

**DEPARTMENT OF TAXATION
2025 Fiscal Impact Statement**

1. **Patron** Mark D. Obenshain
3. **Committee** Senate Finance and Appropriations
4. **Title** Corporate Income Tax: Market-Based Sourcing

2. **Bill Number** SB 1456
House of Origin:
 X **Introduced**
 Substitute
 Engrossed
- Second House:**
 In Committee
 Substitute
 Enrolled

5. Summary/Purpose:

This bill would change Virginia’s method of sourcing sales, other than sales of tangible personal property, from the cost of performance method to market-based sourcing.

This bill would be effective for taxable years beginning on or after January 1, 2026.

6. **Budget amendment necessary:** Yes.
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7. **Fiscal Impact Estimates are:** Preliminary (See Line 8.)

8. Fiscal implications:

Administrative Costs

The Department of Taxation (“the Department”) considers implementation of this bill as routine and does not require additional funding.

Revenue Impact

This bill would have an unknown impact on General Fund revenues beginning in Fiscal Year 2027. Developing a revenue impact for adopting market-based sourcing (“MBS”) is significantly limited by insufficient data. Precisely estimating the revenue impact would require information regarding the income, accumulated net operating losses, and apportionment factors of out-of-state corporations that are not currently required to file income tax returns with Virginia but sells services and intangibles to Virginia customers.

However, based on data from the IRS Statistics of Income—including industry-specific net income information—and using Virginia's share of the 2023 US Census Bureau population estimates as a proxy for Virginia's market as compared to the United States as a whole, the Department was able to produce a speculative estimate that suggests this bill would have the following impact on revenues:

- A negative General Fund revenue impact of approximately \$24 million in FY 2027 and \$2 million in FY 2028; and
- A positive General Fund revenue impact of approximately \$10 million in FY 2029 and \$23 million in FY 2030.

The anticipated negative revenue impact for FY 2027 and FY 2028 would be due to delayed compliance by out-of-state corporations, which would likely pay more under market-based sourcing and may not initially file and pay tax under the new rules. By FY 2029 and subsequent fiscal years, the Department anticipates that the revenue impact of this bill would be positive as compliance with Virginia's market-based sourcing rules by out-of-state corporations increases.

There are presently 39 states that have adopted market-based sourcing. In addition to the independent analysis referenced above, the Department consulted with a number of these states to understand their analysis and the basis for their decision to implement this policy. While consensus seemed to be that estimating and tracking the revenue implications of market-based sourcing proved difficult, none of the states contacted reported an unexpected revenue loss as a result of market-based sourcing.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Background

Apportionment is the method by which states divide a multistate taxpayer's income for state corporate income tax purposes. The starting point for corporations filing a state income tax return in Virginia and many other states is Federal Taxable Income. If each state were to tax a corporation on 100% of its income, that would violate the Commerce Clause of the U.S. Constitution (Article 1, Section 8, Clause 3), which has been interpreted by the U.S. Supreme Court as prohibiting states from imposing tax rules that place an undue burden on interstate commerce. See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), and *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

To avoid this result, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") created the Uniform Division of Income for Tax Purposes Act ("UDITPA") in 1957 to assist states in taxing multistate corporations. Under UDITPA, business income is apportioned to the states where a taxpayer conducts business using a statutory formula. As discussed below, apportionment is still the approach used by states, including Virginia, to compute the percentage of a corporation's income that is subject to tax in a particular state. However, the specific formula used to apportion income has changed over time.

Historical Apportionment Methodology

Under UDITPA as enacted in 1957, states generally apportioned their income by the application of a three-factor formula: the property factor, the payroll factor, and the sales factor:

- The property factor is a fraction of the average value of the corporation's real and tangible personal property owned or rented in the state during the taxable year as compared to the corporation's property located everywhere.
- The payroll factor is a fraction of total compensation paid or accrued within the state during the taxable year as compared to the total compensation paid or accrued everywhere during the taxable year.
- The sales factor is a fraction of the total sales of the corporation in the state during the taxable year as compared to total sales everywhere during the taxable year.

Some states applied this three-factor apportionment calculation, whereby the property, payroll, and sales factors were summed and divided by three to determine the corporation's apportionment percentage. Other states, including Virginia, opted to double weight the sales factor, meaning that the formula consisted of the property factor plus the payroll factor plus twice the sales factor, divided by four. Under both the three-factor and four-factor apportionment methods, the apportionment percentage was then applied to the corporation's income for the year to determine the amount of income subject to the state's income tax.

Cost of performance and market-based sourcing both refer to methods by which corporations determine how many sales are attributable to a state for purposes of computing the sales factor. To the extent more sales are sourced to a state, the corporation's income tax liability in that state will increase.

Costs-of-Performance ("COP") Sourcing Method

For purposes of computing the sales factor under UDITPA (and under Virginia law), corporations sourced sales of tangible personal property to a state based on where the goods were delivered to the customer. However, this was not originally the method for sourcing sales of services and intangibles. Under the original version of UDITPA, states sourced sales of services and intangibles to a state based on where the income-producing activity was performed. For companies doing business in a single state, sales of services and intangibles were sourced to the state based on the income-producing activity in that state. For multistate corporations, sales were sourced to a state if the greater proportion of the income-producing activity was performed in the state than in any other state (i.e., the "costs of performance" or "COP").

The COP rules were developed under UDITPA in the 1950s when intangible personal property and remote services made up a relatively small part of the economy. The COP rules were proposed as a cost-benefit compromise that made it easier for companies to source this very small part of the overall economy. Historically, most states adopted the COP method of sourcing sales of services and intangibles. However, as the digital age grew the intangible and remote services sectors of the economy, some states started moving away from the older COP rules.

Market-Based Sourcing (“MBS”) Sourcing Method

The states that began shifting away from COP adopted what is known as “market-based sourcing” (“MBS”) for non-tangible sales. These rules are conceptually similar to the destination rules states already used for tangible sales, in that the goal is to source non-tangible sales to the state where those sales was received. Because the model rules under UDITPA still reflected the COP sourcing methodology, states that began to adopt MBS did so slowly at first, and as late as 2010 there were only 12 MBS states. At that time, each state applied slightly different rules in an attempt to identify where the service was received. By 2015, the number of states adopting MBS increased to 23 states, and the sourcing methodology fell into four primary categories:

- Where the benefit of the service was received by the customer,
- Where the service was received by the customer,
- Where the service was delivered by the corporation, and
- Where the customer was physically located.

At this time, while each state’s law had some nuances, such as cascading rules if the service could not be sourced under the default rule, the general approaches were more consistent. The majority states (12 in total) had shifted to a methodology based on where the benefit of the service was received. Subsequently, several states adopted a fifth methodology, based on where the service was used.

As the states began shifting to MBS, the Multistate Tax Commission (“MTC”) began a uniformity project to redraft the sourcing rules for services and intangibles set forth under UDITPA. This project began in July 2009, and market-based sourcing rules were formally adopted in July 2015. Subsequently, the MTC began a workgroup to adopt model regulations providing the more detailed rules for how to implement market-based sourcing in a manner consistent with other states. This project began in 2016 and model market-based sourcing regulations were adopted in 2018.

By 2020, the number of MBS states increased to 37. As of 2024, there are 39 MBS states and only 9 COP states, making the once nearly universally accepted COP method now the outlier.

Summary of Current Law in Other States

Of the 48 jurisdictions that impose a corporate income tax or gross receipts tax, 39 jurisdictions have adopted MBS.

Market-Based Sourcing Jurisdictions (as of December 2024)	
Alabama	Montana
Arizona	Nebraska
California	Nevada

Colorado	New Hampshire
Connecticut	New Jersey
District of Columbia	New Mexico
Georgia	New York
Hawaii	North Carolina
Idaho	Ohio
Illinois	Oklahoma
Indiana	Oregon
Iowa	Pennsylvania
Kentucky	Rhode Island
Louisiana	Tennessee
Maine	Utah
Maryland	Vermont
Massachusetts	Washington
Michigan	West Virginia
Minnesota	Wisconsin
Missouri	

Virginia’s Method of Apportionment

Virginia follows the double-weighted sales factor approach under the original version of UDITPA, which generally requires the Virginia taxable income of a multistate corporation to be apportioned to Virginia by multiplying their income by a fraction, the numerator of which is the property factor plus the payroll factor, plus twice the sales factor, and the denominator of which is four:

$$\frac{\text{Property Factor} + \text{Payroll Factor} + 2(\text{Sales Factor})}{4}$$

As under the original version of UDITPA, the property, payroll, and sales factors are determined as follows:

- The property factor is a fraction that consists of the average value of the corporation’s real and tangible personal property owned or rented and used in Virginia over such property located everywhere.
- The payroll factor is a fraction, the numerator being the total amount of compensation paid or accrued within Virginia during the taxable year by a taxpayer, and the denominator being the total compensation paid or accrued everywhere during the taxable year.
- The sales factor is a fraction, the numerator of which is the total sales of the corporation in Virginia during the taxable year, and the denominator of which is the total sales of the corporation everywhere during the taxable year.

This bill would not change Virginia’s three factor apportionment formula, nor would it change anything about the property or payroll factor. This bill would address only how the sales factor is computed.

Determining the Sales Factor for Purposes of Apportionment

Following UDITPA, when Virginia adopted the three-factor apportionment formula in 1960, it defined the sales factor separately for sales of tangible property (tangible sales) and other sales (non-tangible sales).

Tangible sales are sourced to Virginia (i.e., included in the numerator of the sales factor fraction) if the ultimate destination after all transportation ceased was in Virginia. In the 1960's, some states used other rules for determining where sales occurred for their apportionment formulas, but as they adopted UDITPA, all states with corporate income taxes use the destination rule.

Similarly, Virginia generally followed the rules for non-tangible sales that were originally developed under UDITPA. Under Virginia law, non-tangible sales are deemed in the state if:

- The income-producing activity is performed in the state; or
- The income-producing activity is performed both in and outside of the state and a greater proportion of the income producing activity is performed in the state than in any other state, based on "costs of performance".

An "income-producing activity" is an act or acts directly engaged in by the taxpayer for the ultimate purpose of producing a sale subject to apportionment.

"Cost of performance" is defined as the cost of all activities directly performed by the taxpayer for the ultimate purpose of producing the sale to be apportioned.

Because of this cost of performance rule, the sales factor is not currently "market-based" for sales of non-tangible property. Instead, the sales factor for non-tangible property is often duplicative of the property and payroll factors to the extent it requires sourcing to where a corporation's costs are rather than where its customers are.

Virginia's Adoption of Market-Based Sourcing for Specific Industries

Recently, Virginia has allowed limited exceptions to this general rule to certain industries including debt buyers, certain property information and analytics firms, and certain root infrastructure providers.

Market Based Sourcing for Debt Buyers

During the 2018 Session, the General Assembly enacted legislation (House Bill 798 (2018 *Acts of Assembly*, Chapter 807)) that requires debt buyers to include sales, other than sales of tangible personal property, in their Virginia sales factor if they consist of money recovered on debt that a debt buyer collected from a person who is a resident of Virginia or an entity that has its commercial domicile in Virginia.

Market Based Sourcing for Property Information and Analytics Firms

During the 2022 Session, the General Assembly enacted legislation (House Bill 453 (2022 Acts of Assembly, Chapters 256) and Senate Bill 346 (2022 Acts of Assembly, Chapter 257)) that required a property information and analytics firm that meets certain criteria and chooses to enter into an MOU with the Virginia Economic Development Authority to use a hybrid sales factor in their income apportionment calculations when filing Virginia corporate income tax returns. This hybrid sales factor consists of an MBS rule to determine the sales of services attributable to Virginia for apportionment purposes and a cost of performance rule for the sale of intangible property and real estate.

Market Based Sourcing for Internet Root Infrastructure Providers

During the 2023 Session, the General Assembly enacted legislation (House Bill 1481 and Senate Bill 1349 (2023 Acts of Assembly, Chapters 405 and 406)) that requires internet root infrastructure providers that meet certain criteria and choose to enter into a MOU with the Virginia Economic Development Authority to use a hybrid sales factor in their income apportionment calculations when filing Virginia corporate income tax returns. This hybrid sales factor consisting of an MBS rule to determine the sales of services attributable to Virginia for apportionment purposes and a cost of performance rule for the sale of intangible property and real estate.

Virginia Studies Regarding Market-Based Sourcing

In House Document 3 (2010), entitled "Review of Virginia's Corporate Income Tax System", the Joint Legislative Audit and Review Commission ("JLARC") evaluated market-based sourcing and determined that:

Virginia may wish to give particular consideration to adopting market-based sourcing for intangible goods and services while discontinuing the State's extension of PL 86-272 protections to providers not covered by federal law.

During the 2015 Session, the General Assembly considered House Bill 2233, which would have required the Department to form a working group to review and make recommendations concerning the desirability and feasibility of changing Virginia's method of sourcing a corporation's non-tangible sales to either MBS or to a bifurcated method that utilizes both the COP method MBS. Although the General Assembly did not enact this legislation, the Chairman of the House Finance Committee requested that the Department form a working group of interested parties to:

- Study the desirability and feasibility of Virginia changing its method of sourcing a corporation's non-tangible sales from the cost of performance method to market-based sourcing;
- Study the desirability and feasibility of adopting a bifurcated approach to sourcing a corporation's sales that would allow certain corporations to elect to use MBS in lieu of the COP method;
- Provide recommendations regarding the desirability and feasibility of implementing such changes; and

- Provide draft legislation based on the Department’s recommendations for potential consideration by the General Assembly.

The results of such report were inconclusive, due to a lack of reliable data at the time of the study. Budget language was considered in 2015 that would have required certain corporations to provide pro forma returns reporting information about their tax liability under market-based sourcing, in an attempt to qualify the potential impact of MBS. However, such language was not ultimately adopted.

Since the 2010 JLARC report, several other bills have been introduced to adopt market-based sourcing, including:

- House Bill 1604 (2011) would have adopted market-based sourcing and dedicate revenue generated by the bill to the Highway Maintenance and Operating Fund.
- Senate Bill 1006 (2011).
- House Bill 2253 (2013) would have adopted market-based sourcing as part of an omnibus bill revising rates and tax preferences for several state and local taxes.
- House Bill 442 (2014).
- House Bill 552 (2024).

Proposal

This bill would equalize the treatment of non-tangible sales with the treatment of tangible sales for the purposes of calculating the sales factor for Virginia corporate income tax purpose so that all sales would be sourced to the Commonwealth on a similar basis.

“Sales factor” is a fraction the numerator of which is the total number of sales in the Commonwealth and the denominator of which is the total number of sales everywhere.

“Sourcing” of sales refers to the rules by which a state requires companies to determine in which state a sale took place for corporate income tax purposes.

This bill would change Virginia’s default method for sourcing non-tangible sales from the costs-of-performance (“COP”) method to the market-based sourcing (“MBS”) method; meaning non-tangible sales would be deemed in Virginia if the benefit or use of such sale is received at a location (“market”) in the Commonwealth. These rules are based on the methodology set forth in the model regulations adopted by the MTC in 2018.

A taxpayer’s market for such a sale would be deemed in Virginia:

- In the case of sales of services, to the extent that the purchaser of the service receives the benefit of the service in Virginia;
- In the case of sales of intangible personal property, to the extent that the purchaser of the intangible personal property uses such property in Virginia;
- In the case of sales of marketable securities, if the customer is in Virginia;
- In the case of sales from the sale, lease, rent or licensing of real property, if such real property is located in Virginia; and
- In the case of sales from the lease, rent or licensing of tangible personal property, if such tangible personal property is located in Virginia at the time of the lease, rental,

or licensing.

This bill would not change Virginia's current three factor (property, payroll and double-weighted sales) apportionment formula.

This bill would require the Department to promulgate guidelines on market-based sourcing, and remove the requirement that the Department, upon request, report to the Chairmen of the House Committee on Appropriations and the Senate Committee on Finance and Appropriations the number of returns processed for property information and analytics firms that used MBS and the annual estimated revenue impact of MBS as compared with COP.

This bill would become effective for taxable years beginning on or after January 1, 2026.

Similar Bills

HB 1866 is identical to this bill.

cc : Secretary of Finance

Date: 01/22/2025 SJH
SB1456F161