CORPORATE INCOME AND FRANCHISE TAX APPORTIONMENT

SINGLE SALES FACTOR?

MARKET BASED SOURCING?

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Apportionment

- Multi-state corporations divide income among states where they do business for taxation
- Apportionment intended to prevent double taxation
- Apportion Income and Franchise Tax

Apportionment Formula

- Uniform Division of Income for Tax Purposes Act (UDIPTA) (1950s)
  - Model law relating to the apportionment of income among the states for corporations that do business in multiple states
  - Three Factors
    - Percentage of property located in a state
    - Percentage of payroll paid in a state
    - Percentage of sales in a state
  - Equally weighted - 3 Factors

Double weight sales vs. Model: $1,000 Taxable Income

North Carolina (2xSales)

NC property:	50%
NC payroll:	50%
NC sales	20%
NC sales:	20%
Apportionment:	35%
Income to NC:	$350
Tax at 6%	$21

State 2

In-state property:	50%
In-state payroll:	50%
In-state sales:	20%
Apportionment:	40%
Income State 2:	$400
Tax at 6%	$24

Double weight sales vs. 100% sales $1,000 in Taxable Income

North Carolina (2xSales)

NC property:	50%
NC payroll:	50%
NC sales	20%
NC sales:	<u>20%</u>
Apportionment:	35%
Income to NC	$350
Tax at 6%	$21

State 2 changes to 100% sales factor

sales:	20%
Apportionment:	20%
Income State 2:	$200
Tax at 6%	$12

Arguments For Single Sales Factor

- Economic Development
  - Encourages investment and job creation in NC
  - Rewards companies that increase share of property and payroll in NC
  - Exports the tax burden to out-of-state companies that use the state as a market rather than as a location for their jobs, investment, and production activity
- Consistency
  - NC allows single sales factor for some industries already

Arguments Against Single Sales Factor

- Not an Effective Economic Development Tool
  - States follow the trend in a race to the bottom
- Arbitrarily Picks Winners and Losers
  - Policy change will result in big winners and losers in both income and franchise tax
  - If NC share of company sales is more than NC share of company property and payroll, tax liability increases
- Ignores why businesses pay tax
  - Property and employees = demand for government services
  - Ignores the investment and production activity that occurs in the State

Some Arguments Against Single Sales Factor

- Does not help the majority of North Carolina companies because their sales are entirely in North Carolina
  - Small NC company that serves as a supplier to a large multi-state corporation does not benefit but the multistate corporation with large manufacturing plant gets a big benefit. Most corporate income tax returns are filed by 100% NC companies
  - Lower tax rate benefits all? Cost of single sales factor at 5% tax rate in effect for 2015 is approximately $90 million

Apportionment Formulas
Neighbor States

☐ Virginia: Double-weighted sales with option of single sales factor apportionment for manufacturing and retail companies

☐ South Carolina: Sales factor only

☐ Tennessee: Double-weighted sales factor

☐ Georgia: Sales factor only

MARKET BASED SOURCING

Should NC switch to market-based sourcing in calculating the sales factor for services?

Sales Factor Sourcing Methodologies Services

Cost of Performance

- A service is an in-state service if the greater proportion of the service is performed in the state

- Contract to out of state customer = $100, 90% of income-producing activity is in-state.

- $100 is an in-state sale and is in numerator of sales factor 100/100

Sales Factor Sourcing Methodologies Services

- **Pro-Rated (Current NC law)**

  - Sourcing is proportional based on the percentage of income-producing activity occurring in-state

  - Contract to out of state customer = $100, 90% of activity is in NC.

  - $90 is NC sale and is in the numerator of sales factor (90/100)

Sales Factor Sourcing Methodologies Services

□ **Market Based**

    ▣ Revenue is assigned based on the location of either

        1.   Customer address (Dept. suggestion) or

        2.   Where the customer received the benefit from the service

    ▣ Contract to out of state customer = $100

    ▣ Sales Factor is 0

    ▣ Revenue not assigned based on where the income producing activity occurs

    ▣ Trend? 16 States now use market-based sourcing

Arguments For Market Sourcing

- Better administration (Department of Revenue Recommendation)
  - Easier to assign revenue based on the customer location rather than trying to pro-rate based on where the income producing activity occurs
  - More efficient tax system for service-based economy
- Economic Development
  - Encourages investment and job creation in NC
  - Moving to single sales factor does not facilitate economic development objective for service companies unless NC adopts market based sourcing

Single Sales Factor
Pro-Rated vs. Market Sourcing

Pro Rated	Market
□ $100 contract for Non-NC customer:	□ $100 contract for Non-NC customer:
□ 90% of activity in NC	□ 90% activity in NC
□ Sales factor = 90%	□ Sales Factor is 0%
□ prop/payroll = 50%	□ Apportionment = 0
□ Apportionment=90%	(Same result if selling widgets)
(70% under current law)	

Arguments Against Market Sourcing

- Not a better way to administer tax
  - NC pro-rated approach is middle-of-the-road and more equitable than all or nothing approaches of cost of performance and market based sourcing
  - Customer has multiple addresses/benefits in multiple locations (market states have extensive rules to deal with these issues)
  - Tax Planning (Easy to order from another address?)
  - Most states use cost of performance or pro-rated (modified cost of performance)

Arguments Against Market Sourcing

- Adjoining states have not adopted market-based sourcing

- Model Legislation for states suggests using cost of performance (MTC suggests changing to market)

- Similar to a sales tax

- Ignores where the work is performed

Questions?

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