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SINGLE SALES FACTOR APPORTIONMENT MAY BE COMING TO NORTH CAROLINA

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In the last two years, the General Assembly has enacted major changes to North Carolina's corporate income tax law, including significant rate reductions, elimination of numerous incentive credits and replacement of North Carolina's peculiar "net economic loss" with a "net operating loss" that conforms to its federal counterpart. But the General Assembly is apparently not finished. The legislative agenda for the long session that convenes January 14 may include further significant reforms including adoption of single sales factor apportionment.

Traditional Apportionment Formulas

"Apportionment" refers to the rules that determine how much of a multi-state corporation's business income is attributable to its in-state operations. Some method of "fair apportionment" is required by the Due Process and Commerce Clauses of the Constitution, but within this framework the states have wide latitude to craft their own rules.

The "classic" method of apportionment is to multiply a corporation's business income by the average of three fractions expressing the ratio of the corporation's in-state property, payroll, and sales to its total property, payroll and sales everywhere. This formula expresses the theory that a corporation's income is derived from three factors:

1. Capital (property)
2. Labor (payroll)
3. Markets (sales)

The equal weighting of these three factors presumes that each contributes more or less equally to the production of income.

Three-factor apportionment reached its high water mark in 1978, when it was employed by 43 of the 46 jurisdictions that imposed corporate income taxes. Since then, the traditional formula has been steadily losing ground to other approaches that place more emphasis on the sales factor.

Increased Reliance on the Sales Factor

Economists view the three factors as implicit taxes on the activities they represent. Under this view, the property and payroll factors are indirect taxes on investment and job creation. Increasing the weight of the sales factor in the apportionment formula thus reduces a drag on economic development. Many states responded to this view by double-weighting the sales factor. North Carolina did so in 1989. More recently, a number of states have adopted single-factor apportionment formulas that rely exclusively on the sales factor.

The movement received a major endorsement in 2000 when two prominent economists published a paper quantifying the economic impact of single sales factor apportionment.[1] Their study showed that a state adopting single sales factor apportionment would lose corporate income tax revenues, but that this would be offset by enhanced personal income tax collections resulting from increases in in-state employment. A number of subsequent studies have reached similar conclusions. For instance, when Georgia moved to single sales factor apportionment, a fiscal impact study found that corporate income tax collections would decrease by $134 million over five years, but personal income tax collections would increase by $240 million.

Today, twenty-six jurisdictions, including Virginia, South Carolina and Georgia, have adopted or are phasing in single sales factor apportionment for at least some taxpayers.

North Carolina has some experience with single sales factor as an economic incentive. In 2009, in a successful effort to entice Apple to build a large datacenter in Catawba County, the State authorized single sales factor apportionment for certain taxpayers investing at least $1 billion in the State. Legislative interest in expanding on this success appears to be growing, and the issue has been on the agenda of the legislature's Revenue Laws Study Committee during the current legislative interim.

What are Advocates and critics saying?

The chief appeal of single sales factor apportionment is that it encourages new investment and job creation without picking specific winners and losers through narrowly-drawn credits or other targeted incentives. Moreover, with more and more states adopting single sales factor, North Carolina may need to follow suit just to remain competitive. Using a single apportionment factor also advances the goal of tax simplification by eliminating computation, compliance and enforcement issues related to the property and payroll factors.

The single sales factor approach does have its critics. Some argue that it is unfair to corporations with significant out-of-state property and payroll who would see more of their income apportioned to North Carolina. It can also be argued that single sales factor apportionment increases the corporate income tax burden borne by wholly in-state corporations. Although such corporations would not see any change to their tax bills, they may bear a larger share of the total corporate income tax burden as multi-state corporations see their tax bills decline. Some critics also doubt the effectiveness of single sales factor as an economic stimulus.[2] Empirical studies of this issue are, of course, problematic, because of the difficulty of isolating a single variable in a dynamic economy.

Open Issues

If single sales factor advocates prevail over their critics, the General Assembly will have to consider a number of corollary issues in drafting the implementing legislation. These include:

- Will single sales factor apportionment be available to all multi-state taxpayers or only certain industries, such as manufacturers and retailers?
- If single sales factor apportionment is to be available only to selected industries, how will those industries be defined? For instance, if only manufacturers are covered, will the statute define "manufacturer" or will the term be defined by reference to an external standard such as NAICS classification?
- Will single sales factor be required, or will taxpayers be given the option of using either single sales factor or some other method?
- If the formula is elective, will conditions be placed on the election? For instance, will the election be binding for a specified period, or will hiring, investment, health insurance or wage standards be imposed on electing taxpayers?
- Will the change to single sales factor be accomplished in a single year, or will it be phased in over a period of years by gradually increasing the weight given to the sales factor until it reaches 100%?
- If corporations using different apportionment methods are included in a combined return, what apportionment formula will apply to their combined income?
- Since exclusive reliance on the sales factor makes determining the source of a sale crucial, will the current sourcing rules be changed?

How these and other issues are addressed in the upcoming legislative session will present opportunities as well as potential pitfalls for multi-state corporations operating in the state. For more information about single sales factor apportionment or other state tax reforms, contact a member of **Smith Anderson's Tax group**.

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[1] Austan Goolsbee & Edward Maydew, "Coveting Thy Neighbor's Manufacturing: The Dilemma of State Income Apportionment," 75 *Journal of Public Economics* 125 (2000).

[2] Michael Mazerov, "The 'Single Sales Factor' Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?," *Center on Budget and Policy Priorities* (2005).

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