Inside Deloitte
Market Sourcing for Services: Comparing California and Oregon Regs

By Scott Schiefelbein, Deloitte Tax LLP
Market Sourcing for Services: Comparing California and Oregon Regs

by Scott Schiefelbein

Reprinted from State Tax Notes, January 14, 2019, p. 121
Market Sourcing for Services: Comparing California and Oregon Regs

by Scott Schiefelbein

Scott Schiefelbein is a managing director with Deloitte Tax LLP.

In this installment of Inside Deloitte, Schiefelbein compares California’s and Oregon’s market-sourcing rules for sales of services.

This article does not constitute tax, legal, or other advice from Deloitte Tax LLP, which assumes no responsibility for assessing or advising the reader about tax, legal, or other consequences arising from the reader’s particular situation.

Copyright 2018 Deloitte Development LLC. All rights reserved.

The apportionment of income for state corporate income tax purposes is an important — and vexing — consideration for the state income tax practitioner. In 2018 Oregon became the last West Coast state to adopt the market-sourcing regime for the apportionment of sales of items other than tangible personal property.¹ California had adopted mandatory market sourcing for the apportionment of such sales as early as 2013,² while since June 1, 2010, Washington state had adopted market sourcing for revenues from services and other “apportionable activities” for purposes of the state’s business and occupation tax.³

This article compares the market-sourcing rules for sales of services for the two West Coast states that impose corporate income taxes. Including over 8,000 words, California’s market-sourcing regulations ranked among the most extensive, detailed set of rules in the country in 2017.¹ However, the Oregon market-sourcing rules almost double that word count. Both of these sets of regulations attempt to bring clarity to an incredibly complex question — how to source sales from two extremely broad sectors of economic activity — “services” and “intangibles” — for state income tax purposes. Given the length of the rules, the sourcing of revenue from sales of intangibles will be analyzed in-depth in a separate article; while this article refers to the sourcing of intangibles to provide the broad framework of the California and Oregon rules, it focuses on the detailed provisions for sourcing sales of services.

Both sets of rules attempt to use categorization of different economic activities, varying sets of “cascading” rules (discussed below), and examples to provide clarity to taxpayers and tax advisers alike. However, as this article will demonstrate, the two sets of rules, despite using highly similar terminology, often take very different approaches to the seemingly simple question: “Where does this sale occur?”

A note to readers regarding GILTI and market sourcing: As a result of federal tax reform, this “Where does the sale occur?” question is increasingly important for multinational taxpayers that file state income tax returns on a

² Cal. Rev. & Tax. Code section 25136. Starting in 2011, California had allowed taxpayers in most industries to elect to use market sourcing if the taxpayers elected to use the single sales factor for apportionment purposes. Cal. Rev. & Tax. Code section 25128.5.
water’s-edge basis. For tax years beginning on or after January 1, 2018, new IRC section 951A requires U.S. taxpayers to include in taxable income their share of global intangible low-taxed income earned by some foreign affiliates. These foreign affiliates may generate GILTI through sales or licensing of services and intangibles. The U.S. Constitution requires the fair apportionment of GILTI, which could lead U.S. taxpayers to conduct detailed apportionment reviews under market-sourcing regimes for such sales. A discussion of GILTI and market sourcing will be the subject of a forthcoming article.

I. California’s Market-Sourcing Rules

The foundation for California’s market-sourcing rules is found in its apportionment statute, which provides the following broad principles for sourcing sales of services and intangibles:

- sales of services are sourced to California to the extent the purchaser receives the benefit of the service in California, and
- sales of intangible property are sourced to California to the extent the property is used in California.

The law for sourcing sales of intangibles further provides that for “marketable securities,” such sales are sourced to California if the customer is in California.

The market-sourcing statute does not provide further clarification for how to apply these standards. However, the market-sourcing regulations are extremely detailed and provide several points to consider for taxpayers engaged in a variety of business activities. This article now turns to an analysis of those rules as applied to sales of services.

A. California Sourcing Rules for Sales of Services

The market-sourcing regulations work within the broad limits of the statute to apply the “benefit received” approach for sourcing sales of services. The regulations first divide services into two broad categories:

- sales provided to customers who are individuals;
- sales provided to customers that are business entities.

B. Sales Provided to Customers Who Are Individuals

For sales when the seller’s customer is an individual, the regulations adopted a straightforward set of rules. First, the location where the benefit of the service is received is presumed to be the state of the customer’s billing address. If the taxpayer uses the customer’s billing address for this purpose, the California “Franchise Tax Board will accept this method of assignment.” This method may have been adopted out of a concern for administrative simplicity, as many taxpayers compile billing address information from their customers.

The taxpayer has the option of rebutting this presumption “by showing, based on a preponderance of the evidence,” that the benefit of the service was received in whole or in part in a state other than the customer’s billing address. The taxpayer must rely on such items as its contract with the customer and the taxpayer’s books and records kept in the ordinary course of the taxpayer’s trade or business in order to sustain its burden of proof.

In the event that the taxpayer can (a) establish via a preponderance of evidence that the benefit of the service was received in whole or in part in a state other than the customer’s billing address, but (b) fails to demonstrate that an alternative method of sourcing can be established based on the taxpayer’s books and records, then the state where the benefit of the service is deemed received will be “reasonably approximated.”

---

7 Id.
12 Id.
13 Id.
14 Id.
The California market-sourcing rules rely heavily on the concept of “reasonable approximation.” The rules define “reasonable approximation” as, considering all available information other than the taxpayer’s books and records, “the location of the market for [the services or the intangibles] determined in a manner that is consistent with the activities of the customer to the extent such information is available to the taxpayer.”16 Further, reasonable approximation “shall be limited to the jurisdictions or geographic areas where the customer or purchaser, at the time of the purchase, will receive the benefit of the services or use of the intangible property.”17 The rule specifically provides that “population” is one method of reasonably approximating the market.18 If “population is a reasonable approximation, the population used shall be the U.S. population as determined by the most recent U.S. census data,” although the populations of other countries can be used if they are relevant.19 Overall, in the context of reasonable approximation, the rule provides that specific information is preferred over general information.

The rules include examples that help clarify how they apply. Two examples involve a business — Travel Support Corp. — in California that provides travel information services to individuals through a call center in California.20 In the first example, the taxpayer charges its customers on a per-call basis and can establish through its books and records that 15 percent of its customers have billing addresses in California but only 7 percent of the calls to the call center originate in California.21 This example concludes that because the taxpayer’s books and records demonstrate where the benefit of the service is actually received (that is, the calls originated inside and outside the state indicate where the customer is when receiving the benefit of the service), the presumption in favor of the billing address is overcome and the taxpayer should source 7 percent of its service revenue to California.22

In the second example, the regulation changes only one fact: instead of charging its customers on a per-call basis, Travel Support charges its customers a monthly service fee.23 According to the regulation, this distinction reduces the evidence of where individual customer support calls are placed; accordingly, the presumption in favor of using the customer’s billing address to source the monthly service fee applies.24

C. Sales Provided to Customers That Are Business Entities

California also provides a specific set of tiered sourcing rules for sales of services to corporations and other business entities. Rather than starting with the customer’s billing address, these rules start with the contract between the taxpayer and the customer or the actual books and records of the taxpayer — it is presumed that either form of documentation will indicate the location where the benefit of the service is received.25 Either the taxpayer or the FTB may overcome this presumption if, based on the preponderance of evidence, it can be shown that the taxpayer’s books and records do not indicate the actual location where the benefit of the service was received.26

The “second tier” sourcing rule applies if either of the following occurs:

1. the contract and the taxpayer’s books and records do not provide the location where the benefit of the service is received; or
2. either the taxpayer or the FTB overcomes the presumption in favor of the taxpayer’s books and records or the contract indicating where the benefit of the service is received.27

---

17 Id.
18 Id.
19 Id.
20 Cal. Code Regs. section 25136-2(c)(1)(C)2. 3. The travel information services include information regarding hotels, restaurants, and other travel-related information. Id.
21 Id.
22 Id.
24 Id.
26 Id.
If either of these criteria is established, the location (or locations) where the benefit of the service is received must be reasonably approximated. 28

If neither the first tier nor the second tier sourcing rules can ascertain where the benefit of the service is received, the regulation then applies another presumption: the benefit of the service is presumed to be received at the location from which the customer placed the order for the service. 29

If this third tier cannot be applied, the benefit of the service is considered received at the location of the customer’s billing address. 30

By using the customer’s billing address as the last tier in its sourcing rules for sales of services to businesses, but as the first tier sourcing rule for sales of services to individuals, the regulation implicitly recognizes that while businesses may manipulate their billing addresses, individuals are unlikely to do so.

D. California’s Distinction Between Marketing And Non-Marketing Services

Taxpayers often submit written requests for binding rulings from the FTB regarding specific fact patterns and applications of California tax law. The FTB may issue chief counsel rulings (CCRs) in response to such requests. The FTB says a CCR is similar to an IRS private letter ruling. 31

CCRs are generally published on a redacted basis so as not to identify the taxpayer.

In 2015 the FTB issued an important CCR, 2015-03, for purposes of applying the market-sourcing regulations. 32 The taxpayer provided “integrated financial information and analytical applications to its global investment community business entity customers who in turn provide financial services to their business entity customers.” 33

Accordingly, the taxpayer’s services provided benefits to both its direct business customers and the customers of its direct business customers. The taxpayer sought guidance from the FTB for how to source its service revenue — to the location of its direct business customers, or to the location of its customers’ customers.

While a thorough review of the FTB’s reasoning in CCR 2015-03 is beyond the scope of this article, the FTB based a key part of its analysis on the observation that California’s regulations for sourcing revenues derived from intangibles 34 draw a distinction between “marketing and non-marketing intangibles.” 35 The FTB noted that the rules apply the following two sourcing rules:

1. revenues derived from the use of “marketing intangibles” are sourced to the location of the customer of the taxpayer’s customer (i.e., the “customer’s customer” location); but
2. revenues derived from the use of a “non-marketing intangible” are sourced to the location of the taxpayer’s customer (the “customer location”). 36

The FTB then extended this distinction to marketing services and non-marketing services even though the market-sourcing regulations provide “no examples which address assigning the sale of a service where the service gives value to the taxpayer’s customer by its use in the customer’s business, but which service also adds value to the services provided by the taxpayer’s customer to its own customers.” 37

The absence of such examples was unfortunate, according to the FTB, because in some situations, “the location of where the benefit of the service is received might actually be the location of the customers of the taxpayer’s customer who directly benefit from the taxpayer’s services.” 38

The CCR noted that California’s market-sourcing regulations include an example that demonstrates how to source sales derived from online advertising — the revenue is sourced to the location of the customer’s customer (when the taxpayer knows the location of its direct business customers). 39

28 Id.
31 California Franchise Tax Board, FTB Notice 88-693 (Jan. 25, 1989).
33 Id., at 2.
35 CCR 2015-03, supra note 32, at 1-2.
36 Id.
37 Id., at 5.
38 Id.
customer’s customer). The CCR observed that this example is consistent with the sourcing regime for marketing intangibles. Therefore, the CCR concluded that it is appropriate to extend the same treatment to non-marketing services as to non-marketing intangibles — “As is true for a non-marketing intangible, the value of a non-marketing service lies not in the advertising or promoting of a product, service or other item, but rather the value lies in the service being used in the business operations of the taxpayer’s customer.” Accordingly, “sales receipts for non-marketing services should be sourced to this state to the extent its customers receive the benefit of the service in this state.”

The FTB has affirmed this guidance with CCR 2017-01. Regarding a service provider that administered complex health plans provided by a range of business entities, the FTB concluded that the administration of health plans is a non-marketing service. Accordingly, the sales should be sourced to the location of the taxpayer’s customer, not the customer’s customer. Further, the FTB concluded that the benefit of the outsourced health plan administration service was “that of being relieved of the obligation to perform the business functions required under” the health plans. Under the applicable cascading rules, the FTB concluded that the “best reasonable approximation of the location of where the benefits are received would be the location that the [customers] would conduct the . . . benefit services, if they canceled the . . . contracts.”

E. Next Steps for California Market-Sourcing Regulations for Sourcing Sales of Services

Despite the extensive details provided by California’s market-sourcing regulations, the FTB continues to hold “interested party meetings” to discuss potential amendments to these rules. A meeting was held May 18, 2018, and included such topics as revisions to the definition of reasonably approximated and how to source sales derived from sales to government entities. The proposed amendments “were developed after considering approaches taken in from other states.” Accordingly, it appears reasonable to conclude that the California market-sourcing regulations are not in their final form, but may be subject to amendment and continued evolution.

II. Oregon’s Market-Sourcing Rules

Oregon’s market-sourcing statutes, like California’s, provide a broad outline of the applicable standards, rules, and tests. The Oregon legislature adopted the model market-sourcing statute promulgated by the Multistate Tax Commission. The market-sourcing regime applies to tax years beginning on or after January 1, 2018.

The establishment of market sourcing is straightforward: “Sales, other than tangible personal property, are in this state if the taxpayer’s market for sales is in this state, as determined under ORS 314.666.” The cross-referenced statute, however, provides little detail for how to source sales of services: It says only that they are sourced to Oregon “if and to the extent the service is delivered to a location” in Oregon.

Sales of intangibles receive slightly more clarification. In addition to providing that the taxpayer’s “market for sales” is in Oregon to the extent the property is “used” in Oregon, the statute provides these details:

- A licensed or rented intangible “utilized in marketing a good or service to a consumer is deemed to be used in” Oregon if the good or service is purchased by a consumer in Oregon.

---

41 Id.
43 Id.
44 Id., at 6.
45 FTB, Interested Parties Meeting Agenda (May 18, 2018).
46 FTB, Meeting Notice and Information, “Third Interested Parties Meeting, Market-Based Rules for Sales Other Than Sales of Tangible Personal Property — California Code of Regulations, Title 18, Section 25136-2.”
48 2017 Or. Laws Ch. 549, sections 3 and 5.
• For intangibles that are sold:
  • Contract rights, government licenses, or similar intangibles that authorize the user to conduct business activities in specific geographies are sourced to Oregon if the geographic area includes “all or part of” Oregon.  
  • Intangible sales that are “contingent on the productivity, use or disposition of” the intangible are treated as licenses or rentals of the intangible.  
  • All other sales of intangibles are excluded from the sales factor.

Finally, the statute provides that if the state or states of sourcing cannot be determined for the sales described above, “the state or states shall be reasonably approximated.”  

A. Oregon’s Market-Sourcing Rules for Sales of Services

To implement the limited guidance of the MTC’s model market-sourcing statute as adopted by Oregon, the Department of Revenue promulgated market-sourcing rules that generally follow the MTC’s model regulations. These rules are extensive — over 16,000 words — and include numerous clarifying examples. This article provides an overview of these provisions, but a thorough exegesis is beyond the scope of this article.

While the stated purpose of Oregon’s market-sourcing rules is to “establish uniform rules” for sourcing the sales of services and intangibles, these rules differ in many key respects from the rules adopted to date by California. Consistent with California’s rules, however, the Oregon apportionment regime “provides various assignment rules that apply sequentially in a hierarchy.” The California and Oregon hierarchies may be very different. The rule does require Oregon taxpayers to “make a reasonable effort to apply the primary rule applicable to the sale” before moving down the hierarchy, and taxpayers must also attempt to apply the hierarchies “in good faith and with reasonable effort” before moving to the method of reasonable approximation.

B. A Different Perspective on Reasonable Approximation

While both states use the concept of reasonable approximation, they apply this standard differently. As discussed above, the California rules rely on the concept of reasonable approximation to determine the state to which sales should be assigned when the specific state cannot be determined. This guidance is open-ended rather than providing specific methods for how to reasonably approximate where sales should be sourced, although the use of relevant populations is contemplated.

The Oregon rules are different. They provide specific rules for how sales should be reasonably approximated in some circumstances (discussed in greater detail below when relevant) but also allow that in other circumstances, “the applicable rule permits a taxpayer to reasonably approximate the state or states of assignment using a method that reflects an effort to approximate the results that would” otherwise be obtained using the rule.

Regarding sales of services, the Oregon rule allows taxpayers to make an approximation “based on known sales.” If a taxpayer can source a “substantial portion” of its sales to a state or states, but not all, and the taxpayer also reasonably believes that its sales of “substantially
similar services” are spread across the same geographic distribution as the assigned sales, then the taxpayer “must include receipts from those sales which it believes tracks the geographic distribution of the assigned receipts in its sales factor in the same proportion as its assigned receipts.” This provision represents a departure from Oregon’s greater-cost-of-performance sourcing regime, which required a separate cost-of-performance analysis for each separate transaction.

C. ‘Where the Service Is Delivered’ and Oregon’s Categories of Services

Oregon did not follow California’s benefit-received approach to determining the market for services, and instead provided that sales of services are sourced to Oregon “if and to the extent that the service is delivered to a location in Oregon.” This location focuses on the taxpayer’s market, “which may not be the location of the taxpayer’s employees or property.” Like the benefit-received approach, the “where the service is delivered” approach is a rather vague standard, and the Oregon rules attempt to address this ambiguity by breaking down sales of services into narrower subcategories and providing more precise guidelines for those subcategories.

While California applies different sourcing hierarchies based on two general dichotomies in how services are classified (that is, sales to individuals versus businesses and sales of marketing services versus non-marketing services), Oregon applies different subcategories of services in its apportionment regime. An overview of the rules for these subcategories follows.

D. In-Person Services

The first subcategory of services established by Oregon’s market-sourcing rules is “in-person services.” These “are services that are physically provided in person by the taxpayer, where the customer or the customer’s real or tangible property upon which the services are performed is in the same location as the service provider,” including services performed on behalf of the taxpayer by a third-party contractor. Examples of these services include:

- warranty and repair services;
- construction contractor services;
- medical and dental services, including medical testing, X-rays, and mental healthcare and treatment; and
- in-person training or lessons.

The general rule for sourcing sales of such services is the location where the service is received (for example, X-ray services for an individual customer in Oregon or services performed on real estate are sourced to the physical location of the customer or real estate). If the service is performed on tangible personal property and the property is to be shipped to the customer, the service is received in Oregon if the property is shipped to Oregon regardless of where the service is performed. The rule further provides that if the state where the “service is actually received cannot be determined, the taxpayer must reasonably approximate such state or states.”

Unlike California’s market-sourcing rules, Oregon does not subdivide this category based on whether the customer is a business or an individual.

E. Services Delivered to the Customer or on Behalf of the Customer, or Delivered Electronically Through the Customer

The next subcategory of services is broad. If the service provided by the taxpayer:
- is not an in-person service under Oregon’s rules; or

---

66 Id.
67 AT&T Corp. & Includible Subsidiaries v. Department of Revenue, 357 Or. 691 (2015).
69 Id.
71 Id.
• is not a professional service under Oregon’s rules; and
• the service is delivered to or on behalf of the customer; or
• delivered electronically through the customer; then

the receipts are sourced to Oregon “if and to the extent the service is delivered in Oregon.”\(^7\) For purposes of this rule, a service is delivered to the customer when the customer is the recipient of the service rather than a third party.\(^7\) If the customer contracts for the service but the service is delivered to one or more third parties, the service is performed on behalf of the customer.\(^7\) Services may be delivered to or on behalf of a customer either through physical means or by electronic transmission.\(^7\)

Oregon’s rule provides that the sourcing of such sales “depends on the method of delivery of the service and the nature of the customer.”\(^7\) The rule provides further breakdown of this subcategory.

F. Delivery to or on Behalf of a Customer by Physical Means

Sales of services that are delivered to or on behalf of a customer by physical means apply the same sourcing standard regardless of whether the customer is an individual or a business.\(^8\) Examples of such services include product delivery services, advertising and advertising-related services delivered to the intended audience in a physical medium, and the sale of custom software under which the taxpayer installs the software at the customer’s site.\(^8\) To source such sales, the “taxpayer must first attempt to determine the state or states where the service is delivered” and source sales accordingly.\(^8\) If the taxpayer cannot do so, the taxpayer must reasonably approximate the state or states, although no guidance is provided for how to do this.\(^8\)

G. Services Delivered by Electronic Transmission To an Individual Customer

Oregon’s rule for sourcing sales delivered by electronic transmission to individual customers is straightforward: the sale is sourced to Oregon if the taxpayer can determine that Oregon is among the state or states where the service is received.\(^8\) If the taxpayer cannot assign the sales based on where the service is received, the taxpayer must “reasonably approximate the state or states” of assignment.\(^8\) The rule specifically provides that if the taxpayer lacks other information for making such a reasonable approximation, the taxpayer “must reasonably approximate the state or states using the customer’s billing address.”\(^8\)

H. Services Delivered by Electronic Transmission To a Business Customer

While Oregon creates a different set of sourcing rules for services delivered electronically to business customers, the first-tier sourcing rule is the same as for such sales to individuals: If the taxpayer can determine the state or states where the service is received, the taxpayer must source the sale to that state or states.\(^8\) However, the rule further provides that “it is intended that the state or states where the service is received reflect the location at which the service is directly used by the employees or designees of the customer.”\(^8\)

For this subcategory of sales, Oregon provides more robust rules for reasonable approximation. The first-tier rule is straightforward: If the taxpayer cannot determine the state or states for assigning the sales, the taxpayer can rely on available information for a reasonable approximation.\(^8\)

\(^7\) Or. Admin. R. 150-314-0435(4)(c)(A).
\(^7\) Id.
\(^7\) Id.
\(^7\) Id.
\(^7\) Or. Admin. R. 150-314-0435(4)(c)(B).
If the taxpayer cannot use the first-tier rule, the taxpayer may attempt to apply a “safe harbor” using the customer’s billing address. This safe harbor allows the taxpayer to assign its receipts from sales to a customer based on the customer’s billing address if the taxpayer can meet the following two tests:

1. the taxpayer engages in substantially similar service transactions with more than 250 customers (business or individual) in the same tax year as the sales at issue; and
2. the taxpayer does not derive more than 5 percent of its sales of all services from the customer at issue.\(^{90}\)

If the taxpayer cannot use either of the preceding sourcing rules, the taxpayer can use a “secondary rule of reasonable approximation,” provided the business customer is not a related party.\(^{91}\) Under this test, the taxpayer must reasonably approximate the state or states of assignment as follows:

- first, to the state “where the contract of sale is principally managed by the customer”;\(^{92}\)
- second, if the taxpayer cannot reasonably determine where the contract is managed, to the customer’s place of order; and
- third, if neither of the preceding tests applies, then to the customer’s billing address.\(^{93}\)

If the taxpayer’s sales to one customer exceed 5 percent of its total receipts, the taxpayer is required to identify the state from which the contract of sale is “principally managed.”\(^{94}\)

Oregon defines the state where a contract of sales is principally managed as:

the primary location at which an employee or other representative of a customer serves as the primary contact for the taxpayer with respect to the day-to-day execution and performance of a contract entered into by the taxpayer with the customer.\(^{95}\)

Oregon’s market-sourcing rules also specify how to source sales of services “delivered electronically through or on behalf of an individual or business customer.” In these transactions, the customer contracts for the service to be delivered electronically to third parties rather than the customer.\(^{96}\) Oregon’s first-tier sourcing rule for assigning such sales to Oregon is to the extent the service is delivered to a recipient in Oregon.\(^{96}\) The rule includes the example of advertising services — regardless of where the customer is, the service is delivered to Oregon to the extent the audience for the advertising is in Oregon.\(^{97}\)

The rule also provides that if the location of the ultimate recipients cannot be determined, the taxpayer must reasonably approximate the state or states for assigning the corresponding sales.\(^{98}\) This subsection does not provide how this reasonable approximation must be performed, which appears to provide the taxpayer with some discretion on how to perform this analysis. However, if the taxpayer lacks the necessary information for making such a reasonable approximation, the rule further provides two “select secondary rules for reasonable approximation” that apply in some circumstances:

1. For advertising sales: For taxpayers delivering advertising to a known list of subscribers, the taxpayer must use a percentage that reflects the ratio of the Oregon subscribers over the total subscriber population. If the taxpayer does not know this information about the audience, the taxpayer must use a percentage that “reflects the ratio of the state’s population in the specific geographic area in which the advertising

\(^{90}\) Or. Admin. R. 150-314-0435(1)(c)(I).
is delivered relative to the total population of the area."\(^99\)  

2. For sales when the taxpayer’s customer acts as the taxpayer’s intermediary for reselling the service: For sales for which the taxpayer lacks information regarding the ultimate recipients’ location, the taxpayer must reasonably approximate the sourcing of sales by using a “percentage that reflects the ratio of the state’s population in the specific geographic area in which the taxpayer’s intermediary resells the services, relative to the total population of that area.”\(^100\)  

Taxpayers that apply either of these secondary rules may include in the reasonable approximation only those areas where the service “was substantially and materially delivered or resold.”\(^101\) The rule also includes a presumption that the taxpayer is delivering services solely within the United States, unless the taxpayer demonstrates that it is making sales outside the United States.\(^102\)

I. Professional Services

The final broad subcategory is “professional services.” Oregon defines these as “services that require specialized knowledge and in some cases require a professional certification, license, or degree.”\(^103\) These services include, but are not limited to:

- management services;
- financial custodial services;
- investment and brokerage services;
- tax preparation;
- legal services;
- engineering and architectural services; and
- consulting services.\(^104\)

The rules for sourcing professional services address several unique issues arising from professional services. The first is that professional services can overlap with other categories, such as in-person services. The rule provides that these services, such as dental services performed on a patient, are in-person services and should be apportioned using the sourcing rules for in-person services.\(^105\) Other professional services “where the service is of an intellectual or intangible nature, such as legal, accounting, financial and consulting services,” are professional services even though they “may involve some amount of in-person contact.”\(^106\)

The rule also provides that while professional services may involve the transmission of documents or other communications, professional services are to be sourced as professional services rather than using the sourcing rules for services delivered to a customer “set forth in section 4(c) of this rule.”\(^107\)

Oregon’s sourcing rules conclude that professional services are so varied that “the location of delivery in the case of professional services is not susceptible to a general rule of determination and must be reasonably approximated.”\(^108\) Oregon’s rule then applies two broad rules for how to reasonably approximate such sales, depending on whether the customer is an individual or a business:

1. Individual Customers: The taxpayer must source sales of professional services to individual customers using the following hierarchy:
   - to the customer’s state of primary residence, if known;
   - if the customer’s primary residence cannot reasonably be identified, then to the customer’s billing address; or
   - if the taxpayer derives more than 5 percent of its receipts from sales of all services from an individual customer, the taxpayer must identify the customer’s primary state of residence and assign the sales to that state.\(^109\)

---

102 Id.  
104 Id. The rule also clarifies that this provision does not supersede the application of Oregon’s special industry apportionment rules for financial institutions as provided by Or. Rev. Stat. 314.280. Id.  
106 Id.  
2. **Business Customers:** The taxpayer must source sales of professional services to business customers using the following hierarchy (subject to a safe harbor, discussed below):
   - to the state from which the contract of sale is “principally managed by the customer”;
   - if that state is not reasonably determinable, then to the state of the customer’s place of order;
   - if that state is not reasonably determinable, then to the customer’s billing address; or
   - if the taxpayer derives more than 5 percent of its receipts from sales of all services from a business customer, the taxpayer must identify the state from which the customer principally manages the contract of sale.\(^\text{110}\)

A taxpayer that has a “large volume of transactions” of professional services is eligible to use the safe harbor if the taxpayer meets the following two criteria in the tax year:

1. the taxpayer engages in substantially similar service transactions with more than 250 customers, whether individual or business; and
2. the taxpayer does not derive more than 5 percent of its receipts from sales of all services to the customer at issue.\(^\text{111}\)

If the taxpayer meets both of these tests in a particular year, the taxpayer may assign its receipts from a particular customer to that customer’s billing address.\(^\text{112}\) So, for example, a taxpayer who sells substantially similar services to 300 customers and Customer A represents 4 percent of the taxpayer’s total service revenues while Customer B represents 6 percent, the taxpayer can use Customer A’s billing address to source the sales from Customer A but cannot use the Customer B’s billing address for the same purpose.

Oregon’s sourcing rules for professional services carve out “architectural and engineering services” for special sourcing rules:

- architectural services are assigned to the state or states where the real estate improvements are located (or expected to be); and
- engineering services are assigned to a specific state or states to the extent the services are associated with property in those states.\(^\text{113}\)

If these rules do not apply to the specific service at issue, the architectural or engineering service receipts are assigned using Oregon’s general rule for professional services.\(^\text{114}\)

Oregon’s sourcing rules for professional services also provide special rules for sales of professional services to related parties. Sales of professional services to related parties are sourced using the following hierarchy:

1. if the service primarily relates to the related party’s specific operations or activities, the sales are sourced to where “those operations or activities are conducted in proportion to the related party’s payroll at the locations to which the service relates in the state or states”; or
2. if the service relates to the related party’s operations only generally, the sales are assigned to the state or states in which the related party has employees according to the related party’s payroll in each state.\(^\text{115}\)

### III. Conclusion

The extensive bodies of sourcing rules for sales of services adopted by California and Oregon may indicate that the sourcing of service revenues is among the most complex undertakings in state tax. Unfortunately for taxpayers, even though Oregon has attempted to promote the cause of uniformity by adopting the MTC’s model rules, California (and many other states) adopted its market-sourcing regime before the MTC’s adoption of its model rule. Most affected taxpayers have already analyzed how their revenues from services should be apportioned for California purposes. These


\(^{112}\) Id.


taxpayers likely will not be able to simply leverage their California analyses and apply the same method for their Oregon sales factor calculations. As this article demonstrates, the MTC’s model rule, as adopted by Oregon, is broad in scope and extensive in detail, creating multiple subcategories of service activities that are not found in the California rules (for example, professional services and electronically delivered services). While the Oregon rules use some of the same terms as California’s (for example, “reasonable approximation”), the Oregon rules might apply those terms quite differently.

Accordingly, any taxpayer that needs to analyze its Oregon sales factor in light of the new market-sourcing rules should conduct a thorough review of these new provisions, and will likely not find any previous California analysis helpful.

The fact remains that Oregon is among the first states to adopt the MTC’s model market-sourcing regime. By adopting the MTC’s rules that will require a significant investment of taxpayer time and effort to apply, Oregon has confirmed its commitment to uniformity. Assuming that other states follow the MTC and attempt to promote uniformity among the states, taxpayers may be able to leverage their Oregon sales factor analysis for other states.

Montana’s new market-sourcing rules for sourcing sales of services is also modeled on the MTC model statute. Admin. R. Mont. section 42.26.248 (effective January 1, 2018). Colorado’s new market-sourcing statute, applicable for tax years beginning on or after January 1, 2019, is also modeled on the MTC’s “where the service is delivered” standard, although the underlying rules have not been adopted as of the date of this article. Colo. Rev. Stat. section 39-22-303.6(6)(a).