

Demystifying the Sales Factor: Market-Based Sourcing

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This is the third article of a series on composition of the sales factor and the potential tax saving opportunities hidden within state statutes and regulations. As more states shift to a single or more heavily weighted sales factor, it is important for taxpayers to understand the intricacies of the sales factor and opportunities that exist in computing it.

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I. Introduction

In this article, we explore market-based sourcing of receipts from the performance of services. States already generally employ a market-based sourcing regime for sales of tangible personal property. An increasing number of states have migrated to market-based sourcing for service receipts over the past several years. At first glance, market-based sourcing seems simple in its uniform, destination-based approach. But when looking at it from a national perspective, it is hardly uniform and can be fairly difficult to apply.

The key problem faced by most service providers is determining where the market for their services is located. Depending on the state, the market may be where the benefit of the service is received by the customer,¹ where the service is received,² where the customer is located,³ or where the service is delivered.⁴ Those varying interpretations of the market may produce dramatically different results and cre-

ate complexities and uncertainties. There are also controversies created by expansive interpretations of market-sourcing rules either through regulations or on audit. For example, we have seen states attempt to adopt a look-through approach, sourcing service receipts based on the location of the customer's customer, especially when doing so increases tax revenue. Those interpretations of market-based sourcing may be constitutionally suspect and may exceed the scope of the statute. Taxpayers may want to consider challenging them.

II. The Move to Market

A. Exporting the Burden

Many states have adopted market-based sourcing for service receipts in lieu of the traditional Uniform Division of Income for Tax Purposes Act costs of performance (COP) rule.⁵ Under UDITPA section 17, service receipts are assigned to the state in which the income-producing activity is performed. If the income-producing activity is performed in two or more states, the receipt is assigned to the state in which the taxpayer performed a greater proportion of the income-producing activity, based on COP. State tax administrators criticize the all-or-nothing results and complain that the income-producing activity and COP determinations are difficult to administer. The COP rule tends to source service receipts to production states and does not provide revenue to the states where the taxpayer has merely a market presence.

The perceived COP rule shortcomings were a primary motivation for the recent Multistate Tax Commission UDITPA rewrite project. However, the project seems too little, too late because states have been moving away from the UDITPA sourcing provisions and are doing so in a nonuniform manner. Nineteen states have adopted market-based sourcing statutes for service receipts, and the rules vary greatly.⁶

⁵For a more in-depth discussion of the COP rule, see Battin, et al., "Demystifying the Sales Factor: Costs of Performance," *State Tax Notes*, Jan. 20, 2014, p. 153.

⁶The 19 states are Alabama, Arizona, California, Georgia, Illinois, Iowa, Maine, Maryland, Massachusetts, Michigan, Minnesota, Nebraska, New York, Ohio (for purposes of alternative entity-level taxes), Oklahoma, Pennsylvania, Utah, Washington (for purposes of alternative entity-level taxes), and Wisconsin.

¹See, e.g., Cal. Rev. & Tax. Code section 25136(a)(1).

²See, e.g., 35 ILCS 5/304(a)(3)(C-5)(iv).

³See, e.g., Ga. Comp. R. & Regs. r. 560-7-7-.03(5)(c).

⁴See, e.g., Ala. Code section 40-27-1.

Market-based sourcing has been touted as the holy grail for sourcing service receipts. In sharp contrast to COP, under a market-based rule, a taxpayer generally assigns service receipts to the state in which the benefit of the service is received where the customer is located. When a taxpayer performs the activities that generate the receipt is irrelevant.

A market-based rule has political appeal because it reduces the taxes imposed on service providers with in-state operations that service out-of-state customers. But the bottom line is that most states believe that moving to market-based sourcing, when coupled with aggressive nexus rules and a single receipts factor, will result in more revenue. For example, the Massachusetts Department of Revenue anticipates that its recent transition from COP to market-based sourcing will generate up to \$37 million annually.⁷

B. Moving to Market Without the Legislature

Some state tax authorities have employed a market-based sourcing method without statutory support. For example, last year the New Jersey Division of Taxation released proposed regulations for market-based sourcing of service receipts. Despite the statute's unequivocal statement that the receipts should be sourced based on where the services are performed, the proposed regulations reflected a market-based sourcing method. Commentators were quick to point out that the regulations contradicted the statute. Perhaps in recognition of the regulations' vulnerability to attack, the division quickly reversed itself. Citing a handful of revisions and further research, the division's director, Michael Bryan, said the division is unlikely to propose market-based sourcing regulations again this year.⁸

Some state tax authorities have invoked alternative apportionment to support market-based sourcing when they don't like the results of COP-sourcing. Before statutory market-based sourcing was enacted in Illinois, the DOR tried that approach but had little success when challenged. Other states have been more successful. A recent and well-publicized example of a state invoking alternative apportionment to achieve market-based sourcing is Mississippi. In *Equifax Inc. v. Mississippi Department of Revenue*,⁹ the Mississippi Supreme Court upheld the DOR's use of market-based sourcing despite a regulation requiring the application of a COP rule. That case may embolden other states to do the same.

⁷Jennifer DePaul, "Massachusetts Market-Based Sourcing Regs May Create Difficulties for Taxpayers, Practitioners Say," *State Tax Notes*, Mar. 31, 2014, p. 759.

⁸Jennifer DePaul, "New Jersey Unlikely to Proceed with Market-Based Sourcing This Year," *State Tax Notes*, Mar. 31, 2014, p. 762.

⁹125 So. 3d 36 (Miss. 2013), *petition for cert. filed*, No. 13-1006 (U.S. Feb. 19, 2014); *see also*, *Bellsouth Adver'g & Publ'g Corp. v. Chumley*, 308 S.W.3d 350 (Tenn. Ct. App. 2009).

C. The Latest Market-Based States

As discussed, the departure of states from UDITPA provisions led the MTC to undertake its UDITPA rewrite project. As part of the project, the MTC is proposing to eliminate the "all-or-nothing" COP approach and replace it with a market-based sourcing method. State and local tax expert Richard Pomp of the University of Connecticut School of Law served as the hearing officer for a two-day hearing on the rewrite project, which took place in March 2013. The result of that hearing was a report in which Pomp examined several controversial UDITPA provisions, including COP, and provided various recommendations to the MTC, including addressing the purported COP weaknesses. In March 2014 the MTC Uniformity Committee voted to stick to its UDITPA rewrite, and in May the MTC Executive Committee voted to forward to a survey of the states (the last step before a final MTC vote for adoption) four of the draft UDITPA amendments, including market-based sourcing for service receipts.¹⁰

Despite the committee vote, given that 19 states have already statutorily adopted some form of market-based sourcing for service receipts, it is difficult to imagine how uniformity can be easily achieved. Below we examine the latest states to blaze divergent trails to market-sourcing: Massachusetts, New York, and Pennsylvania.

1. Massachusetts

In 2013 the Massachusetts legislature abandoned COP and moved to market-based sourcing for service receipts. For tax years beginning on or after January 1, 2014, taxpayers will be required to include service receipts in the numerator of the sales factor to the extent the service is delivered to a location in Massachusetts.¹¹

The new law contains two throwout provisions that are likely to be controversial and raise constitutional concerns. First, a receipt will be thrown out of the numerator and denominator if the taxpayer cannot determine or reasonably approximate the state to which it should be assigned.¹² Second, a receipt will be thrown out of the numerator and denominator if the taxpayer is not taxable in the state to which a sale would ordinarily be assigned.¹³ The statute

¹⁰The draft amendments sent to a survey of the states were: the definition of sales, market-based sourcing for services and intangibles, factor weighting, and the definition of business income. The Executive Committee is working on draft revisions to the section 18 alternative apportionment provisions that will incorporate many of Pomp's recommendations.

¹¹M.G.L. ch. 63, section 38(f).

¹²*Id.*

¹³*Id.* New Jersey had adopted a similar, short-lived throwout rule that the New Jersey Supreme Court held was facially constitutional when applied to untaxed receipts from those states that lack jurisdiction to tax the taxpayer because of insufficient business activity in that state, but not when applied to receipts that are untaxed because of a state's determination not to have an income or similar business activity tax. *Whirlpool Props. Inc. v. Director, Div. of Tax'n*, 208 N.J. 141 (2011).

provides that if a taxpayer can't readily determine the market for a particular receipt it can be "reasonably approximated."¹⁴

Massachusetts recently released lengthy draft regulations on its new market-based sourcing law. Those with the stamina to review them in their entirety will note that they are complex and cumbersome. For example, there are different rules for in-person services; professional services; and services delivered to, through, or for the customer.

In-person services are services that are physically provided in person by the taxpayer when the customer, or the customer's real or tangible property on which the services are performed, is in the same location as the service provider when the services are performed.¹⁵ The rule includes situations in which the services are provided by an independent contractor. In-person services include warranty and repair services, cleaning services, plumbing services, medical and dental services, landscape services, pest control services, child care, hair and salon services, live entertainment, athletic performances, and in-person training or lessons. When the service provided by the taxpayer is an in-person service, the service is delivered at the location where the service is received.¹⁶

Professional services include legal, management, banking, financial, financial custodial, investment and brokerage, fiduciary, tax return preparation, payroll and accounting, lending, credit card, consulting, video production, engineering, architectural, graphic, and other design services.¹⁷ The sourcing of receipts from the sale of professional services depends on whether the customer is an individual or business.¹⁸ If the customer is an individual, the receipt is sourced to the state of the customer's primary residence, if known, or to the state of her billing address. If the taxpayer derives more than 5 percent of its receipts from sales of services provided to an individual customer, the taxpayer has an affirmative duty to identify the customer's state of primary residence and must assign the receipts from the service provided to the customer to that state.

If the customer is a business, the receipt is first sourced to the state where the contract of sale is principally managed by the customer, if known; second to the customer's place of order, if known; and third to the customer's billing address. Again, if the taxpayer derives more than 5 percent of its receipts from sales of services from a single customer, the taxpayer has an affirmative duty to identify the state in which the contract of sale is principally managed by the customer.¹⁹

When the service is not an in-person service or professional service and the service is delivered to the customer or delivered through or for the customer, the sale is in Massachusetts if and to the extent the service is delivered to Massachusetts.²⁰

Separate rules of assignment apply to services delivered by electronic transmission.²¹ Receipts from services delivered electronically to an individual customer are sourced to where the customer receives the service if that is known or can be reasonably approximated. Otherwise, it is sourced to the customer's billing address.²² Receipts from services delivered electronically to a business customer are sourced in the same way. However, if the place of receipt cannot be determined or reasonably approximated, the sale is sourced to the state where the contract is principally managed, if known; or the customer's place of order, if known; or the customer's billing address. If the taxpayer derives more than 5 percent of its sales from providing services to one customer, the taxpayer has an affirmative duty to identify the state in which the contract is principally managed.²³

The draft regulations also attempt to explain what is meant by the phrase "reasonable approximation." They provide that the reasonable approximation must consider all sources of information available to the taxpayer, including the taxpayer's books and records.²⁴ The reasonable approximation must be applied consistently to similar transactions and from year to year.²⁵ Taxpayers should consult with their tax advisers before filing affected tax returns because they won't be allowed to modify their method later by filing amended returns.²⁶ Taxpayers should also be aware that if they wish to change their method of approximation in subsequent years, they must disclose that fact on their returns, as well as the nature and extent of the change and the reason for it.²⁷

Comments to the draft regulations were due May 19. It will be interesting to see how the Massachusetts DOR responds to taxpayers' expected pleas for simplification.

2. New York

In general, New York's new law expands the market-based sourcing regime that applies to sales of tangible personal property and some asset management and investment advisory services to all receipts "that are included in the computation of the taxpayer's business income for the taxable year." Regarding application of market-sourcing principles most service receipts, New York's new law provides that receipts "shall be included in the numerator of the

¹⁴M.G.L. ch. 63, section 38(f).

¹⁵Mass. Working Draft Reg. 830 CMR 63.38.1(9)(d)(4)(b)(i).

¹⁶*Id.* at (9)(d)(4)(b)(ii).

¹⁷*Id.* at (9)(d)(4)(d)(i).

¹⁸*Id.* at (9)(d)(4)(d)(ii).

¹⁹*Id.* at (9)(d)(4)(d)(ii)(A).

²⁰*Id.* at (9)(d)(1)(c)(i).

²¹*Id.* at (9)(d)(1)(c)(ii).

²²*Id.* at (9)(d)(1)(c)(B)(1).

²³*Id.* at (9)(d)(1)(c)(B)(2).

²⁴*Id.* at (9)(d)(1)(b)(i).

²⁵*Id.* at (9)(d)(1)(d)(iii).

²⁶*Id.* at (9)(d)(1)(d)(i).

²⁷*Id.* at (9)(d)(1)(d)(ii).

apportionment fraction if the location of the customer is within the state.²⁸ Determining whether the customer is in the state is done through a hierarchy of sourcing methods: (1) the benefit is received in the state; (2) delivery destination; (3) the apportionment fraction for the receipts within the state determined for the last tax year; and (4) the fraction used for *other* “other services and other business receipts” under (1) and (2). The new law requires taxpayers to exercise due diligence at each level of the hierarchy before proceeding to the next method (based on information that would be known to the taxpayer conducting a reasonable inquiry).²⁹

3. Pennsylvania

Pennsylvania has adopted a market-based sourcing scheme for service receipts for tax years beginning after December 31, 2013.³⁰ Like Massachusetts, service receipts are sourced to Pennsylvania if the service is delivered to a location in Pennsylvania. If the service is delivered both to a location in and outside Pennsylvania, the sale is sourced to Pennsylvania based on the portion of the total value of services delivered to a Pennsylvania location. For customers who are individuals (other than sole proprietors), if the state or states of delivery cannot be determined, the service is deemed to be delivered at the customer’s billing address.

For other customers, if the state or states of delivery cannot be determined, the service is deemed to be delivered at the location from which the service was ordered in the customer’s regular course of operations. If the location from which the service was ordered in the customer’s regular course of operations cannot be determined, the service is deemed to be delivered at the customer’s billing address.

III. Problems in Applying Market-Based Sourcing

Because states have blazed the trail to market-based sourcing on their own, the rules are inconsistent and their application may lead to dramatically different results by state. That creates compliance burdens and difficulties for taxpayers, and perhaps most egregious, the inclusion of the same receipts in multiple state numerators. Taxpayers that provide multistate services cannot rely on the same data for purposes of computing the receipts factor numerator for various states and should evaluate each separate stream of revenue to properly determine the sourcing result in each state.

For example, assume that Law Firm A, with taxable nexus in all 50 states, provides litigation consulting services to Corporate Client B that is commercially domiciled in Pennsylvania. A is engaged by B after B executes a letter of engagement from its office in Massachusetts (where the legal department resides). Massachusetts is also the state from which the litigation consulting services are managed by B.

The litigation consulting services provided to B involve trial preparation that occurs in New York and Pennsylvania (for example, meeting with witnesses in New York and Pennsylvania). All the services provided by A to B are provided by A’s attorneys located in New York and Pennsylvania. All of A’s bills are sent to and approved by B’s legal department in Massachusetts. How does A source its receipts from the performance of its litigation consulting services to B in Massachusetts, New York, and Pennsylvania?

In Massachusetts, A is first required to source the receipts (assuming not more than 5 percent of its receipts are from B) to the state where the contract of sale is managed by the customer. Since the engagement letter, which would be the contract of sale in that case, is managed by B in Massachusetts, does that mean that A is required to source all of its receipts derived from the services performed for B to Massachusetts? Under the Massachusetts regulations, that seems to be the answer.

In New York, A is first required to source the receipts to New York if the benefit is received there. Because B receives at least a portion of its services from A in New York, does that mean that A must source that portion (if it can so determine through its books and records) to New York? Unlike Pennsylvania, New York law does not provide for proportional allocation. Also, there is no guidance for purposes of determining what it means to receive the “benefit” of a service in the state. Does that mean that there is a risk that New York will seek inclusion of all of A’s receipts in the New York numerator? Perhaps, although the better answer is to include only that portion of A’s receipts from B that relate to the benefit received by B in New York.

In Pennsylvania, A is required to source the receipts to Pennsylvania based on the portion of the total value of the service delivered to a location in Pennsylvania. If A is able to show through its books and records the portion of the litigation consulting services that were delivered to B in Pennsylvania, that portion will be in its Pennsylvania receipts factor numerator.

Therefore, A may be required to source all its receipts from B to Massachusetts and also source a portion of those same receipts to New York and Pennsylvania.

It is clear from this example that market-based sourcing among the states may prove to be a difficult task. That is counterintuitive to the appeal of a simplistic destination-based approach and may result in double taxation. Careful consideration should also be given to whether those widely varying market-based sourcing rules, particularly when coupled with single-sales-factor apportionment regimes, violate fundamental notions of fair apportionment as required by the due process and commerce clauses of the U.S. Constitution.

Below is a list of questions taxpayers should ask themselves when faced with a market-based sourcing regime:

- What is the primary sourcing rule?

²⁸N.Y. Tax Law section 210-A(10).

²⁹*Id.*

³⁰72 Pa. Stat. Ann. section 7401(3)(2)(a)(16.1)(C).

- Is the critical question the address of the recipient or where the service or the benefit of the service is received?
- Is there a presumption about where the service or the benefit of the service is received?
- Is there a fallback rule if the location of the service or where the benefit of the service is received cannot be determined?
- Are there cascading rules that provide how a taxpayer should source the receipts from services?
- Do the rules apply an all-or-nothing approach or can a taxpayer prorate among several states?
- Is there a throwout or throwback rule if the taxpayer is not taxable in the state where the service is delivered or where the benefit of the service is received?
- Does the primary sourcing rule vary depending on whether the customer is a corporation, partnership, or individual?
- Are there special rules, such as in Massachusetts, if the service receipts relate to real property, tangible personal property, or intangible property?
- Are there industry-specific provisions that differ from the primary sourcing rules?
- Does the state impose enhanced record-keeping requirements?
- Is there existing guidance with examples on how to apply the sourcing rules?

IV. Look-Through Sourcing Rules

Taxpayers should also be on the lookout for state DORs attempting to apply look-through sourcing rules, which look to the customer's customer as the market for the taxpayer's services.

In states using market-based sourcing rules, which define the market with reference to the location of the customer or where the benefit is received by the customer, a strong argument may exist that regulations that then go on to use a look-through approach are void as contrary to the statutory language requiring sourcing based on customer location. Most states have case law stating that regulations must be within the fair contemplation of the enabling statute. If the state does not define the term "customer," under normal statutory construction rules, courts will then look to the plain meaning of the term. The plain meaning of the term "customer" is "one that purchases a commodity or service."³¹ A conduit approach is inconsistent with that definition.

That is consistent with the Minnesota Supreme Court's decision in *Lutheran Brotherhood Research Corp. v. Commissioner of Revenue*, 656 N.W.2d 375 (Minn. 2003). There, the court held that an investment adviser's fee revenue for services provided to a Minnesota-based mutual fund should be attributed to Minnesota rather than to the locations of

the adviser's ultimate customers (the mutual fund's shareholders) within and outside Minnesota, because the services were consumed by the mutual fund itself, not the fund's individual owners.

The Minnesota statute in effect was a general market-based sourcing statute providing that receipts would be "attributed to the state in which the benefits of the services are consumed."³² While recognizing the conduit nature of a mutual fund, the court noted that each mutual fund was its own entity with a board or trustees having non-delegable fiduciary duties.³³ It reasoned that "while investors benefit generally from the management of the mutual fund, the investors derive no particular benefit from [the mutual fund] contracts having those management services performed by [the asset management services companies] instead of performing those services itself."³⁴

Regulations requiring a taxpayer to look through to its customer's customer in states that have adopted market-based sourcing may also be challenged under both the due process and commerce clauses. The 14th Amendment's due process clause requires that "income attributed to the state for tax purposes must be rationally related to 'values connected with the taxing state.'"³⁵ In an early application of that requirement, the U.S. Supreme Court found an apportionment method unconstitutional when the method "operates so as to reach profits which are in no just sense attributable to transactions within the jurisdiction."³⁶

Further, under both clauses, a formula apportioning income to a business within and outside the state must be fair.³⁷ The commerce clause's fair apportionment requirement mandates that a state may tax only that portion of a company's income and capital that is reasonably attributable to the company's commercial activities within the state. Under that requirement, an apportionment formula must be invalidated if the formula, as applied to the taxpayer, is not at least a "rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State."³⁸

The fair apportionment requirement has two components — an internal consistency test and an external consistency test.³⁹ Internal consistency is evaluated through the hypothetical application of one state's apportionment rules

³²*Id.* at 378.

³³*Id.* at 380.

³⁴*Id.* at 381.

³⁵*Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (quoting *Norfolk & Western Railway Co. v. State Tax Commission*, 390 U.S. 317, 325 (1968)); see also *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 452 n.4 (1980).

³⁶*Hans Rees' Sons Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 134 (1931).

³⁷*Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).

³⁸*Moorman Mfg.*, 437 U.S. at 273.

³⁹*Container*, 463 U.S. at 169.

³¹Merriam-Webster Online Dictionary.

in all the states across the country to determine whether a risk of multiple taxation would arise. External consistency requires that the “factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.”⁴⁰ That requirement examines “the economic justification for the State’s claim upon the value taxed, to discover whether a State’s tax reaches beyond that portion of value that is fairly attributable to activity within the taxing State.”⁴¹

In determining whether an apportionment formula meets the fairness requirements, the critical inquiry requires that there be some in-state aspect of the interstate business, such as property, payroll, or sales. Also, “the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs.”⁴²

Regulations that require a taxpayer to source its receipts based on the location of the customer’s customer, such as California’s regulation applicable to mutual fund service providers,⁴³ calculate the receipts factor in a way that bears

no relationship to the taxpayer’s in-state operations or market. For example, if a mutual fund service provider is incorporated in Massachusetts, has all its employees and property in Massachusetts, and performs services only in Massachusetts for a mutual fund located in Massachusetts, but the mutual fund’s shareholders all live in California, its receipts factor in Massachusetts would be 0 percent and its receipts factor in California would be 100 percent. That egregious result would occur because the formula does not account for the location of performance or the location of the service provider’s customer (the mutual fund). The mutual fund service provider has nothing to do with the locations of its customers’ shareholders, and consequently the locations of those shareholders cannot serve as a basis for apportioning the income of the mutual fund service provider.

V. Conclusion

The trend toward market-based sourcing seems unlikely to provide uniform rules that are easier for taxpayers to follow or state tax authorities to administer. Thus far, each state that has adopted market-based sourcing uses a slightly different method to determine how to source service receipts. The UDITPA rewrite project may provide some uniformity down the road, but to a large extent the damage has already been done. Taxpayers may want to consult with their tax advisers about developing a multistate approach for sourcing service receipts. In states like Massachusetts, it is important to get it right from the beginning. ☆

⁴⁰*Id.*

⁴¹*Oklahoma Tax Comm’n v. Jefferson Lines*, 514 U.S. 175, 185 (1995).

⁴²*Exxon Corp. v. Dep’t of Revenue of Wisconsin*, 447 U.S. 207, 219 (1980) (quoting *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 436 (1980), and *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 460 (1959)).

⁴³Cal. Code Regs. tit. 18, section 25137-14.