Virginia's Apportionment Formula

Presented to the:

**Joint Subcommittee Studying Manufacturing Needs
And The Future Of Manufacturing In Virginia –
Pursuant To SJR 361**

August 25, 2005

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Background

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 1958. Under UDITPA, business income is viewed as unitary, that is, all parts contribute to the whole. The income of this unitary business is 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.

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 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.

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.

Economic Development

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

<u>The Apportionment Formula</u>

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.

Of the 47 states and the District of Columbia that impose a corporate income tax, all but 13 permit or require businesses to weight the sales factor at 50% or more. Eight states use a single sales factor for all taxpayers or for specified industries, usually manufacturing, and three more are phasing in a single sales factor. (See the table below.) 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.

Today, Virginia's apportionment formula is in the mainstream in that more states use the same formula as Virginia than any other variation. Recently several states have moved toward a pure sales factor (whether for all mulitstate businesses or for selected industries). It has been suggested that Virginia should consider similarly changing its apportionment formula.

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 is likely to be negative. Let's examine the impact on taxpayers first.

Sales Factor Weight In Apportionment Formula		
Sales factor only	**4**	IL, IA, NE, TX
Three factors, sales weighted more than 50%	**6**	MI (90%), MN (phase in 100%), OH (60%), OR (phase in 100%), PA (60%); WI (phase in 100%)
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%	**17**	AZ, AR, CA, GA, ID, IN, KY, LA, ME, NH, NJ, NY, 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: 2005 Multistate Corporate Tax Guide, Vol. I, CCH Incorporated;
CCH State Tax Review – Vol. 66 Issue 30 (News 7/26/05)

Winners and Losers

Who benefits when the weight of the sales factor is increased?

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.

- This can be seen in Example 1. The sum of the property and payroll factors (58.33%) is significantly greater than the sales factor, doubled (20%). Increasing the weight of the sales factor reduces the business's Virginia apportionment factor and its tax liability.

- In Example 2, however, the property and payroll factors (9.76%) are less than the doubled sales factor (20%), so increasing the weight of the sales factor will increase the apportionment factor and tax liability of this business.

- In Example 3 the property, payroll and sales are relatively equal. As a result the business' tax liability will not be significantly affected by changes to the weight of the sales factor.

What types of businesses do these three examples represent? Example 1 represents a business that has a greater percentage of its facilities in Virginia than its sales in Virginia. Assuming that the business is profitable, it is probably producing more goods and services in Virginia than it sells in Virginia.

The business in Example 2 has a higher percentage of its sales in Virginia than it has facilities in Virginia. Again, assuming a profitable business, it is likely that much of what it sells in Virginia is produced outside of Virginia. The business in Example 3 appears to be balanced in the relationship between what it produces in Virginia and what it sells in Virginia.

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%**

Triple-weight sales:
25.00% + 33.33% + (3 x 10.00%) = 88.33% ÷ 5 = **17.66%**

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%**

Triple-weight sales:
5.00% + 7.50% + (3 x 10.00%) = 42.50% ÷ 5 = **8.50%**

Single sales factor: **10.00%**

Example 3	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%

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

Triple-weight sales:
8.00% + 12.00% + (3 x 10.00%) = 50.00% ÷ 5 = **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 they 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.

If an established manufacturer needs to expand, it may compare adding on to an existing facility or building a new facility in another state. In this situation the manufacturer's sales factor will not be affected by the location of the expanded or new facility, only its property and payroll factors.

- If the new facility is placed in Maryland (which has a single sales factor for manufacturers), it would have no impact on Maryland's corporate income tax liability because 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.

While a single sales factor would generally be considered a favorable factor by manufacturing businesses considering locating a facility in Virginia, this is not always true.

- There are businesses that have structured their operations to minimize state taxes. Sometimes the emphasis on a sales factor is detrimental to tax planning, so increasing the weight of the sales factor would not be viewed favorably. In other cases, the tax planning may take advantage of the absence of a property and payroll factor.

- An established out-of-state retail business may expand into Virginia by making a substantial investment in property and payroll to open retail establishments in Virginia, but the sales of the new establishments may take a few years to grow.

- Paradoxically, if an affiliated group of corporations that files a combined Virginia return has one member that is unprofitable, the group would benefit from a higher Virginia apportionment factor for that unprofitable member.

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

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 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 supported a single factor in Michigan (for its single business tax), but opposed adoption of a single factor in

Illinois. Similarly, Kraft Foods, headquartered in Illinois, supported adoption of a single sales factor in Illinois, but opposed it in Maryland.[1]

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.[2]

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.

Revenue Impact

In order to estimate the revenue impact of increasing the weight of the sales factor, the Department examined 293 returns filed by a sample of corporations for taxable year 2003 (the latest year for which complete data is available). This sample included all returns for corporations with $10 million or more in taxable income from Virginia sources, about 97% of the returns with $5 to $10 million in taxable income, and representative samples of those with smaller incomes. The returns in the sample represented 72% of Virginia's total corporate income tax receipts for the 2003 taxable year.

The returns were recalculated to determine the impact of changing the weight of the sales factor in the apportionment formula to 100% (single sales factor) and 60% (triple weighted factor). 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

[1] 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.
[2] 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.

affiliates were included in a combined or consolidated return. The results are shown below:

Single Sales Factor (Weight = 100% of Formula)

Income from Virginia Sources	Winners	Losers	No Change	Amount of Change in Tax	Percentage Change
More than $10 Million	52	28	17	-$28.0 million	-13.8%
$ 5 to $10 Million	47	38	11	-$4.2 million	-10.0%
$2 to $5 Million	10	14	1	+$3.1 million	+7.2%
$1 to $2 Million	9	13	3	-$3.4 million	-12.6%
$0.5 to $1 Million	11	13	1	-$0.2 million	-1.0%
$0.1 to $0.5 Million	16	8	1	-$4.8 million	-22.7%
Totals	**145**	**114**	**34**	**-$37.5 million**	

Triple-Weighted Sales Factor (Weight = 60% of Formula)

Income from Virginia Sources	Winners	Losers	No Change	Amount of Change in Tax	Percentage Change
More than $10 Million	54	26	17	-$5.8 million	-2.9%
$ 5 to $10 Million	47	38	11	-$0.9 million	-2.1%
$2 to $5 Million	10	14	1	+$0.6 million	+1.4%
$1 to $2 Million	9	12	3	-$1.2 million	-4.4%
$0.5 to $1 Million	11	13	1	-$0.04 million	-0.2%
$0.1 to $0.5 Million	16	8	1	-$1.0 million	-4.5%
Totals	**147**	**112**	**34**	**-$8.3 million**	

As can be seen from the tables, more corporations are winners than losers when the weight of the sales factor is increased. The greater the weight placed on the sales factor, the greater the impact of the change on corporate tax liability. For the Commonwealth, increasing the weight of the sales factor will result in a revenue loss, and the loss from a single sales factor would be more than four times greater than the loss from triple-weighting the factor. This is consistent with the result of a similar analysis performed in connection with legislation that changed Virginia's apportionment formula from equally-weighted factors to double-weight the sales factor.

This data represents the consequences had the revised apportionment formula been in effect for taxable year 2003. 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 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.