

Demystifying the Sales Factor: Classifying Receipts

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This is the second article of a series on composition of the sales (receipts) 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, and opportunities that exist in computing, the sales factor.

In this article, we will explore the significance of classifying receipts to determine the composition of the sales factor. Historically, this issue has arisen in the context of classifying receipts from mixed transactions involving the provision of both tangible personal property and something other than tangible personal property. Currently, this issue frequently arises in the relatively uncharted area of digital products and services when determining whether receipts derived therefrom are properly classified as from the sale of tangible personal property, services, intangibles, or some combination of each.¹

I. Why Is Classification Important?

Classification of a receipt directly influences how that receipt will be reflected in a taxpayer's apportionment for-

¹The trials and tribulations of classifying digital products and services for the sales factor also exist in the sales and use tax context when distinguishing sales of tangible personal property from sales of services or sales of intangibles. See Arthur R. Rosen, et al., "Cloud Computing: Revenue Departments' Cloudy Minds Lead to Inappropriate Assessments" (parts 1, 2, and 3), *BNA Tax Management Weekly State Tax Report* (Oct. 11, 2013; Oct. 18, 2013; and Oct. 25, 2013).

mula.² For purposes of the sales factor, classification will generally govern the rules for inclusion of receipts in the sales factor numerator (sourcing), and whether the receipt is subject to a jurisdiction's rules on throwback.

A. Sourcing Considerations

A taxpayer's sales factor is generally a fraction, the numerator of which is the taxpayer's receipts from sales within the state and the denominator of which is its receipts from all sales.³ The sales factor typically includes all of a taxpayer's business receipts, including those from sales of tangible personal property, services, intangibles, rentals, and royalties.⁴

Classification of receipts, other than as business or non-business, has relatively little, if any, impact on the sales factor

²While this article focuses on sales factor considerations, the classification of a taxpayer's assets as tangible property or intangible property may also influence the composition of the property factor. The classification of a taxpayer's sales transactions is also important for purposes of determining if a taxpayer is afforded the protections of Public Law 86-272, which protects taxpayers from net income taxation if their activities in a state are limited to the solicitation of orders for tangible personal property. See, e.g., *Accuzip, Inc. v. Director, Div. of Tax'n*, 25 N.J. Tax 158 (Aug. 13, 2009).

³Uniform Division of Income for Tax Purposes Act section 15; MTC Regs. Art. IV.15.

⁴Under UDITPA, the sales factor includes "all gross receipts of the taxpayer not allocated" as nonbusiness income. UDITPA section 1(g). UDITPA also defines business and nonbusiness income as follows:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. . . .

(e) "Non-business income" means all income other than business income.

UDITPA section 1. The Multistate Tax Commission's model regulations define the terms in a similar way and clarify that business income means income of any type or class, and from any activity, that meets the relationship described in either the transactional test or the functional test and that nonbusiness income means all income other than business income. MTC Regs. Art. IV.1(a). States may also exclude other types of receipts from the sales factor (both numerator and denominator) — such as gross receipts that arise from an incidental or occasional sale of a fixed asset (even if used in the regular course of the taxpayer's trade or business) or other extraordinary items of income. See, e.g., Arizona Admin. Code section R15-2D-903(1).

denominator because the denominator generally includes all apportionable gross receipts or sales.⁵ However, when it comes to the composition of the sales factor numerator, classification can make a world of difference. The classification of a receipt governs whether the sourcing rule for sales of tangible personal property, sales of services, or sales of intangibles should apply.

‘In the absence of guidance, taxpayers may need to think outside the box and apply analogous concepts from other areas of state and federal tax law.’

Generally, receipts from sales of tangible personal property are included in the sales factor numerator if “the property is delivered or shipped to a purchaser . . . within this state.”⁶ This is commonly referred to as destination sourcing.⁷ On the other hand, receipts from sales “other than sales of tangible personal property,” which by definition includes receipts from services and intangibles, are generally sourced under one of two methods: one, a market-based approach, which may or may not mirror destination sourcing; or two, a costs of performance approach.⁸ As discussed in the first article of this series, a cost of performance approach widely diverges from a destination-based sourcing approach.⁹ Thus, classification of a receipt as derived from the sale of tangible personal property as opposed to from the sale of a service or an intangible may have different results in terms of calculating a taxpayer’s sales factor numerator — depending on the jurisdiction at issue.

For example, in *Appeal of PacifiCorp*,¹⁰ the California State Board of Equalization held that an Oregon power company’s sales of electricity were sales of services — not tangible personal property — for sales factor purposes. Accordingly, the taxpayer’s receipts from sales of electricity were required to be sourced (at that time) outside California according to the location of the taxpayer’s income-producing activity (based on costs of performance), rather than to California based on the destination of the sales.

⁵UDITPA sections 1 and 15.

⁶See UDITPA section 16; see 4 Jerome Hellerstein and Walter Hellerstein, *State Taxation*, para. 9.18 (2012).

⁷Although all states generally adopt destination sourcing for receipts from sales of tangible personal property, they may adopt different rules to determine the destination of the goods. For example, UDITPA, as interpreted by the MTC’s regulations, sources sales to the state where the goods are delivered, regardless of whether that is the ultimate destination of the goods, while other states may source sales to the location where the property is ultimately received by the purchaser. Compare, e.g., MTC Regs. IV.16(a)(3) with 20 NYCRR 4-4.2.

⁸Battin, Eberle, and LaCava, “Demystifying the Sales Factor: Costs of Performance,” *State Tax Notes*, Jan. 20, 2014, p. 153.

⁹*Id.*

¹⁰No. 2002-SBE-005 (Cal. Bd. Equalization 2002), rehearing denied No. 2002-SBE-005-A (Cal. Bd. Equalization, 2002).

Similarly, in *TradeARBED Inc.*,¹¹ the New York State Tax Appeals Tribunal held that a taxpayer that purchased inventory from a related corporation and then resold it at a small profit was a seller of tangible personal property and not a commissioned sales agent providing sales agent services. Consequently, the taxpayer’s receipts were properly sourced outside New York to the destination state. Had the tribunal found that the receipts were from services, those receipts would have been sourced to New York based on where the services were performed.

These cases illustrate the importance of classifying receipts and the dramatically different sourcing results that can follow from such classifications.

B. Throwback

To prevent so-called nowhere income from escaping taxation by any state, many states have enacted throwback rules. In general, throwback rules provide:

Sales of tangible personal property are in this state if . . . the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.¹²

Thus, throwback rules generally reassign receipts from sales of tangible personal property to the state from which the goods are shipped if a taxpayer is not taxable in the state of destination.¹³ If a receipt is properly classified as derived from the sale of tangible personal property, consideration should be given to the existence and application of throwback rules.

II. Considerations in Classifying Receipts

Much of the dilemma in classifying receipts for sales factor purposes originates from states’ failure to define “tangible personal property” for corporate income tax purposes.¹⁴ Because many states provide for the sourcing of two basic categories of receipts, tangible personal property and other than tangible personal property, the definition of and construction of the term tangible personal property is critical. Additional problems arise as a result of states’ failure to address unique categories of receipts or receipts from

¹¹No. 802706 (N.Y. Tax App. Trib. 1989).

¹²UDITPA sections 3 and 16.

¹³At least one state extends a similar throwback concept to other types of receipts. For example, a North Carolina statute provides that “where a corporation is not taxable in another state on its apportionable income but is taxable in another state only because of nonapportionable income, all sales shall be treated as having been made in this State.” N.C. Gen. Stat. section 105-130.4(j)(1) (2013).

¹⁴At least one state expressly adopts for income tax purposes the same definition of tangible personal property employed in that state’s sales and use tax statutes. See, e.g., Mich. Comp. Laws section 206.611(1) (2013).

“mixed” transactions (for example, receipts derived from both the sale of tangible personal property and the performance of services).¹⁵

In the absence of guidance, taxpayers may need to think outside the box and apply analogous concepts from other areas of state and federal tax law. The better equipped a taxpayer is to support its receipts classifications, the more likely the taxpayer is to succeed in defending those classification on audit.

A. Is There Anything Directly on Point?

In developing a receipts classification strategy, the first inquiry should always be whether the jurisdiction at issue employs a sales factor sourcing method directly applicable to the types of receipts generated by a taxpayer’s business. While many states have two categories of receipts (receipts from tangible personal property and other receipts), some have adopted more refined categories of receipts, each with specific sourcing rules.

For example, assume Corporation A has receipts from providing cloud computing services. Further assume that Corporation A has nexus (under constitutional standards) in Nebraska and that Corporation A sells cloud computing services to customers in that state. How should Corporation A source its receipts from providing cloud computing services in computing the numerator of its Nebraska sales factor?

Coincidentally, Nebraska has sourcing provisions applicable to receipts derived from cloud computing services.¹⁶ The provisions address the sourcing of application services, which are defined as “computer-based services provided to customers over a network for a fee without selling, renting, leasing, licensing or otherwise transferring software.”¹⁷ An application service “includes, but is not limited to, software as a service, platform as a service, or infrastructure as a service.”¹⁸ Assuming that the cloud computing service offered by Corporation A meets that definition, Corporation A should source its receipts to Nebraska “if the buyer uses

the application service in [the] state.”¹⁹ In determining whether a buyer uses an application service in the state, the provisions look to whether the buyer “(i) [u]ses it in the regular course of business in [the] state; or (ii) [i]f the buyer is an individual, his or her billing address is in [the] state.”²⁰

Regarding the treatment of cloud computing services or digital transactions generally, Nebraska is the exception. Most states to do not have specific rules on point and have not addressed the proper classification of such receipts outside the sales tax context. Thus, taxpayers seeking to classify receipts in states with the two basic categories of receipts (tangible personal property and other) should consider resorting to other areas of the law to determine the proper treatment of those receipts.

B. Has the State Sanctioned ‘Thinking Outside the Box’?

1. Sales and Use Tax Concepts

While it seems logical to look to state sales and use tax authorities to classify receipts, these transaction tax concepts are not intended to be analogous. State sales and use taxes are primarily focused on whether a particular item is taxable, while income taxes are focused on where the income is taxable — resulting in different consequences and policy considerations.²¹ Nevertheless, courts in several states have applied sales and use tax authorities to ascertain whether particular receipts are more properly classified as from a sale of tangible personal property or from something other than tangible personal property. Also, in many instances, especially those involving the classification of digital goods and services, sales and use tax authorities are the only available authorities.

The California Court of Appeal addressed this issue in *Microsoft Corporation v. Franchise Tax Board*.²² At issue in *Microsoft* were receipts from licenses to replicate and install software. The parties argued over whether the receipts were from licenses of tangible personal property (which would be treated as California receipts if shipped to a purchaser within the state) or intangible property (which at that time would

¹⁵At least one state provides for the treatment of receipts from mixed transactions for both the sale of tangible personal property and the sale of services. See, e.g., N.J. Admin. Code section 18:7-8.10(d) (2013). In New Jersey, if a taxpayer receives a lump sum in payment for services and also for materials or other property, the sum received must be apportioned on a reasonable basis and sourced as follows: that part apportioned to services performed is includable in receipts from services; and that part apportioned to materials or other property is includable in receipts from sales. *Id.* Full details of such an allocation are required to be submitted with the taxpayer’s return. *Id.*

¹⁶Neb. Rev. Stat. section 77-2734.04(2) (2012) (effective Jan. 1, 2014). In January 2014 New York legislation (S. 6359) was introduced that addresses the sourcing of digital products and employs a hierarchy method centered on a destination sourcing concept. Interestingly, this hierarchical or cascading approach has also been implemented by Washington for sales tax purposes. Wash. Admin. Code section 458-20-15503.

¹⁷Neb. Rev. Stat. section 77-2734.04(2).

¹⁸*Id.*

¹⁹Neb. Rev. Stat. section 77-2734.14(3)(b).

²⁰Neb. Rev. Stat. section 77-2734.14(3)(b). Regarding instances in which a buyer other than an individual “uses the application service within and without this state,” the sales are apportioned between the use in Nebraska in proportion to the use of the application service in Nebraska and the other states. If the location of a sale cannot be determined, the sale of an application service is in the state from which the order was placed in the regular course of the customer’s business. If that office cannot be determined, the sales are considered to be received at the customer’s billing address. *Id.*

²¹See, e.g., *GTE Automatic Electric Inc. v. Allphin*, 369 N.E.2d 841 (Ill. 1977), which states that “the formula applied here is not a sales tax, but is a method of measuring the business activity within this State of a corporation doing multistate business.”

²²212 Cal. App. 4th 78 (Cal. 2012).

have been treated as California receipts only if a greater proportion of the costs of performance were incurred in California).

The court relied on both California's sales and use tax treatment of software licenses and the federal classification of software licenses under Internal Revenue Code section 936 and related regulations to distinguish between tangible property and intangible property. It acknowledged that a purchase of software may be the purchase of tangible property, but the right to replicate and install software required a separate analysis. The court observed that under California's sales and use tax and relevant federal tax laws, such a right was intangible and therefore, for purposes of the California corporate income tax, the receipts should similarly be characterized as from intangibles and sourced based on the greater costs of performance.

In a case involving the sourcing of receipts from sales of customized computer software, a New York administrative law judge similarly determined that it would be appropriate to refer to sales tax definitions.²³ The judge noted that while prewritten software is treated as tangible personal property for sales tax purposes, the software at issue was custom software and, since custom software is not subject to sales tax (and by implication is not tangible personal property for sales and use tax purposes), the custom software should not be treated as tangible personal property for corporate franchise (income) tax purposes. Instead, the receipts were treated as derived from services and sourced accordingly.

Regarding mixed transactions, the Michigan Court of Appeals determined — relying partially on Michigan's sales tax authorities — that a corporation's remanufacturing contracts with various transit authorities were predominantly for the provision of a rehabilitation service, rather than for the purchase of bus parts, such that the contracts were sales "other than sales of tangible personal property" for purposes of computing the single business tax.²⁴ Accordingly, receipts from the sales at issue should have been sourced to Michigan, where the installation services were performed, rather than to the destinations where the replacement parts were shipped. In so concluding, the court applied an "incidental to service" six-part test set forth in *Catalina Marketing Sales Corp.*²⁵ to determine whether a transaction should be considered a sale of tangible personal property or a sale of a service for purposes of the Michigan sales tax.

Other state courts and revenue departments have applied similar sales tax "incidental to service" or "true object"

²³In *Infosys Technologies Limited*, No. 820669 (N.Y. Div. Tax App. 2007), *aff'd* No. 820669 (N.Y. Tax App. Trib. 2008).

²⁴*Midwest Bus. Corp. v. Dep't of Treasury*, 793 N.W.2d 246 (Mich. Ct. App. 2010).

²⁵678 N.W.2d 619 (Mich. 2004).

concepts²⁶ to determine the classification of receipts from mixed transactions to source those receipts in computing the state's sales factor numerator. For example, in determining the sales factor sourcing method to apply to receipts from a web-based membership program whereby the members received membership privileges and benefits — such as discounts to third-party attractions, restaurants, hotels, car rentals and air fares, road and towing protection, credit card fraud protection, and theft and loss protection — the Illinois Department of Revenue looked to sales and use tax authorities to determine the "essence of the transaction."²⁷ The DOR concluded that receipts from the membership fees were from the sale of an intangible to be sourced based on the income-producing activity of the taxpayer.

2. Federal Income Tax Concepts

An additional avenue available in determining the proper classification of receipts is the application of federal income tax concepts. For example, some states provide that to the extent a term is not defined within the state corporate income tax law, that term should have the same meaning as when used in the "comparable context" of the IRC.²⁸ Some state courts have concluded that because there is no apportionment or sales factor concept for federal income tax purposes, federal income tax concepts have no bearing on state income tax apportionment provisions (that is, there is no comparable

²⁶In the state sales and use tax context, most states apply — by statute, regulation, or through case law — a true object test for determining whether a transaction consisting of taxable property and nontaxable services should be viewed as predominantly property or services, with the predominant aspect of the sale determining taxability. Substantially similar tests go by names such as primary purpose (New York), dominant purpose and common understanding (Arizona), real object (Massachusetts), or essence of the transaction (Pennsylvania). The true object test recognizes that some components of a single transaction may be subject to sales or use tax when viewed in isolation, but because they are incidental to the nontaxable true object of the transaction, they are disregarded for sales tax imposition purposes. Stated simply, if the true object sought by the buyer is the nontaxable item or service, the transaction may not be subject to tax, but if the true object of the buyer is to purchase the taxable item or service, the entire transaction — including, for example, an otherwise nontaxable service — would be subject to tax.

²⁷Ill. Dept. of Rev. Gen. Info. Ltr. No. IT 08-0025 GIL. *See also Qualcomm Inc. v. Dep't of Revenue*, 249 P.3d 167, 172 (Wash. 2011). The Washington Supreme Court applied a true object test to determine the business and occupation tax rate to be applied to a business that involved both telecommunications and information processing components, observing that "while the case before us does not involve an attempt to separate tangible goods from intangible services, it presents an analogous problem."

²⁸*See, e.g.*, 35 Ill. Comp. Stat. 5/102 (2013); Neb. Rev. Stat. section 77-2714 (2013).

federal tax context).²⁹ Other states, however, have looked to federal income tax concepts to classify receipts.

For example, in *American Business Information v. Egr*,³⁰ the Nebraska Supreme Court held that a company should treat its receipts from sales of customized customer lists to its clients as sales of tangible personal property. The taxpayer sought to classify the sales as tangible personal property so that the receipts could be sourced according to the destination rule, rather than based on costs of performance; presumably the taxpayer's income-producing activity occurred in Nebraska. Under Nebraska law, tangible personal property is defined by reference to the IRC.³¹

Relying on federal income tax authority, the court held that since the taxpayer's customers were not permitted to reproduce the customer lists provided by the taxpayer on printed paper, index card, or disks and acquired no rights in the taxpayer's intellectual property, the information provided was tangible personal property. Relying on a Nebraska Supreme Court case dealing with the nature of electronic signals for sales and use tax purposes, the court also held that information the taxpayer provided to its customers online (as opposed to on disk) was tangible personal property.

As noted above, the California Court of Appeal also applied federal income tax concepts, specifically IRC section 936 and related regulations, to distinguish between tangible property and intangible property for purposes of classifying receipts from licenses to replicate and install software.³²

C. Practical Considerations of Form and Substance

In classifying receipts, issues often have arisen when the form of a transaction does not reflect its substance. When the form of a transaction does not necessarily reflect its substance, unintended consequences may result.

Consider Corporation B, a financial institution lending funds to its customers to purchase tangible personal property. However, Corporation B's lending transactions — unlike most traditional lending arrangements in which the lender takes a security interest in the property subject to the loan — involve Corporation B taking temporary legal title to the property. Corporation B enters into a futures contract to sell the tangible personal property through an exchange in the future. The borrower also has the opportunity to repurchase the tangible personal property from Corporation B before the expiration of the futures contract. While Corporation B temporarily takes legal title to the tangible personal property, the borrower is responsible for paying — either

directly or indirectly — all costs of carry to hold the tangible personal property. How should Corporation B's receipts from this financing business be classified for state corporate income tax purposes? Will states elevate form over substance and conclude that the acquisition of title equates to classification as a sale of tangible personal property?

In New York, the State Tax Appeals Tribunal has elevated form over substance and accordingly determined that receipts arising from an actual transfer of title were receipts from sales of tangible personal property, notwithstanding that the transaction at issue was intended to operate as a financing arrangement.

It must be recognized that when the form of a transaction does not necessarily reflect its substance, unintended consequences may result.

In *Matter of Christian Salvesen, Inc.*, the tribunal determined that a taxpayer's receipts were properly classified as receipts from the sale of tangible personal property and not receipts from refrigeration, cold storage, and related financing services.³³ The taxpayer had purchased inventory from a customer, stored the inventory in cold storage, and resold the inventory back to the customer at cost plus an amount equal to the prime rate plus 2.5 percent. The taxpayer argued that the arrangement was merely a financing and storage arrangement and should be treated as such to compute its receipts factor.

However, the tribunal determined that the form for the transaction chosen by the taxpayer — which included taking actual title to the inventory primarily out of concern for the potential default of the customer involved in the transaction — was controlling in determining that the transaction was a sale of tangible personal property. Five years later, the tribunal reaffirmed its characterization of these types of lending transactions as sales of tangible personal property in a case involving the same taxpayer and the same agreement.³⁴

²⁹ See *Combustion Eng'g v. Comm'r*, No. F228740 (Mass. App. Tax. Bd. 2000); *Dreyfus Special Income Fund Inc. v. N.Y. State Tax Comm'n*, 514 N.Y.S.2d 130 (3d Dep't 1987), *aff'd* 72 N.Y.2d 874 (App. Div. 1988).

³⁰ 650 N.W.2d 251 (Neb. 2002).

³¹ Neb. Rev. Stat. section 77-2714.

³² See *supra* text accompanying note 23. A further issue typically arises in the context of IRC section 199 and the classification of receipts from software for state apportionment purposes.

³³ *Christian Salvesen Inc.*, No. 813434 (N.Y. Tax App. Trib. 1998).

³⁴ *CS Integrated LLC*, No. 817548 (N.Y. Tax App. Trib. 2003). In *Christian Salvesen*, the taxpayer had originally computed its receipts factor based on treating the receipts at issue as receipts from sales of tangible personal property and later requested a discretionary adjustment to recharacterize those receipts as receipts from a financing arrangement — consistent with the substance of the transaction, which was denied. In *CS Integrated*, the taxpayer (the successor to the taxpayer from *Christian Salvesen*) computed its receipts factor based on treating the receipts as receipts from a financing arrangement, consistent with the substance of the transaction, and the Department of Taxation and Finance sought to recharacterize those receipts on audit as receipts from sales of tangible personal property.

The Illinois DOR similarly alluded to elevating form over substance in considering the classification of a taxpayer's pharmacy benefit management business receipts.³⁵ In General Information Letter IT 05-0043-GIL, the department considered whether receipts from a company that provided prescription benefit management services to its clients, including insurance companies and other managed care organizations, should be classified as receipts from the sale of tangible personal property or services to compute its Illinois receipts factor. The company's services primarily reduced costs and enhanced the quality of prescription drug benefits provided to its clients' members. The company accomplished this by managing prescriptions filled through its national network of retail pharmacies and its own mail-order pharmacies, negotiating competitive rebates and discounts from pharmaceutical manufacturers, and obtaining competitive discounts from retail pharmacies.

The DOR concluded that based on the company's activities in performing its contractual obligations to its clients, it is properly classified as "a service provider for purposes of computing the sales fraction and sourcing [its] receipts." The department stated that following factors "would support a finding that [company] is a service provider:

1. [company] does not take title or possession to any drugs that are dispensed by the independent pharmacies.
2. [company] is engaged by its clients to manage prescription benefit programs."

Accordingly, "since [the company] does not take title or possession to any drugs dispensed in its [business] and its core function is to manage prescription benefit programs for its clients, we believe that [the company] is performing a service . . ." This letter clearly suggests that if the company at issue had taken title to or possession of any of the drugs dispensed in its business, the answer may be quite different — in essence, elevating form over substance.

Therefore, taxpayers seeking to structure sales transactions should consider the potential sales factor implications if the transaction's form does not comport with its substance.

D. Does 'Consistency' Matter?

The answer to this age-old question may differ depending on the taxpayer's facts and circumstances. Regarding classification of receipts, four consistency concerns are implicated: federal income tax versus state income tax consistency; state income tax consistency among states; state income tax versus state sales and use tax consistency; and state income tax versus financial accounting consistency. The level of importance for each consistency concern may differ for every taxpayer.

³⁵Ill. Dep't of Rev. Gen. Info. Ltr. IT 05-0043GIL.

As a practical matter, a taxpayer may be wary of classifying its receipts for corporate income tax purposes in a manner different from other states or from its sales and use tax or federal income tax classifications. But inconsistent classifications should withstand scrutiny if the taxpayer is prepared to support its sales factor classification with an explanation and an analysis of the authorities that support that classification. Fundamentally, there is no duty of consistency requiring taxpayers to treat items in the same manner across all states and across all types of taxes (or other relevant reporting requirements),³⁶ unless explicitly required.³⁷ However, if a taxpayer seeks to rely on analogous authorities in other contexts to justify its sales factor classification of a receipt, the receipt should, of course, be classified consistently within those analogous contexts.

The level of importance for each consistency concern may differ for every taxpayer.

As a policy matter, there are also several reasonable arguments supporting a taxpayer's decision to treat items of income differently for sales factor purposes than for sales tax or federal income tax purposes. As noted, the classification of receipts for sales tax purposes has a different focus than the classification for sales factor sourcing purposes. In the sales tax context, the question is *whether* an item is taxable in the first instance, while sales factor sourcing rules are aimed at determining *where* that item is taxable. As far as the application of federal income tax concepts, some state courts have observed that there is no basis for accepting or applying federal income tax treatment of various items of income, since there is no federal income tax equivalent to apportionment. Moreover, even in states that reference IRC definitions as applicable when a corporate income tax concept is undefined (such as the lack of a definition for tangible personal property), that IRC reference is often accompanied by a caveat requiring that such definition be used in a "comparable context" within the IRC. There is no federal income tax equivalent to state tax apportionment, thus, how could a true "comparable context" exist?

That said, if a taxpayer takes inconsistent positions, it should do so consistently. If a taxpayer claims that sales derived from electronically downloaded software are not subject to sales tax as sales of tangible personal property, but treats its receipts from such software as tangible personal

³⁶See *e.g.*, *Oracle Corp. v. Oregon Department of Revenue*, No. TC-MD 070762C (Ore. Tax Ct. 2010), which noted that "the right of each state to have its own tax laws and interpret them in its own fashion is fundamental to our federal system of government."

³⁷See *supra* text accompanying note 26. Michigan's incorporation of the definition of tangible personal property embodied in its sales and use tax law into its corporate income tax law requires consistent classifications for purposes of sales and use and corporate income tax.

property for federal income purposes and as an intangible property for corporate net income tax purposes, the taxpayer's documentation on each issue should be consistent. (That is, its analysis of each tax implication should reference the other and provide the factual and legal basis for the inconsistent treatment.) The better prepared a taxpayer is to explain its business — including publicly available and internal documentation regarding how a receipt is earned — the less likely the taxpayer is to receive excessive scrutiny from state tax authorities.

III. Conclusion

When it comes to classifying receipts, tax-saving opportunities exist when guidance regarding the proper classification of particular receipts does not. Taxpayers should be creative in applying analogous concepts in other areas of state and federal tax law to support the desired result. ☆

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