



HOUSE BILL 1030: 2016 Appropriations Act, Sec. 38.4: Market-Based Sourcing

2015-2016 General Assembly

Committee:		Date:	July 26, 2016
Introduced by:		Prepared by:	Cindy Avrette Legislative Analyst
Analysis of:	Sec. 38.4 of S.L. 2016-94		

OVERVIEW: *Beginning in 2018, North Carolina will use a single sales factor apportionment formula for apportioning the corporate income and franchise tax liability of multistate corporations. Single sales factor apportionment provides an incentive for multistate corporations to select North Carolina as their primary state to conduct business activities, unless the corporation provides a service instead of a product. Single sales factor apportionment does not provide the same incentive to a multistate company that provides services, because its sales factor is not based on the percentage of income derived from consumption of the company's services in the North Carolina marketplace. Consequently, states that adopt a single sales factor apportionment incentive usually adopt a market-based calculation of the sales factor for all multistate corporations, including those that provide services. This section does not enact market-based sourcing however; it does direct the Department of Revenue to adopt rules to implement market-based sourcing by January 1, 2017. The rules, if approved by the Rules Review Commission, cannot be entered into the Administrative Code until the General Assembly enacts market-based sourcing legislation and directs the Codifier of Rules to do so. The provision ensures that the General Assembly, and the public, will know what the rules pertaining to market-based sourcing would be if the General Assembly decides to enact market-based sourcing legislation in the future.*

This section became effective July 14, 2016.

CURRENT LAW AND BACKGROUND: A corporation that does business in more than one state must pay income tax to each of the states in which it has nexus. The U.S. Supreme Court cases have upheld the right of states to tax the income of multistate corporations so long as the income is fairly sourced to the taxing state. The conventional method used by states to determine how much of a corporation's income should be taxed in each state has been the apportionment formula, which is used to derive an apportionment percentage. Generally speaking, a taxpayer multiplies its taxable income by its apportionment percentage to determine the amount of its income sourced to a particular state. The state's corporate income tax rate is then applied to the corporation's income apportionable to that state.

For many years, most states used an apportionment formula based on three factors: sales, property, and payroll. In 1989, North Carolina began using a double-weighted sales factor apportionment formula. In recent years, many states have moved towards a formula weighted more heavily by sales. For taxable year 2016, at least 21 states used single sales factor apportionment.¹ Last session, in S.L. 2015-241, the General Assembly enacted legislation to phase in single sales factor apportionment over three years, beginning in taxable year 2016; the single sales factor apportionment formula will be fully phased-in by taxable year 2018.

¹ [State apportionment of corporate income tax, compiled by the Federation of Tax Administrators.](#)

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A single sales factor arguably makes a state a more attractive place for a multistate company that provides products to expand its property and payroll because if those factors are ignored in calculating a state's corporate tax, then the company can hire employees or build a plant without incurring additional state tax on its corporate profits. Single sales factor does not provide the same incentive to a multistate company that provides services, because its sales factor is not based on the percentage of income derived from consumption of the company's services in a state's marketplace. Instead, its sales factor is based on the percentage of business activities conducted in a state, which is generally measured by the amount of labor costs and capital investment incurred in a state to provide the services. Consequently, states that adopt a single sales factor apportionment incentive usually adopt a market-based calculation of the sales factor for all multistate corporations, including those that provide services.²

S.L. 2015-241 directed the Revenue Laws Study Committee to study the calculation of the sales factor using market-based sourcing. It also required corporate taxpayers with apportionable income greater than \$10 million and a North Carolina apportionable percentage less than 100% to file an information report with the Department of Revenue showing the calculation of the taxable year 2014 sales factor using market-based sourcing rules based on the model market-sourcing regulations drafted by the Multistate Tax Commission. The Committee heard several presentations on the issue. Based on the data from the informational reports, the Fiscal Research Division estimated a \$10 million increase in annual tax collections.³ This amount is comprised of both income and franchise tax collections because the percentage used to determine the share of a multistate corporation's income to tax is also used to determine the percentage of a corporation's capital that is subject to the franchise tax.

The Revenue Laws Study Committee did not recommend legislation to the 2016 Session of the General Assembly. Senators Rucho and Rabon introduced Senate Bill 869, *Market-Based Sourcing*, and the Senate Finance Committee discussed the bill on May 25, 2016. The Senate passed the substance of Senate Bill 869 in its version of the budget, House Bill 1030, 5th and 6th Editions, Section 38.4.

BILL ANALYSIS: Section 38.4 of S.L. 2016-94, does not enact market-based sourcing principles. However, it does direct the Department of Revenue to adopt rules regarding the implementation and administration of market-based sourcing principles, based upon the proposed statutory changes contained in subsection (c) of this section. The Department must submit the rules to the Rules Review Commission on or before January 20, 2017. If the Commission approves the rules, it must deliver them to the Codifier of Rules but the Codifier cannot enter the rules into the Administrative Code until the General Assembly enacts the proposed statutory changes contained in subsection (c) of this section and directs the Codifier to do so.

The Department of Revenue is exempt from the notice and hearing requirements of rulemaking. However, for purposes of the rules regarding market-based sourcing, the Department must observe the notice and hearing requirements of Article 2A of Chapter 150B with the following exceptions:

- The Department must accept comments on the text of the proposed rules for at least 90 days, rather than the statutory 60 days.⁴
- The Department does not need to submit the text of the proposed rules to the Office of State Budget and Management for a fiscal and regulatory impact analysis.

² As of 2015, at least 21 states used market based sourcing. *State Apportionment Update – Market Based Sourcing*, by John Iannotti, Dixon Hughes Goodman LLP, presentation on September 25, 2015. [http://www.tei.org/chapters/carolinas/Public%20Documents/November%202012,%202015%20Meetng%20Handouts/DHG%20-%20TEI_Presentation%20-%20Charlotte%20\(FINAL%2011-12-2015\)%20wkd.pdf](http://www.tei.org/chapters/carolinas/Public%20Documents/November%202012,%202015%20Meetng%20Handouts/DHG%20-%20TEI_Presentation%20-%20Charlotte%20(FINAL%2011-12-2015)%20wkd.pdf)

³ [Fiscal Memo for Senate Bill 869, Market-Based Sourcing.](#)

⁴ [DOR notice to taxpayers desiring to receive notice of text on market-based sourcing rules.](#)

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The proposed statutory changes in subsection (c) of this section would calculate the sales factor based on the percentage of income attributed to consumption of products and services in the North Carolina marketplace, not based on labor costs and capital investment in North Carolina. Here is a general description of the income apportionment concept proposed in subsection (c), coupled with the single sales factor legislation, for a corporation that does business in North Carolina and in other states:

Percentage of Income Taxed by NC = Total Income Multiplied By a Ratio:

$$\frac{\text{Consumption in North Carolina of a Corporation's Products and Services}}{\text{Total Consumption of the Corporation's Products and Services}}$$

States often have a separate set of apportionment rules outlined for banks. Under current North Carolina law, banks are allowed single sales factor apportionment and the formula is already based on a market-based calculation of the sales factor. Subsection (c) proposes to apply similar sourcing rules for banks as is currently applied under North Carolina law.

States may also have a separate set of apportionment rules for companies that create and produce movies and television shows. These companies receive licensing fees from cable, satellite, and internet streaming companies in return for the rights to offer the shows to consumers as well as advertising revenue from advertisers. Under current practice, as a result of a private letter ruling, these content providers apportion their income to North Carolina when a contract is executed in North Carolina to give a company the rights to offer their shows.⁵ The model rules proposed by the Multistate Tax Commission would apportion the income for these companies differently than current North Carolina practice. Under the model rules, the sourcing is based on the percentage of the viewing audience in a state compared to its total viewing audience. Subsection (c) of this section does not specifically define how the sales factor would be determined for these companies.⁶

EFFECTIVE DATE: This section became effective July 14, 2016.

⁵ [DOR private letter ruling.](#)

⁶ The Senate version of the budget would have used the model rules for determining the sales factor for these companies.