The 2020 National Multistate Tax Symposium
Mastering the Art (and Articulation) of State Tax—Distilling the Complex

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Living with market-based sourcing – calculating today’s sales factor
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Agenda

• Introduction

• Historical Perspective: Sales Other Than Sales of Tangible Personal Property

• Market-Based Sales Sourcing Overview

• Applying the State’s Rules to Calculate the Sales Factor
  – Market-Based Sales Sourcing Rules: In General
  – Market-Based Sales Sourcing Rules: State Comparison

• Calculating Today’s Sales Factor
  – Potential Risks of Market-Based Sales Sourcing
  – Market-Based Sales Sourcing Potential Considerations

• Questions
Introduction
Purpose of Apportionment and Increased Reliance on the Sales Factor

• Goal of apportionment is to compute percentage of total profits attributable to a particular state

• Historical concept is that business profits are a function of productive capital (property factor), labor (payroll factor) and market (sales factor)

• In 21st century business environment, there are many complexities with this historical three factor apportionment model which led to the trend to increase the weight of the sales factor, with many states moving to single sales factor formula
  – Sales factor is intended to give recognition to importance of customer and benefits afforded to seller by customer’s state
  – Effectively shifts tax burden to out-of-state companies
  – Attracts businesses to relocate to the state

• Replacing cost of performance (“COP”) rules for sales other than sales of tangible personal property (“TPP”) with various market-based sourcing rules

• “Finnigan” method vs. “Joyce” method
Historical perspective: sales other than TPP
Historical Perspective: Sales Other Than Sales of TPP

• Determining sourcing of receipts other than from sales of TPP can be complicated and time-consuming for taxpayers

• Per the pre-2014 Multistate Tax Compact (MTC) Article IV apportionment provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), sales, other than TPP, were sourced based on the COP method

• COP method, adopted by UDITPA and later MTC, states that sales other than sales of TPP, are in this State if:

  − Income-producing activity is performed in this State; or

  − Income-producing activity is performed both in and outside this State and greater proportion of income-producing activity is performed in this State than in any other State, based on costs of performance
Historical Perspective: Sales Other Than Sales of TPP (cont’d)

• Many states have abandoned use of COP rules, either through legislative action or administrative practice, in favor of market-based sourcing rules
  – Proponents of market-based sourcing contend traditional COP rules are difficult
  – Unclear what constitutes income-producing activity
  – Unclear where activity occurred
  – Unclear what costs are includable in applying rule
  – Unclear on what level of revenue granularity is the test applied at
  – All or nothing approach
  – Premise behind market-based sourcing rules better align sales to state reflecting taxpayer’s market
Historical Perspective: Sales Other Than Sales of TPP (cont’d)

• On July 30, 2014, MTC revised the Compact’s rules for sourcing sales other than sales of TPP

• On February 24, 2017, MTC formally adopted revisions to reflect market-based sourcing approach of receipts from sales of services and intangibles rather than previous COP methodology

• Compact’s market-based sourcing rules provide that “[s]ales, other than sales of tangible personal property...are in this State if the taxpayer’s market for the sale is in this state”

• Trend of states enacting market-based sourcing rules expected to continue for sales of other than TPP
  – Diversity among states with respect to sales sourcing methodologies may increase risk of apportioning more than 100% of taxpayer’s income
  – Market-based sourcing rules vary considerably among states
    – Depth of market-based sourcing examples varies by state
    – Services that taxpayers provide may be so unique and diverse that it may not be possible to address every fact pattern
Market-based sales sourcing overview
Sales Factor: Mandatory Market-Based Sales Sourcing States for General Taxpayers 
(as of December 2019)

* States that have adopted market-based sourcing for tax years 2019 or later
** States that impose a gross receipts tax based on sales
Sales Factor: Mandatory Market-Based Sales Sourcing States for General Taxpayers (as of December 2019)

- Alabama
- Arizona (elective 2014-2017)
- California
- Colorado (2019 for corps)
- Connecticut (2016 for corps and 2017 for partnerships)
- District of Columbia (2015)
- Georgia
- Hawaii (2020)
- Illinois
- Indiana (2019)
- Iowa
- Kentucky (2018)
- Louisiana (2016 for corps)
- Maine
- Maryland
- Massachusetts (2014)
- Michigan (CIT)
- Minnesota
- Missouri (2020)
- Montana (2018)
- Nebraska (2014)
- Nevada (Commerce Tax 7/1/2015)
- New Hampshire (2021)
- New Jersey (2019 for corps)
- New Mexico (2020)
- New York State (2015 for corps)
- New York City (2015 for corps)
- North Carolina (2020)
- Ohio (CAT and Individual Income Tax)
- Oklahoma
- Oregon (2018)
- Pennsylvania (2014)
- Rhode Island (2015)
- Tennessee (effective for tax years beginning on or after 7/1/16)
- Utah
- Vermont (2020)
- Washington Business & Occupation Tax
- Wisconsin
Sales Factor: Mandatory Single Sales Factor States for General Taxpayers (as of December 2019)

- Arkansas (2021)
- California
- Colorado
- Connecticut
- Delaware (2020)
- District of Columbia
- Georgia
- Illinois
- Indiana
- Iowa
- Kentucky (2018)
- Louisiana
- Maine

- Maryland (2022)
- Michigan (CIT)
- Minnesota
- Mississippi
- Missouri (2020)
- Nebraska
- New Hampshire (2022, unless a majority of the Legislative Committee on Apportionment votes to rescind)
- New Jersey
- New York State
- New York City (2018)

- North Carolina (2018)
- Oregon
- Pennsylvania
- Rhode Island
- South Carolina
- Texas
- Utah (2021 for all corps)
- Wisconsin
Applying the state’s rules to calculate the sales factor
Market-Based Sales Sourcing Rules

• As of December 31, 2019, 25 states have enacted legislation requiring taxpayers to use a single sales factor and apply market-based sourcing rules to sales other than sales of TPP

• Market-based sourcing rules for sales of services are generally considered:
  – Where the service was received
  – Where the benefit of the service was received;
  – Where the service was delivered; or
  – Where the customer is located

• Reasonable approximation

• Application of different market-based sourcing rules to taxpayer’s facts is often not a straightforward exercise under varying rules
### Market-Based Sales Sourcing Rules: State Comparison

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<tr>
<th>California</th>
<th>Connecticut</th>
<th>Massachusetts</th>
<th>New York State</th>
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<td>For tax years beginning on or after January 1, 2013, receipts from the provision of services must be sourced to California to the extent the purchaser of the service received the benefit of the service in the state. Cal. Rev. &amp; Tax Code § 25136; Cal. Code Regs. tit. 18, § 25136-2(c).</td>
<td>Under Conn. Gen. Stat. Sec. 12-218(b)(2), for tax years beginning on or after January 1, 2016, gross receipts from services are assigned to Connecticut (“CT”) if the market for the services is in CT. The taxpayer’s market for services is in CT if and to the extent the services are used at a location in CT.</td>
<td>For tax years beginning on or after January 1, 2014, sales, other than sales of tangible personal property, are “delivered” to Massachusetts (“MA”) if and to the extent that the taxpayer’s market for the services is in MA. G.L. c. 63, § 38(f). The sale of a service is sourced to MA if the service is “delivered” at a location in the state. 830 CMR 63.38.1(9)(d)(4)(d)(a).</td>
<td>New York State (“NYS”) adopted market-based sourcing for general corporation tax purposes for tax years beginning on or after January 1, 2015. Under NY Tax Law Sec. 210-A(10), receipts from services and other business receipts are sourced to NYS based on a hierarchy of methods, the first method requires such receipts to be sourced to the location where the customer receives the benefit of the service.</td>
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The term “benefit of a service is received” means the location where the taxpayer’s customer has either directly or indirectly received value from delivery of that service. Cal. Code Regs. tit. 18, § 25136-2(b)(1). In a business to business context, the location of the receipt of the benefit of the service shall be determined under the following cascading rules: • The contract with the taxpayer’s customer, or the taxpayer’s books and records kept in the normal course of business. • Reasonable approximation. • Location where customer placed the order. • Customer’s billing address. Cal. Code Regs. tit. 18, § 25136-2(c)(2). Under Conn. Gen. Stat. Sec. 12-218(b)(8), to the extent the taxpayer cannot reasonably determine the assignment of receipts, the taxpayer may petition the CT Commissioner of Revenue Services for permission to use a reasonable approximation methodology. The CT Department of Revenue issued Special Notice 2017(1) to provide guidance on Conn. Gen. Stat. Sec. 12-218. The Special Notice provides multiple examples to illustrate the application of these market-based sourcing rules. The MA apportionment regulation, CMR 63.38.1, provides distinct rules of assignment for sourcing receipts from several specific types of services. When a service provided by the taxpayer is delivered to or on behalf of the customer, or delivered electronically through the customer, the rule of assignment varies based upon the method of delivery of the service and the nature of the customer. NYS has released draft regulations that apply a “look-through” approach in the case of “intermediary transactions” (i.e., source to the location of the customer’s customer). An alternative apportionment method may be available under NY Tax Law Sec. 210-A(11) if the statutory apportionment method prescribed in NY Tax Law Sec. 210-A(1)-(10) does not result in the proper reflection of the taxpayer’s business income or capital within the state. The party seeking the adjustment bears the burden of proof. |
Calculating Today’s Sales Factor
Calculating Today’s Sales Factor: Potential Risks of Market-Based Sourcing

• Differing approaches may apply for determining where benefit of service received
  − In general, benefit received at location of customer

• If benefit received in more than one state, different rules may apply depending on following variables:
  − Individual customers vs. business customers
    − Your customer vs. your customer’s customer (i.e., look-through)
  − Order location vs. billing location
  − Benefit location is indeterminable
  − No nexus or fixed place of business in business location
Calculating Today’s Sales Factor: Potential Risks of Market-Based Sourcing (cont’d)

• Market-based sourcing rules raise several issues taxpayers should be prepared to recognize and address

• Limited guidance
  – Many states with market-based sourcing rules do not define key terms such as “received” or “delivered”
  – Some states have not issued regulations to interpret and clarify
  – Since most of these rules have recently been enacted, may be several years before well-developed body of case law addresses market-based sourcing issues

• Proportionate or “All-Or-Nothing” Sourcing
  – Market-based sourcing states are divided on whether receipts from sales of services to a multistate customer should be sourced exclusively to one state (all-or-nothing) or proportionately among all states customer receives portion of benefits of the service

• Requiring taxpayers to use alternative sales factor apportionment methodology
Calculating Today’s Sales Factor: Potential Risks of Market-Based Sourcing (cont’d)

• Taxpayer Burden
  − Navigating and tracking various states’ application of market-based sourcing rules
  − Spending time and resources formulating determinations around what is the “market”
  − Defending taxpayer’s position on audit
  − Financial reporting for income taxes ASC 740
Calculating Today’s Sales Factor: Potential Considerations of Market-Based Sales Sourcing

• During transition between methods, taxpayers may wish to consider the following steps:
  − Evaluate prior sourcing methodology for more favorable sourcing treatment in prior tax years still open under statute of limitations
  − Analyze what constitutes taxpayer’s market when determining how to source receipts under new market-based methodology

• Notwithstanding general intent of market-based sourcing rules to make state’s sales factor more reflective of taxpayer’s market, there is little uniformity among the states with respect to rules themselves and application

• Taxpayers may also wish to request:
  − Alternative sales factor apportionment methodology
  − Rulings for guidance

• Potential state specific opportunities
Questions?
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