MONTANA
Department of
REVENUE

Governor Steve Bullock

Director Gene Walborn

Memorandum

To: Ed Caplis, Tax Policy Research

From: Finn McMichael, Tax Policy Research FM

Date: March 4, 2020

Subject: Impact of TCJA and market based sourcing on Corporate Income Tax

This memo discusses some of the potential impacts of the Tax Cuts and Jobs Act of 2017 (TCJA), and the impacts of Montana switching our apportionment calculation from cost of performance sourcing to market based sourcing on corporate income tax liability. Both changes went into effect around January 1, 2018. This timing matches up with the beginning of tax year 2018 for most corporations, with about 70 percent of corporations operating on a tax year from January 1 to December 31.

The primary change in the TCJA that was likely to impact state corporate tax revenues was decreasing the federal tax rate while broadening the tax base. This broadened tax base should carry over to a broader state tax base and, as a result, increase state corporate income tax revenues, while keeping the state corporate income tax rate constant. Theoretically on Montana corporate income tax returns, this would show up as an increase in federal taxable income, federal adjusted gross income, Montana taxable income, and tax liability from TY 2017 to TY 2018.

The impact of Montana's switch to market based sourcing should theoretically show up as a change in the receipts factor (formally sales factor) portion of the apportionment factor for multi-state corporations. An increase in Montana receipts relative to total receipts would indicate that market based sourcing resulted in more of the total sales for a corporation being allocated to Montana for apportionment purposes. In turn, this increase in the receipts factor should result in a higher tax liability for multi-state corporations than was the case with cost of performance based sourcing.

My analysis compares the corporate tax returns for TY 2018 that with the returns for those same corporations for TY 2016 and TY 2017. As of February 5, 2020, 13,444 TY 2018 returns had been filed and 10,934 of those corporations also filed returns in TY 2016 and TY 2017. The following figures and analysis are based on that dataset of 10,934 corporations with returns for TY 2016, TY 2017 and TY 2018.

Figure 1 shows increases in federal taxable income, adjusted federal taxable income and tax liability in TY 2018 from very similar totals in TY 2016 and TY 2017. These increases are consistent with the expected impacts of the TCJA. Also note the significant difference between federal taxable income and adjusted federal taxable income in TY 2018, compared to very little difference between the two in both TY 2016 and TY 2017. This change is the result of significantly lower average total additions in TY 2018 compared to TY 2017 ($8.5 million vs. $77 million). These data suggest that most of the additions that were formerly claimed on corporations Montana tax returns are now included as part of their federal taxable income, which is also consistent with the increased tax base that was one of the goals of the TCJA.

Figure 1.

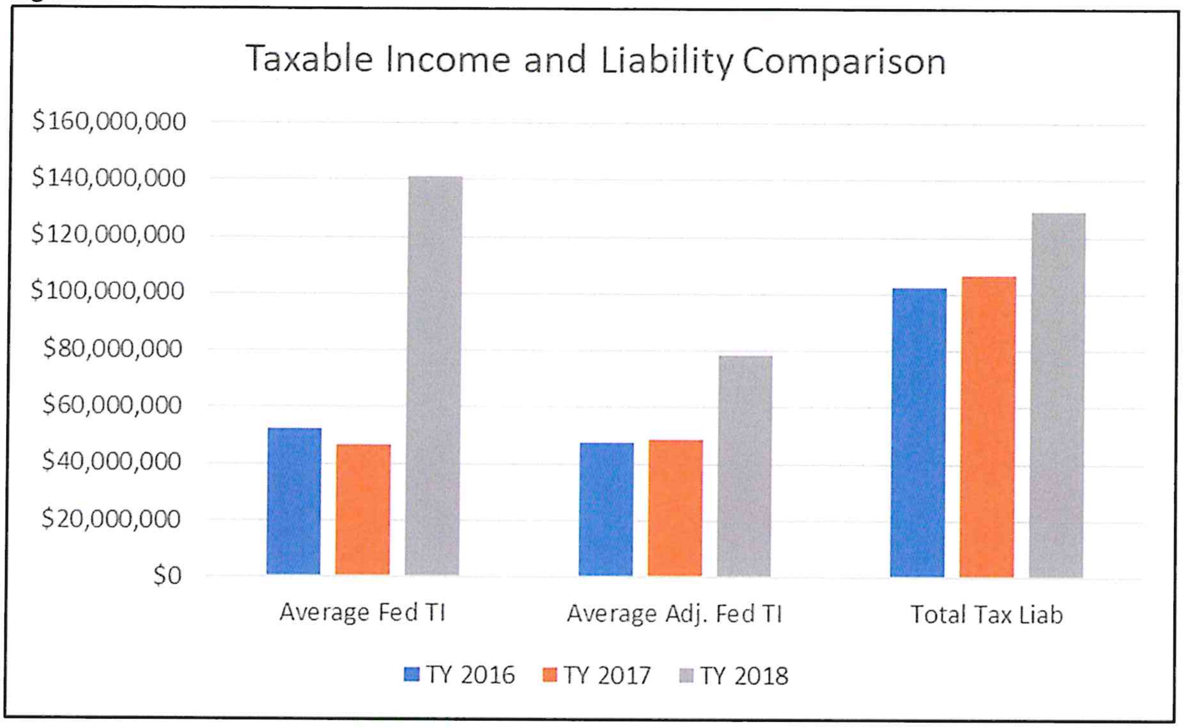
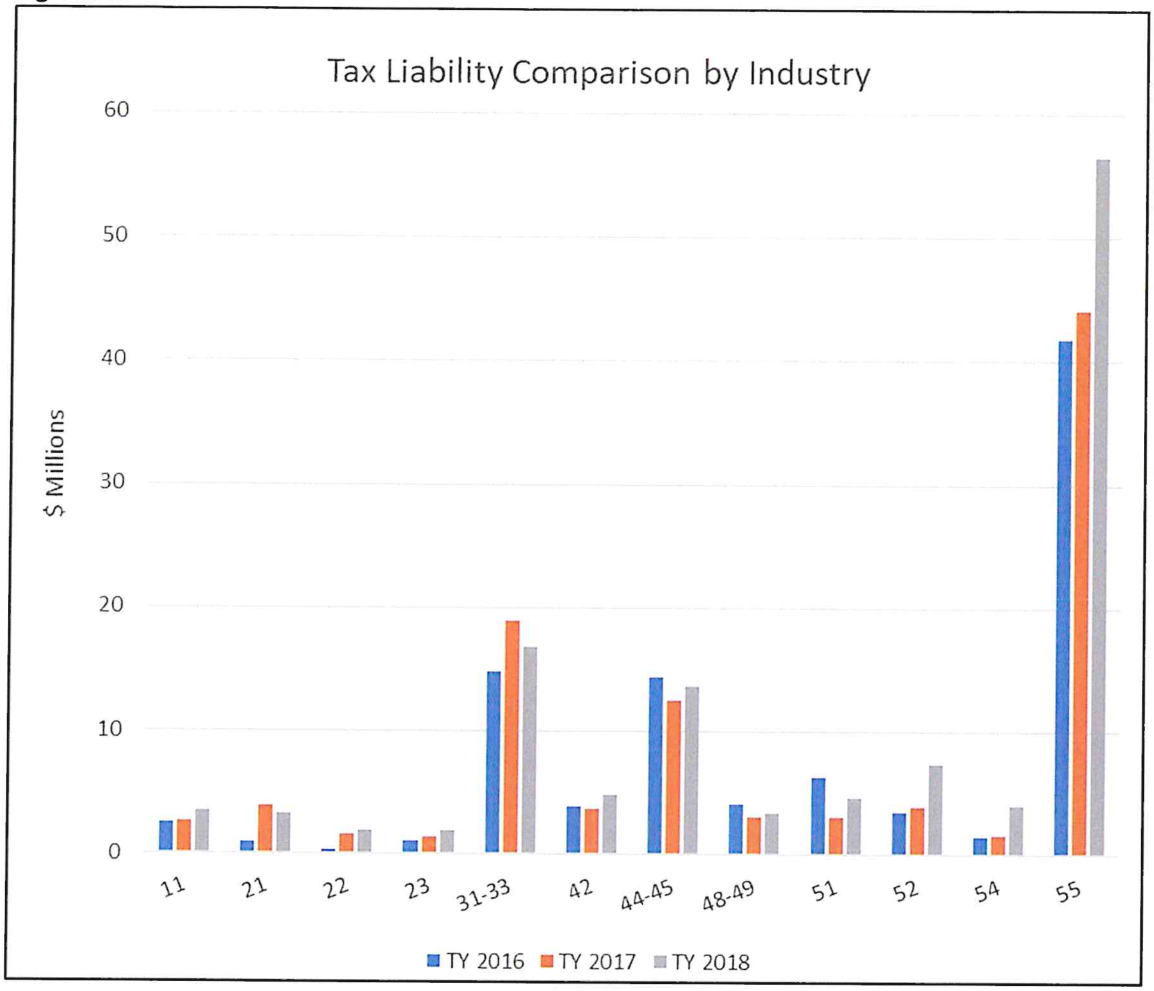


Figure 2 shows the breakdown of tax liability by 2-digit NAICS industry codes for 12 industries. The list of all industries with their corresponding codes is listed below the figure for reference. The first big takeaway from this figure is how large of a portion of total corporate tax liability is made up by corporations classified as Management of Companies and Enterprises. In this dataset, there are 651 corporations in this industry, and they combined for 44 percent of total tax liability in TY 2018. Also, about 87 percent of the corporations in this industry are multi-state corporations, compared to only 35 percent of all the corporations in the data. This industry also accounted for the most significant growth in tax liability in TY 2018 with an increase of 28 percent from TY 2017 compared to a 16 percent increase among all other corporations. This suggests that the large, multi-state corporations that make up a large portion of this industry classification have experienced the greatest impact because of the TCJA and/or market-based sourcing. Figure 3 below helps to try and identify whether market based sourcing is responsible for some of this increase in tax liability.

Figure 2.



<u>NAICS Industries:</u>
11 - Agriculture, Forestry, Fishing and Hunting
21 - Mining, Quarrying, and Oil and Gas Extraction
22 - Utilities
23 - Construction
31-33 - Manufacturing
42 - Wholesale Trade
44-45 - Retail Trade
48-49 - Transportation and Warehousing
51 - Information
52 - Finance and Insurance
53 - Real Estate and Rental and Leasing
54 - Professional, Scientific, and Technical Services
55 - Management of Companies and Enterprises
56 - Administrative and Support and Waste Management and Remediation Services
61 - Educational Services
62 - Health Care and Social Assistance
71 - Arts, Entertainment, and Recreation
72 - Accommodation and Food Services
81 - Other Services (except Public Administration)

Figure 3 shows the increase in the total receipts factor in TY 2018 for the corporations in the Management of Companies and Enterprises industry, relative to all other corporations. The total receipts factor for Management corporations increase from just under 0.1 in tax years 2016 and 2017 (0.096 and 0.099) to 0.224 in tax year 2018. It should be noted that this significant increase was the result of not only an increase in Montana receipts in TY 2018, but also a decrease in total receipts in TY 2018, the reason for which is unclear. The total receipts factor among all other corporations increased slightly from 0.041 in TY 2016 to 0.045 in TY 2017 to 0.050 in TY 2018. The increase in receipts factors is consistent with the expected impact of the change to market based sourcing. It also makes sense that the impact is concentrated among corporations in the Management of Companies and Enterprises industry because many of those companies are large, multi-state corporations with a lot of sales in many states, and a lot of income that can be allocated to different states depending on the calculation of apportionment factors.

Figure 3.

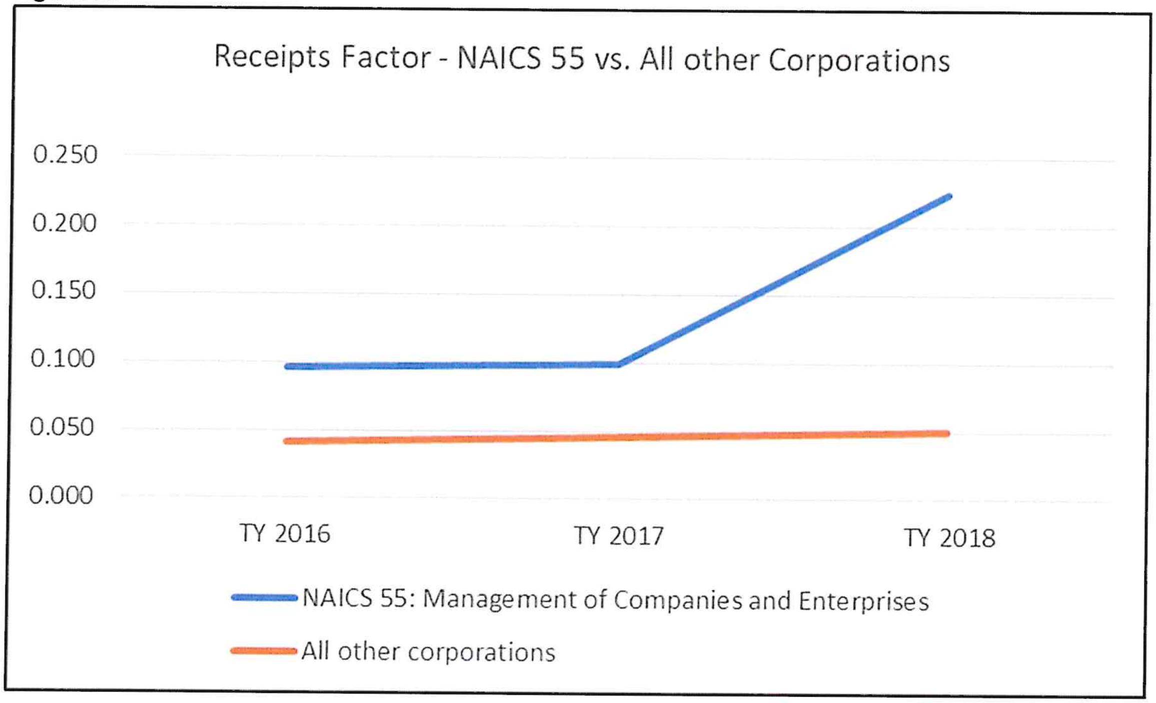


Table 1 below shows the total tax liability increase over tax years 2016 to 2018 for all corporations, Montana-only corporations and multi-state corporations. Although multi-state corporations make up only 35 percent of the corporations, they account for 86 percent of the tax-liability. Interestingly, and somewhat contrary to the expectations set forth by the figures above, this table shows that the tax liability percentage change from TY 2016 to TY 2018 has been about equal for Montana corporations and Multi-state corporations at 26-27 percent. This would suggest that the TCJA has impacted Montana-only and multi-state corporations similarly and that market-based sourcing has not had a significant impact on multi-state corporations relative to Montana-only corporations in terms of tax liability.

Table 1. TY 2016 – TY 2018 Tax Liability for MT and Multi-State Corporations

	# Corps	2016 Tax Liability	2017 Tax Liability	2018 Tax Liability	% Change 2016 to 2018
Total	10,934	$102,399,558	$106,758,390	$129,011,885	26%
MT Corps	7,097	$14,169,628	$13,349,013	$17,955,249	27%
Multi-state Corps	3,837	$88,229,930	$93,409,377	$111,056,636	26%

In conclusion, the return data available allowed for these observations and speculations to be made, but no specific conclusions could be drawn from the limited number of returns and tax years available at this point. In another couple of years, it may be clearer which of the changes discussed above can be attributed to the TCJA or market based sourcing, and which are just products of the unpredictability and volatility of corporation income taxes or other factors.