

DEPARTMENT OF TAXATION

2022 Fiscal Impact Statement

1. **Patron** George L. Barker

3. **Committee** House Finance

4. **Title** Property Analytics Firms; Corporate Income Tax
Apportionment and Sourcing of Sales

2. **Bill Number** SB 346

House of Origin:

 Introduced

 Substitute

 Engrossed

Second House:

 X **In Committee**

 Substitute

 Enrolled

5. **Summary/Purpose:**

This bill would require property analytics firms that meet certain criteria and choose to enter into a memorandum of understanding (“MOU”) with the Virginia Economic Development Partnership Authority (“the Authority”), when calculating their income from Virginia sources, to source sales of services to Virginia if the benefit of the service is received in Virginia. This would allow property analytics firms to source such sales using market-based sourcing but otherwise following the standard three-factor apportionment formula with sales weighted twice. Under current law, the default rule for sourcing sales other than tangible personal property is based on cost-of-performance.

This bill would be effective for taxable years beginning on and after January 1, 2022, provided that the property analytics firm and the Authority enter into an MOU no later than August 1, 2022. In addition, the Act would be subject to termination unless the Authority delivers within seven days of signature a copy of the MOU to the Chairmen of the MEI Project Approval Commission, the House Committee on Appropriations, and the Senate Committee on Finance and Appropriations.

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

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

8. **Fiscal implications:**

Administrative Costs

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

Revenue Impact

This bill would have an unknown negative General Fund revenue impact beginning as early as Fiscal Year 2023. To avail themselves of the modified method of apportionment permitted in this bill, a property analytics firm would be required to meet specified criteria and enter into a memorandum of understanding with the Authority regarding the firm’s commitment to capital investment and job creation in Virginia. It is uncertain to what extent property analytics firms would meet such criteria and utilize the apportionment modifications that this bill would provide.

9. Specific agency or political subdivisions affected:

Department of Taxation
Virginia Economic Development Partnership Authority

10. Technical amendment necessary: No.

11. Other comments:

Apportionment of Corporate Income

Corporations doing business in multiple states are required to allocate and apportion their income to determine the income subject to tax in Virginia. In the 1960's most states imposing a corporate income tax used an equally-weighted three-factor formula of property, payroll and sales. The sales factor sourced sales of tangible property to the state in which it was delivered, while other sales were sourced to the state in which the greater portion of costs of performance were incurred.

Virginia's Methods of Apportionment

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. 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 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.

Modified Method of Apportionment for Manufacturing Companies

During the 2009 Session, the General Assembly enacted legislation (House Bill 2437 (2009 *Acts of Assembly*, Chapter 821)) that allows manufacturing companies to elect whether to apportion Virginia taxable income using the statutory method of apportionment or using a single sales factor method of apportionment. This modification was phased in as follows:

- For taxable years beginning on or after July 1, 2011, but before July 1, 2013, qualifying corporations could 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 could 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.

A manufacturing company that elects to use the modified method of apportionment will be subject to additional taxes if such manufacturing company's average annual number of full-time employees for the first three taxable years that it used the modified method of apportionment is less than 90 percent of its base year employment, or if the average wages of the manufacturing

company's full-time employees, as certified by the manufacturing company, is not greater than the lower of the state or local average weekly wage for its industry. "Base year employment" is defined as the average number of full-time employees employed by the manufacturing company in Virginia in the taxable year that ended immediately prior to the first taxable year in which the manufacturing company used the modified method of apportionment for manufacturing companies.

Modified Method of Apportionment for Retail Companies

During the 2012 Session, the General Assembly enacted legislation (House Bill 154 and Senate Bill 49 (2012 *Acts of Assembly*, Chapters 86 and 666)) that requires certain retail companies to apportion Virginia taxable income using a single sales factor method of apportionment. This modification was phased in as follows:

- For taxable years beginning on or after July 1, 2012, but before July 1, 2014, such corporations were required to use a triple-weighted sales factor;
- For taxable years beginning on or after July 1, 2014, but before July 1, 2015, such corporations were required to use a quadruple-weighted sales factor; and
- For taxable years beginning on or after July 1, 2015, and thereafter, such corporations are required to use the single sales factor method to apportion Virginia taxable income.

Modified Method of Apportionment for Certain Enterprise Data Center Operations

During the 2015 Session, the General Assembly enacted legislation (House Bill 2162 and Senate Bill 1142 (2015 *Acts of Assembly*, Chapters 237 and 92)) that requires a taxpayer with an enterprise data center operation to apportion Virginia taxable income using single factor apportionment based on sales if such taxpayer enters into a memorandum of understanding with the Virginia Economic Development Partnership on or after July 1, 2015, to make a new capital investment of at least \$150 million in an enterprise data center in Virginia on or after July 1, 2015. The modified method of apportionment applies beginning with the taxable year for which the Virginia Economic Development Partnership provides a written certification to such taxpayer that the new capital investment has been completed. The modification is being phased in as follows:

- From July 1, 2016 until July 1, 2017, qualifying corporations are required to use a quadruple-weighted sales factor; and
- From July 1, 2017, and thereafter, qualifying corporations are required to use the single sales factor method to apportion Virginia taxable income.

Modified Method of Apportionment 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 apportion their Virginia taxable income using a single factor method of apportionment based on sales. The legislation also provides that, for debt buyers, sales other than sales of tangible personal property are in Virginia 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. The modified method of apportionment applies for taxable years beginning on and after January 1, 2019.

Modified Method of Apportionment for Specific Industries

In addition to the modified methods of apportionment described above, Virginia requires a taxpayers in certain industries to apportion their Virginia taxable income using single factor apportionment. However, this form of single factor apportionment is not necessarily based upon sales but instead is based upon other criteria that reflect how income is earned in the particular industry. These industry-specific methods of apportionment include:

- **Motor carriers.** Motor carriers of property or passengers must apportion their income to Virginia by multiplying their Virginia taxable income by a fraction, the numerator of which is vehicle miles in-state and denominator of which is total vehicle miles everywhere.
- **Railway companies.** Railway companies apportion their income to Virginia by multiplying their Virginia taxable income by a fraction, the numerator of which is revenue car miles in Virginia and the denominator of which is total revenue car miles everywhere.
- **Financial Corporations.** Financial corporations apportion their income to Virginia by multiplying their Virginia taxable income by a fraction, the numerator of which is business in Virginia and the denominator of which is the total business. Business in Virginia is based on cost of performance in Virginia over cost of performance everywhere.
- **Construction Corporations.** Construction corporations electing to report income on the completed contract basis apportion their income to Virginia by multiplying their Virginia taxable income by a fraction, the numerator of which is business in Virginia and the denominator of which is total business.

Certified Company Apportionment

During the 2018 Session, the General Assembly enacted legislation (House Bill 222 and Senate Bill 883 (2018 Acts of Assembly, Chapters 801 and 802)), which allow certain companies that have been certified by VEDP ("certified companies") to use certified company apportionment. Under certified company apportionment, a certified company may elect to modify the application of Virginia's statutory three-factor method of apportionment by:

- Reducing the numerator of the property factor by an amount equal to the value of its property acquired in any qualified localities on or after January 1, 2018 but before January 1, 2025;
- Reducing the numerator of the payroll factor by an amount equal to any payroll attributable to jobs created on or after January 1, 2018 but before January 1, 2025 in any of such localities; and
- Reducing the numerator of the sales factor by an amount equal to any sales in Virginia for the taxable year.

In addition to certified companies using Virginia's statutory three-factor method of apportionment, certified company apportionment permits a certified company using certain single factor methods of apportionment to modify its apportionment factor. Certified company apportionment also permits a certified company conducting its entire business within Virginia to elect to apportion its income between qualified localities and other Virginia localities and utilize modified apportionment factors, provided that the certified company does not apportion any of its income to a state other than Virginia

Alternative Method of Apportionment

If any corporation believes that the statutorily prescribed method of apportionment has operated or will operate as to subject it to taxation on a greater portion of its Virginia taxable income than is reasonably attributable to business or sources within Virginia, then it may submit a statement of objections to the Department and detail an alternative method of apportionment that it believes to be proper under the circumstances. If the Department concludes that the statutorily prescribed method of apportionment is inapplicable or inequitable, then it shall redetermine the corporation's taxable income by another method that best assigns to Virginia the portion of the income reasonably attributable to business and sources within Virginia. The amount assigned through an alternative method of apportionment may never exceed the amount that would have been assigned using the statutorily prescribed method.

The Department will not grant permission to use an alternative method of apportionment unless it determines that (a) the statutorily prescribed method of apportionment is inapplicable because it produces an unconstitutional result under the taxpayer's particular facts and circumstances; or (b) the statutorily prescribed method of apportionment is inequitable because (i) it results in double taxation of the income, or a class of income, of the taxpayer; and (ii) the inequity is attributable to Virginia, rather than to the fact that some other state has a unique method of allocation and apportionment.

Apportionment by Pass-Through Entities

Virginia requires the Virginia taxable income of a multistate pass-through entity to be apportioned to Virginia by using the apportionment methods applicable to corporations. However, the effect of the pass-through entity's apportionment method may vary from one owner to another, depending on the entity types of the owners:

- Virginia resident individual owners are taxable on all of their pass-through entity income regardless of the pass-through entity's apportionment method;
- Nonresident individual owners must use the entity's Virginia apportioned income in determining his or her own Virginia nonresident percentage; and

A corporate owner must include the pass-through entity's apportionment factors in determining its own apportionment percentage.

Determining the Sales Factor for Purposes of Apportionment

Sales Factor

Since the 1960's most states sourced sales of other than tangible personal property to the state in which the greater portion of costs of performance were incurred. Recently other states have adopted other criteria intended to reflect market-based sourcing ("MBS"), although the specific criteria varies among states. The market-based sourcing criteria used for services has varied among the location where the service is used, delivered or received, and where the benefit of a service is received by the customer. The criteria for sourcing sales of intangible property is sometimes different from that for services, but tends to be focused on where the intangible property is used.

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.

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 ten 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.

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.

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.

Double Taxation and Nowhere Income

Corporations that have customers in several states may be subject to tax in states that use market-based sourcing and cost-of-performance sourcing. Because of the different sourcing

methods the corporations face the risk that some of their income could be taxed by more than one state, while other income may not be taxed by any state.

For example, a corporation with its primary, or only, office in Virginia selling services to customers in many states would have 100 percent of its income from sales of services sourced to Virginia because most of its costs of performing those services are sourced to the Virginia office. However, sales of services to customers in market-based sourcing states are likely to be sourced to, and taxed by, the market-based sourcing state even though all of its service sales would be sourced to, and taxed by, Virginia.

On the other hand, if the primary office is in a market-based sourcing state, it would tax only the sales of services sourced to that state. Sales of services to customers in Virginia would not be taxed by any state because only a minority, if any, costs of performance would be incurred in Virginia.

Proposed Legislation

This bill would require a property information and analytics firm ("the Firm") that meets certain criteria and chooses to enter into an MOU with the Authority to use a hybrid sales factor consisting of a market-based sourcing rule to determine the sales of services attributable to Virginia for apportionment purposes and the standard costs of performance rule for all other sales other than sales of tangible personal property. The Firm would use the standard three-factor apportionment formula, with sales double weighted, except that sales of services would be sourced to Virginia if the benefit of the service was received in Virginia. Sales of intangible property and real estate would continue to be sourced to Virginia based on the location of the greater portion of costs of performance.

To qualify as a property information and analytics firm and begin using the hybrid sales factor for taxable years beginning on and after January 1, 2022, but before January 1, 2029, the Authority would be required to certify to the Department that the Firm:

- Is an entity, including any owned or subsequently acquired affiliates, that as of January 1, 2022, is primarily a commercial real estate information and analytics firm that has a location and at least 1,000 full-time employees in the City of Richmond;
- Is expected to make or cause to be made a capital investment in the City of Richmond of at least \$460.5 million; and
- It is expected to create at least 1,984 new jobs with average annual wages of at least \$85,604 per job.

To continue using the hybrid sales factor for taxable years beginning on and after January 1, 2029, the Authority must certify to the Department that the Firm:

- Has at least 2,785 full-time employees in the City of Richmond as of January 1, 2029, and
- From January 1, 2022, through December 31, 2028, has made or caused to be made a capital investment for its facilities in the City of Richmond of at least \$460.5 million.

Once the Authority certified that the Firm has met the job and capital investment requirements above as of January 1, 2029, no additional certifications shall be required and the Firm would be required use to the hybrid sales factor in all future taxable years.

The Firm would be required to enter into an MOU with the Authority between December 1, 2021, and August 1, 2022, that contains provisions regarding the commitment of the Firm to make or cause to be made certain investments and to create and maintain certain new jobs. The MOU

shall require the Firm to report annually to the Secretaries of Commerce and Trade and Finance beginning January 1, 2023, such information as is necessary to demonstrate the Firm is in compliance with the performance criteria set forth in the MOU. The information shall include the new jobs created, the new investments made, the anticipated liability of the Firm related to use of the unique market-based sourcing formula, and such other information as the Authority and the Secretaries deem necessary to demonstrate that the Firm will be able to fulfill the obligations of the MOU regarding the repayment of the benefit of the unique market-based sourcing rule should it fail to meet the terms and conditions of the MOU.

For the taxable years beginning on and after January 1, 2022, but before January 1, 2032, the Firm must include with its income tax return information regarding the hybrid sales factor as compared to cost of performance, including the amounts of the property, payroll, and sales factors under both methods, the apportionment percentages under both methods, and the amount of tax calculated under both methods. The Department must compute an estimate of the fiscal savings to the Firm and may provide information, including confidential tax information, to the Authority and the Secretaries of Finance and Commerce and Trade as may be necessary to facilitate the purposes of this bill. Upon request, the Department must 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 analytics firms that used the hybrid sales factor and the annual estimated revenue impact of the hybrid sales factor compared with costs of performance. Any person to whom confidential tax information is divulged shall be subject to the prohibitions and penalties set forth in law regarding the confidentiality of taxpayer information as though he were a tax official.

The MOU between the Firm and the Authority shall contain a provision that should the Firm be out of substantial compliance with the performance criteria set forth in the MOU for three consecutive years, then the MOU shall terminate and the Firm shall repay the benefits received under this bill proportional to the failure to create new jobs and make new investments and the Secretary of Finance shall notify the Department that the Firm shall no longer be able to use the hybrid sales factor.

The hybrid sales factor and other provisions of this bill would not become effective unless the MOU between the Firm and the Authority is signed on or before August 1, 2022. If such MOU is not signed by August 1, 2022, use of a hybrid sales factor would not be applicable.

The Department would be required to develop and make publicly available guidelines implementing this bill. The guidelines would not be subject to the Administrative Process Act, but the Department would be required to cooperate with and seek the counsel of interested groups and conduct a public hearing before promulgating preliminary or final guidelines. Preliminary guidelines would be required to be published by December 31, 2022, and final guidelines would be required to be published by December 31, 2023. After December 31, 2023, the guidelines would be subject to the Administrative Process Act and accorded the weight of regulations.

This bill would be effective for taxable years beginning on and after January 1, 2022, provided that the property analytics firm and the Authority enter into an MOU no later than August 1, 2022. In addition, the Act would be subject to termination unless the Authority delivers within seven days of signature a copy of the MOU to the Chairmen of the MEI Project Approval Commission, the House Committee on Appropriations, and the Senate Committee on Finance and Appropriations.

Similar Bills

House Bill 453 is substantively identical to this bill except that it references different capital investment requirements.

cc : Secretary of Finance

Date: 2/22/2022 JPJ
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