Market Based Sourcing and Single Sales Factor Analysis

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Overview

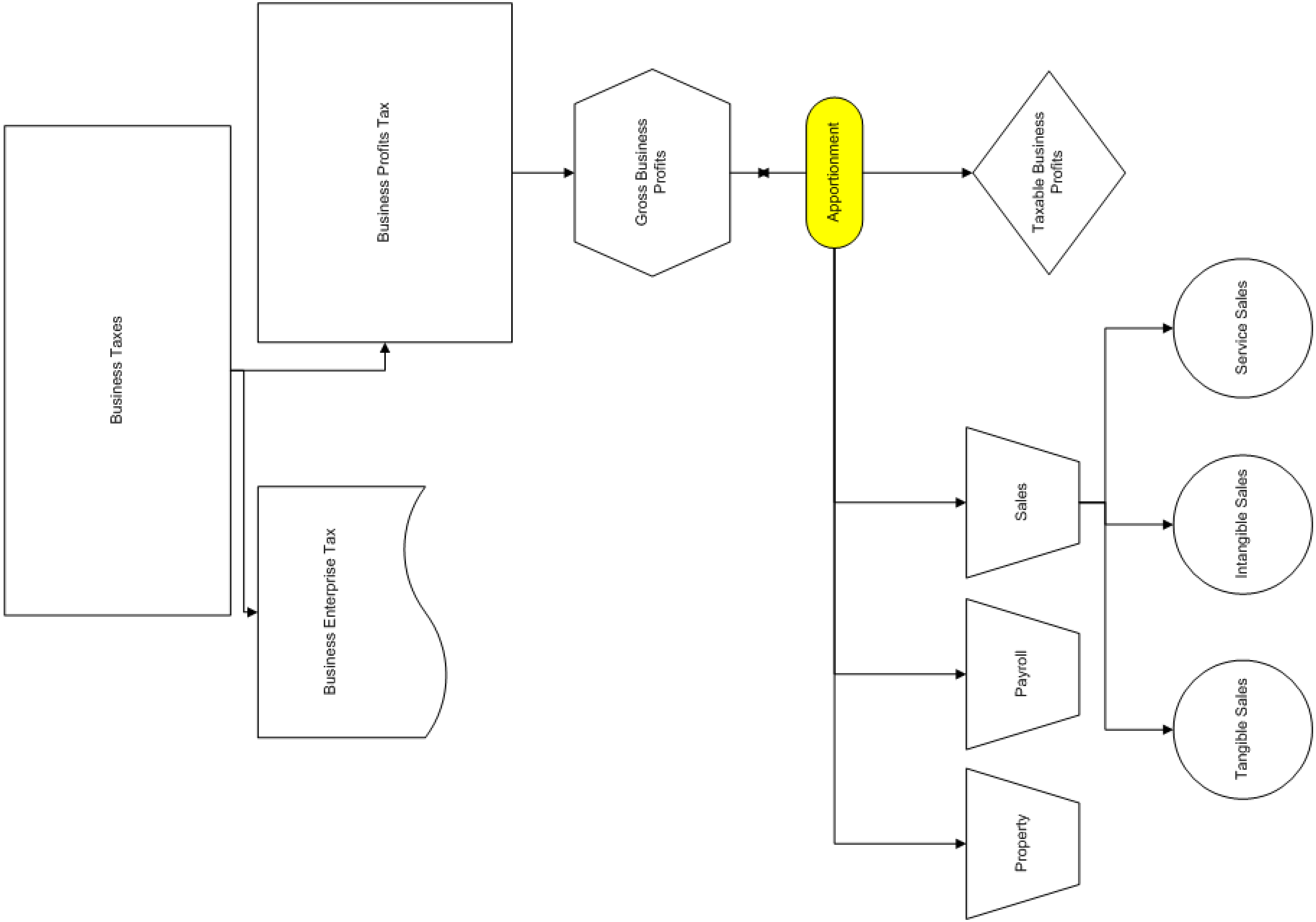
- Refresher on Apportionment
- Analysis Considerations
- Two items most discussed by the Commission:
  - Market Based Sourcing Analysis
  - Single Sales Factor Analysis
- Conclusions
- Reference Slides

Apportionment

- What factors are utilized?
  - Sales
  - Payroll
  - Property
- How are the factors weighted?
  - Equal weighting of all three factors
  - Double weighting of sales factor **(NH)**
  - Single Sales Factor (Sales only, no payroll or property)

Apportionment

- The NH apportionment equation is dictated by law (RSA 77-A:3 Apportionment)
- The risks of a change to NH apportionment are higher because the proportion of Business Profits Tax to total NH revenue is large
  - This is not true in many other states
- The current apportionment statute and rules have advantages and disadvantages to individual taxpayers
  - Any change will create different advantages and disadvantages to a different set of taxpayers


Business Taxes
Business Profits Tax
Business Enterprise Tax
Gross Business Profits
Apportionment
Taxable Business Profits
Sales
Payroll
Property
Service Sales
Intangible Sales
Tangible Sales

New Hampshire Apportionment

Numerator		Denominator	Double Weight		Factor
NH Sales	/	Everywhere Sales	X2	=	Sales Factor
NH Payroll	/	Everywhere Payroll		=	Payroll Factor
NH Property	/	Everywhere Property		=	Property Factor
				+	All Factors
				/4	= NH Apportionment

Apportionment – Sales

- Generally three types of sales:
  - Tangible personal property (TPP)
    - Ex. A car tire
  - Intangibles
    - Ex. The name of the car tire brand
  - Services
    - Ex. Installing a car tire
    - Cost of Performance vs. Market Based Sourcing Issue

Apportionment – Service Sales
Cost of Performance

- In NH services are sourced using what is generally referred to as Cost of Performance (COP)
  - The COP rule is generally an all or nothing approach
  - The entire sale is attributed to the single state in which the greater proportion of the income-producing activity is performed, based on costs of performance
- Example: Assume a consulting firm receives a $100,000 fee for services performed by the taxpayers' employees
  - 70% of the COP are incurred in NH, and 30% of the COP are incurred in VT
  - Result: The entire $100,000 in the NH numerator

Apportionment – Service Sales Market Based Sourcing

- Regulations and rules of Market Based Sourcing (MBS) are not universal
  - Examples include the location of the ultimate customer, location of initial customer, the state where the service or intangible is used, state where benefit is received, etc.
- Example: Service Company has nexus (does business) in States A, B, and C
  - 20% of company's sales are to customers in State A, 40% of sales are to customers in State B, 40% are to customers in State C, assume that the three states have similar sourcing rules
  - Under a MBS approach the respective sales into each state (A, B, and C) are attributable to each state for apportionment purposes

Analysis Considerations

- Conducted analysis of MBS and SSF
  - Two items most discussed by the Commission
- About 90% of the states that have a form of SSF also have MBS
  - SSF varies in its applicability in many states, some states have an election, and in others it is only for certain industries
- Some states have MBS without SSF, and some have SSF without MBS
- There appears to be a correlation between MBS and SSF, however they are not dependent on each other

Market Based Sourcing Analysis

- The fiscal impact to Business Profit Tax revenue is indeterminable because it would require a detailed analysis of each individual taxpayers books and records which the Department does not have
- Challenge defining the impact on in-state vs. out-of-state businesses is difficult
  - What defines an in-state or an out-of-state business?
  - Even if defined, DRA does not have the data to make a determination
- There has been discussion in the Commission that a change to MBS would benefit in-state businesses
  - What is an in-state business?
  - There is no way to avoid negative effects to individual taxpayers under the current statute or with a change in statute

Market Based Sourcing Analysis

- We reached out to other states for their estimates
  - There is a lack in uniformity of the MBS rules which makes it impossible to rely on other states' estimates
  - In many cases the state did not determine a fiscal impact for MBS, or MBS was part of a larger tax reform bill and the state could not parse out the MBS impact
  - In states where they did determine an impact, it was generally an increase in revenue, but it is not possible to extrapolate their estimates to NH
    - Other states generally only tax corporations
    - The weighting of factors, and other apportionment rules, may be different than NH
  - Some states required the filing of information returns for a year to determine an impact

Single Sales Factor Analysis

- The use of only sales to calculate apportionment
- Taxpayers who benefit from SSF are those whose average payroll and property factors are greater than their sales factor
  - A company who has its largest office in NH, a majority of its employees in NH, but sells most of its product out of state will reduce its NH apportionment with a change to SSF
  - If the company is a service company, with all sales apportioned to NH under a Cost of Performance, potentially the NH apportionment factor increases with a SSF analysis
  - This is why SSF and MBS generally have a relationship

Single Sales Factor Analysis

- The fiscal impact of SSF is inconclusive for various reasons
- An analysis of tax year 2011-2014 shows inconclusive results
- Several factors could significantly change the fiscal impact:
  - Data quality issues including the amount of credits being applied to outstanding BPT and how taxpayers would utilize outstanding credits on file, especially the Insurance Premium Tax Credit
  - Variable results year to year depending on the activity of the Top 500 filers
  - Taxpayers may adjust how they source sales if the law were to change
  - Taxpayers may reevaluate their nexus if the law were to change

Single Sales Factor & Market Based Sourcing Analysis

- Cannot analyze even the direction of the impact of a change to SSF with MBS
  - Taxpayers do not report the type of sale in the sales factor (tangible, intangible, or service)
    - This is not uncommon among the states
  - Cannot limit analysis to those taxpayers who apportion
    - With MBS some taxpayers who do not apportion with COP would with MBS

Conclusions

- With only one factor apportionment (SSF), changes have the potential to have a larger effect to NH revenues, positively or negatively
- Ensuring a business does not pay more than 100% is not possible
- There are negative and positive effects to individual taxpayers by retaining COP and three factor apportionment, by making a change to MBS and/or SSF, or by any other change in apportionment
- Consider making one change at a time – we still may not be able to isolate the effect of the change, but trends will be clearer

Questions?

Reference Slides

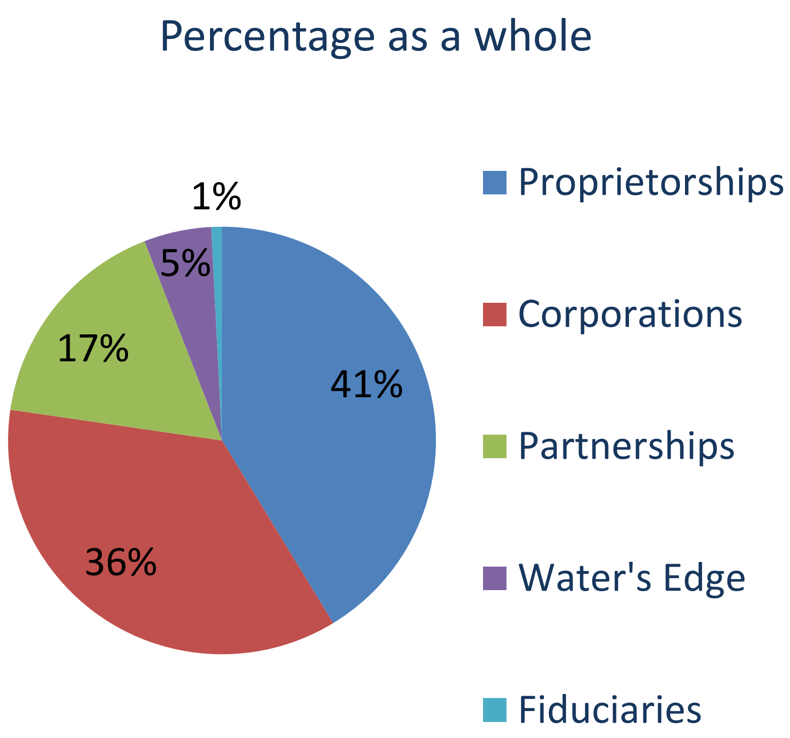
Business Profits Tax Revenues

- Business Tax Revenue:
  - Business Tax Revenue is composed of the Business Profits Tax (BPT) and the Business Enterprise Tax (BET). The revenue relationship between the two taxes averages out to be a 60/40 split with 60% of the Business Tax Revenue attributable to BPT and 40% of the Business Tax Revenue attributable to BET.
  - BPT Revenue reported on a cash basis in the June Revenue Focus, produced by Admin. Services, generated $348 million in FY2015 and $384.5 million in FY2016.
  - BPT revenue represents about 17% of the total audited General and Education Trust Fund revenues.

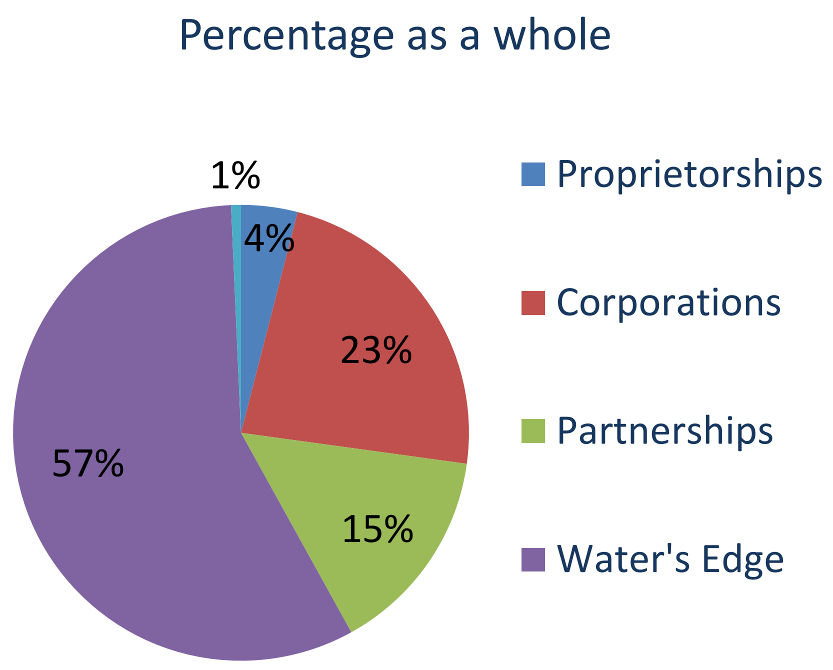
Business Profits Tax Taxpayers

For Tax Year 2014

Entities Filing BPT Tax Returns



Entities Paying BPT Tax



Who Pays BPT?

BPT - Tax Year 2014

Business Profits Tax Stats by Tax Year and Amount of Tax Liability

This Population includes all Corporations, Partnerships, Proprietorships, and any other Entity that Files BPT

DRAFT as of 9/16/16

Tax Year 2014 Range in Tax Paid	COUNT	Sum BP TAX	% of POP	% of Tax Liability by POP
$0	51,164	$0	74.3%	0.0%
$1 - $500	5,663	$957,510	8.2%	0.3%
$500 - $1K	2,057	$1,488,873	3.0%	0.5%
$1K - $10K	7,205	$25,458,841	10.5%	8.2%
$10K - $50K	1,988	$42,467,589	2.9%	13.6%
$50K - $100K	314	$22,328,066	0.5%	7.2%
$100K - $MIL	434	$122,354,130	0.6%	39.3%
>$1MIL	45	$96,352,501	0.1%	30.9%
Totals:	68,870	$311,407,510		

2014	COUNT	Sum BP TAX	% of Total POP	% of Total Tax Liability by POP
Corporations	24,775	$72,263,163	36.0%	23.2%
Water's Edge	3,506	$178,761,808	5.1%	57.4%
Partnerships	11,566	$45,977,636	16.8%	14.8%
Proprietors	28,443	$12,336,819	41.3%	4.0%
Fiduciaries	580	$2,068,083	0.8%	0.7%
Totals:	68,870	$311,407,510		

NOTE: Figures are unaudited and subject to change until all final and amended returns for the Tax Year are filed.

Tax Expenditure Report

- The Tax Expenditure Report analyzes New Hampshire's weighting of the Sales Apportionment Factor (RSA 77-A:3, II(a)) (Net Loss)
  - For taxable periods ending on or after December 31, 1991 to June 30, 1994, the sales factor of the New Hampshire 3 factor apportionment formula for the BPT was modified. The sales factor was multiplied by 1.5 then combined with the payroll and property factors, the sum of which was divided by 3.5. Therefore, sales comprised 42.8% of the apportionment factor, while payroll and property comprised 28.6% each. It is important to note that this change had no effect on New Hampshire business organizations that did not apportion.
  - Taxpayers with tax years ending on or after July 1, 1994 double weight the sales factor of the apportionment formula. This change results in the sales factor comprising 50% of the apportionment factor, with payroll and property comprising 25% each.
  - The analysis for the Tax Expenditure Report calculates the tax that would have been due using equally weighted sales, payroll, and property factors on a fiscal year basis and does not take into consideration credits that were utilized by the taxpayer to offset tax liability.