

# Finding the “Market”: Practical Approaches to Market-based Sourcing

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# **Overview & UDITPA Rewrite**

# Historical Perspective – Sales Factor

- Per the Multistate Tax Compact ("Compact") effective prior to July 30, 2014, sales are sourced in the following manner:
  - Tangible personal property ("TPP") – Destination sourcing
  - Other than TPP (services or intangibles) – Cost of Performance
    - *States are focusing on their cost of performance rules and how to interpret them*
    - *States are moving towards market-based sourcing rules*
- Market-based sourcing arguably serves the purpose of the sales factor by more accurately reflecting the customer base for taxpayer's services
- Cost of performance tends to overweight the sales factor for service providers operating in a state. May be viewed as a disincentive for service providers considering investment in the state

# Historical Perspective – Cost of Performance

- The General Rule:
  - Sales, other than sales of tangible personal property, are in this State if:
    - *(a) the income-producing activity is performed in this State; or*
    - *(b) the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance (UDITPA, Article IV, Section 17)*
- “Costs of Performance” defined – No bright line test
  - Taxpayer’s costs as determined in a manner consistent with GAAP or the taxpayer’s trade or business
  - Common costs include wages, taxes, interest, depreciation, costs of materials consumed, etc.
  - “Direct costs” versus “indirect costs”

# Historical Perspective – Sales Factor

A number of states have changed their sales factor sourcing rules, shifting from a cost of performance approach to adopt market-based sourcing regimes for services and intangibles receipts.

- Rationale:
  - The complexity of sourcing receipts from non-tangible property;
  - Administrative burden on all parties to determine cost of performance components;
  - Aimed at attributing revenue to the ~~state-based~~ “market” (i.e., state) that contributes to taxpayer's income; and
  - Typically favored by in-state business community, generally in connection with a statutory apportionment shift that emphasizes the state’s sales factor.

# Update on Proposed UDITPA Rewrite

- In light of the overwhelming lack of uniformity among the states, the Multistate Tax Commission (“MTC”) approved a public hearing to review five provisions of UDITPA:
  - Sales factor numerator for sourcing services and intangibles
  - The definition of “sales”
  - Factor weighting
  - The definition of “business income”
  - Equitable apportionment

# Update on Proposed UDITPA Rewrite

- December 2012 – The MTC Executive Committee (“Executive Committee”) approved public hearing for proposed amendments to UDITPA.
- March 2013 – Public hearing conducted by Hearing Officer Professor Richard Pomp of the University of Connecticut Law School
  - Report recommended replacing the “all-or-nothing” approach to cost of performance with a proportionate approach and determining “income producing activity” viewing the entire apportionable business income of a unitary business
- December 2013 – Executive Committee discussed Report and determined all suggested revisions be sent back



# Update on Proposed UDITPA Rewrite

- March 2014 – MTC Uniformity Committee (“Uniformity Committee”) sends its original five recommendations from December back to the Executive Committee
- May 2014 - Executive Committee voted to circulate proposed revisions to all five sections of Article IV, excluding certain equitable apportionment proposals, for state survey
- July 2014 - MTC amends UDITPA and incorporates all five revisions, including certain equitable apportionment proposals and charges the Uniformity Committee with drafting model regulations
  - Note that states must separately enact these amendments for them to become effective
- December 2014 – The MTC’s Uniformity Committee on December 11 voted to instruct the work group charged with designing market-based sourcing model regulations to use as its starting draft the package of rules proposed in Massachusetts.

# MTC Revisions to UDITPA §17

(a) Sales, other than sales of tangible personal property described in Section 17, are in this State if the taxpayer's market for the sales is in this state:

...

- (3) in the case of sale of a service, if and to the extent the service is delivered to a location in this state; and
- (4) in the case of intangible property
  - (i) that is rented, leased, or licensed, if and to the extent the property is used in this state, provided that intangible property utilized in marketing a good or service to a consumer is “used in this state” if that good or service is purchased by a consumer who is in this state; and

# MTC Revisions to UDITPA §17

(4) in the case of intangible property (continued)

(ii) that is sold, if and to the extent the property is used in this state, provided that:

(A) a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area is “used in this state” if the geographic area includes all or part of this state;

(B) receipts from intangible property sales that are contingent on the productivity, use, or disposition of the intangible property shall be treated as receipts from the rental, lease or licensing of such intangible property under subsection (a)(4)(i); and

(C) all other receipts from a sale of intangible property shall be excluded from the numerator and denominator . . . .

# MTC Revisions to UDITPA §17

- (b) If the state or states of assignment under subsection (a) cannot be determined, the state or states of assignment shall be reasonably approximated.
  
- (c) If the taxpayer is not taxable in a state to which a sale is assigned under subsection (a) or (b), or if the state of assignment cannot be determined under subsection (a) or reasonably approximated under subsection (b), such sale shall be excluded from the denominator of the sales factor.

# **Applying Market-based Sourcing**

# Market-based Sourcing

There are a number of alternatives for defining the “market”

- Where benefit of services is received by customers;
- Where services are performed;
- Where intangibles are used; or
- Where the customers are located

# Market-based Sourcing

There are a number of theories that have evolved from the adoption of a market-based approach:

- Delivery – generally defaults to the customer or other delivery location
- Receipt of service – does this differ from delivery?
- Benefit received – generally applies to services
- Use – intangible's customer or user's location
- Reasonable approximation – utilized when applying one of the theories is not possible.

# Market-based Sourcing

There are different approaches for identifying where the benefit of the service is received

- Generally, benefit is received at the customer's location
  - Should there be a “look through” to the ultimate customer or beneficiary?
- Benefits received in more than one state:
  - Individual customers vs. business customers
  - Order location vs. billing location
  - Benefit location is indeterminable
  - No nexus or fixed place of business in benefit location



# Market-based Sourcing

Sourcing receipts derived from the sale or license of intangible property is difficult because intangibles, by their nature, do not have a definite geographical location.

Receipts are derived from intangibles through the following transactions:

- Sales of intangibles
- Licensing of intangibles in exchange for royalties

# Market-based Sourcing

There are issues associated with determining where intangibles are utilized

- Where utilized by payor (e.g., licensee)
  - Where licensee is located?
  - Where licensee manufactures product?
  - Where licensee sells product?
- What if location of utilization cannot be determined?
- What if taxpayer/licensor is not taxable where intangibles are utilized?
- What about wholesale license transactions?

# **The State Trend Toward Market**

# Adoption of Market-based Sourcing

- Alabama
- Arizona (elective, 2014 - 2017 phase in)
- California
- District of Columbia (2015)
- Georgia
- Illinois
- Iowa
- Maine
- Maryland
- Massachusetts (2014)
- Michigan
- Minnesota
- Nebraska (2014)
- New York State (2015)
- Ohio (CAT)
- Oklahoma
- Pennsylvania (2014)
- Rhode Island (2015)
- Utah
- Washington (B&O)
- Wisconsin

# Examples of Market-based Sourcing Services

## MTC – “Delivered”

- Alabama – MTC model
- Massachusetts – MTC Model

## “Received”

- Maine – “receipts from the performance of services must be attributed to the state where the services are received”
- Minnesota – “attributed to the state where the services are received”

# Examples of Market-based Sourcing Services

- Arizona – benefit-received theory elective beginning 2014.
  - “Received the benefit of the services in this state” means “the services are received by the purchaser in this state”.
- California – benefit-received effective 2013.
- Michigan – where the benefit received by customer/client
- New York – generally where the benefit received (special rules for financial and other services).
- Georgia – receipts “derived from customers” within the state or “otherwise attributable to this state’s marketplace”

# Examples of Market-based Sourcing Intangibles

- Alabama – MTC statute, look to place of use
- California – generally “use” and marketing intangibles sourced based on the sale of the underlying goods or services.
- Georgia – state where the intangible is used by the purchaser
- Illinois – place of utilization (special rules for certain activities)
- Kentucky – possession, control, use in business
- Michigan – use
- New York – use
- Washington – use

# Market-based Rules — Massachusetts

On July 24, 2013, the Massachusetts Legislature voted to override the Governor's veto of the Massachusetts Transportation Bill 2013, H.B. 3535 ("Bill".) Among other significant corporate excise tax and sales/use tax changes, the Bill provides for:

- Market-based sourcing for service revenue
- "Throwout rule" for sales of other than TPP only, while retaining throwback rule for TPP. Assumed nexus for foreign sales of tangible personal property only.
- For tax years beginning on or after Jan. 1, 2014, sales, other than sales of tangible personal property, are in Massachusetts if corporation's market for sale is in state
- For services, sale is sources to state to extent service is delivered to location in state



# Market-based Rules — Massachusetts (cont.)

The department issued a 58-page "working draft" proposed regulation on March 25, 2014, received comments through May 2014, and issued a 71-page revised draft regulation on October 30, 2014 revising the rules set forth at 830 CMR 63.38.1(9)(d), pertaining to the sales factor apportionment of sales "other than sales of tangible personal property."

The Department of Revenue issued final regulations on January 2, 2015, pertaining to sales factor apportionment of sales "other than sales of tangible personal property"

# Market-based Rules — Massachusetts (cont.)

- The regulations provide significant examples and specifics in many areas, including:
  - Service transactions (e.g., the determination of sourcing for in-person services, services delivered electronically)
  - License transactions (e.g., sourcing a marketing intangible, a production intangible, mixed intangible)
  - Other sourcing rules for sales or license of digital goods or services, software transactions, etc.
  - Rules of reasonable approximation

# Market-based Rules — Massachusetts (cont.)

Notable elements of the final regulations issued on January 2, 2015 include the following:

- “Reasonable approximation” (which permits taxpayers that have insufficient information regarding a sale's delivery location to approximate that location based on sales from which the taxpayer does have sufficient information) expanded to include professional services.
- A broader safe harbor for professional services and receipts from electronically delivered services, to source based on billing address, regardless of where the services were actually delivered.
- Previously, the safe harbor rules applied when a taxpayer had substantially similar services with more than 1,000 customers, but the threshold lowered to 250 customers in the final regulations.

Final regulations include six circumstances in which the Department can make an adjustment to the taxpayer's method of reasonably approximating receipts, but limits the taxpayer's ability to file refund claims or offset assessments based on a change to the approximation method.

# **State Specifics and Cascading Rules**

# Applying Market-based Sourcing - California

## Regulation 25136-2

(b)(1) “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.

. . .

(6) “Service” means a commodity consisting of activities engaged in by a person for another person for consideration. The term “service” does not include activities performed by a person who is not in a regular trade or business offering its services to the public, and does not include services rendered to another member of the taxpayer’s combined reporting group. . . .

# Applying Market-based Sourcing - California

## Regulation 25136-2

- (c) Sales from services are assigned to this state to the extent the customer of the taxpayer receives the benefit of the service in this state.
  - (1) In the case where an *individual* is the taxpayer's customer, receipt of the benefit of the service shall be determined as follows:
    - (A) The location of the benefit of the service shall be presumed to be received in this state of the billing address of the taxpayer's customer, as determined at the end of the taxable year, is in this state . . . . This presumption may be overcome by the taxpayer . . . .

# Applying Market-Based Sourcing - California

(2) In the case where a . . . *Business entity* is the taxpayer's customer . . .

(A) The location of the benefit of the service shall be presumed to be received in this state to the extent the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the normal course of business . . . Indicate the benefit of the service is in the state . . . .

(B) If neither the contract nor the taxpayer's books and records provide the location where the benefit of the service is received . . . then the location (or locations) where the benefit is received shall be reasonably approximated.

(C) If the location where the benefit of the service is received cannot be determined under subparagraph (A) or . . . (B), then the location where the benefit of the service is received shall be presumed to be in this state if . . . Taxpayer's customer placed the order for the service . . . In this state.

(D) If [none of the above suffice] the benefit of the service shall be in this state if the taxpayer's customer's billing address is in this state.

# Cascading Rules — Maryland

Md. Regs. Code tit. 3, §§ 03.04.03.08(C)(3)(c) and (D) provides the following cascading rules

For services:

- To **individual** customers
  - Individual's state of domicile
- To **business enterprises**
  - Business enterprise's state of domicile, defined as the state in which the office or place of business that provides the principal impetus for the sale is located

For intangibles:

- Included in the numerator based upon the average of the property and payroll factors



# Cascading Rules — Utah

Utah Admin. Code R865-6F-8(10)(g) and (11)(d) provide the following cascading rules

For services:

- State where purchaser of the service receives a greater benefit of the service
- If the benefit of the service is received in more than one state, the following sourcing rules may be applied in sequential order:
  - the receipt is sourced to Utah if the office from which the purchaser placed the order for the service is in Utah;
  - if the office from which the order was placed cannot be determined, the receipt is sourced to Utah if the purchaser's billing address is in Utah; and
  - if the state of the purchaser's billing address cannot be determined, the receipt must be included in the sales factor in Utah.
- Additional cascading rules for receipts from intangibles

# State-specific Rules

# Applying Market-based Sourcing – Alabama

- Market-based sourcing as of Dec. 31, 2010, Ala. Code sec. 40-27-1
- Regulation on sourcing of services – April 9, 2013
  - Distinguishes individual and unrelated business customers
  - Individuals – customer’s billing address (if service is a “direct personal service,” source to location where customer received service)
  - Businesses – source to customer’s commercial domicile (if service substantially connected to specific geographic location, source to that geographic location)
- “Reasonable approximation” provisions where sourcing methodology is either deemed to be difficult to administer or fails to reasonably reflect taxpayer’s market (disclosure req’d).
- Non-binding mediation in accordance with MTC rules is available in situations where a taxpayer may be subject to different sourcing methodologies in different states resulting in double taxation

# Applying Market-based Sourcing – Georgia

- By regulation, receipts of services are generally sourced in proportion to benefit received by the receipt of the service. Reg.560-7-7.03(5)(c)(ii).
- Examples:
  - A corporation headquartered in State A, building an office complex in Georgia, contracts with an engineering firm from State B to oversee construction of the buildings on the site. The engineering firm performs some of their service in Georgia at the building site and additional service in State B. All of the gross receipts from the engineering service are attributable to Georgia.
  - A corporation from State A contracts with a computer software company from State B to develop and install custom computer software used by the corporation from State A in a business office in Georgia and in a business office in State A. The gross receipts are included in the numerator in proportion to the extent the software is used in Georgia.

# Applying Market-based Sourcing — Nebraska

- For tax years beginning on or after January 1, 2014, Nebraska uses market-based sourcing to source most types of services to the location of the buyer. Neb. Rev. Stat. sec 77-2734.14(3).
- If service relates to property, look to location of property
- If service provided to individual, look to location of individual
  - Sourcing sales from the cloud (application services)
    - The term application service is defined as – “computer-based services provided to customers over a network for a fee without selling, renting, leasing, licensing, or otherwise transferring computer software.”

# Applying Market-based Sourcing — Nebraska

- Application service includes software as a service, platform as a service and infrastructure as a service
- Application services are considered Nebraska sales if buyer's use location is in Nebraska
  - Buyer's use location is:
    - Buyer's business address if used in the regular course of the buyer's business, or
    - Individual buyer's billing address
  - Where use of application service (by a buyer other than an individual) occurs on a multistate basis, sales are apportioned based on proportion of the use of the application service that occurs in Nebraska and elsewhere.

# Applying Market-based Sourcing — New York

- Historically, services were sourced to the location where earned – similar to pro rata sourcing, though not based on UDITPA language
- Statute enacted in March 2014 revamps sales factor apportionment provision, and generally switches to market-based sourcing. NY Tax Law sec. 210-A(4)(c)(1)-(c)(4).
- Digital products/services – use hierarchy
  - Customer’s primary use location
  - Location where product is received
  - Last year’s apportionment for that digital product (per hierarchy)
  - This year’s apportionment for other digital products sourced

# Applying Market-Based Sourcing — New York

- Other services/business receipts – the sale is sourced to the location of the customer, which is determined pursuant to the following hierarchy of methods:
  - Location where benefit is received
  - Delivery destination
  - Last year’s apportionment for that type of receipt (per hierarchy)
  - This year’s apportionment for other receipts sourced (per hierarchy)
- Due diligence standard to use highest method in hierarchy
- Alternative apportionment available if the statutory apportionment provisions do not result in proper reflection of income or capital – burden of proof on party requesting it



# Applying Market-based Sourcing—Pennsylvania

- Historically, Pennsylvania used cost of performance
- For tax years beginning on or after January 1, 2014, services are sourced to the location of delivery (for multistate services, pro rata based on percentage of total value of the services in each state)
  - For individuals that are not sole proprietors, source to customer's billing address if location of delivery is undeterminable
  - For businesses and sole proprietors, source to customer's ordering address (in the regular course of operations), or if undeterminable, source to customer's billing address
- Income from intangibles is sourced to the place where the branded property is sold.

# Industry Focus

# Financial Services Industry – Sourcing Rules

## New York

- Currently, New York sources deposits to the extent that such deposits are “maintained” by the taxpayer at the “branch” location. This is known as the deposits factor and has caused much controversy with regard to determining the location of maintenance and the branch location.
- New legislation in the state requires the use of market-based sourcing and eliminates the deposits factor for banking corporations for tax years beginning January 1, 2015. Under the new law, the following rules are a sample of how receipts from financial transactions may be sourced:
  - Interest on loans secured by real property – sourced to location of real property
  - Interest on other loans – sourced to location of borrower
  - Net gains from sales of secured loans – sourced based on ratio of gross proceeds from sales of NY secured loans over all secured loans
  - Net gains from sales of other loans – sourced based on ratio of gross proceeds of such loans to purchasers located in NY to all such loan sales

# Media and Entertainment Industry

Two "market" based methods generally exist for sourcing receipts earned by taxpayers in the media and entertainment industry such as advertising and licensing revenue.

## Audience Factor

- Approach looks to where content is viewed

## Commercial Domicile

- Approach looks to where the commercial domicile of the advertiser or licensee of the content is located

# Illinois - Publishing Industry Rules

The department has adopted a “circulation factor” to determine when publishing and advertising services are sourced to Illinois for purposes of computing the sales factor. *86 Ill. Admin. Code 100.3373.*

The “circulation factor” is the ratio that a taxpayer's in-state circulation to purchasers and subscribers of the published material bears to its total circulation of the published material to purchasers and subscribers everywhere.

- Computed for each individual publication by the taxpayer of published material containing advertising.
- Can look to:
  - Geographic information;
  - Books and records;
  - Rating statistics sources (e.g., Audit Bureau of Circulations, etc.)
- Effective June 5, 2012.

# Oregon — Sourcing Rules for Broadcasters

For years beginning on or after January 1, 2014 and before January 1, 2017, Oregon apportions gross receipts from interstate broadcasting to the state if the interstate broadcaster's customer is commercially domiciled in OR.

- For prior periods, such receipts were sourced to OR based on the ratio of the interstate broadcaster's audience or subscribers located in OR.
- “Interstate broadcaster” is defined as a “taxpayer that engages in the for-profit business of broadcasting to persons located both within and without this state”.
  - Must also have been subject to “audience factor” rules noted above for years beginning before January 1, 2014.
- "Customer" means an advertiser, a licensee or any other person that has a direct contractual relationship with an interstate broadcaster under which revenue is derived by the interstate broadcaster.

# Pennsylvania — Sourcing Rules for Satellite Companies

For years beginning on or after January 1, 2014, receipts of providers of satellite television services will be apportioned to Pennsylvania based on the value of owned or rented equipment located in the state which is used to generate, process, or transmit satellite television services.

- Does not matter whether equipment is affixed to real estate.
- Includes equipment owned or rented by an entity included in a controlled group (as defined by IRC Sec. 267(f)) with the taxpayer.
- Value of owned equipment is cost less depreciation per the books and records of the taxpayer. Value of rented equipment is 8 times the net annual rental rate.

# Sales Sourcing Considerations

## Service Revenue

- Where is the service performed?
- Is the service performed in multiple locations?
- Is the customer a national account serviced in multiple locations?
- Where is the contract negotiated?
- Where is the customer domiciled?
- Where is the office of the customer which ordered the sale?
- What type of service revenue is being sold?
- Is the service part of a bundled transaction?

What is the revenue stream?

## License of an Intangible

- Where is the license utilized?
- Does the customer have the right to sublicense?
- Does the contract give the customer rights to a specific marketing area/zone?

## Tangible Personal Property

- How is the product shipped?
- Do customers pick up at the seller's warehouse?
- Is product being sold to a retailer's warehouse or through a distribution company?

**Records are key, so plan ahead !!!**



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