

# OVERVIEW OF CORPORATE INCOME TAX

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Jonathan Tart, Fiscal Research Division

# Corporate Income Tax Revenue

- Corporation Income Tax is the third largest category of revenues for the State
- Collections were approximately \$1.2 Billion for FY 12-13
- About 76,000 Corporate Income Taxpayers
- 60% of collections come from 225-250 Taxpayers
- 85-90% of collections come from 1,500 Taxpayers

# NC Corporate Income Tax Rates

- 1921: 3% of net income
- 1939: 6% of net income
- 1987: 7% of net income
- 1991: 7.75% of net income, plus surtax
- 1996: phased down rate to 6.9%, effective after 1999

# House Bill 998

- House Bill 998 reduces the corporate income tax rate from 6.9% to:

2014: 6%

2015: 5%

2016: 4% if FY14-15 Revenues \$20.2 Billion or more

2017: Rate reduced by 1%  
if FY 15-16 Revenues \$20.975 Billion or more

# Tax Rate Comparison

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- South Carolina 5%
- Georgia 6%
- Virginia 6%
- Tennessee 6.5%

# Computing NC Taxable Income

- NC taxable income = Federal taxable income, as adjusted
  - ▣ Internal Revenue Code Update
  - ▣ Net Economic Loss vs. Net Operating Loss
- Apportion the income for multi-state businesses
- Apply tax rate to income apportioned to NC
- Reduce by available tax credits

# NEL vs. NOL

- **Should NC adopt federal net operating loss?**
- Net operating loss: for federal tax purposes: Tax Deductible Expenses are more than **taxable** revenues
- Net economic loss for NC purposes: Tax Deductible Expenses are more than **all** revenues

# NOL vs. NEL Comparison

Life insurance Proceeds:	\$50	Life insurance Proceeds:	\$50
Taxable income:	\$250	Taxable income:	\$250
Less deductible expenses:	\$300	Less deductible expenses:	\$300
NOL:	-\$50	NEL:	\$0



# NEL vs. NOL

- Most states including all of neighboring states adopt federal net operating loss
- Net Economic Loss is a source of contention/litigation between Department of Revenue and taxpayers
- Moving to Net Operating Loss would reduce revenue by an estimated \$10-15million over a three-year period

# Apportionment

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- ❑ Multi-state corporations divide the income among states for taxation
- ❑ Only apportion income to states where they are doing business (nexus)
- ❑ Apportionment intended to prevent double taxation

# 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

# Standard Three Factor Formula

- Each factor is given a weight of  $33 \frac{1}{3} \%$

- In State: 
$$\frac{\text{Property} + \text{Payroll} + \text{Sales}}{\text{Total: Property Payroll Sales}} \div 3$$

- Multiply State taxable income by apportionment percentage

# NC: Double Weighted Sales Factor

- More weight is placed on sales
- NC : 
$$\frac{\text{Property} + \text{Payroll} + 2 \text{ Sales}}{\text{Property} + \text{Payroll} + \text{Sales} \times 4}$$
- Property & Payroll factor = 25% weight each  
Sales factor = 50% weight

# Three factor vs. Double weight sales

Taxable income: \$1,000

NC property: 50%

NC payroll: 50%

NC sales: 20%

Apportionment%: 40%

Income to NC: \$400

Tax at 6% \$24

Taxable income: \$1,000

NC property: 50%

NC payroll: 50%

NC sales 20%

NC sales: 20%

Apportionment%: 35%

Income to NC: \$350

Tax at 6% \$21

# Sales Factor Only Apportionment

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Taxable Income:	\$1,000
NC Sales:	20%
Income to NC:	\$200
Tax at 6%:	\$12

# Apportionment Formulas: Other 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



# NC Exceptions to General Apportionment Formula

- ▣ Sales factor only for some businesses
  - Excluded Corporations
  - Public Utilities
  - Qualified Capital Intensive Corporation
  
- ▣ Special Formulas for Certain Industries
  - Motor carriers of passengers/property
  - Air or Water Transportation Company

# Special Formulas for Certain Industries

- How do you determine if taxpayer is in a certain industry?
- Revenue Statute does not define industry types
- Department of Revenue Procedure: Use industry classification system (NAICS) to make the determination
- Should General Assembly codify to confirm and clarify administrative procedure?

# Excluded Corporation

- “Any corporation engaged in business as a building or construction contractor, a securities dealer, a loan company, or a company that receives more than (50%) of its ordinary income from **intangible property**”
- “Intangible property” not defined by statute for purposes of apportionment
- Statutorily define intangible property for apportionment purposes?

# Sales Factor for Service Companies?

- How do you determine if a sale is considered an in-state service for purposes of the sales factor numerator?
  - ▣ Cost of Performance?
  - ▣ Pro-Rated based on where activity takes place? (NC current law)
  - ▣ Market Based?

# Sales Factor for Service Companies

- Cost of Performance: If service is performed in two or more states, assign revenue to where the greatest portion of service is performed (all or nothing)
- Pro-Rated: Pro rate revenue based on measure of time spent/cost incurred? (NC approach)
- Market Based: Assign revenue based on customer location/benefit
- **Should North Carolina switch to market-based sourcing?**

# Cost of Performance vs. Market

- R&D \$100 contract for Non-NC customer:
  - 75% cost in NC, 25% of cost not in NC:
  - COP: \$100 is NC sale because majority of cost incurred in NC
  - Prorated: \$75 is NC sale
- R&D \$100 contract for Non-NC customer:
  - 75% cost in NC, 25% of cost not in NC:
  - Market: \$0 is NC sale because it is sourced to where customer is located/benefit received

# Recap



- ❑ Net Operating Loss
- ❑ Single Sales Factor
- ❑ Using NAICS code to determine if taxpayer is in certain industry for apportionment purposes
- ❑ Definition of intangible property for purposes of determining excluded corporation
- ❑ Method for sales factor sourcing (Cost of performance, pro-rated, market-based)

# Questions?

Jonathan Tart

Fiscal Research Division

733-4910

[Jonathan.tart@ncleg.net](mailto:Jonathan.tart@ncleg.net)