JOINT LEGISLATIVE AUDIT AND REVIEW COMMISSION
Fiscal Impact Review
2011 Session

Bill Number: SB 1006
Review Requested By: Senator Colgan

JLARC Staff Fiscal Estimates

JLARC staff partially concur with the estimates of the fiscal impact statement (FIS) prepared for Senate Bill (SB) 1006. SB 1006 would mandate that multistate corporations selling services or intangible goods begin sourcing their sales to Virginia using a market-based sourcing method. Under market-based sourcing, multistate corporations would source sales of services or intangible goods to Virginia if the benefit or use of such sale was to a person or location in Virginia. Currently, multistate corporations source sales of services or intangible goods to Virginia if the greater proportion of the income producing activity is performed in Virginia. The FIS prepared for SB 1006 estimates that implementing the bill would reduce the income tax liability of multistate corporations currently paying corporate income taxes in Virginia by $8.3 million in FY 2012 and $16.6 million in FY 2013. SB 1006 is expected to result in additional revenue from certain out-of-state corporations that currently do not pay corporate income taxes to Virginia but would begin sourcing sales to Virginia under the market-based sourcing method and be required to file a return and remit taxes owed. However, the magnitude of this additional revenue was reported as "unknown" in the FIS.

JLARC staff find that the FIS estimates of the reduction in income tax revenue from multistate corporations that currently pay Virginia taxes appear to be based on the best available information and are therefore reasonable. JLARC staff also concur that implementing market-based sourcing would result in additional revenue collections from out-of-state corporations that would begin sourcing sales to Virginia and be required to file a corporate income tax return and remit taxes owed. While data are not available to develop a precise estimate of how much additional revenue could be collected if SB 1066 were implemented, JLARC staff developed several assumptions to estimate a potential fiscal impact.

An explanation of the JLARC staff review is included on the following pages.

Authorized for Release:

Glen S. Tittermary
Director

JLARC offers Fiscal Impact Reviews in accordance with Item 30D of Chapter 874 (2010 Acts of Assembly). JLARC Fiscal Impact Reviews do not comment on the merits of the bill under review.

Bill Summary:
Multistate corporations with income from Virginia sources must apportion income to Virginia using an apportionment factor, which is comprised of a payroll factor, a property factor, and a sales factor. SB 1006 would change the method that multistate corporations providing services or intangible goods use to calculate their sales factor. The sales factor is the amount of sales or gross receipts sourced to Virginia divided by the total sales or gross receipts everywhere. Currently, sales of services and intangible good are sourced to Virginia if the greater proportion of the income producing activity is performed in Virginia. This is different from the policy used for sales of tangible personal property, which are sourced to Virginia if the property is received in Virginia by the purchaser. If implemented, SB 1006 would mandate that multistate corporations selling services or intangible goods begin sourcing their sales to Virginia using a market-based sourcing method. Under market-based sourcing, multistate corporations would source sales of services or intangible goods to Virginia if the benefit or use of such sale is to a person or location in Virginia.

Discussion of Fiscal Implications:
The fiscal impact statement (FIS) for SB 1006 estimates that implementing this bill would result in a reduction in tax revenue collected from corporations that currently file and pay Virginia corporate income taxes by $8.3 million in FY 2012 and $16.6 million in FY2013. JLARC staff concur with this estimate and have conducted additional analyses to illustrate how multistate corporations that currently file and pay Virginia corporate income taxes might be impacted if the bill were implemented.

In addition, the FIS accurately states that some out-of-state corporations that currently do not file and pay Virginia corporate income taxes may have to begin sourcing their sales of services and other intangible goods to Virginia under market-based sourcing, thereby having to file returns and remit taxes owed to the State. However, the FIS states that the revenue impact is unknown because data are not available to precisely estimate the impact. JLARC staff have refined a prior estimate that more accurately reflects the extent to which corporate income tax revenues could be impacted by the adoption of market-based sourcing, including the estimated impact attributable to out-of-state corporations that do not currently file tax returns in Virginia.

<u>(1) Estimated Impact on Corporations That Currently File and Pay Virginia Income Taxes</u>

The Department of Taxation used data from tax year (TY) 2006 corporate income tax returns to develop the estimated impact on corporations that currently file and pay Virginia income taxes. Although corporate income tax returns include a field intended to capture the industry to which each corporate filer belongs, this field is often not filled in or can be misleading when a single return includes multiple affiliated corporations from different industries that are owned by the same parent corporation. As a result, using the industry field to identify which corporations would be impacted by market-based sourcing would have been inaccurate. Instead, TAX staff assumed that all corporations sell both tangible goods and services, and adjusted the income tax liability on each return in two primary ways.

First, the sales factor of each corporate taxpayer was replaced with an estimated sales factor under market-based sourcing that was generated by a formula to adjust their original sales factor according to (1) Virginia's proportion of U.S. Gross Domestic Product (3.08 percent) in 2009 for the service industry and (2) the corporate filers' current physical presence in Virginia. Virginia's proportion of GDP for service activity was used as a proxy for the average proportion of service-related sales made to Virginia consumers. The formula also accounted for the filers' physical presence in Virginia because corporate filers with relatively high property and payroll factors are more likely regional in nature, therefore their sales factor under market-based would be higher than 3.08 percent, which is the estimated average.

Second, tax liability was adjusted by Virginia's GDP from service activity as a proportion of total Virginia GDP in 2009. This adjustment was made to account for the amount of income which was derived from service activity only, and reduced the income that is taxable in Virginia by 48.67 percent. The table below illustrates the impact on corporate income tax returns and revenue, by level of tax liability, if market-based sourcing had been in place in TY 2006.

Original Level of Income Tax Liability	**Impact on Corporate Filers, by Change in Tax Liability (TY 2006)[a]**					**Overall Tax Liability, $Million (TY 2006)[a]**		
	Reduced		**Increased**		**Same**	**Market-Based ($M)**	**Change**	
	$M	**#**	**$M**	**#**	**#**		**$M**	**%**
Tax ≥ $1.26M	($16.2)	70	$3.0	105	11	$548.4	($13.1)	(0.02)
$538,000 ≤ Tax $1.26M	-3.3	56	0.4	75	10	82.1	(2.9)	(0.03)
$242K ≤ Tax < $538K	-0.3	6	0.1	52	4	6.7	(0.2)	(0.04)
$83K ≤ Tax < $242K	-0.1	2	0.0	0	0	0.1	(0.1)	(0.48)
$6K ≤ Tax < $83K	-0.2	20	0.0	50	0	0.2	(0.2)	(0.47)
Tax < $6K	0.0	75	0.0	1	321	0.1	(0.0)	(0.47)
Total	**($20.1)**	**229**	**$3.5**	**282**	**346**	**$637.6**	**($16.6)**	**(0.03)**

[a] Extrapolated to all corporate filers in tax year 2006.

As illustrated in the table above, 857 current corporate income tax filers in Virginia were estimated to have experienced a combined net reduction of $16.6 million (three percent) reduction in their tax liability if market-based sourcing had been implemented in TY 2006. Of those, 40 percent would likely not experience a change in tax liability, while 27 percent would have an estimated tax liability reduction totaling $20.1 million, and the remaining 33 percent would face a higher tax liability totaling $3.5 million. Corporate filers whose income tax liability was less than $242,000 would have experienced the greatest percent reduction in tax liability in 2006. Even though corporate filers with tax liabilities over $1.26 million would have experienced the greatest dollar reduction in tax liability ($13.1 million), a significant number of filers in this group would have experienced an increase in tax liability. Additionally, even though it was estimated that 282 current corporate filers would have experienced an increase in tax liability if market-based sourcing had been in place, the increase per corporate filer would have been just over $12,000 on average.

As mentioned above, industry codes are not useful for identifying the group of corporate income tax returns that would be impacted by market-based sourcing. However, the table on the following page illustrates the extent to which corporations with service-related industry codes could have been positively or negatively impacted if market-based sourcing had been in place in TY 2006. It is important to note that this table does not include the returns of corporations reporting non-service industry or no industry codes.

As illustrated in the table that follows, current corporate income tax filers with service industry codes were estimated to have experienced a combined $6.2 million (five percent) reduction in their tax liability if market-based sourcing had been implemented in TY 2006. Although reductions were not significant overall, corporate filers in the health care and other services sectors would have experienced the greatest percent reductions in their tax liability if market-based sourcing had been in place. Other services corporations would have faced an estimated combined increase of $0.3 million. The greatest number of corporations that would have experienced an increase in tax liability is in the professional and technical and information service sectors.

Industry Category	Impact on Corporate Filers, by Change in Tax Liability (TY 2006)[a]					Overall Tax Liability, $Million (TY 2006)[a]		
	Reduced		Increased		Same	Market-Based ($M)	Change	
	$M	#	$M	#	#		$M	%
Accommodations and Food	($0.1)	6	>$0.1	2	16	$1.8	($0.1)	(0.05)
Administrative, Support, and Waste Management Services	(0.4)	4	0.0	0	11	4.9	(0.4)	(0.07)
Arts and Entertainment	(0.0)	2	0.0	0	5	0.0	(0.0)	0.00
Health Care	(0.5)	6	>0.1	3	16	4.7	(0.5)	(0.09)
Information	(2.9)	13	0.1	8	20	50.5	(2.8)	(0.05)
Professional/Technical	(2.2)	34	0.1	13	41	44.8	(2.1)	(0.04)
Real Estate, Rental, and Leasing	(0.2)	11	0.1	4	25	6.7	(0.1)	(0.02)
Transportation and Warehousing	(0.0)	6	>0.1	3	12	6.6	0.0	0.00
Other Services	(0.3)	11	>0.1	2	22	3.31	(0.3)	(0.08)
Total	**($6.4)**	**93**	**$0.3**	**35**	**168**	**$123.2**	**($6.2)**	**(0.05)**

[a] Not extrapolated to all corporate filers in tax year 2006.

It is also important to note that the information presented in the tables above reflect the estimated changes in income tax liability that would have occurred for corporate income tax returns filed in TY 2006. The actual impact on corporate taxpayers of implementing market-based sourcing may differ from year to year based on numerous economic and other factors.

The table below provides additional context as to what types of corporations would likely be included within each industry category.

Industry Category	Includes Companies Performing the Following Activities
Accommodations and Food	Provide lodging and meal preparation for immediate consumption such as hotels, bed and breakfasts, and restaurants.
Administrative and Support and Waste Management	Provide routine support activities for day-to-day company operations including office administration, security, cleaning, and waste disposal services. Some companies may also provide similar services to households.
Arts and Entertainment	Provide cultural, recreational, performing arts, and other entertainment services such as concert and sporting facilities, and amusement parks.
Health Care and Social Assistance	Provide medical care or social services by trained professionals.
Information	Provide publishing, motion picture, sound recording, telecommunications, data processing, internet, and cable television or other broadcasting services.
Professional/Technical	Provide services that require a high degree of expertise or training, such as legal, accounting, architectural, and advertising services.
Real Estate, Rental, and Leasing	Provide realty and real estate appraisal, property management, and equipment rental services.

Industry Category	**Includes Companies Performing the Following Activities**
Transportation and Warehousing	Provide transportation of passengers or cargo, scenic or sightseeing transportation, logistic or other transportation support services, and warehousing or storage of goods.
Other Services	Provide services including instruction and training, equipment, dry cleaning and laundry, pet care, and temporary parking services.

(2) <u>Estimated Impact on All Corporations, Including Those That Do Not Currently File and Pay Virginia Income Taxes but May Be Required to Under Market-Based Sourcing.</u>

Data are not available to develop a precise estimate of how much additional revenue could be collected from corporations that would be required to file and pay taxes if market-based sourcing were implemented. However, JLARC staff developed several assumptions to estimate the potential magnitude of the additional revenue that could be collected. This estimate also accounts for the impact to corporations that currently file and pay Virginia corporate income taxes. Because this is not a precise estimate, it should be considered an estimate of the maximum amount of tax revenue that could be collected if market-based sourcing had been adopted in Virginia.

JLARC staff reported in *Review of Virginia's Corporate Income Tax System* (HD 3, 2011), that the potential impact of adopting market-based sourcing could reach up to $248.7 million, based on TY 2006 returns. This estimate overstates the actual revenue impact for several reasons, as discussed in the JLARC report as well as the FIS. First, the estimate includes additional revenue collections from certain corporations that sell tangible goods but cannot be taxed in Virginia because of federal law (P.L.86-272). Second, there are many tax planning strategies that corporations can use to reduce their state income tax liability. Third, some corporations believe that states cannot subject them to taxation unless they have a physical presence in the state and may not voluntarily comply with Virginia's policy change.

While some of the challenges leading to overestimation cannot be addressed, JLARC staff made additional assumptions to more precisely estimate the impact of implementing market-based sourcing for this fiscal impact review (FIR). In particular, further assumptions were made to isolate the income tax liability that is derived from service activity by excluding income tax liability derived from the sales of tangible goods. This adjustment specifically attempts to exclude the income tax liability of out-of-state corporations that sell only tangible goods to Virginia customers and are protected from income taxation in Virginia by federal law. Due to an inherent absence of information about the potential reaction of corporations to SB 1006, this estimate still does not account for the reduction in additional revenue due to tax planning and noncompliance, and therefore constitutes a maximum amount. According to the estimate for this FIR, implementing market-based sourcing could have resulted in additional revenue collections of <u>up to</u> approximately $171.5 million in TY 2006. The table on the following page illustrates the methodology that was used to develop this estimate.

The vast majority of the impact of adopting market-based sourcing would accrue from out-of-state corporations that have no presence in the State (that is, have no employees, offices, stores, or other business locations in the State) but sell services or intangible goods to Virginia customers. These corporations would begin filing a return and paying taxes to Virginia, if they complied with Virginia's new policy. The industries that would most likely be impacted include the same categories identified for current corporate filers, as illustrated in the table on page 4 of this FIR.

Steps in Analysis	**Estimate ($ Millions)**
Federal Taxable Income (FTI) of All Corporations (excluding financial/ management industries) Filing US Corporate Income Tax Return (2006) *Internal Revenue Services, Statistics of Income, TY 2006*	$922,835.5
Estimated Virginia Taxable Income (VTI) (2006) *VTI as a proportion of FTI, based on TY 2006 Virginia corporate income tax returns, excluding financial/management industries*	591,901.6
Income Taxable in Virginia (2006) *VTI x average apportionment factor of 0.0297, based on data from the 2007 Economic Census and 2006 GDP for service industries only*	17,560.9
Income Taxable in Virginia from Service Activity Only (2006) *Virginia GDP from service activity represents 0.4671 of total Virginia GDP in 2006, based on data from Bureau of Economic Analysis*	8,202.3
Income Tax Liability	**Estimate ($ Millions)**
Under Market-Based Sourcing, Service Activity Only (2006) *Income taxable in Virginia from service activity x 0.06 tax rate*	$492.1
Current Policy, All Corporations, Service Activity Only (excluding financial/management) (2006) *Corporate income tax revenue based on TY 2006 Virginia corporate income tax returns*	320.6
Maximum Change in Revenue Impact if Market-Based Sourcing Is Implemented and All Affected Corporations Are Fully Compliant (2006)	**$171.5**

SB 1006 would also require TAX to publish guidelines to implement market-based sourcing, and the guidelines could alter the revenue impact. In particular, the estimated impact on revenue in the table above assumes that TAX would discontinue its policy of extending protections of federal law (PL 86-272) to service providers. PL 86-272 is the federal law that protects out-of-state corporations from being taxed in a state if their only connection to the state is their sales of tangible goods to customers in the state. While applicable at the federal level to providers selling tangible goods only, TAX has a longstanding policy of extending the protections of PL 86-272 to providers selling services and other intangible goods. Because of this policy, the State does not exercise its right to tax out-of-state corporations that solicit sales of services or intangible goods to Virginia customers.

Budget Amendment Necessary: Yes. The budget of the Department of Taxation (TAX) would need to be adjusted to account for an additional staff person, as indicated in the FIS for SB 1006. While revenue would likely increase if market-based sourcing were adopted, the revenue estimate represents a maximum and lacks precision necessary to include in the budget document. In particular, the revenue estimate is based on corporate returns from TY 2006 as the necessary information for more recent tax years has not been automated. The estimate was also not forecasted to the upcoming fiscal years. Corporate tax revenue is highly volatile from year to year because of changes in corporate operations and economic cycles. In addition, the revenue that could be collected is dependent on the guidelines TAX publishes for implementing market-based sourcing and the compliance of corporate taxpayers that would be required to source sales to Virginia and therefore file and remit taxes.

Agencies Affected. Department of Taxation

Date Released, Prepared By: 12/02/2011; Ellen Miller.