DEPARTMENT OF TAXATION
2024 Fiscal Impact Statement

1. **Patron** Joseph P. McNamara

2. **Bill Number** HB 552
   House of Origin:
   _X_ **Introduced**
   _____ **Substitute**
   _____ **Engrossed**

   Second House:
   _____ **In Committee**
   _____ **Substitute**
   _____ **Enrolled**

3. **Committee** House Finance

4. **Title** Corporate Income Tax; Market-Based Sourcing

5. **Summary/Purpose:**

   This bill would change Virginia's method for 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, 2025.

6. **Budget amendment necessary:** No.

7. **Fiscal Impact Estimates are:** Not available. (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 2025. Developing a reliable revenue impact for adopting market-based sourcing is significantly limited by insufficient data. 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 which sell services and intangibles to Virginia customers.

   Based solely upon information regarding corporations that were required to file income tax returns with Virginia in 2020, it is estimated that this bill could cause a potential negative revenue impact of up to $61 million in the first fiscal year during which it is implemented. However, this estimate does not include the potential offsetting positive revenue impact from out-of-state corporations who would now be required to file returns and pay corporate income tax to Virginia. Therefore, while the revenue impact of market-based sourcing in the first year of implementation is likely to be negative, the actual revenue impact is unknown. However, it would likely not exceed $61 million.

After the first fiscal year during which market-based sourcing is implemented, the Department anticipates that the negative revenue impact of this bill would decrease and potentially result in a positive revenue impact as compliance with Virginia's market-based sourcing rules by out-of-state corporations increases. However, the actual impact is unknown due to the lack of data on the potential tax liability of out-of-state taxpayers that are currently not filing returns, and the uncertainty regarding the rate of compliance by out-of-state taxpayers.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

<u>Virginia's Methods of Apportionment</u>

Statutory Method of Apportionment

Virginia generally requires the Virginia taxable income of a multistate corporation to be apportioned to Virginia by multiplying the 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.

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The property factor is a fraction that cons[illegible]of the average value of the corporation's real and tangible personal property owned or [illegible]ed and used in Virginia over the like 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 change the how companies are required to determine whether a sale, other than a sale of tangible personal property, would be considered "in Virginia" for purposes of calculating the sales factor.

Determining the Sales Factor for Purposes of Apportionment

Virginia's Cost of Performance Method

For Virginia apportionment purposes, sales of tangible personal property are deemed in Virginia if the tangible personal property is delivered to a location in Virginia. In contrast, sales, other than sales of tangible personal property, are deemed in Virginia if:

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

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. When it is applied, Virginia's cost of performance method acts as an "all-or-nothing" sourcing rule because it sources a particular sale completely to one jurisdiction to the exclusion of all other jurisdictions. Under Virginia's cost of performance method, a sale may not be sourced to more than one jurisdiction.

Cost of Performance Method in Other Jurisdictions

Eleven out of the 45 jurisdictions that impose a corporate income tax or a gross receipts tax on businesses use the cost of performance method. Arizona generally requires taxpayers to use the cost of performance method, but allows certain taxpayers the option of using market-based sourcing. In addition, Texas applies the cost of performance method to its gross receipts tax. Therefore, 11 jurisdictions are considered to be cost of performance method jurisdictions:

Cost of Performance Jurisdictions (as of July 2022)	
Alaska	Mississippi
Arizona	North Dakota
Arkansas	South Carolina
Delaware	Texas
Florida	Virginia
Kansas	

Market-Based Sourcing

Until recently, the majority of jurisdictions utilized the cost of performance method to source sales of intangible property and services. However, the trend in state corporate income taxation over the past fifteen years has been for jurisdictions to adopt market-based sourcing. The term "market-based sourcing" encompasses several variations of an apportionment method that sources a sale to the jurisdiction in which the corporation's market for such sale is located. When providing guidance regarding how a corporation is to determine its market for sales, other than sales of tangible personal property, market-based sourcing jurisdictions have distinguished between sales of intangible property and services. All market-based sourcing jurisdictions generally source sales of intangible property to the jurisdiction where such property is used. Market-based sourcing jurisdictions have developed five general methods for sourcing sales of services:

- Where the benefit of the service is received by the customer;
- Where the service is delivered;
- Where the service is received;
- Where the customer is located; or
- Where the service is used.

Of the 45 jurisdictions that impose a corporate income tax or gross receipts tax, 35 states and the District of Columbia have adopted market-based sourcing. The application of market-based sourcing is mandatory in 34 of those jurisdictions. Only Arizona allows certain corporations to elect whether to apply either the cost of performance or market-based sourcing. In addition, Ohio, Nevada and Washington apply mandatory versions of market-based sourcing to their respective taxes on gross receipts that are imposed in lieu of a corporate income tax. Therefore, 39 jurisdictions are considered to be market-based sourcing jurisdictions.

Market-Based Sourcing Jurisdictions (as of July 2022)	
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 Market-based Sourcing Exceptions

For sales other than sales of tangible personal property, Virginia requires most companies to source their sales to Virginia using to the cost of performance method. Recently, Virginia has allowed limited exceptions to this general rule to certain industries including, debt buyers, property information and analytics firms, and 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 (the "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 consisting of a market-based sourcing rule to determine the sales of services attributable to Virginia for apportionment purposes and the costs of performance rule for the sale of intangible property and real estate.

Market Based Sourcing for Internal 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 internal 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 a market-based sourcing rule to determine the sales of services attributable to Virginia for apportionment purposes and the costs of performance rule for the sale of intangible property and real estate.

Market-Based Sourcing Studies

North Carolina's Study on Market-Based Sourcing

On September 18, 2015, in lieu of adopting market-based sourcing, North Carolina enacted a budget measure that required the North Carolina General Assembly's Revenue Laws Study Committee to complete a study regarding market-based sourcing. To help estimate the revenue impact of enacting market-based sourcing for purposes of such study, North Carolina required each corporate taxpayer with apportionable income greater than $10 million and a North Carolina apportionment percentage of less than 100 percent to file an informational report with the North Carolina Department of Revenue on or before April 15,

2016. Corporations who failed to comply were subject to a fine of $5,000.

For purposes of North Carolina's informational reporting requirement, corporations were required to include:

- The corporation's actual 2014 North Carolina apportionment percentage;
- The corporation's 2014 North Carolina apportionment percentage determined using market-based sourcing;
- The corporation's primary industry code under the North American Industry Classification System; and
- Any other information prescribed by the North Carolina Secretary of Revenue.

The Revenue Laws Study Committee completed such study during 2016, but did not make a comprehensive report regarding the results of the study publicly available.

In 2019, North Carolina adopted market-based sourcing for taxable years beginning on or after January 1, 2020. In a Legislative Fiscal Note, North Carolina estimated the revenue impact of switching to market-based sourcing to be approximately a $1 million loss in the first year of implementation and a $3.5-$5 million of gain in subsequent years.

Other State Studies Requiring the Filing of Informational Returns

Vermont's Tax Commissioner recently expressed interest in utilizing a methodology similar to North Carolina's for purposes of studying the impact of enacting market-based sourcing. Similar reporting requirements have been imposed by Maryland and Rhode Island when studying the adoption of measures such as single sales factor apportionment and combined reporting.

Virginia's Study on Market-Based Sourcing

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 sales, other than sales of tangible personal property, to either market-based sourcing or to a bifurcated method that utilizes both the cost of performance method and market-based sourcing. 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 sales, other than sales of tangible personal property, 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 market-based sourcing in lieu of the cost of performance 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, primarily because the Department does not currently have access to the data necessary to provide a concrete revenue estimate. To develop a definitive estimate regarding the impact of enacting market-based sourcing, it is critical for the Department to have data from corporations regarding the amount of sales that are sales of intangible property or services, and where such sales would be sourced under a particular version of market-based sourcing. Corporations do not currently report such information to the Department, and the Department does not have access to any other source of data that would let it ascertain such information.

Proposed Legislation

This bill would change Virginia's method for sourcing sales, other than sales of tangible personal property, from the cost of performance method to market-based sourcing. 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 be effective for taxable years beginning on or after January 1, 2025.

Similar Legislation

House Bill 551 would allow corporations to elect to apportion their income to Virginia using the single-sales factor method.

cc : Secretary of Finance

Date: 2/2/2024 JLOF
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