



## Legislative Fiscal Bureau

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TO: Members  
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Senate Substitute Amendment 1 to Senate Bill 197 and Assembly Bill 413: Single Sales Factor Apportionment Under the Wisconsin Corporate Income and Franchise Tax

Senate Bill 197, relating to the phase-in of single sales factor apportionment under the state corporate income and franchise tax, was introduced on June 12, 2003, and was referred to the Senate Committee on Economic Development, Job Creation, and Housing. Senate Substitute Amendment 1 to Senate Bill 197 was adopted by that Committee on June 13, 2003, and recommended for passage by a vote of 4 to 1. Assembly Bill 413, a companion bill, was introduced on June 13, 2003, and referred to the Joint Committee on Finance. AB 413 is identical to SSA 1 to SB 197.

### **CURRENT LAW**

In general, state definitions of income and deductions under the corporate income and franchise tax are referenced to federal law. As a result, the Wisconsin corporate income and franchise tax is determined using federal provisions to determine income and deductions and then apportioning the net income of a multistate corporation, applying the tax rate, and allowing for any credits. Under current Wisconsin law, each separate corporation, including a member of an affiliated group of corporations, is taxed as a separate entity. Each individual corporation reports its own income, its own deductions, and its own net tax due.

For state tax purposes, specified rules and laws are used to allocate or assign income of a particular corporate taxpayer.

100% Wisconsin Corporations. A corporation which conducts all of its business and owns property only in Wisconsin has all of its income subject to taxation in Wisconsin. Usually, such

firms are incorporated in Wisconsin. These types of firms are often referred to as 100% Wisconsin firms and they compute their taxes very much like a Wisconsin resident does under the individual income tax.

Multijurisdictional Corporations. A corporation which conducts its business operations and owns property both within and outside of the state is subject to a different corporate income and franchise tax treatment than is a 100% Wisconsin firm. When the states tax the income of corporations generated by activities carried on across state lines, they are required under the strictures of the due process and commerce clauses of the U.S. Constitution to tax only income that is fairly attributable to activities carried on within the state. In order to meet this constitutional obligation, Wisconsin generally employs one of three methods of assigning income to the state--separate accounting, formula apportionment, or specific allocation.

a. *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 is one that operates as a unit; its business cannot be segregated into independently operating branches. Its operations are integrated, and each branch is dependent upon or contributory to the operating of the business as a whole. The Department of Revenue may permit separate accounting in any case in which it is satisfied that the use of the method will properly reflect the income that is taxable by the state. Currently, few multijurisdictional corporations in the state use separate accounting to determine their net tax liability.

b. *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. Many states, for example, specifically allocate the income from real and tangible personal property, such as rents from real estate, and oil and mineral royalties, to the state where the underlying property is located. Income from intangible property, such as dividends and interest, is often allocated to the taxpayer's commercial or legal domicile or to the state in which the intangible property is utilized.

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: (1) the sale of nonbusiness real property or nonbusiness tangible personal property; (2) rental of nonbusiness real property or nonbusiness tangible personal property; and (3) royalties from nonbusiness real property or nonbusiness tangible personal property. In addition, income or gain or loss from intangible property that is earned by a personal holding company is nonapportionable income and is allocated to the state in which the business is incorporated.

The state statutes provide that income or loss from intangibles (interest, dividends, royalties from patents, and similar types of income) is generally apportionable business income which follows the situs of the business. However, interest, dividends, and capital gains may be exempt from state tax when the recipient and payor are not a unitary business and the recipient and payor are not related as a parent company and subsidiary or affiliates, and the investment activity from which the income is received is not an integral part of a unitary business, or the transaction does not serve an operational function. Conversely, if the corporation has commercial or legal domicile in Wisconsin, this intangible income is treated as business income for tax purposes.

c. *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. 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.

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 based on three factors: property, payroll, and sales. Specifically, the apportionment ratio is determined by adding three fractions--the corporation's property value in Wisconsin divided by its total property value, 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. Figure I provides an illustration of the Wisconsin apportionment formula.

**FIGURE I**

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

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

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. Real and tangible personal property includes land, buildings, machinery and equipment, inventories, furniture and fixtures, and other tangible personal property actually owned and used in producing apportionable income. Property owned by the taxpayer is valued at its original cost adjusted for any improvements. Rented property is valued at eight times the net annual rent. Property used in the production of nonapportionable income must be excluded from the numerator and denominator of the property factor.

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. Compensation is considered to be paid in Wisconsin if: (1) the individual's service is performed entirely in Wisconsin; (2) the individual's service is performed within and outside of the state, but the service performed outside of the state is incidental to the service performed in Wisconsin; (3) a portion of the service is performed within the state and the individual's base of operations is in Wisconsin; (4) a portion of the service is performed within the state, and if there is no base of operations, the place from which the individual's service is directed or controlled is in Wisconsin; (5) the individual's residence is in Wisconsin and a portion of the service is performed within the state and neither the base of operations of the individual nor the place from which the service is directed or controlled is in any state in which some part of the service is performed; or (6) the individual is neither a resident of nor performs services in the state, but is directed or controlled from an office in Wisconsin and returns to Wisconsin periodically for business purposes, and the state in which the individual resides does not have jurisdiction to impose income or franchise taxes on the employer.

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 are 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 the 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.

Interstate air carriers, motor carriers, railroads, pipeline 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. The specific apportionment factors used by these types of firms are shown in Table 1. Public utilities not specified in Table 1 are required to use the arithmetic average of the ratios of the regular three-factor (payroll, property, and sales) formula to apportion income to the state. The sales factor is not double-weighted.

## TABLE 1

### Apportionment Factors Used by Certain Types of Multijurisdictional Corporations

<u>Type of Corporation</u>	<u>Apportionment Factors</u>
Interstate Air Carrier	<ol style="list-style-type: none"><li>1. Ratio of aircraft arrivals and departures in state to total aircraft arrivals and departures.</li><li>2. Ratio of revenue tons handled at airports in state to total revenue tons handled.</li><li>3. Ratio of originating revenue in state to total originating revenue.</li></ol>
Interstate Motor Carrier	<ol style="list-style-type: none"><li>1. Ratio of gross receipts from carriage of persons or property, or both first acquired for carriage in Wisconsin to total gross receipts from carriage of persons or property, or both.</li><li>2. Ratio of ton miles of carriage in Wisconsin to total ton miles of carriage.</li></ol>
Interstate Railroads and Sleeping Car and Carline Companies	<ol style="list-style-type: none"><li>1. Ratio of gross receipts from carriage of property, or persons, or both, first acquired for carriage in Wisconsin to total gross receipts from carriage of property, or persons, or both, everywhere.</li><li>2. Ratio of revenue ton miles of carriage in Wisconsin to revenue ton miles of carriage everywhere.</li></ol>
Interstate Pipeline Company	<ol style="list-style-type: none"><li>1. Ratio of net cost of real and tangible property owned and used in Wisconsin to produce apportionable income to total net cost of such property used everywhere.</li><li>2. Ratio of traffic units (e.g. barrel miles, cubic foot miles, or other appropriate measure of product movement) in Wisconsin to the total of such units everywhere.</li><li>3. Ratio of compensation paid to employees located in the state to total compensation paid to all employees.</li></ol>
Interstate Finance Company	<ol style="list-style-type: none"><li>1. Ratio of gross receipts in Wisconsin to total gross receipts. ("Gross receipts" include all business income, such as interest, finance charges, and service charges associated with the lending of money in the normal course of business. Gains from sales of assets, charges to a related corporation for personal services of employees, and miscellaneous income are excluded.) Gross receipts are assigned to Wisconsin if the transaction producing the income was principally negotiated in Wisconsin.</li><li>2. Ratio of compensation paid to employees located in Wisconsin to total compensation paid to employees everywhere. Compensation paid includes deductible management or service fees paid to a related corporation for the performance of personal services.</li></ol>

Insurance Companies. Although most insurance companies that conduct business in the state are generally exempt from the state corporate income and franchise tax and, instead, pay the state insurance premiums tax, certain types of insurance companies are subject to the corporate franchise tax. Specifically, the state corporate franchise tax is imposed on most domestic nonlife insurance companies and on the nonlife insurance business of domestic life insurance companies. Insurers generally exempt from the state franchise tax include:

- a. Foreign insurance companies (companies not organized under Wisconsin laws);
- b. Domestic life insurance companies engaged exclusively in life insurance business. If a life insurance company engages in a business other than life insurance, the net income from the nonlife insurance business is subject to the state franchise tax. These companies pay the state premiums tax on their life insurance business;
- c. Domestic insurers transacting mortgage guaranty insurance business as defined under the state administrative code;
- d. Town mutual insurers organized under or subject to state law;
- e. Insurers exempt from federal income taxation under the IRC; and
- f. Certain corporations that are bona fide cooperatives operating without pecuniary profit to any shareholder or member, or operated on a cooperative plan pursuant to which they determine and distribute their proceeds in compliance with state law. However, cooperative sickness care associations, service insurance corporations, and nonprofit organizations that derive income from an HMO or LSHO are subject to tax on that income.

Exempt insurers that realize income from the sale or purchase and subsequent sale or redemption of lottery prizes, if the winning ticket was purchased in Wisconsin, must pay state franchise tax on this income.

Similar to the tax treatment of other corporations, the income and deductions of insurance companies are generally determined by reference to federal law. The basis for determining net Wisconsin taxable income is federal taxable income. However, insurance companies are required to make the certain adjustments to federal taxable income.

Depending upon the type of insurance company involved, the adjusted federal taxable income amount might require further modifications before arriving at Wisconsin net taxable income. Domestic insurance companies not engaged in the sale of life insurance that have collected premiums written on property and risks located only in Wisconsin are not required to further modify this measure of income. For these insurance corporations, adjusted federal taxable income is Wisconsin net income (before any offset for business loss carryforwards).

However, domestic insurance corporations that are not engaged in the sale of life insurance but that have collected premiums written on property and risks located both in and outside of Wisconsin must allocate a portion of total adjusted federal income to the state. The allocation is accomplished by computing the average of: (1) the ratio of the company's payroll paid outside the state to total payroll paid everywhere; and (2) the ratio of the company's premiums written on property and risks located outside the state to total premiums written on property and risks located everywhere. The average ratio is then applied to adjusted federal income. This amount is subtracted from total adjusted federal income to arrive at Wisconsin net income before any offset for business loss carryforwards.

Domestic insurance companies that are engaged in the sale of both life insurance and other types of insurance must first determine the nonlife insurance portion of total adjusted federal income. As a first step in calculating Wisconsin net income, these companies are required to multiply total adjusted federal income by the ratio of the company's net gain from its nonlife insurance operations to total net gain from operations (with specific exceptions). If this amount is from premiums written on property and risks located only in Wisconsin, then the amount represents Wisconsin net income (before business loss carryforward offsets). However, if the calculated nonlife insurance income is from premiums written on property and risks located both in and outside of the state, then Wisconsin net income is determined using the allocation method described above.

Under state law, the amount of tax that an insurance company pays under the state franchise tax cannot exceed 2% of gross Wisconsin premiums. (The 2% gross premiums limitation does not apply to income from lottery prizes.)

## **SUMMARY OF BILL**

Senate Substitute Amendment 1 to Senate Bill 197/Assembly Bill 413 would phase in, under the state corporate income and franchise tax, 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. The phase-in of the single sales factor apportionment formula would be accomplished as follows:

Corporations, Nonresident Individuals, Estates and Trusts in General. For tax years beginning before January 1, 2006, 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, 2005, and before January 1, 2007, 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, 2006, and before January 1, 2008, 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, 2007, a single sales factor apportionment formula would be used to apportion income to Wisconsin.

Financial Institutions. For tax years beginning before January 1, 2006, 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, 2005, and before January 1, 2008, 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 the Department of Revenue (DOR). For tax years beginning after December 31, 2007, 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.

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.

As noted, income is currently 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, 2006, 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, 2005, and before January 1, 2007, 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, 2006, and before January 1, 2008, 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, 2007, income would be apportioned using only the premiums factor.

Gas, Electric and Telecommunications Utilities. These companies would be subject to the same apportionment provisions as corporations in general.

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

Use of Sales Factor in Certain Circumstances. The bills include provisions that specify how the sales factor is to be used in determining the apportionment ratio in certain cases. If both the numerator and denominator of the sales factor were zero, the sales factor would be eliminated from the apportionment formula in determining net income for tax years beginning before January 1, 2008, and none of the taxpayer's net income would be apportioned to the state for tax years beginning after December 31, 2007. If the numerator of the sales factor was a negative number and the denominator of the sales factor was a positive number, a negative number, or zero, the sales factor would be zero for tax years beginning before January 1, 2008, and none of the taxpayer's net income would be apportioned to the state for tax years beginning after December 31, 2007. If the numerator of the sales factor was a positive number and the denominator of the sales factor was zero or a negative number, the sales factor would equal one for tax years beginning before January 1, 2008, and all of the taxpayer's income would be apportioned to the state for tax years beginning after December 31, 2003.

## **FISCAL EFFECT**

SSA 1 to SB 197/AB 413 would phase in the use of a single sales factor apportionment formula over three years, beginning in tax year 2006, for corporations, nonresident individuals, and estates and trusts engaged in business within and outside the state. Based on information in the 1999 corporate income tax sample developed by the Department of Revenue, the annualized fiscal effect of adopting a single sales factor apportionment formula would be an estimated decrease in corporate income and franchise tax revenues of \$45 million. As noted, use of single sales factor apportionment would be phased-in over three years, beginning with tax year 2006. Table 2 shows the estimated annualized fiscal effect, compared to current law, of the single sales factor apportionment formula provisions under SSA 1 to SB 197/AB 413. The fiscal effect assumes that the bills would be enacted before tax year 2004 (January 1, 2004). Note that, due to the difference in tax years and state fiscal years, the full effect of single sales factor apportionment would not occur until the fourth year (fiscal year 2008-09) after the beginning of the phase-in.

**TABLE 2**

**Annualized Fiscal Effect  
Phase-in of Single Sales Factor Apportionment Formula**

<u>Fiscal Year</u>	<u>Sales Factor</u>	<u>Payroll Factor</u>	<u>Property Factor</u>	<u>Estimated Fiscal Effect</u>
Current Law	50%	25%	25%	N.A.
2005-06	60	20	20	-\$5,000,000
2006-07	80	10	10	-19,000,000
2007-08	100	---	---	-36,000,000
2008-09 (and thereafter)	100	---	---	-45,000,000

Under current revenue estimates, state corporate income and franchise tax revenues are projected to be \$490 million in 2002-03, \$540 million in 2003-04, and \$555 million in 2004-05.

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