

INCOME AND FRANCHISE TAX APPORTIONMENT

NC ENACTS SINGLE SALES FACTOR (HB 97)

AND MARKET BASED SOURCING STUDY

Revenue Laws Committee, 1/12/2016
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Objectives



- Refresher on Apportionment and Single Sales Factor
- Explanation of how sales factor is calculated
- Market Based Sourcing
- Financial Institutions and Multistate Tax Commission Guidelines

WHAT TYPE OF BUSINESS
HAS TO DO
APPORTIONMENT?



Businesses Impacted by Apportionment

- C corporations
- S corporations
- Other pass-through entities like LLCs and partnerships, if there are out of state owners
- **Not** Sole proprietorships

Apportionment **does not** apply to **any** of these business types if they are only taxable in North Carolina. In most cases, this means businesses that apportion will have property and/or payroll in more than one state.

WHAT TAXES ARE SUBJECT
TO APPORTIONMENT?

What type of business taxes do we apportion?

- Income Tax (mostly corporate, sometimes individual)
- Franchise Tax
- Not Sales Tax

WHAT IS APPORTIONMENT?



What is apportionment?

- Apportionment is a method of allocating profits and net worth among the states where a company is taxable
- A company is taxable in a state in most cases because it is using property in a state or employees/agents are doing some work there
- The apportioned amount of profit and net worth is the amount subject to income and franchise tax in NC

Apportionment of Profit

NC Tech Parts Manufacturing, Inc.

- Parts produced in NC
- Most of property and payroll located in NC

Profit	\$2 million
NC apportionment %	10%
Portion subject to NC income tax:	\$200,000

Apportionment allocates the profit attributed to NC

Apportionment of Net Worth

NC Tech Parts Manufacturing, Inc.

- Parts produced in NC
- Most of property and payroll located in NC

Franchise Tax Base	\$15 million
NC apportionment %	10%
Portion subject to NC franchise tax:	\$1.5 million

Apportionment allocates the net worth attributed to NC

WHAT IS THE FORMULA
FOR CALCULATING AN
APPORTIONMENT %?

North Carolina Apportionment Formula 1989-2015

- Double Weighted Sales Factor Apportionment
- Apportionment % = the **average** of four parts, the sales factor making up two of the parts:

NC Property		NC Payroll		NC Sales		NC Sales
Total Property	+	Total Payroll	+	Total Sales	+	Total Sales

HB97 phases in Single Sales Factor Apportionment

□ 2016: Triple Weighted Sales Factor

- Apportionment % = the **average** of five parts, the sales factor making up three of the parts:

NC Property	+	NC Payroll	+	NC Sales	+	NC Sales	+	NC Sales
Total Property		Total Payroll		Total Sales		Total Sales		Total Sales

□ 2017: Quadruple Weighted Sales Factor

- Apportionment % = the **average** of six parts, the sales factor making up four of the parts:

NC Property	+	NC Payroll	+	NC Sales	+	NC Sales	+	NC Sales	+	NC Sales
Total Property		Total Payroll		Total Sales		Total Sales		Total Sales		Total Sales

NC Property and Payroll investment is gradually diluted in the formula

2018: Single Sales Factor Apportionment

- Single Sales Factor means the amount of Property and Payroll located in NC is not part of the calculation of the apportionment percentage
- The Sales factor is the apportionment percentage

$$\text{Apportionment \%} = \frac{\text{North Carolina Sales}}{\text{Total Sales}}$$

Single Sales Factor Apportionment Objective

- Increased investment in NC by a multistate company does not result in higher apportionment percentage in NC
- Increase in NC property and NC payroll does not result in increased percentage of profit/net worth being subject to NC Income and Franchise Tax.
- Encourage companies to locate facilities and workforce in NC

Apportionment of Profit

Single Sales Factor

NC Tech Parts Manufacturing, Inc.

- Parts produced in NC
- Most of property and payroll located in NC
- 10% of parts sold to NC customers

Profit	\$2 million
NC Sales Factor %	10%
Portion subject to NC income tax:	\$200,000

Under single sales factor, only 10% of income is subject to tax even though most of workforce and investment is in NC

HOW DO YOU CALCULATE
THE NC SALES FACTOR?
WHAT IF WE USED MARKET
BASED SOURCING?

Sales Factor Calculation

North Carolina Sales	\$1,000,000	10%
Total Sales	\$10,000,000	

“Sales” means **all receipts/revenues** received in the regular course of business.

How do we determine the amount of Total Sales that are **North Carolina** sales?

Rules of Thumb for Determining the Amount of Total Sales that are North Carolina Sales			
Current Law Compared to Market Based Sourcing			
	Source of Business Receipts	NC Sales under current law?	Market Based Sourcing
1	Sale of Goods (manufacture, wholesale, retail, farm)	If customer delivery in NC	No Change
2	Real Property Rental	If customer rented property in NC	No Change
3	Personal Property Rental	If customer using property in NC	No Change
4	Receipts from licensing patents	If customer using patent in NC	No Change
5	Royalty from licensing trademarks	If customer using trademark in NC	No Change
6	Providing a service	If provider performed service in NC	If customer in NC

Apportionment of Profit

Single Sales Factor Without Market Based Sourcing

NC Tech Services, Inc.

- 10% of services to NC
- 60% of work to provide services performed by NC Tech in NC
- Most of property and payroll located in NC

Profit	\$2 million
NC Sales Factor %	60%
Portion subject to NC income tax:	\$1,200,000

If company wants to hire/invest in additional NC workforce/facility, and do more of the IT work here, the sales factor increases.

Apportionment of Profit

Single Sales Factor With Market Based Sourcing

NC Tech Services, Inc.

- 10% of services to NC
- 60% of work to provide services performed by NC Tech in NC
- Most of property and payroll located in NC

Profit	\$2 million
NC Sales Factor %	10%
Portion subject to NC income tax:	\$200,000

10% instead of 60% of income is subject to tax due to market based sourcing, same result if this were NC Tech. Parts Manufacturing.

Market Based Sourcing Policy Considerations

- Without market based sourcing, does single sales factor provide an incentive for service companies to locate workforce and investment in NC?
- Single sales factor and market based sourcing are a good match for service companies?
- Most states using single sales factor apportionment also use market based sourcing.

Market Based Sourcing Policy Considerations

- What is the fiscal impact? Winners and Losers?
- Companies using North Carolina more as a customer base than as a core place for workforce/investment will tend to pay more tax under market based sourcing
- Tends to export the tax base.
- Fiscal impact of apportionment including market based sourcing becomes less significant as the corporate income tax rate drops

Pro Forma Reports to assist with Fiscal Estimate

- Large companies will file pro forma report in April using market based sourcing to assist with estimating fiscal impact
- Report Due April 15, 2016 based on guidelines published by Department of Revenue for companies with \$10 million or more in income before apportionment
- Department of Revenue guidelines will be based on apportionment guidelines developed by the Multistate Tax Commission

SALES FACTOR CALCULATION FOR FINANCIAL INSTITUTIONS



Sales Factor for Financial Institutions



- States often have special guidelines for calculating the sales factor of Financial Institutions
- NC banks tend to have a larger sales factor using Multistate Tax Commission proposed calculation for financial institutions

	Rules of Thumb for Determining the Amount of Total Sales that are NC Sales		
	Financial Institutions		
	<u>Source of Business Receipts</u>	<u>In -State under current law?</u>	<u>Multistate Tax Commission Recommendation</u>
1	Receipts from loans secured by real property (interest, fees, sale)	if real property is in NC	No Change
2	Receipts from loans not secured by real property	if borrower is in NC	No Change
3	Receipts from credit/debit cards	if the cardholder is in NC	No Change
4	Receipts from merchant discounts	if the merchant is in NC	No Change
5	Receipts from investment assets and trading activities	If payer is in NC	if bank management of assets is in NC

Sales Factor for Financial Institutions



- Sales factor calculation for financial institutions does not have to conform to Multistate Tax Commission
- Market based Sourcing can be adopted without increasing the sales factor of NC banks

SUMMARY



Summary of Concepts

- Apportionment determines the portion of a multistate company's profit and net worth subject to NC income and franchise tax

- Single sales factor apportionment phased in from 2016-2018

North Carolina Sales
Total Sales

- Market Based Sourcing = NC portion of sales factor for receipts from services is focused on location of customer/benefit, not on location of provider/performance

Summary of Market Based Sourcing Policy Considerations



Single sales factor and market sourcing can make a happy couple for a service company that lives and primarily works in NC



Fiscal Impact? Estimate will be done from reports filed in April

Summary of Market Based Sourcing Policy Considerations

- If NC General Assembly decides to make further apportionment changes such as market based sourcing to go with single sales factor, it can customize the legislation to best **suit** North Carolina.



Questions?

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