory apportionment methods that do not use the sales factor or costs of performance.

Regulations state that costs of performance are principally assigned to places where employees and property are located.[11] Thus, if the service business sends its employees and equipment to the customer's location, then the sales factor is likely to be

[9] Va. Code § 58.1-417.
[10] Va. Code § 58.1-418.
[11] 23 V.A.C. 10-120-230 for sales other than tangible personal property, and 23 V.A.C. 10-120-250 for financial corporations.

comparable to the sales factor for sales of tangible personal property, i.e., based on the customer's location or destination. Most businesses selling services and intangible property, however, probably have the greater portion of their costs at one of their offices. In this case the sales factor will be based on originating office location instead of customer location. Any change in the sales factor will have no impact on financial corporations and other businesses that have special statutory methods. However, any change to the definition of costs of performance for sales of other than tangible personal property may affect financial corporations too.

It has long been recognized that UDITPA does not do a good job of apportioning the income from services and intangibles. In 1957 they were a much smaller part of the economy than they are today. The National Conference of Commissioners on Uniform State Laws (NCUSL) recently formed a committee to consider revising UDITPA to address this and other issues. It is not clear at this point whether a revision will take place.

VI. Definition of Manufacturer

One of the options would be to limit use of a single sales factor to specific types of taxpayers. House Bill 1514, considered during the 2008 Session of the General Assembly, would have allowed manufacturers to elect to use a single sales factor. Defining manufacturer for purposes of this tax preference could be controversial.

A. What is Manufacturing?

"Manufacturing" is not defined in the Code for tax purposes, but according to numerous Virginia Supreme Court cases manufacturing is an activity which transforms new materials into an article or product of substantially different character so that the raw materials are not recognizable in the finished product without previous knowledge.[12] Merely processing, manipulation, rearrangement or blending raw materials, without substantial transformation, is not manufacturing. Over the years the application of this definition by the courts, Attorney General, Tax Commissioner and local tax officials has resulted in some baffling distinctions. For example:

- Turning chickens into fryers is not manufacturing,[13] but turning cattle and hogs into meat products, bacon, sausage, etc. is manufacturing.[14]

- Pasteurizing milk and turning it into buttermilk is not manufacturing, but turning it into cheese is.[15]

[12] Solite Corp. V. County of King George, 220 Va. 661,261 S.E.2d 535 (1980). Prentice v. City of Richmond. 197 Va. 724, 90 S.E.2d 839 (1956).
[13] Prentice v. City of Richmond, 197 Va. 724 (1956).
[14] Commonwealth v. Meyer, 180 Va. 466 (1942), Morris & Co. v. Commonwealth, 116 Va. 912 (1914). The Tax Commissioner ruled that a business engaged in turning turkeys and chickens into "feed mash, burgers, sausages, ready-to-cook products, salads and various other meat products and foodstuffs" should be classified as a manufacturer. P.D. 02-2 (1/4/02).
[15] Richmond v. Dairy Company, 156 Va. 63 (1931), 1995 Atty. Gen. Ann. Rep. 257.

- Grading and packing herbs is not manufacturing, but if the herbs are also dried and crushed then it is manufacturing.[16]

- Adding water to juice concentrate is not manufacturing, but adding water to powdered tea is.[17]

- Embroidering or screen printing tee shirts is manufacturing because it transforms underwear into outerwear.[18]

B. Where Does Manufacturing Occur?

Should a corporation be treated as a manufacturer by Virginia if its manufacturing activities occur outside Virginia? The Virginia Supreme Court has said that the classification of a business as a manufacturer is to be liberally construed "because the public policy of Virginia is to encourage manufacturing in the Commonwealth."[19]

Some of the significant tax preferences granted to manufacturers apply only to manufacturing activities in Virginia. But this is due to the nature of the tax, not the definition of manufacturer. For example:

- Machinery and tools. This property tax classification applies to machinery and tools actually and directly used in a manufacturing process.[20] Since the property tax applies only to property located in Virginia, as a practical matter the manufacturing process in which the property is directly used must also be in Virginia.[21]

- Business, Professional and Occupational License Tax ("BPOL"). An exemption from the BPOL tax is granted for sales at wholesale at the place of manufacture. Since the BPOL tax applies only to a definite place of business in a Virginia locality, the tax and exemption apply only when goods are manufactured and sold at the same definite place of business. A wholesale sales office in Virginia for products manufactured outside of Virginia would not qualify for the exemption.[22]

In one case a locality tried to restrict a property tax classification applicable to property used in a manufacturing business to businesses that conducted manufacturing activity in the locality. The Virginia Supreme Court held that the property classification could not be limited to businesses with manufacturing facilities in a Virginia locality because

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[16] 1984-85 Atty. Gen. Ann. Rep. 399.
[17] 1995 Atty. Gen. Ann. Rep. 257.
[18] 1996 Atty. Gen. Ann. Rep. 214.
[19] County of Chesterfield v. BBC Brown Boveri, 238 Va. 64, 69 , 380 S.E.2d 890, 893 (1989)
[20] The Daily Press, Inc. v. City Of Newport News, 576 Se2d 430 (2003).
[21] The court noted in Daily Press, Id., that a press plate was created outside of the press room where all of the manufacturing activity took place. Because the plate was carried into the press room and attached to the press, it was the only item outside the press room classified as machinery and tools. Theoretically, the press plate could be created outside the state where the printing press is located.
[22] Atty. Gen. Ann. Rep.

the General Assembly did not use the word "directly" when it referred to property used in a manufacturing business or otherwise indicate an intent to limit the application of the property tax classification in that manner.[23]

C. Who is a Manufacturer?

Manufacturers do more than just manufacture goods. They often conduct research, design and development activity before manufacturing the items, and then engage in various types of marketing activity to sell the manufactured items. They may have to finance the products they manufacture in order to sell them. They may offer repair services to purchasers of their manufactured items. Each of these nonmanufacturing activities may expand beyond facilitating the sale of their own products and become a separate profit center or business. Financing and repair services, for example, may be offered for similar products manufactured by others.

1. Ancillary Activities

The Virginia Supreme Court has said that a manufacturer does not lose its classification because it engages in some nonmanufacturing activity, "but it will still be classified as a manufacturer for tax purposes if the manufacturing portion of its business is substantial."[24] The term "substantial" in this context means "not insubstantial." Therefore, it is not necessary that the manufacturing activities constitute the majority or predominant activity for the business to qualify as a manufacturer. In fact, some have argued that if manufacturing activity is as little as 5% of all activities, depending on how they are measured, the business may qualify as a manufacturer.

2. Consolidated Returns

In many cases, e.g., financing, the nonmanufacturing activity may be conducted through an affiliated corporation. No one would argue that a financing corporation should be classified as a manufacturer merely because it is affiliated with a manufacturer. But Virginia law allows affiliated corporations to file a single consolidated return for all affiliates with income from Virginia sources.[25] A consolidated return has a single apportionment formula applied to the group's income. If a special apportionment formula is enacted for manufacturers, and the manufacturing corporation files a consolidated Virginia return with nonmanufacturing affiliates, what happens?

In 1990 the General Assembly amended the consolidated return statute to ensure that affiliated groups that include corporations using different apportionment factors could still file a consolidated return.[26] TAX has promulgated regulation detailing how a blended apportionment formula is computed in this situation.

[23] City of Winchester v. American Woodmark Corporation, 250 Va. 451 , 464 Se2d 1458 (1995).
[24] County of Chesterfield v. BBC Brown Boveri, 238 Va. 661, 261 S.E.2d 890 (1989).
[25] Va. Code § 58.1-442.
[26] 1990 Acts of Assembly, c. 619.

D. North American Industry Classification System (NAICS) Codes

The North American Industry Classification System ("NAICS") is a market-oriented, or demand-based, hierarchical classification system for products (goods and services). It is being developed by the statistical agencies of the United States, Canada and Mexico as part of the implementation of the North American Free Trade Agreement. A numerical code is assigned to each establishment based upon the primary product or service produced at that establishment.

The definition of the manufacturing sector (codes beginning with 31-33) begins with a definition that refers to transformation of raw material into a new product, and is substantially similar to Virginia's definition developed by the courts. But, because it is product oriented it includes facilities related to those products even though no manufacturing occurs there. In an understatement, US Census Bureau's description of the manufacturing codes concedes that "The boundaries of manufacturing and the other sectors of the classification system can be somewhat blurry."[27] They go on to give some examples, many of which would not be considered manufacturing under Virginia law. For example, milk pasteurizing and bottling is given a manufacturing NAICS sector code, but, as noted above, the Attorney General has opined that it is not manufacturing. Another example is printing and publishing, which is given a NAICS sector code of 51 because it is disseminating information. But printing is considered manufacturing under Virginia law.[28]

In some cases the NAICS codes may be easier to apply than the court-developed definition of manufacturing. But, because of the product-oriented focus of the NAICS, their use may extend manufacturing treatment to businesses that would not be considered manufacturers under Virginia law, and may deny manufacturing treatment to other businesses that would be considered manufacturers under Virginia law.

VII. Tax Policy Implications

Increasing the weight of the sales factor is being urged for economic development purposes, not for tax policy reasons. In an ideal world, all states would use the same apportionment formula. When states use different methods of apportioning income, corporations can take advantage of the situation to create "nowhere income," that is, income that is not apportioned to any state for taxation.

For example, a manufacturer with one factory but nationwide sales would benefit from a single factor formula in the state where the factory is located and an equally weighted three-factor formula in all of the states where it markets its products. It would pay tax on about 2% of its income in its home state, but the 98% of its sales in other states would be reduced as the three-factor formula divides sales in the state by three (since there

[27] "2002 NAICS Definitions, 31-33 Manufacturing," published by the US Census Bureau, retrieved 9/23/08 from http://www.census.gov/epcd/naics02/def/NDEF31.HTM#N31-33.
[28] The Daily Press, Inc. v. City Of Newport News, 576 SE2d 430 (2003).

would be no property or payroll in the other states). Adding up the income apportioned to all of the states would result in just over one-third of its income being taxed – almost two-thirds of its income would be "nowhere income."

That same manufacturer would see its tax increase in other states that adopt a single sales factor, and if all states adopted a single factor about 100% of its income would be taxed by the states. This explains why

- Ford Motor Corporation, headquartered in Michigan, supported a single factor in Michigan (for its single business tax), but opposed it in Illinois.[29]
- Kraft Foods, headquartered in Illinois, supported adoption of a single sales factor in Illinois, but opposed it in Maryland.[30]
- AT&T, headquartered in New Jersey, supported adoption of a single sales factor in New Jersey, but opposed it in Oregon.[31]

The impact of federal laws must also be considered. Federal law currently prohibits states from taxing a corporation whose only contact with the state is the sale of tangible personal property through salesmen who can only solicit orders (contracts have to be approved outside the state). Most manufacturers can easily structure their marketing to take advantage of this federal law and avoid taxation in many states. Indeed, at least one commentator speculates that corporations have a two-pronged plan to gut state income taxes by seeking a single sales factor in states, while lobbying Congress to expand the federal law prohibiting state taxation of corporations with limited business activity in the state.[32]

One way to limit the creation of nowhere income associated with the sales factor is to adopt a "throwback rule" that attributes sales to the state from which goods are shipped when the corporation is not taxable in the destination state. Virginia adopted a throwback rule in 1960, but repealed it in 1981. A throwback rule was also included in the Governor's tax reform proposal in 2004, but was not enacted. Businesses generally oppose the adoption of a throwback rule.

VIII. Revenue Impact

In order to estimate the revenue impact of increasing the weight of the sales factor, TAX examined 297 returns filed by a sample of corporations for taxable year 2006 (the latest year for which complete data is available). This sample included all returns for the 97 corporations with the largest tax liability, and represented 60% of the Commonwealth's

[29] Mazerov, "The 'Single Sales Factor' for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway," Center for Budget and Policy Priorities. Retrieved 8/19/05 from http://www.cbpp.org/3-27-01sfp.htm.
[30] Id.
[31] Forsberg, "Single Factor – Double Trouble," retrieved 9/9/08 from http://www.njpp.org/rpt_singlefactor.html.
[32] Mazerov, "Federal 'Business Activity Tax Bill: Half of a Two-Pronged Strategy To Gut State Corporate Income Taxes," State Tax Notes, February 7, 2005, p. 399.

total corporate income tax revenue from multistate corporations (i.e., that apportioned income) for taxable year 2006. The remaining 200 returns in the sample were selected from four groups of returns representing roughly equal amounts of revenue. About 20,000 returns from multistate corporations with a tax liability of less than $6,000, or $100,000 of taxable income, were ignored because they represented only 1% of corporate income tax revenue and any change in their apportionment formula would be statistically immaterial. Another 47,000 returns from wholly Virginia corporations (i.e., who did not apportion income) were ignored because any change in the apportionment formula would have no impact on their tax liability. The sample breakdown is shown in the table below.

Sample Selection

Tax Liability	No. of Returns			Sampled Income*	Total Income*
	Sample	Total	Percent		
More than $1.26 Million	97	97	100%	425.0	425.0
$538,000 to $1,260,000	50	89	56%	42.9	74.4
$242,000 to $538,000	50	195	26%	17.7	70.5
$83,000 to $242,000	50	498	10%	6.6	70.7
$6,000 to $83,000	50	2,524	2%	1.2	61.9
Less than $6,000	0	20,096	0%	0	7.7
(100% Va. Corp)	0	46,767	0%	0	91.6
Totals*	**297**	**70,266**		**493.6**	**801.9**

* Amounts in $ millions. Amounts may not add up to totals because of rounding.

A. Impact of 2000 Law Change

Prior to determining the impact of changing the weight of the sales factor in the appointment formula to 100%, TAX looked back at the impact of the 2000 change in the apportionment formula from equal-weighted factors to double weighting the sales factor.

Impact of Change from Equally-Weighted to Double-Weighted Sales Factor

Tax Liability	Equally-Weighted*
More than $1.26 Million	19.9
$538,000 to $1,260,000	2.6
$242,000 to $538,000	1.0
$83,000 to $242,000	(1.7)
$6,000 to $83,000	(4.6)
Totals*	**17.3**

* Amounts in $ millions. Amounts may not add up to totals because of rounding.

The inverse of this number represents the current-year impact of the 2000 change to double-weight the sales factor. The change from equally-weighted factors to double-weighted sales factor, effective in 2000, saved corporations about $17.3 million in their returns for taxable year 2006

B. Impact of Alternatives Considered

Four alternatives were considered: (1) making the change to single sales factor mandatory for all corporations, (2) making the change to single sales factor optional for all corporations, (3) making the change to single sales factor mandatory, applicable only to manufacturers, and (4) making the change to single sales factor optional, applicable only to manufacturers.

All Corporations

Tax Liability	Single Sales Mandatory*	Single Sales Optional*
More than $1.26 Million	(57.9)	(78.2)
$538,000 to $1,260,000	(7.9)	(16.7)
$242,000 to $538,000	(2.9)	(10.4)
$83,000 to $242,000	5.2	(5.0)
$6,000 to $83,000	16.1	(12.5)
Totals*	**(47.4)**	**(122.7)**

* Amounts in $ millions. Amounts may not add up to totals because of rounding.

Had the use of single-weighted sales factor been in effect for taxable year 2006, then corporations, as a group, would have saved $47.4 million. If, however, the single-sales factor were an election for taxable year 2006, then only corporations whose tax would be reduced by the election would choose it, and they would have saved $122.7 million. These savings are in addition to the $17.3 million saved as a result of the switch from equally-weighted factors in 2000.

Note that the single sales factor would reduce the tax of some, while increasing the tax of others. If the single sales factor is made mandatory for all corporations, then the winners would pay $122.7 million less tax, while the losers would pay $75.3 million more tax, to produce the net revenue reduction of $47.4 million for all corporations as a group.

Applicable to Manufacturers Only

Tax Liability	Single Sales Mandatory*	Single Sales Optional*
More than $1.26 Million	(42.7)	(48.0)
$538,000 to $1,260,000	1.7	(3.2)
$242,000 to $538,000	1.1	(2.7)
$83,000 to $242,000	1.4	(2.9)
$6,000 to $83,000	4.6	(7.8)
Totals*	**(33.9)**	**(64.7)**

* Amounts in $ millions. Amounts may not add up to totals because of rounding.

If the single sales factor were to apply only to manufacturers (mandatory or elective) the revenue impact would be less. Had the use of single-weighted sales factor been in effect for taxable year 2006, then manufacturers, as a group, would have saved $33.9

million. If, however, the single-sales factor were an election for taxable year 2006, then only manufacturers whose tax would be reduced by the election would choose it, and they would have saved $64.7 million. Again, these savings are in addition to the $17.3 million saved as a result of the switch from equally-weighted factors in 2000.

Like corporations in general, note that the single sales factor would reduce the tax of some, while increasing the tax of others. If the single sales factor is made mandatory for all manufacturers, then the winners would pay $64.7 million less tax, while the losers would pay $30.8 million more tax, to produce the net revenue reduction of $33.9 million for all manufacturers as a group. It is interesting to note that if single sales factor was mandatory in taxable year 2006, only the top strata (those who have a tax liability of more than $1.26 million), as a group, would pay less tax.

Generally, this estimate is based upon the NAICS code shown on the returns in the sample. Actual results may vary depending upon the definition of manufacturer used. Also, the sample included many consolidated returns for which no data existed to break down the affiliates between manufacturers and nonmanufacturers. If the NAICS code for the consolidated return indicated manufacturing the apportionment factor for the entire group was recalculated, not just the manufacturing affiliates.

These amounts do not exactly match the revenue loss to the Commonwealth by fiscal year because corporate income tax for taxable year 2006 was paid over the course of three fiscal years. Although the bulk of the revenue impact would fall into Fiscal Year 2007, some estimated payments would have been made in Fiscal Year 2006, while payments filed with returns filed under extension and by corporations using a fiscal year would fall into Fiscal Year 2008.

1. Winners and Losers

In addition to noting the amount by which tax liability changed, the number of taxpayers that saw their tax reduced by the change (winners) and increased (losers) was noted. Corporations that had their entire operations in Virginia do not apportion income and showed no change. A few corporations were subject to a minimum tax (telecommunications or electric suppliers) and also showed no change. The "winner/loser" designation was applied to each return regardless of how many affiliates were included in a combined or consolidated return. The results are shown below:

Single Sales Factor All Corporations

Tax Liability	Winners	Losers	No Change	Amount of Change in Tax	Percentage Change
More than $1.26 Million	51	33	13	-57.9 million	-13.6%
$538,000 to $1,260,000	27	20	3	-7.9 million	-10.6%
$242,000 to $538,000	20	24	6	-2.9 million	-4.1%
$83,000 to $242,000	19	27	4	+5.2 million	+7.3%
$6,000 to $83,000	19	28	3	+16.1million	+26.1%
Totals	**136**	**132**	**29**	**- 47.4 million**	**-6.7%**

Single Sales Factor Manufacturers Only

Tax Liability	Winners	Losers	No Change	Amount of Change in Tax	Percentage Change
More than $1.26 Million	15	6	3	-42.7 million	-24.8%
$538,000 to $1,260,000	5	9	-	+1.7 million	+9.0%
$242,000 to $538,000	3	7	-	+1.1 million	+9.0%
$83,000 to $242,000	6	6	1	+1.4 million	+8.5%
$6,000 to $83,000	8	12	-	+4.6 million	+17.3%
Totals	**37**	**40**	**4**	**- 33.9 million**	**-13.8%**

As can be seen from the tables, slightly more corporations are winners than losers when the weight of the sales factor is increased for all corporations. When the results are limited to just manufacturers, **there are actually more losers (pay more tax) than winners (pay less tax)**. For both groups, the winners are concentrated in the top stratum of corporations. While some corporations that pay very large amounts of tax will see a tax savings from switching to a single sales factor, many other corporations will actually see a tax increase from the change.

2. Use of these Estimates as Predictors

Moreover, translating these results into revenue forecasts useful for budgeting purposes is difficult. Corporate income tax revenue is quite volatile. The corporate income tax revenue for the last 10 fiscal years is shown in the table below along with the year-to-year percentage change in revenue. Over this 10-year period the year-to-year change in revenue fluctuated from a negative -35.7% to a positive 44.9%.

Corporate Income Tax Revenue

Fiscal Year	Revenue	Change
1997	$432,297,934	-
1998	450,779,925	4.3%
1999	420,421,456	-6.7%
2000	565,909,181	34.6%
2001	363,757,398	-35.7%
2002	290,215,035	-20.2%
2003	343,318,607	18.3%
2004	425,715,754	24.0%
2005	616,690,263	44.9%
2006	867,115,786	40.6%
2007	879,575,371	1.4%

There appears to be no direct correlation between changes in total corporate income tax revenue and the fiscal impact of changing the apportionment factor. When TAX prepared its fiscal impact statement on HB 1514, data from a similar study based on taxable year 2003 returns was used. Comparable estimates based on the 2003 and 2006 taxable years are presented below, along with the total corporate revenue for the fiscal year in which most of the taxable year payments were collected.[33]

Alternatives (amounts in $ millions)	**TY 2003**	**TY 2006**	**Change**
Mandatory Single Sales for All Corporations	(37.4)[34]	(47.4)	27%
Optional Single Sales for All Corporations	(65.6)	(122.7)	87%
Mandatory Single Sales for Manufacturers	(25.4)	(33.9)	33%
Optional Single Sales for Manufacturers	(36.0)[35]	(64.7)	80%
Most Closely Related Fiscal Year	FY 2004	FY 2007	
Total Corporate Income Tax Revenue	425.7	879.6	107%
Manufacturers' Corp. Income Tax Revenue	129.9	307.9	137%
Manufacturers' Percent of Total Corp. Tax	31%	35%	

This data represents the consequences had the revised apportionment formula been in effect for taxable year 2006. Projections of the impact on future fiscal year revenue of the Commonwealth have not been provided. Corporate income tax revenue is the most volatile of our revenue sources. While an individual corporation's apportionment factor usually does not change significantly from year to year, its profitability does. Thus, the impact of changing the apportionment formula will depend on overall corporate profits, as well as which corporations have good or bad years.

The information captured on corporate income tax returns does not allow reliable classification of taxpayers among industry groups. The return asks corporations for their North American Industry Classification System (NAICS) code, but such codes are self-assigned, and may not be representative of large corporations that are engaged in several business sectors. As discussed above, the industry in which a taxpayer is engaged has little impact on its apportionment. The location of its property and payroll in relation to its sales is the critical factor in apportioning its income. Nevertheless, inspection of the codes revealed that holding companies were consistently winners. Holding companies often have subsidiaries engaged in different industries, and frequently structure their holdings and operations for maximum tax advantage.

The returns have two items of information representing their location: (i) the state of incorporation, and (2) the address on the return. The state of incorporation has little relationship to the corporation's commercial domicile or base of operations. The

[33] Revenue from a specific taxable year is received over at least three fiscal years. For example, corporations made estimated 2006 payments in April and June of 2006 (FY 06), estimated payments in September 2006 and January 2007 (FY 07). At least 90% of the 2006 tax must be paid by April 15, 2007, to avoid penalty (FY 07). Most large corporations file their 2006 returns in October 2007 with any remaining tax owed (FY 08). Payments for taxable year 2006 continue to be received after October 2006 for fiscal year corporations, late payments, audits and amended returns.

[34] This amount is taken from "Virginia's Apportionment Formula," presented to Joint Subcommittee studying manufacturing needs pursuant to SJR 361 (2005) on August 25, 2005. The report may be retrieved from: http://dls.state.va.us/groups/SJR361/MEETINGS/082505/sales.pdf

[35] This amount is taken from the Fiscal Impact Statement for HB 1514 (2008).

address on the return is normally the tax office of the corporation, which may or may not be located at the headquarters of the corporation, and which does not always represent the location of most of its operations. Thus, return location information is not relevant to this issue.

IX. Conclusion

The single sales factor apportionment formula is being sought on economic development grounds. However, analysis of returns representing most of the Commonwealth's corporate income tax revenue shows that a single sales factor will produce an immediate and substantial revenue loss.

Tax Policy considerations may support changing the factor for sales of other than tangible personal property to more closely follow the destination approach for tangible personal property. The special method for financial corporations may also bear changing to incorporate customer location for a portion of the factor comparable to other corporations. There is no consensus, however, as to what changes would be appropriate and any changes to the apportionment formula would have a revenue impact. Further study may be appropriate on these issues.