DEPARTMENT OF TAXATION
2009 Fiscal Impact Statement

1. Patron Kathy J. Byron

2. Bill Number HB 2437

House of Origin:
_____ **Introduced**
_____ **Substitute**
_____ **Engrossed**

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

3. Committee Passed House and Senate

4. Title Corporate Income Tax; Apportionment for Manufacturers

5. Summary/Purpose:

This bill would modify the corporate apportionment formula by allowing manufacturing companies to use a single factor apportionment based on sales to determine their Virginia taxable income. This modification would be phased in as follows: for taxable years beginning on or after July 1, 2011, but before July 1, 2013, qualifying corporations may elect to use a triple-weighted sales factor; for taxable years beginning on or after July 1, 2013, but before July 1, 2014, qualifying corporations may elect to use a quadruple-weighted sales factor; and for taxable years beginning on or after July 1, 2014, and thereafter, qualifying corporations may elect to use the single sales factor method to apportion Virginia taxable income.

This bill would provide that once a corporation elects to use these methods, it may not change for three taxable years. In addition, a taxpayer making this election would be required to certify to TAX that the average weekly wages of its full-time employees was greater than the lower of the state or local average weekly wages for the taxpayer's industry.

This bill would also require corporations to maintain a base year level of employment in the Commonwealth for the first three taxable years after electing to use a single factor apportionment based on sales. If a corporation does not satisfy this criterion, TAX would be directed to assess the corporation the difference between taxes calculated under the standard apportionment in which sales are double-weighted and sales-only apportionment. In addition, a ten percent penalty would be assessed; and interest would accrue.

This bill would be effective for taxable years beginning on and after July 1, 2011.

This bill is the recommendation of the joint subcommittee studying the benefits of adopting a single sales factor. This subcommittee was created as a result of House Joint Resolution 177 and Senate Joint Resolution 101, which were passed during the 2008 General Assembly session.

6. Fiscal Impact Estimates are: Preliminary. (See Line 8.)

6b. Revenue Impact:

Fiscal Year	***Dollars***	***Fund***
2008-09	$0	GF
2009-10	$0	GF
2010-11	$0	GF
2011-12	($3.8 Million)	GF
2012-13	($7.6 Million)	GF
2013-14	($14.3 Million)	GF
2014-15	($30 Million)	GF

7. Budget amendment necessary: Yes. (See Line 8.)
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8. Fiscal implications:

Administrative Impact

TAX has not assigned any administrative costs to this bill because the changes required by a single bill such as this can be implemented as part of the annual changes to our systems and forms. TAX considers implementation of this bill as "routine," and does not require additional funding.

Revenue Impact

In order to determine the revenue impact of this bill, TAX examined a sample of corporations for taxable year 2006, which is the latest year for which the detail of data necessary is readily available. This data shows that this bill would create a substantial negative revenue impact once the single sales factor was fully phased in.

Due to the timing factors in this bill, there would be no revenue impact during the current biennium. Beginning in FY 2012, however, there would be a reduction in revenue. The negative revenue impact would be $3.8 million in FY 2012, $7.6 million in FY 2013, $14.3 million in FY 2014, and $30 million in FY 2015. The FY 2015 impact does not represent a full-year impact for the final phase-in of the single sales factor method. The full impact would not fall until FY 2017 and would exceed $55 million.

TAX is unable to provide a reliable estimate of how the employment requirement provision of this bill would impact revenue. Data necessary to accurately determine levels of employment in the Commonwealth are not readily available. Therefore, an estimate regarding how many taxpayers would cease to qualify for this method of apportionment and be subject to penalties cannot be determined.

The tax benefit created by this bill would be heavily concentrated in a small number of taxpayers. In addition, this revenue estimate could be greatly affected by changes in corporate income tax revenue. Corporate tax revenue is one of the most volatile revenue sources in Virginia. This is demonstrated in the chart below, which lists corporate income tax revenue for FY 1998-2008.

Corporate Income Tax Revenue	
Fiscal Year	Amount
1998	$450,779,925
1999	$420,421,456
2000	$565,909,181
2001	$363,757,398
2002	$290,215,035
2003	$343,318,607
2004	$425,715,754
2005	$616,690,263
2006	$867,115,786
2007	$879,575,371
2008	$807,851,584

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

<u>Background</u>

In Virginia, multistate corporations are generally required to use a three-factor formula of property, payroll and double-weighted sales. The sum of the property factor, payroll factor and twice the sales factor is divided by four to arrive at the final apportionment factor. This amount is then multiplied by Virginia taxable income.

The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned and used or rented and used in Virginia during the taxable year, and the denominator of which is the average value of all the corporation's real and tangible property owned and used or rented and used during the taxable year and located everywhere; to the extent that such property is used to produce Virginia taxable income and is effectively connected with the conduct of a trade or business within the United States and income derived is includible in federal taxable income.

The payroll factor is a fraction, the numerator of which is the total amount paid or accrued in Virginia during the tax period by the corporation for compensation, and the denominator of which is the total compensation paid or accrued everywhere during the tax period; to the extent that such payroll is used to produce Virginia taxable income and is effectively connected with the conduct of a trade or business within the United States and income derived is includible in federal taxable income.

The sales factor is a fraction, the numerator of which is the total sales of the corporation in Virginia during the tax period, and the denominator of which is the total sales of the corporation everywhere during the tax period, to the extent that such sales are used to produce Virginia taxable income and are effectively connected with the conduct of a trade or business within the United States and income derived is includible in federal taxable income.

Prior to 1999, the property, payroll, and sales factors were weighted equally. In 1999, the formula was changed so that the sales factor was double counted. According to the Federation of Tax Administrators, as of January 1, 2008, at least sixteen other states also have a sales factor of 50%. Eleven states still utilize the standard three factor formula, and three states have a sales factor between 50% and 100%. An additional seventeen states either currently have, or will have within the next five years, a sales factor of 100% for either all taxpayers or for specified industries. These states are Connecticut, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Missouri, Nebraska, New York, Oregon, South Carolina, Texas, and Wisconsin.

Proposal

This bill would modify the corporate apportionment formula by allowing manufacturing companies to use a single sales factor to determine their Virginia taxable income. This modification would be phased in as follows: for taxable years beginning on or after July 1, 2011, but before July 1, 2013, qualifying corporations may elect to use a triple-weighted sales factor; for taxable years beginning on or after July 1, 2013, but before July 1, 2014, qualifying corporations may elect to use a quadruple-weighted sales factor; and for taxable years beginning on or after July 1, 2014, and thereafter, qualifying corporations may elect to use the single sales factor method to apportion Virginia taxable income.

This bill would provide that once a corporation elects to use these methods, it may not change for three taxable years. In addition, a taxpayer making this election would be required to certify to TAX that the average weekly wages of its full-time employees was greater than the lower of the state or local average weekly wages for the taxpayer's industry.

This bill would also require corporations to maintain a base year level of employment in the Commonwealth for the first three taxable years after electing to use a single factor apportionment based on sales. If a corporation does not satisfy this criterion, TAX would be directed to assess the corporation the difference between taxes calculated under the standard apportionment in which sales are double-weighted and sales-only apportionment. In addition, a ten percent penalty would be assessed; and interest would accrue.

TAX would be required to develop guidelines, exempt from the Administrative Process Act, that include procedures for determining the number of full-time employees of a manufacturing company in cases such as a merger, acquisition, spin-off, or other change in corporate structure.

"Base year employment" would mean the average number of full-time employees employed by the manufacturing company in the Commonwealth in the taxable year that ended immediately prior to the first taxable year in which the manufacturing company used the alternative apportionment method.

"Full-time employee" would mean an employee of a manufacturing company who is employed for an indefinite duration in the Commonwealth for which the standard fringe benefits are paid by the manufacturing company, for which employment requires a minimum of either (i) 35 hours of an employee's time per week for the entire normal year of such manufacturing company's operations, which "normal year" shall consist of at least 48 weeks, or (ii) 1,680 hours per year.

This bill would define a “manufacturing company” as a domestic or foreign corporation which is primarily engaged in activities that, in accordance with the North American Industrial Classification System (NAICS), United States Manual, United States Office of Management and Budget, 1997 Edition, would be included in Sector 11, 31, 32, or 33. This would include the sectors of agriculture, forestry, fishing, and hunting and manufacturing.

This bill would be effective for taxable years beginning on and after July 1, 2011.

This bill is the recommendation of the joint subcommittee studying the benefits of adopting a single sales factor. This subcommittee was created as a result of House Joint Resolution 177 and Senate Joint Resolution 101, which were passed during the 2008 General Assembly session.

Impact of This Proposal

In general, the single sales factor would reduce the tax liability of manufacturers whose property and payroll ratios are on average greater than the sales factor. This would, generally, be manufacturers with headquarters and major production facilities located in Virginia. However, because the single sales factor would be optional, manufacturers whose sales ratio is the dominant factor, or those with few or no facilities in Virginia, would not have any increase in taxable income apportioned to Virginia.

While this proposal would provide a benefit to some manufacturers located in Virginia, those manufacturers that are not located in Virginia would not be negatively affected in any way. Accordingly, the incentive for out-of-state manufacturers to relocate to Virginia would not be as great as if this proposal did not allow manufacturers to choose the method of apportionment that results in the lowest tax. This would also result in a much higher negative revenue impact, because the lower tax liability of the manufacturers benefiting from this bill would not be offset by other taxpayers.

Non-Severability Clause

The U.S. Supreme Court has ruled multiple times that providing a tax benefit that discriminates against out-of-state businesses violates the Commerce Clause of the U.S. Constitution. To the extent that this bill would deny the election of this more favorable apportionment formula to a manufacturer that shifts employees from Virginia to other states, a court might hold that the bill discriminates against an out-of-state business.

The risk of litigation may be higher for this bill than for other types of tax benefits, such as the Major Business Facility Jobs Tax Credit, because manufacturers who make the election may subsequently fail to qualify and would be assessed with additional taxes and penalties. In challenging the assessment of the additional taxes and penalties, the constitutionality of the in-state limitation may be placed in issue.

Credits and other tax benefits tied to in-state activity often have a non-severability clause to ensure that the tax benefits can never be claimed by those for whom it was not intended. The Major Business Facility Jobs Tax Credits has such a clause. TAX would advise that a similar clause be added to this bill in order to prevent all manufacturers from being able to elect to use the single sales factor method of apportionment.

cc : Secretary of Finance

Date: 2/23/2009 TLG
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