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June 5, 2001 Joint Committee on Finance Paper #103

# Corporate Income and Franchise Tax -- Single Sales Factor Apportionment Formula (General Fund Taxes -- Individual and Corporate Income Taxes)

[LFB 2001-03 Budget Summary: Page 23, #9]

## CURRENT LAW

Under Wisconsin law, formula apportionment is used to determine taxable income in Wisconsin if a corporation's Wisconsin activities are an integral part of a unitary business which operates both within and outside of the state. The apportionment ratio is the end result of the application of the Wisconsin apportionment formula to a particular corporation. For most corporations, the apportionment ratio or fraction is determined by dividing the corporation's property value, payroll and sales in Wisconsin by the corporation's total property value, payroll and sales, respectively. The apportionment ratio is determined by adding three fractions (referred to as the three factors of the formula)--the corporation's property in Wisconsin divided by its total property, the corporation's payroll in Wisconsin divided by its total payroll and the corporation's sales in Wisconsin divided by its total sales--double weighting the sales factor, and dividing the aggregate sum by four.

## GOVERNOR

Phase in the use of a single sales factor apportionment formula to apportion to Wisconsin the income of corporations, including insurance companies, and nonresident individuals, and estates and trusts engaged in business within and outside of the state. Use of property and payroll to apportion income would be phased out. Use of single sales factor apportionment would be phased in over three years beginning with tax years beginning after December 31,

2002. For tax years beginning after December 31, 2004, a single sales factor apportionment formula would be used to apportion income to Wisconsin.

The phase-in of using a single sales factor apportionment formula would reduce corporate income and franchise tax revenues by an estimated $8,000,000 in 2002-03. Once fully phased-in in 2005, these provisions would reduce tax revenues by an estimated $80,000,000 per year.

**DISCUSSION POINTS**

1. The phase-in of the single sales factor apportionment formula would be accomplished as follows:

a. *Corporations, Nonresident Individuals, Estates and Trusts in General*. For tax years beginning before January 1, 2003, income would be apportioned using the current apportionment formula with the sales factor representing 50% of the apportionment ratio, the property factor representing 25%, and the payroll factor representing 25%. For tax years beginning after December 31, 2002, and before January 1, 2004, the apportionment ratio would be calculated with the sales factor representing 60% of the apportionment ratio, the property factor representing 20%, and the payroll factor representing 20%. For tax years beginning after December 31, 2003, and before January 1, 2005, the apportionment ratio would be calculated with the sales factor representing 80% of the apportionment ratio, the property factor representing 10%, and the payroll factor representing 10%. For tax years beginning after December 31, 2004, a single sales factor apportionment formula would be used to apportion income to Wisconsin.

b. *Financial Institutions*. For tax years beginning before January 1, 2003, income would be apportioned using the current apportionment formula (specified by administrative rule) with a gross receipts factor representing 50% of the apportionment ratio and a payroll factor representing 50% of the apportionment ratio. For tax years beginning after December 31, 2002, and before January 1, 2005, the apportionment ratio would be calculated with a sales factor that represented more than 50% of the apportionment ratio as determined by administrative rule by DOR. For tax years beginning after December 31, 2004, a single sales factor apportionment formula would be used to apportion income to the state as determined by administrative rule by DOR. The Department would be required to promulgate administrative rules governing the apportionment of the income of financial organizations and submit them to the Legislative Council by the first day of the fourth month beginning after the effective date of the bill.

c. *Insurance Companies*. The method used for calculating the Wisconsin net income of taxable insurers would be modified to use an apportionment ratio based on premiums and payroll in Wisconsin and to apply that ratio to federal total taxable income. Specifically, the premiums factor of the apportionment formula would be the ratio of direct premiums and assumed premiums written for reinsurance with respect to property and risks resident, located or performed in the state, divided by the total of such premiums everywhere. "Direct premiums" would be defined as direct premiums reported for the tax year on the annual statement required

to be filed with the Commissioner of Insurance. "Assumed premiums" would be defined as assumed reinsurance premiums from domestic insurance companies reported for the tax year also on the annual statement required to be filed with the Commissioner of Insurance. The payroll factor would be the ratio of payroll in Wisconsin to total payroll everywhere. The arithmetic average of the premiums and payroll ratios would be applied to federal taxable income to determine Wisconsin net income.

Currently, income is apportioned to Wisconsin by first calculating the arithmetic average of the ratio of premiums outside Wisconsin to total premiums and the ratio of payroll outside Wisconsin to total payroll. This ratio is then applied to federal taxable income and the resulting amount is subtracted from federal taxable income to determine Wisconsin taxable income.

For tax years beginning before January 1, 2003, income would be apportioned with the premiums factor representing 50% of the apportionment ratio and the payroll factor representing 50%. For tax years beginning after December 31, 2002, and before January 1, 2004, income would be apportioned with the premiums factor representing 60% of the apportionment ratio and the payroll factor representing 40%. For tax years beginning after December 31, 2003, and before January 1, 2005, income would be apportioned with the premiums factor representing 80% of the apportionment ratio and the payroll factor representing 20%. For tax years beginning after December 31, 2004, income would be apportioned using only the premiums factor.

d. *Gas, Electric and Telecommunications Utilities*. These companies would be subject to the same apportionment provisions as corporations in general. Under current law, all public utilities are subject to apportionment under rules promulgated by DOR.

e. *Other Public Utilities*. Interstate railroads, motor carriers, air carriers, sleeping car, carline and pipeline companies would continue to apportion income under current law provisions.

2. The state corporate income tax was first introduced in Wisconsin in 1911 and over the next ten years, seven more states--Connecticut, Virginia, Missouri, Montana, New York, Massachusetts, and North Dakota--enacted the tax. Currently, 45 states have a corporate income tax; Nevada, Texas, South Dakota, Washington and Wyoming do not have a corporate income tax. Since the tax was first imposed, one of the more difficult problems in administering the tax has been allocating a portion of the income of a corporation doing businesses in several states to a particular state for tax purposes. Initially, most states used separate accounting to allocate corporate income. However, because of the difficulty in determining income from intercompany transactions and attributing expenses to specific activities in individual states, most states adopted apportionment formulas to allocate multistate corporate income.

3. The earliest state apportionment formulas used only a single factor, usually property. However, by the 1930s the most widely used formula was one that originated in Massachusetts and consisted of three factors: property, payroll and sales (or gross receipts). There were wide variations in the way states defined these factors. For many years, states continued to use the three-factor formula with each factor evenly weighted. The standard approach was to use the formula adopted

by the Uniform Division of Income for Tax Purposes Act (UDITPA) in 1957. The formula was a political compromise between manufacturing states in the east and the market states in the west. In addition, states adopted special apportionment formulas to apply to businesses, such as banking, financial services and insurance, for which the traditional three-factor formula was not well suited. Over time, however, most states modified the standard three-factor formula to double-weight the sales factor. More recently, some states have begun to use a single-sales factor apportionment formula, at least for some industries.

4. Table 1 shows the apportionment formulas that are generally applied to corporations in the states. The table shows that 24 states use a double-weighted sales factor and another four states give greater weight to sales. Currently, Illinois, Iowa and Nebraska use a single-sales apportionment formula.

**TABLE 1**

**State Apportionment Formulas**
**January 1, 2001**

| State | Formula | State | Formula |
|---|---|---|---|
| Alabama | 3 Factor | Montana | 3 Factor |
| Alaska | 3 Factor | Nebraska | Sales |
| Arizona | Double wtd. sales | Nevada | No State Income Tax |
| Arkansas | Double wtd. sales | New Hampshire | Double wtd.sales |
| California | Double wtd. sales | New Jersey | Double wtd. sales |
| Colorado | 3 Factor/Sales & Property | New Mexico | Double wtd. sales |
| Connecticut | Double wtd. sales/Sales | New York | Double wtd. sales |
| Delaware | 3 Factor | North Carolina | Double wtd. sales |
| Florida | Double wtd. sales | North Dakota | 3 Factor |
| Georgia | Double wtd sales | Ohio | 60% Sales, 20% Property & Payroll |
| Hawaii | 3 Factor | Oklahoma | 3 Factor |
| Idaho | Double wtd. sales | Oregon | Double wtd. sales |
| Illinois | Sales | Pennsylvania | Triple wtd. sales |
| Indiana | Double wtd. sales | Rhode Island | 3 Factor |
| Iowa | Sales | South Carolina | Double wtd. sales/Sales |
| Kansas | 3 Factor/Sales & Property | South Dakota | No State Income Tax |
| Kentucky | Double wtd. sales | Tennessee | Double wtd. sales |
| Louisiana | Double wtd. sales | Texas | No State Income Tax |
| Maine | Double wtd. sales | Utah | 3 Factor |
| Maryland | Double wtd. sales | Vermont | 3 Factor |
| Massachusetts | Double wtd. sales/Sales | Virginia | Double wtd. sales |
| Michigan | 90% sales, 5% property and payroll | Washington | No State Income Tax |
| Minnesota | 75% sales, 12.5% property and payroll | West Virginia | Double wtd. sales |
| Mississippi | Accounting/3 Factor | Wisconsin | Double wtd. sales |
| Missouri | 3 Factor/Sales | Wyoming | No State Income Tax |
| | | Dist. Of Columbia | 3 Factor |

Source: Compiled by Federation of Tax Administrators (FTA) and other sources.
Note: Formulas listed are for general manufacturing businesses. Some industries have special apportionment formulas that may differ from the reported formulas.

5. In order for a state to impose a tax on a corporation engaged in interstate commerce, the tax must meet the tests of both the Commerce and Due Process Clauses of the U.S. Constitution. The U.S. Supreme Court has ruled (Complete Auto Transit Inc. v Brady, 1977) that a state tax meets the requirements of the Commerce Clause if: (a) the taxed activity is sufficiently connected with the taxing state to justify a tax; (b) the tax is fairly related to benefits provided by the state; (c) the tax does not discriminate against interstate commerce; and (d) the tax is fairly apportioned. Similarly, the Court stated in Mobil Oil Corp. v. Commissioner of Taxes of Vermont (1980) that the Due Process Clause imposes two limitations on a state's exercise of jurisdiction over a nonresident taxpayer: (a) the taxpayer must have minimum contacts with the taxing state; and (b) there must be a rational relationship between the income attributed to the state and the intrastate value of the enterprise. These principles lend support to the use of apportionment formulas to allocate the income of multistate firms.

6. The U.S. Supreme Court has generally upheld formula apportionment as an appropriate way to allocate the income of a multistate corporation to a particular state. In Butler Brothers v McColgan (1942), the Court ruled that California's three-factor apportionment formula based on property, payroll and sales was "fairly calculated" to assign to the taxing state that portion of net income "reasonably attributable" to the business done there. The Supreme Court has indicated that the three-factor apportionment formula has become "something of a benchmark against which other apportionment formulas are judged" (Container Corp. of America v Franchise Tax Board, 1983). However, the Court has approved many different apportionment methods and has declined to mandate a uniform method in all states. The Court has recognized that the lack of uniformity in apportionment practices of the states creates a risk of overlapping taxes on interstate commerce, but has insisted that Congress should decide whether there is an overriding national interest in uniformity, and if so what the rules should be. For example, in Moorman Mfg. Co. v Bair, (1978), the Court upheld Iowa's single-sales factor formula against challenges under the Due Process and Commerce Clauses. The Court found that the formula method of computing taxable income is employed as a rough approximation of a corporation's income that is reasonably related to a taxpayer's activities conducted within the taxing state.

7. In order to use an apportionment formula to compute tax liability, the taxpayer's activities within and outside the state must be part of a unitary business. If the activities are separate and discrete, the income from the in-state activities can be determined by separate accounting and the formula method is neither necessary nor appropriate. In addition, apportionable income needs to be determined. Formula apportionment spreads the income of the corporation over all the states where the principal business activity occurs. Therefore, only income which bears reasonably close connection to the central business should be included in income that is apportioned. If the business has income from property or activities only remotely connected with the central business, it may be more appropriate to allocate the income specifically to the situs of the property or the activity that

produced it.

8. Wisconsin generally employs one of three methods of assigning income to the state--separate accounting, formula apportionment or specific allocation.

*Separate Accounting*. Under separate accounting, a geographic or functional area of a single, multistate corporation is treated separately from the rest of the business activities of the corporation. Net income is computed as if the activities of the corporation were confined to that geographic or functional area. Separate accounting implies that both the income and expenses of each specific function or activity of a multijurisdictional corporation can be accounted for individually and independently. Under Wisconsin law, a multijurisdictional corporation may use separate accounting when the corporation's business activities in the state are not an integral part of a unitary business. Generally, a unitary business exists when the corporation's in-state activities are dependent upon, or contributory to, the operations outside of Wisconsin. Currently, few multijurisdictional corporations in the state use separate accounting to determine their net tax liability.

*Formula Apportionment.* Under the formula apportionment method of assigning corporate income, a formula is employed for dividing the income of a multistate corporation among the states in which its business is conducted. States have developed apportionment formulas as a rough means of attributing a reasonable share of the income tax base of a multistate unitary business to the taxing state. Under Wisconsin law, formula apportionment is used if a corporation's Wisconsin activities are an integral part of a unitary business which operates both within and outside of the state.

*Specific Allocation.* Specific allocation traces income to the state of its supposed source and includes the income in that state's tax base. Generally, this method of assigning income is applied to income from property with the source of the income generally following the location of the property. Wisconsin law distinguishes nonapportionable income from apportionable income. In determining a corporation's tax liability, total corporate nonapportionable income or loss is removed from the total income of a unitary multistate corporation and the remaining income or loss is apportioned to the state. Nonapportionable income allocated to Wisconsin is then added to apportioned business income to determine Wisconsin net income. Nonapportionable income is allocable directly to the state in which the nonbusiness property that produced the income, gain or loss is located. For state income and franchise tax purposes, nonapportionable income includes income, gain or loss from: (a) the sale of nonbusiness real property or nonbusiness tangible personal property; (b) rental of nonbusiness real property or nonbusiness tangible personal property; or (c) royalties from nonbusiness real property or nonbusiness tangible personal property.

9. Most multistate or multinational corporations use the state apportionment formula to allocate income to Wisconsin for tax purposes. In these cases, the corporation adds its total gross income from its in-state and out-of-state unitary activities, subtracts its deductions, and multiplies the amount of net income by its apportionment ratio as determined by the Wisconsin apportionment formula. The apportionment ratio is used to approximate how much of a corporation's total net income is generated by activities in Wisconsin. Figure I provides an illustration of the Wisconsin apportionment formula under current law.

**FIGURE I**

**Computation of Apportionment Percentage**
**Under the Current Wisconsin Apportionment Formula**

$$\text{Apportionment Percentage} = \left[ \left[ \frac{\text{Property in WI}}{\text{Total Property}} \right] + \left[ \frac{\text{Payroll In WI}}{\text{Total Payroll}} \right] + 2 \left[ \frac{\text{Sales by WI Destination}}{\text{Total Sales}} \right] \div 4 \right]$$

10. The property factor of the apportionment formula is the ratio of the average value of real and tangible personal property owned or rented and used by the taxpayer in Wisconsin to that for the company as a whole. Tangible property includes land, buildings, machinery and equipment, inventories, furniture and fixtures and other tangible personal property actually owned and used in producing apportionable income.

11. The payroll factor is the ratio of the total amount of compensation paid by the company in the state to the total compensation paid by the company. Compensation includes wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

12. The sales factor is the ratio of the total sales of the taxpayer in the state to total sales everywhere. Sales are generally all gross receipts from the course of the taxpayer's regular trade or business operations which produce apportionable business income. For the sales factor, sales of tangible personal property are generally considered to be in Wisconsin if the property is delivered or shipped to a purchaser within Wisconsin or if the property is shipped from Wisconsin and the taxpayer is not subject to the taxing jurisdiction of the state of destination. The latter type of sales are "throwbacks" and single-weighted in the apportionment formula. In addition, sales of tangible personal property from an office in the state, but shipped from an out-of-state supplier to an out-of-state customer are considered throwback sales if neither the supplier nor the customer are subject to the taxing jurisdiction of the states in which they are located. Sales to the federal government are only considered to be in Wisconsin if they are shipped from a location within the state and are delivered to the federal government at a location within the state or if they are "throwback" sales. Federal throwback sales are single-weighted in the apportionment formula. Sales other than sales of tangible personal property are usually considered to be in Wisconsin if the income-producing activity is performed wholly in Wisconsin. Generally, sales of intangible assets are excluded from the sales factor. Sales which produce nonapportionable income are also excluded from the sales factor.

13. Interstate air carriers, motor carriers, pipeline companies, taxable insurance companies and financial organizations are required to use different apportionment formulas to determine Wisconsin net taxable income. These corporations must use special apportionment factors in order to attribute income to their Wisconsin business activities. Public utilities for which an apportionment formula is not specified are required to use the arithmetic average of the ratios of the regular three-factor (payroll, property, sales) formula to apportion income to the state. Thus, generally, public utility companies apportion income using the average of the ratios of payroll, property and sales in-state to total payroll, property and sales. The sales factor is not double-weighted.

14. Instituting a single-sales factor apportionment formula would have no effect on the taxes paid by corporations whose business property, operations and income are entirely in Wisconsin, because these corporations do not use an apportionment formula to determine tax liability. Most corporate taxpayers do not apportion income and, as a result, most businesses in Wisconsin would not directly benefit from a change to single-sales factor apportionment. However, if the change in the apportionment formula decreases total corporate income and franchise taxes, then 100% Wisconsin corporations would pay a larger proportionate share of the remaining total collections.

15. Although most corporations operating in Wisconsin are not multistate or multinational firms, substantially more taxes are paid by firms that apportion income. Table 2 shows the distribution of net income and tax liability for corporations that apportion income compared to the totals for all corporations. The data is from 1999 corporate aggregate statistics and shows that multijurisdictional firms represented about 17% of all corporate taxpayers but paid $419.7 million or 73% of total corporate income taxes.

**TABLE 2**

**Distribution of Net Income and Tax Liability of Multistate Corporations (1999)**

| | Multistate Corporations | | | All Corporations | | |
|---|---|---|---|---|---|---|
| Net Income Class | Net Income | Net Tax | Corporations | Net Income | Net Tax | Corporations |
| Zero or Less | $0 | $0 | 10,369 | $0 | $0 | 80,492 |
| 0--10,000 | 7,242,898 | 566,991 | 2,628 | 31,112,167 | 2,420,421 | 10,045 |
| 10,000--25,000 | 14,861,367 | 1,162,711 | 911 | 67,766,082 | 5,249,185 | 4,113 |
| 25,000--50,000 | 24,613,301 | 1,935,445 | 683 | 122,171,304 | 9,422,233 | 3,353 |
| 50,000--100,000 | 49,907,111 | 3,829,109 | 693 | 200,546,540 | 15,398,276 | 2,860 |
| 100,000-250,000 | 119,483,341 | 9,066,694 | 749 | 310,351,072 | 23,537,067 | 2,002 |
| 250,000-500,000 | 160,263,472 | 11,860,972 | 452 | 338,077,095 | 25,377,420 | 953 |
| 500,000--1,000,000 | 230,804,378 | 17,126,465 | 325 | 457,396,078 | 34,210,314 | 647 |
| 1,000,000-5,000,000 | 1,214,336,941 | 86,908,088 | 538 | 1,718,907,961 | 125,883,666 | 811 |
| 5,000,000--10,000,000 | 767,739,173 | 53,981,004 | 107 | 870,417,921 | 62,076,758 | 121 |
| 10,000,000+ | 3,390,106,785 | 233,222,765 | 97 | 3,918,955,632 | 274,991,940 | 111 |

| Total | $5,979,358,767 | $419,660,244 | 17,552 | $8,035,701,852 | $578,567,280 | 105,508 |
|---|---|---|---|---|---|---|

16. Compared with the current three-factor formula, the single-sales factor apportionment formula would increase the tax on some multijurisdictional corporations and decrease it on others. The exact pattern of the effects depends on the mathematical relationship between the sales factor and the property and payroll factors. Specifically, corporations whose sales factors are less than the average of their property and payroll factors would benefit from a move to a single-sales factor apportionment formula; corporations whose sales factors are greater than the average of their property and payroll factors would be disadvantaged. Data developed by the Department of Revenue from 1999 corporate income and franchise tax returns for which specific apportionment data was available indicates that the total decrease in tax liability from switching to a single-sales factor apportionment formula would have been $79.7 million. However, 4,259 firms would have experienced an aggregate tax increase of $47.1 million ($11,055 average); while 2,141 would have experienced a total tax decrease of $115.3 million ($53,867 average). This data does not include corporations that would experience a tax change but for which information was insufficient to calculate a specific change in liability.

17. Replacing the current three-factor formula with a single-sales factor apportionment factor would reduce taxes on corporations that have a substantial amount of their production activities in the state. The single-sales factor would reduce the tax impact on multistate businesses that place jobs and capital in-state by giving them lower tax bills than would occur under the three-factor method of apportionment. On a more specific level, Wisconsin's current three-factor formula creates a disincentive for businesses that require large investments in tangible property and payroll to locate in the state, when compared with the surrounding states. Iowa and Illinois use a single-sales apportionment factor and Michigan is phasing in such a formula. Minnesota attributes a 70% weight to the sales factor. All of these apportionment formulas place a relatively lower income tax burden on property and payroll than Wisconsin's. Because of these impacts, converting to a single-sales factor is viewed as a means of generating economic growth. A 2000 study conducted by economists Austau Goolsbee, Edward Maydew and Michael Schadewald estimated that switching to a single-sales factor apportionment formula in Wisconsin would have the long run effect of increasing the number of manufacturing jobs by about 2.9% or 18,000 jobs. Nonmanufacturing employment would increase 2.4% or by 49,000 new jobs. Also, $51 million in additional tax revenue would be generated. The study was based on experiences of other states that modified their apportionment formulae between 1978 and 1995 and controlled for other factors that could affect employment.

18. A business that sells a substantial amount of its products and also has some business operations in-state would have less incentive for keeping those operations here under single-sales factor apportionment. Moreover, there would be an incentive for many firms that sell tangible personal property in the state to reduce in-state operations solely to the solicitation of orders to be protected from taxation under federal law relating to corporate nexus (Public Law 86-272). This, in turn, would make it even less likely that the business would locate property or production personnel in the state. In addition, there are a number of elements in a state's tax code that are equally or more important in determining the relative tax burden on businesses in different states. For example, both Illinois and Minnesota require multistate corporations to use combined reporting in determining

state tax liability. For many firms, this method has a greater impact on tax burden than the type of apportionment formula used. Finally, the two states that have used single-sales factor apportionment the longest, Iowa and Nebraska, have not had relatively greater increases in investment than surrounding states. These states have not become regional manufacturing centers.

19. The Department of Revenue has recommended technical changes to address the computation of the sales factor when the denominator or numerator is negative or zero. The Committee may wish to adopt those recommended changes to clarify computation of the sales factor in those circumstances.

## ALTERNATIVES TO BILL

1. Approve the Governor's recommendation to phase in the use of a single sales factor apportionment formula to apportion to Wisconsin the income of corporations, including insurance companies, and nonresident individuals, and estates and trusts engaged in business within and outside of the state. Provide that use of single sales factor apportionment would be phased in over three years beginning with tax years beginning after December 31, 2002. Require, for tax years beginning after December 31, 2004, use of a single sales factor apportionment formula to apportion income to Wisconsin.

2. Adopt technical changes to address computation of the sales factor when the numerator or denominator in the apportionment formula is negative or zero.

3. Maintain current law.

| Alternative 3 | GPR |
|---|---|
| **2001-03 REVENUE** (Change to Bill | $8,000,000 |

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