Tax Assessments

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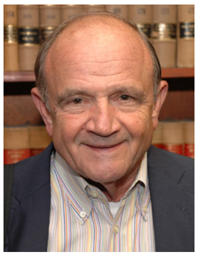
The Chair's Comments



Paul G. Topolka

Welcome Tax Section members: The 2015-16 year should be an enjoyable learning experience filled with exciting events and programs. It will also provide opportunities to give back to the community at large.

As this year's chair, I extend my gratitude to Gene Chianelli for his fine stewardship of the Tax Section last year and also to Mike Wenig, Gene's predecessor. I also thank everyone who agreed to serve on the section council as committee chairs and vice chairs. Your time, efforts and energy are sincerely appreciated. We have three new committees this year: (1) CLE Sponsors for our Annual meeting, chaired by Jason Morton; (2) Liaison with the Young Lawyers Division, chaired by Mike Cashin; and (3) Recent North Carolina Tax Opinions, chaired by Howard Williams. We now have 16 committees within the section council.

The work of each committee through its interface with the Bar, Internal Revenue Service, N.C. Department of Revenue and tax practitioners generates positive contributions to all folks residing in North Carolina. For example, Wells Hall, Kevin May and Jason Morton are at the forefront in providing pro bono services and working in the Military Volunteer Income Tax Assistance (VITA) program. In this program, our section lawyers train armed forces personnel at various bases to become tax return preparers for other military personnel and their families. For more information on this rewarding teaching opportunity and other projects in which you can participate, see Wells Hall's article later in this issue entitled: "Uncle Sam: We Need a Few Good Tax Lawyers – Military VITA Training Opportunities Through the Adopt-A-Base Program."

As you know, the section council has been instrumental in increasing the awareness of legislative developments and tax issues, both procedural and substantive, through our roundtable discussions, newsletters, web-

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State Corporate Income Tax: A Stance on the Sales Factor

By Galina Petrova

1. Single sales factor legislation in North Carolina

A multistate corporation is subject to state corporate income tax on the share of its net business income apportionable to a taxing state where the corporation has minimum contacts. Several methods are constitutionally permissible for apportionment of income to a taxing state. In the late 1950s, the Multistate Tax Commission recommended using a formula with three factors — property, payroll, and sales — with equal weights. States design their apportionment formulas unilaterally, with one, two, or all three apportionment factors, which can be given varied weights.

Two recent proposals had emerged in the North Carolina General Assembly that contemplated a key change in the apportionment of a multistate corporation's net business income. These two bills introducing a transition to single sales factor (SSF) apportionment were Senate Bill 526, The Job Creation and Tax Relief Act of 2015 (S526) and House Bill 117, The North Carolina Competes Act (H117). Each would have adopted a SSF apportionment formula in lieu of a three-factor formula, the present state of affairs in North Carolina. However, House Bill 97, The Current Operations and Capital Improvements Appropriations Act of 2015 (H97) enacted a transition to SSF apportionment as part of state tax reform incorporated in the 2015 biennial state budget. Governor Pat McCrory signed H97 on Sept. 18.

H117 came forward on Feb. 24, and S526 followed on March 26. The primary sponsors of S526 were Sens. Bob Rucho (Mecklenburg County),

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Bill Rabon (New Hanover County), and Jerry Tillman (Randolph County). Building on tax legislation enacted in 2013, S526 presented a comprehensive tax reform over a two-year period — 2016 and 2017 — with significant changes for corporations. The proposal would have phased in an SSF apportionment formula by increasing the weight of the sales factor from two to four in 2016 and basing the formula solely on sales in 2017. In addition to SSF apportionment, S526 provided for a move to market-based sourcing of sales, a tax policy advocated by the Multistate Tax Commission.

S526 also proposed reducing the corporate income tax rate to 4.5 percent in 2016 and ultimately to 4 percent in 2017, which would have been a further reduction from 6.9 percent in 2013 and 6 percent in 2014. At 5 percent in 2015, North Carolina's and South Carolina's corporate tax rates are the lowest among their neighboring states, being lower than Georgia's (6 percent), Virginia's (6 percent), and Tennessee's (6.5 percent). Notably, statutory tax rates are not indicative of actual tax rates paid because corporations can have an effective tax rate that is significantly lower than the statutory tax rate. Further, S526 would have reduced the franchise tax, one of North Carolina's oldest corporate taxes, from 0.0015 percent to 0.00135 percent. While the franchise tax is remitted prospectively, for the privilege of doing business in the coming year, the corporate income tax is remitted for business that took place in the preceding year. The bill also would have simplified the corporate tax base by eliminating certain deductions. S526 passed first reading in the Senate and was last referred to the Senate Finance Committee on March 30 without further action having been taken.

H117 was the House version of S526. The primary sponsors of H117 were Representatives Susan Martin (Pitt County), Charles Jeter (Mecklenburg County), Jeff Collins (Nash County), and Bob Steinburg (Camden County). The bill would have phased in an SSF apportionment formula over three years by increasing the weight of the sales factor from two to three in 2016, to four in 2017, and basing the formula solely on sales starting in 2018.

North Carolina already permits some corporations, qualified capital intensive corporations (QCICs), to use an SSF apportionment formula. In 2009, North Carolina made SSF apportionment available to QCICs, at the request of Apple, which constructed a data center in Maiden. To qualify for the SSF apportionment formula, Apple had to hire at least 50 full-time employees and invest at least $1 billion in the infrastructure hub. Today, a QCIC must satisfy the Secretary of Commerce that it has invested or expects to invest at least $1 billion to construct a facility in North Carolina within nine years of commencing construction. G.S. § 105-130.4(s1)(2). If the QCIC fails to invest, the tax benefit of the SSF apportionment formula expires. *Id.* A QCIC's tax benefits from SSF apportionment already received are not recaptured because their expiration is only prospective. H117, however, would have converted the expiration of such tax benefits into a recapture provision should the QCIC fail to make the required investment or otherwise fail to meet the eligibility criteria. The bill also proposed a package of approximately $2 billion in incentives and a move to market-based sourcing of sales in 2016. It would have lessened the tax burden on small and mid-size business owners by lowering the individual income tax rate paid by passthrough entities as well as individuals by reducing the individual tax rate from 5.75 percent in 2015 to 5.5 percent in 2016, with phased-in increases to the standard deduction. The final version of H117 no longer included and no longer impacted SSF apportionment because a transition to SSF apportionment had already become law when Governor McCrory signed H97 on September 18.

H97, the 2015 biennial state budget, phases in SSF apportionment over three years commencing January 1, 2016. Identical to H117, H97 will phase in an SSF apportionment formula by increasing the weight of the sales factor from two to three in 2016, to four in 2017, and basing the formula solely on sales starting in 2018. This transition to SSF will result in an estimated $217.2 million in reduced revenue through fiscal year 2019-20 and will be partially offset by an expansion in the sales tax base. H97 directs the Revenue Laws Study Committee to study market-based sourcing, which is used to determine corporations' sales factors, and the Department of Revenue to provide the committee with its proposed rules. To assist with the study, H97 requires each corporation with apportionable income of more than $10 million and a North Carolina apportionment percentage of less than 100 percent to file an informational report with its 2015 state tax return. This informational report should include a computation of the corporation's 2014 sales factor using market-based sourcing based on model market-sourcing regulations drafted by Multistate Tax Commission. H97 will reduce the corporate income tax rate to 3 percent for any fiscal year in which certain fiscal revenue targets are met. It will leave the current franchise tax rate of 0.0015 percent unchanged while doubling the franchise tax cap from $75,000 to $150,000. H97 will also benefit small and mid-size business owners by lowering the individual income tax rate from 5.75 percent in 2015 to 5.499 percent in 2017 and increasing the standard deduction in 2016.

2. Apportionment factors and the three-factor formula

Each state faces two constitutional prerequisites to having taxing jurisdiction over a multistate corporation: nexus and apportionment. A corporation that does business in two or more states must pay corporate income tax to each state in which it has nexus. U.S. Supreme Court jurisprudence requires a minimal amount of business conducted in a state for nexus to exist. A federal statute, Public Law 86-272 (P.L. 86-272), defines in-state business activities that establish nexus. For example, this federal law prohibits a state from applying its corporate income tax to corporations whose only connection to the state is the solicitation of orders from or the shipment of goods to the residents of the state because those activities do not amount to nexus.

When a corporation has nexus to two or more states where it could be taxed, the question arises as to how to determine the portion of the corporation's net income attributable to each state. Constitutionally, only the portion of net income that is "fairly attributable" to the corporation's in-state business activity can be

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subject to state tax. **Complete Auto Transit Inc. v. Brady**, 430 U.S. 274 (1977). At the same time, the Supreme Court has acknowledged that states have "wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income." **Allied Signal Inc. v. Dir., N.J. Div. of Tax'n**, 504 U.S. 768 (1992).

Through apportionment formulas, a multistate corporation's income tax base is divided among the states in which it does business. Each apportionment formula derives an apportionment percentage, which represents the portion of a corporation's net business income that is sourced to that nexus state. To determine the amount of its income sourced to that state, a corporation multiplies its taxable income by this state-specific apportionment percentage. Ultimately, a state's corporate income tax rate is applied only to the corporation's taxable income apportioned to that state.

Most states with a corporate income tax have adopted the language and principles in the Uniform Division of Income for Tax Purposes Act (UDITPA), a model law for apportioning a multistate corporation's income taxable in two or more states. The UDITPA applies formulary apportionment to approximate the share of a multistate corporation's tax base attributable to a taxing state. The UDITPA was promulgated in 1957, but only three states — Alaska, Arkansas, and Kansas — had adopted it by the mid-1960s. In its quest for uniformity, Congress considered a preemptive strike. It formed the Willis Committee, which studied state tax laws and concluded that although "each of the state laws contains its own inner logic, the aggregate of these laws — comprising the system confronting the interstate taxpayer — defies reason." H.R. Rep. No. 952, 89th Cong., 1st Sess., Pt. VI, at 1143 (1965). Strongly in favor of increased uniformity, the Willis Committee recommended federal legislation to establish a uniform state corporate income tax base and a uniform state two-factor apportionment formula weighing equally property and payroll. Menaced by impending federal intervention, many states adopted the UDITPA to protect their sovereignty.

The UDITPA applies a three-factor formula — property, payroll, and sales — and assigns each factor an equal weight. The formula is comprised of fractions that represent ratios of a corporation's property, payroll, and sales within a taxing state to the corporation's total property, payroll, and sales. The property factor is the ratio of the corporation's in-state real and tangible personal property to its real and tangible personal property located nationwide. Analogously, the payroll factor and the sales factor represent ratios of the corporation's in-state payroll and sales to its respective nationwide payroll and sales. Given the equal weights, the UDITPA's apportionment percentage results from dividing the sum of the three factors by three.

The U.S. Supreme Court has recognized the UDITPA's three-factor formula as a "benchmark against which other apportionment formulas are judged." **Container Corp. of America v. Franchise Tax Board**, 463 U.S. 159 (1983). The three factors are regarded as reasonable approximations of the share of a corporation's income from doing business in a state, based on both the demand for the corporation's output in the state (the sales factor) and its production activity in that state (the property and payroll factors). The rationale for using the three equally-weighed factors for apportionment is that determining with any precision and reliability what the drivers of a corporation's profitability are, and the states in which these drivers of profitability are located, is not realistic. Allocating a corporation's income precisely among the states in which it does business is not entirely possible where a multistate corporation consists of distinct but interdependent departments and divisions that may be integrated vertically or horizontally. It will always be an arbitrary exercise.

When it permitted Iowa to use a sales-only formula, the Supreme Court ruled a three-factor formula is not constitutionally required. **Moorman Manufacturing Co. v. Bair**, 437 U.S. 267 (1978). In fact, each state has the liberty to define unilaterally the rules for determining the factors included in its apportionment formula and their weights. In the past two decades, some states have chosen to increase the weight of the sales factor while reducing the weight of the property and payroll factors. By focusing on nexus standards that are not based on physical presence, such as property and payroll, these states have made it more likely for a multistate corporation to have an income tax filing obligation and become subject to tax in a state where P.L. 86-272 would not apply.

3. Apportionment in North Carolina

North Carolina has followed the UDITPA model in defining its three factors. G.S. § 105-130.4. The numerator of the property factor is the average value of a corporation's real and tangible personal property owned or rented and used in the state. G.S. § 105-130.4(j)(1). The numerator of the payroll factor is the total amount of in-state payroll and the numerator of the sales factor is the total amount of in-state sales. G.S. § 105-130.4(k)(1), (l)(1). Because North Carolina assigns a double weight to sales, a corporation determines its North Carolina apportionment percentage by dividing the sum of the three factors by four, rather than by three as it would with three equally weighed factors. G.S. § 105-130.4(i). The sales factor is double-weighted at 50 percent of the formula while the payroll and property factors each represent 25 percent.

A double-weighted sales factor signals that a corporation's in-state sales are at least twice as significant as the property and payroll factors. In July 2014, the 16 member states of the Multistate Tax Compact unanimously voted to revise the UDITPA and recommend that each state adopt a three-factor formula that double weighs the sales factor. According to the Federation of Tax Administrators, only nine states are using a three-factor formula for 2015 while 12 states are using a double-weighted formula akin to North Carolina's. Further, neighboring states apply apportionment formulas based solely or predominantly on the sales factor. South Carolina and Georgia follow SSF apportionment; this year Tennessee amended its formula from double-weighted to triple-weighted sales; and Virginia uses the SSF method for manufacturing and retail and double-weighted sales for all other sectors.

4. The single sales factor formula

Whether SSF apportionment is an optimal outcome for North Carolina, or any state, is debatable. Compared to an equally weighted three-factor formula, an SSF formula gives extra weight to sales. If North Carolina adopts an SSF formula, the portion of a multistate corporation's net income that is taxable in North Carolina will be determined by using only the sales factor. A multistate corporation making 10 percent of its sales to North Carolina customers would pay North Carolina corporate income tax on 10 percent of its nationwide net income.

SSF apportionment has potential to aid in attracting job creation and investment by encouraging businesses to increase their investments in manufacturing plants and other buildings and to add more workers to their payrolls. Because SSF apportionment does not use the property and payroll factors, a business can hire employees or build a plant in a state with an SSF regime without incurring any incremental corporate income tax. In comparison, three-factor apportionment has been regarded as discouraging investment and job creation because it essentially penalizes increases in property and payroll in the state.

Economic growth claims fueled by changes in apportionment are not necessarily supported by evidence. When a state enacts a new apportionment formula in response to threats of in-state corporations to relocate, there is no guarantee these corporations will not flee in the face of enacted incentives for which they have lobbied. North Carolina transitioned to a double-weighted sales formula in 1988 at the request of RJR Nabisco, which hoped to build a $600 million bakery in Wake County. After the new formula was adopted, RJR Nabisco was acquired, and its plant did not materialize.

Massachusetts enacted an SSF formula in 1995 in response to a threat by the Raytheon Company — the state's then largest industrial employer — to relocate its manufacturing. Initially, Massachusetts limited the application of the SSF formula to defense contractors, but ultimately phased in SSF apportionment for non-defense manufacturers as well. In light of reduced federal defense spending and lesser demand for its products abroad, Raytheon slashed thousands of in-state jobs after the change. Some may assert that regardless of how many Massachusetts jobs Raytheon eliminated, even more would have been lost had the state not enacted the sales-only formula.

By avoiding nexus with an SSF state in which it has sales, a multistate corporation can generate "nowhere income" that remains untaxed. Nowhere income arises when a corporation is not subject to a corporate income tax in a state in which it sells, either because that state does not levy an income tax or because the corporation does not have nexus. Some states capture what would otherwise be "nowhere income" by requiring companies either to count otherwise untaxed sales as sales in the taxing state (throwback) or exclude untaxed sales from a corporation's total sales (throwout). Either method increases the income apportioned to the taxing state by increasing the relative weight of in-state sales in the sales factor. North Carolina does not apply a statutory throwout or throwback rule. However, a corporation must include sales in states where it is not required to file a tax return as sales in North Carolina, which is effectively a throwback.

The portion of a corporation's sales that generates nowhere income is not attributed to the state where the sales were made or to any other state. For example, an out-of-state corporation that sells a large share of its products in an SSF state only by shipping into the state will have no nexus under P.L. 86-272 and therefore nowhere income. If that corporation makes even a small investment in employees or property in the state, it will immediately establish nexus and will have much of its income apportioned to that state because the sales factor counts so heavily. Hence, the SSF could deter an out-of-state corporation from investing in people or tangible property where that may cause the corporation to start paying state tax. In addition, the SSF gives companies with in-state employees an incentive to liquidate their physical presence and move all of their employees out of state to eliminate their nexus with the state.

A multistate corporation's aspiration would be SSF apportionment in the state of its headquarters as well as its top production states, and three-factor treatment in the states where it sells and has nexus. An apportionment formula that weighs the sales factor more heavily than the property and payroll factors may reduce the tax liabilities of in-state corporations while potentially increasing the tax liabilities of out-of-state corporations that have nexus. SSF apportionment benefits companies that sell predominantly outside the taxing state, especially when they have significant property and many employees based in the taxing state. Yet North Carolina businesses with little or no out-of-state sales will be at a competitive disadvantage because of the SSF's sole focus on sales. The Finance Committee counsel's analysis to S526 acknowledges that most North Carolina businesses are not multistate corporations that have to apportion income, and any change in the formula will not benefit them. The analysis also suggests the SSF method of apportionment provides a tax reduction to a corporation with most of its nationwide property and payroll in North Carolina but a small share of its nationwide sales in the state. Manufacturers are likely beneficiaries of an SSF regime because they tend to sell most of their products outside of the few states in which they produce.

In a world where all states used SSF apportionment and P.L. 86-272 did not exist to allow for nexus avoidance, a uniform system based on an SSF would work well. However, the current haphazard use of the SSF has created a lack of uniformity in corporate tax rules. Because the effect of SSF apportionment varies based on the nature of a company's business, there will always be companies to which it is more business friendly and others to which it is not. For this reason, corporations face the same arbitrary treatment that brought into being the UDITPA rules and three-factor apportionment: some multistate corporations find their income taxed more than once, while others are not taxed at all. Some argue that making marginal changes in corporate tax policy has no significant bearing on where corporations invest or create jobs, and that business fundamentals, such as the availability of skilled workers and the cost of energy and transportation, are what attracts investment. Whether the SSF reduces or increases a state's corporate income tax revenue depends on the importance of the state for producing goods relative to its importance as a market for those goods.

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