

Vermont Tax Structure Commission

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Backgrounder

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Corporate Income Tax—Sourcing of Sales for Services

Vermont is one of 45 states, as well as the District of Columbia, that levy a corporate income tax on business profits. As the economy has shifted from the production of goods to the provision of services, corporate income from the sales of services has taken on greater weight and states have had to reassess how to apportion income for taxation. One major decision point is whether to apply a cost-of-performance or market-based sourcing rule to the sale of services and intangible assets.

Vermont utilizes the traditional cost-of-performance rule to source these types of sales, which is based on where the income-producing activity is performed. Under this method, the location of the customer or client is irrelevant for apportioning income to determine tax liability. However, sales of tangible personal property are apportioned to Vermont if delivered to an in-state purchaser. A market-sourcing rule for sales of services and intangible property, by contrast, is based on where the benefit of the service is received or will be used. This approach conforms more closely to the destination-based rule used for the sales tax and would allow Vermont to collect corporate income tax from out-of-state businesses with significant sales of services into the state but little in the way of in-state payroll or property. Conversely, it would eliminate the taxation of those types of sales from Vermont-based companies to out-of-state clients.

The authority to levy a corporate income tax depends on whether a state can establish nexus, that is, does a company have enough presence in the state to be subject to the tax.¹ Multistate companies, those with a presence in more than one state, must apportion their net income based on each state's apportionment formula. Historically, the formula consisted of three equally weighted factors—property, payroll, and sales—but in the last 20 years, states have shifted toward formulas that give more weight, or exclusive weight, to sales within their state. This trend has been spurred, in part, by state efforts to retain businesses and attract new ones to locate within their borders. Vermont enacted a double-weighted sales factor in 2004 as part of the legislation that created the requirement for unitary combined reporting for all C-corporations.

¹ Historically considered as physical presence but the term has expanded to include the concepts of economic presence and factor presence. The Multistate Tax Commission released a uniform proposed law on substantial nexus standard in 2002.

Twenty-six states² with a corporate income tax now apply a market-based sourcing rule to apportion income from the sale of services and lease or sale of intangible property. The remaining 19 states, which includes Vermont, continue to apply a cost-of-performance rule. States have often found the market-based rule advantageous for in-state businesses, and tax administrators view the shift as creating more consistency in the sourcing of receipts from sales of tangible and intangible property.

Of the six New England states (shaded in the table below), all but Vermont and New Hampshire have adopted market-based sourcing, although they don't use the same approach.³ One disadvantage to Vermont's companies that sell services to other New England states is that, with the exception of New Hampshire, the income from those sales could be taxed twice—once in Vermont where the income-producing activity is based and again in a market-based state where a client received the services.

The corporate tax brought in \$96.4 million and accounted for 5.5% of total General Fund tax revenue in FY 2018, but estimating the revenue impact from adopting market-based sourcing would be difficult due to lack of data. A survey of states that have adopted market-based sourcing in the last five years could provide some useful information, but differences among the states in how "market" is defined depending on the type of sales, whether there are industry-specific rules, and other variations in each state's regulations would make it difficult to extrapolate from the data a reliable estimate for Vermont. An additional reason for caution is that the profile of businesses in each state that pay corporate tax and would be affected by the change differs considerably.

Market-based sourcing is no panacea to the complexity of corporate income tax, and a new sourcing rule would require Vermont to revise existing regulations governing the apportionment of income and perhaps to produce new guidance for specific industries. There is now general agreement that market-based sourcing is better suited to the present economy, and Vermont should reconsider whether its current rule for sourcing sales of services and intangibles is out-of-date.

Corporate Income Tax—Sales Factor for Sourcing of Services

State	Sourcing Rule	Type of Market-Based Rule
AK	Cost of performance	
AL	Market-based	
AR	Cost of performance/proportionate method	
AZ	Cost of performance	
CA	Market-based	
CO	Market-based	
CT	Market-based	Services located in state
DC	Market-based	
DE	Cost of performance/proportionate method	
FL	Cost of performance	
GA	Market-based	

² Includes District of Columbia.

³ States may use a different approach to market-based sourcing (e.g., location of receipt or benefit of services), though in most cases the result is the same; some states also apply different rules—and rates—to different types of services.

HI	Cost of performance	
IA	Market-based	
ID	Cost of performance	
IL	Market-based	
IN	Cost of performance	
KS	Cost of performance	
KY	Market-based	
LA	Market-based	
MA	Market-based	Services delivered
MD	Market-based	
ME	Market-based	Services received
MI	Market-based	
MN	Market-based	
MO	Cost of performance	
MS	Cost of performance	
MT	Market-based	
NC	Cost of performance	
ND	Cost of performance	
NE	Market-based	
NH	Cost of performance	N/A
NJ	Market-based	
NM	Cost of performance	
NV	N/A—gross receipts tax on all business entities	
NY	Market-based	
OH	N/A—gross receipts tax on all business entities	
OK	Market-based	
OR	Market-based	
PA	Market-based	
RI	Market-based	Benefit received
SC	Cost of performance	
SD	N/A	
TN	Market-based	
TX	N/A—gross receipts tax on all business entities	
UT	Market-based	
VA	Cost of performance	
VT	Cost of performance	N/A
WA	N/A—gross receipts tax on all business entities	
WI	Market-based	
WV	Cost of performance	
WY	N/A	

* Market-based sourcing effective January 1, 2020

Source: Thomson Reuters Checkpoint

