To Market Sourcing We Go

by Shirley Wei and Valerie Dickerson

Shirley Wei is a senior manager and California controversy and technical lead in Deloitte Tax LLP’s Multistate Tax Services Group. Valerie Dickerson is the managing partner of Deloitte’s Washington National Tax Multistate Tax Services Group.

In this edition of Inside Deloitte, Wei and Dickerson provide a general overview of the corporate tax, market-based sourcing rules as applied to sales of services; discuss the ambiguities surrounding the market determination; and offer approaches a company may consider to strengthen its market position if challenged by a state tax agency.

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For sales other than sales of tangible personal property for corporate tax purposes, states are moving away from cost-of-performance to market-based sourcing. Many states also now require multistate corporate taxpayers to apportion income using a single-sales-factor formula. However, determining the “market” is sometimes difficult in terms of fact gathering and compliance with varying definitions of what constitutes the market. Without proper substantiation, taxpayers potentially expose themselves to audits that may turn into full-blown controversies, which can involve costly and time-consuming litigation. But if you don’t know where you are going, how do you know when you get there?1

Although revenue from sales other than sales of tangible personal property generally includes earnings from both services and intangible property, this article focuses primarily on sourcing service revenue. It explores practical considerations for business taxpayers in determining the proper method for sourcing receipts from services using market-based sourcing, and suggests steps that may help companies support their filing positions upon audit by a state tax authority. It provides an overview of market-based sourcing rules, discusses the ambiguities surrounding the market determination, and offers approaches companies may consider to strengthen their market position.

I. From Counting the Costs to Finding the Market

Rooted in the Uniform Division of Income for Tax Purposes Act model,2 the cost-of-performance method of sourcing sales other than sales of tangible personal property has historically been used by many states. Typically under that method, gross receipts are included in the numerator of a state’s sales factor if a greater proportion of the income-producing activity that generates the gross receipts is performed in that state than in any other state, based on costs of performance. Generally, gross receipts are sourced based on where the direct costs are incurred regarding the activities that generate the revenue stream. This method takes an “all or nothing” approach in which all gross receipts for an income-producing activity are assigned to the majority state and none are assigned to the minority state. As a result, states using this formula are assigned a lesser amount of income from companies that have the bulk of their operations outside the state. Because the cost-of-performance method generally focuses on the location and efforts of the taxpayer’s employees, some argue that it merely duplicates the payroll and property factors.3

2UDITPA section 17. UDITPA provides a model law for assigning the taxable income of multistate corporations among the states where they do business. Article IV of the Multistate Tax Compact incorporates UDITPA. UDITPA section 17 provides for the cost-of-performance method for sourcing sales of other than sales of tangible personal property. In July 2014 the Multistate Tax Commission approved amendments to Article IV, which changed the sourcing method for such sales to market-based sourcing. (Prior coverage: State Tax Notes, Aug. 4, 2014, p. 308.) In July 2015 it approved a resolution adopting recommended amendments to section 18 of the model Multistate Tax Compact Article IV, which contained those and other changes.

3To determine the portion of a multistate corporation’s income attributable to the states where it does business, some states require taxpayers to use a three-factor apportionment formula of property, payroll, and sales factors.

1This sentence is a variation of the quote by Lewis Carroll, author of the book Alice in Wonderland: “If you don’t know where you are going, any road will get you there.”
Generally, market-based sourcing assigns receipts based on where the benefit of the service is received. Therefore, states using a market-based approach to source receipts are assigned more receipts from companies based outside the state than they would have received under a cost-of-performance approach. Accordingly, many states have moved toward a market-based approach over the past several years. In 2008 seven states used market-based sourcing (14 percent of a total of 49 jurisdictions, including the District of Columbia, that impose a corporate-level business tax).\(^4\) That amount increased to 21 states in 2015 (or 43 percent of the total 49).\(^5\) Of the 21 states that use market-based sourcing, 15 states (or 71 percent) apportioned income under a single-sales-factor formula.\(^6\)

California moved from the cost-of-performance rules to market-based sourcing for tax years from January 1, 2011.\(^7\) The California Franchise Tax Board also promulgated Regulation 25136-2, which specifies how each revenue stream should be sourced under the new market-based sourcing rules.\(^8\) Generally, sales other than sales of tangible personal property are sourced to California “if the taxpayer’s market for the sales” is in the state.\(^9\)

Massachusetts also moved to market-based sourcing, having enacted legislation in 2013.\(^10\) Under the new method, sales other than sales of tangible personal property are sourced to Massachusetts if the “Corporation’s market for the sales” is in the state.\(^11\) In 2015 the Department of Revenue amended its apportionment regulation, 830 Mass. Code Regs. section 63.38.1, to reflect the statutory change. The Massachusetts regulation, similar to California’s regulation, detailed how each revenue stream should be sourced to Massachusetts.\(^12\)

II. Paths to Market: Is There a “There” There?

The underlying principle for market-based sourcing is to assign receipts from sales other than sales of tangible personal property to the location that best reflects the taxpayer’s market for those sales. However, in a service context, states have adopted varying terminology and guidance for identifying the market’s location, including where the purchaser receives the benefit of the service, where customers receive the benefit of the service, and the location of the delivery of the service.\(^13\) Although some of these terms seem similar, as the various tax agencies develop regulations, differences in meaning and application arise. For example, Georgia sources receipts from sales of services proportionately based on the states where “the recipient receives the benefit of the services,” and its regulation provides seven examples illustrating how this standard is applied.\(^16\) Ohio sources receipts from services under a similar basis — where the purchaser uses or receives the benefit of the services — but provides specific rules on how 54 different types of services should be sourced.\(^17\) Given that states are interpreting these provisions so differently and an increasing number of states are moving to market-based sourcing, questions may arise as to whether states should be required to re-adopt or amend industry-specific rules as these issues evolve. Although each state’s approach may differ, the goal is essentially the same: to assign the receipts to the state that best reflects the taxpayer’s market for a given revenue stream.

For illustration, we compare the rules in California and Massachusetts. In California, receipts from sales of services are sourced to the state “to the extent the purchaser of the service received the benefit of the services” there; or, in other words, “the location where the taxpayer’s customer has either directly or indirectly received value from delivery of that service.”\(^18\) Similarly, these types of receipts are sourced...
to Massachusetts “if and to the extent the service is delivered to a location" in the commonwealth.19

As noted, the differences between the states’ approaches to sourcing receipts from services lie primarily in the extent to which inquiry into the facts is necessary. While Massachusetts focuses on the state where the service was delivered, California takes it one step further and requires a taxpayer to ascertain the state where the customer “received value” from the delivery of the services.

The issue becomes even more complicated in states that provide cascading rules that must be sequentially applied in determining where receipts from sales of services should be sourced — especially because unless a taxpayer fails to meet the preceding rule, it cannot move to the next respective rule.20 Again, California and Massachusetts provide examples. When the taxpayer’s customer is a business entity,21 receipts from services are sourced to California in the following order:

• First, the benefit of the service is presumed to be in California to the extent that the contract between the taxpayer and the taxpayer’s customer or the taxpayer’s books and records kept in the normal course of business, notwithstanding the billing address of the taxpayer’s customer, indicate the benefit of the service is in California.22 The FTB or the taxpayer may rebut this presumption.23

property in” California. Calif. Code Reg., tit. 18, section 25136-2(b)(8). Sales from intangible property are in California “to the extent the property is used” in California. Calif. Rev. & Tax Code section 25136(a)(2). For marketable securities, sales are sourced to California “if the property is used” in California. Calif. Rev. & Tax Code section 25136-2(c)(2)(A). For intangible property, sales are in California “if the property is located in” California. Calif. Code Reg., tit. 18, section 25136-2(d)(1); 830 Mass. Regs. Code section 63.38.1(9)(d)(4)(ii). For marketable securities, sales are sourced to California “if and to the extent the property is used in” Massachusetts. For receipts derived from the sale, rental, lease, or license of tangible personal property, the receipts are sourced to Massachusetts “if and to the extent the property is located in Massachusetts.” Id. 20

See e.g., Calif. Code Reg., tit. 18, section 25136-2(d)(1); 830 Mass. Code Regs. section 63.38.1(9)(d)(6). The issue is made even more complex where intangibles are licensed, leased, rented, or otherwise used. See e.g., Calif. Code Reg., tit. 18, section 25136-2(d)(2); 830 Mass. Code Regs. Code section 63.38.1(9)(d)(5).

When the customer is an individual, the location of the benefit of the service is presumed to be the customer’s billing address, and if the taxpayer uses that method to assign the sale, the FTB must accept that method. Calif. Code Reg., tit. 18, section 25136-2(c)(1). The taxpayer, and not the FTB, may rebut the presumption by evidence in the contract between the taxpayer and his or her customer or his or her books and records kept in the normal course of business. However, the FTB may examine any alternative method that the taxpayer uses. If the taxpayer overcomes the presumption and an alternative method cannot be determined, the location will be reasonably approximated. Id.

• Second, to the location(s) where the benefit is received based on a reasonable approximation.24

• Third, to the location where the customer placed the order for the service.25

• Fourth, to the customer’s billing address.26

Massachusetts’s cascading rules depend on whether the service is classified as in-person, professional, or other types of services.27 For example, where the service is in-person,28 the delivery of the service is in Massachusetts:

• Where the service is performed on an individual customer or in the customer’s physical presence in Massachusetts.29

• Where the service is performed on a customer’s real estate or tangible personal property, at the customer’s residence or in the customer’s possession in Massachusetts.30

• Where tangible personal property to be used in the performance of the service is shipped or delivered to a customer in Massachusetts.31

• If the service is actually received cannot be determined based on the above, then to the location based on a reasonable approximation.32

• If the location still cannot be determined based on the above, the sale is excluded from the numerator and denominator of the sales factor.33

28In-person services are “physically provided in person by the taxpayer, where the customer or the customer’s real or tangible property on which the services are performed is in the same location as the service provider at the time the services are performed” and include “situations where the services are provided on behalf of the taxpayer by a third-party contractor.” Mass. Reg., tit. 830, section 63.38.1(9)(d)(4)(b).
33Id. Professional services are those requiring a specialized knowledge and, in some cases, a professional certification, license, or degree. 830 Mass. Regs. Code section 63.38.1(9)(d)(f)(i). For business customers, the state where the service is delivered is reasonably approximated and, if the taxpayer derives less than 5 percent of its sales from that customer, the taxpayer must assign the sale as follows: (1) To the state where the contract of sale is principally managed by the customer. (2) If No. 1 cannot be reasonably determined, then to the customer’s place of order. (3) If No. 2 cannot be reasonably determined, then to the customer’s billing address. 830 Mass. Regs. Code section 63.38.1(9)(d)(f)(i). If the taxpayer derives more than 5 percent of its sales from that customer, it is required to identify the state where the contract of sale is principally managed by the customer and source it to that state. Id. There is a safe harbor that applies to the foregoing situation in which a taxpayer may assign its sales to a customer based on the customer’s (Footnote continued on next page.)
These regulations demonstrate that while the goal of sourcing these types of receipts to the taxpayer’s market is the same, the manner to achieve that goal varies considerably among states. Because the taxpayer bears the burden of proof in establishing the validity of the method it uses to source its receipts, it is important — and certainly to the taxpayer’s advantage — to improve its understanding of each state’s rules and then seek to comply with those rules despite the ambiguity of the statutes and regulations. Lack of proof supporting the taxpayer’s sourcing method applied opens it up to a state audit assessment. Sometimes the substantiation required varies by the type of service. For example, for “professional services” that are delivered to a business customer, Massachusetts imposes an affirmative duty on the taxpayer to identify the state where the contract of sale is principally managed by the customer where the taxpayer derives more than 5 percent of its sales from that customer.34

Changing methods can be problematic. California FTB and Massachusetts DOR regulations require taxpayers to continue to use the method they chose and prohibit the taxpayer from changing that method — for example, without prior consent of the tax agency or only for factual or calculation errors.35 Accordingly, companies should try to get it right the first time or risk being stuck with the wrong method for future years, absent a compelling reason to change in the eyes of the tax authorities. In addition to these uncertainties, there are questions about how much documentation is sufficient. Also, although sourcing the receipts to a customer’s billing address may seem like the easiest option, this method is generally disfavored and has been viewed as too narrow and easily manipulated.36

So how can companies address the risks associated with failing to properly document their method? How can they be proactive and potentially enhance the likelihood of a favorable result if a state tax agency audits their returns?

III. Steppingstones to Building Your Case

The good news about the uncertainties surrounding states’ language and possible interpretations of it is that although the path may be unclear at first, these uncertainties give companies flexibility to build a compelling, fact-specific, well-documented marketplace study that reflects the market for their business. More importantly, the timing of such a study is more helpful to a company if it is conducted before a state notice of audit.

Uncertainties in the statutory and regulatory language expose companies to state tax audits and give auditors flexibility to reject a company’s approach because it does not constitute a reasonable approximation of the company’s market. Ultimately, this could result in a full-blown controversy, which could include costly and time-consuming litigation. But companies may have significant opportunity — especially while the rules are relatively new and untested — to enhance their position in an audit.

One proactive approach would be to determine what is driving a company’s revenue and build a documented story around the company’s business and how it relates to that driving force. There are three suggested steps for this process:

- analyze each state’s market-based sourcing rules and methods and how they apply to the company’s market for each revenue stream;
- gather facts to support the sourcing methods that the company determines apply to its revenue stream, including facts to support its designated market for each state; and
- establish processes, procedures, and systems to enhance compliance with each state’s rules, including oversight of relevant company employees charged with the tax compliance function in this regard.

A. First, Evaluate the States’ Rules and Then Determine Sourcing Method

The first step involves the company’s analysis of each state’s market-based sourcing rules and methods. This analysis involves a determination of which states have similar rules (for example, X number of states source receipts from sales of services to the location where the service is delivered, etc.) and which ones require additional analysis and effort for the company to comply. Once that analysis is complete, it may be easier for the company to comply with those rules if it identifies the states that have similar rules and determines the sourcing method that may allow compliance. Is there one sourcing method that could meet the standard for most of those states? For example, when multiple states require receipts from sales of services to be sourced based on the location where the service is delivered, a construction company may want to consider — in light of its business and its customer’s business — if it is reasonable to source its revenue to the state where the construction

billing address in any tax year when the taxpayer engages in substantially similar service transactions with more than 250 customers and does not derive more than 5 percent of its sales of services from such customer. 830 Mass. Regs. Code section 63.38.1(9)(d)(4)(d)(iii)(A) (3).

Massachusetts also has special rules that apply to architectural and engineering services, services provided by financial institutions, and mutual fund sales, but the safe harbor does not apply to those sales. 830 Mass. Regs. Code sections 63.38.1(9)(d)(4)(d)(iii)(B); 63.38.1(9)(d)(4)(d)(iii)(A)(3). And then there are sales from other types of services in which the sourcing determination turns on whether it is delivered to the customer or on behalf of the customer or delivered through physical or electronic means. 830 Mass. Regs. Code section 63.38.1(9)(d)(4)(c). Generally, these types of sales are sourced to the state where the service is actually delivered — or based on a reasonable approximation, where the customer receives it, or the customer’s billing address. Id.


36 See e.g., FTB Summary of Interested Parties Meeting, Reg. section 25136, Sales of Other than Sales of Tangible Personal Property, p.2.
project takes place. For states with more complex or differing rules, the company can customize sourcing methods to meet those individual rules.

Next, the company may want to consider analyzing each revenue stream against the methods it identifies for each state and determine which methods may apply to each revenue stream. A practical approach could be to develop the facts surrounding the company’s and the customer’s businesses, determine the market for each revenue stream, determine whether a sourcing method reflects the market for each revenue stream, and ascertain whether a method is reasonable in light of the circumstances surrounding that revenue stream. A company may want to first examine the circumstances surrounding its business, including what it does, where it operates, the nature of its customers’ businesses and where its customers are located, the activities or sources that drive its revenue, where its employees are located, whether tangible personal property will be used and where it will be shipped, whether services will be performed and where they will be performed, and other pertinent facts. These considerations may indicate the location of the company’s true market for a revenue stream and which method would better reflect that market. In applying cascading market-sourcing rules, companies need to be mindful that documentation will be required to substantiate the approach taken. If a company cannot ascertain the location of its true market, it may want to consider selecting a proxy that is reasonably related to its income to be used to source its sales.

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To illustrate, let’s apply an example fact pattern from California Regulation section 25136-2(c)(2)(E)(1).

Payroll Services Corp. contracts with Customer Corp. to provide all payroll services. Customer Corp. is commercially domiciled in California and has employees in other states. The contract between Payroll Services Corp. and Customer Corp. does not specify where the service will be used by Customer Corp. Payroll Services Corp.’s books and records indicate the number of Customer Corp. employees in each state where it conducts business. Payroll Services Corp. must assign its receipts from its contract with Customer Corp. by determining the ratio of Customer Corp. employees in California compared with all Customer Corp. employees and assign that percentage of Customer Corp. receipts to California.37

In this example, the FTB concluded that the proper way to source receipts derived from the payroll services was by applying a ratio of the customer’s employees in California versus other states. However, that conclusion assumes that the customer is receiving the benefit of the payroll services by way of its employees and that the taxpayer’s true market for these sales is essentially the location of its customers’ employees. Although auditors may default to the method used in the example, a company may be able to prove that its market is elsewhere (or at least position itself to make that argument) if there are other facts that arguably take them outside the realm of the example.

To illustrate, consider these additional hypothetical facts that were not contemplated in the example:

- Payroll Services Corp. provides other administrative outsourcing as well as payroll.
- Payroll Services Corp.’s business strategy is to selectively identify customers with excess administrative costs compared with the customer’s competitors.
- The typical benefit to Payroll Services Corp.’s customers is generally reduced office space and headcount needs.
- Payroll Services Corp. provides periodic reporting on overhead versus competitors to provide more services to existing customers.

In light of these additional facts, is the benefit of the service still properly measured by the employees’ work locations or something else? Could the corporate office where the executives are located be said to be the location where the purchaser of the service receives the benefit?

An alternative to sourcing these sales could focus on where Customer Corp. is headquartered. Under the expanded — and arguably original — facts, the headquarters’ location may more accurately reflect Payroll Services Corp.’s true market for this revenue stream based on Customer Corp.’s strategic choice of outsourcing the payroll function. This alternative method is arguably more consistent with how other states would source sales from payroll services. For example, in Massachusetts, payroll services are considered “professional services.”38 For business customers, professional services are assigned to the state where the service is delivered and that location must be reasonably approximated.39 This method means that if the taxpayer derives less than 5 percent of its sales from that customer, it must assign the sale as follows:

1. To the state where the contract of sale is principally managed by the customer.

38“Professional services’ are those requiring a specialized knowledge and, in some cases, a professional certification, license, or degree. Professional services include, without limitation, . . . payroll and accounting services.” 830 Mass. Code Regs. section 63.38.1(9)(d)(4)(d)(i).
2. If No. 1 cannot be reasonably determined, then to the customer’s place of order.

3. If No. 2 cannot be reasonably determined, then to the customer’s billing address.40

If the taxpayer derives more than 5 percent of its sales from that customer, it is required to identify the state where the contract of sale is principally managed by the customer and source the related revenue to that state.41

Assuming that Payroll Services Corp. derives more than 5 percent of its sales from Customer Corp. in Massachusetts, it would be required to identify the state where Customer Corp. principally manages the sales contract. As noted, business customers typically handle these administrative functions (and thus, principally manage these types of contracts) from their headquarters. If that is the case, Payroll Services Corp. would be required to source the sale to Customer Corp.’s state of headquarters, provided it maintains sufficient documentation supporting that determination.

B. Second, Gather Facts to Support the Market for Each Revenue Stream

The second step focuses on fact gathering. Once a company has determined where it will source a revenue stream (for example, the location of the market for that revenue), it may be beneficial to articulate its business facts and determine what documentation is needed to prove that the market is in fact located in a particular state, including the factors that the company considered in making that determination. Regardless of whether a company “reasonably approximates” its market or applies a specific prong set forth in the applicable cascading rules, it is prudent to adequately document its position. The company may want to consider compiling those documents and information, maintaining them in its books and records, and applying the same approach consistently for each year. For example, if the company is performing construction services on a customer’s building in Texas, but the customer is headquartered in California, it may be helpful to obtain documents — whether from the company’s own books and records, its customer’s books and records, or public documents — that discuss the construction project and other details that may help establish that the company’s services were performed in Texas.

A company may also want to consider maintaining documents explaining why other easily obtainable information (such as publicly available information that auditors may obtain) does not reflect a reasonable approximation of the company’s market. Because some auditors may search public data and attempt to draw conclusions with or without contrary data, a company may want to conduct its own search to identify potential conflicting information. To strengthen its position, a company may also want to consider compiling and maintaining publicly available documents supporting its position and ones indicating why an alternative method would not reflect its market.

Although the applicable sourcing methods and documentation may vary, and companies are generally not necessarily required to implement specific processes, procedures, or systems to address the states’ sourcing rules,42 some may benefit from adopting a system to identify and collect information to facilitate a consistent approach each year and in each state. To assist in this data gathering, it may be helpful for companies to consider implementing some of the following in their business, which could strengthen their positions and make it more difficult for state tax agencies to successfully challenge the sourcing of their revenue streams. The key is to demonstrate adequate processes in the company’s business as well as consistency in approach.

- Consider developing robust questionnaires that can be distributed to and completed by the company’s subsidiaries and divisions to assist in understanding all aspects of the business and in analyzing the location of the company’s market for its revenue, and thus where the sales may be sourced.
- Although not a requirement, there may be some benefit to adopting customized technology approaches and systems that can assist in documenting and sourcing the company’s revenue to the appropriate market state.
- Consider developing and including in the company’s policies and procedures the steps for acquiring and maintaining necessary documents and information so that obtaining those documents, document maintenance, and retention are part of the company’s books and records kept in the normal course of its business.

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40 Id.
41 Id.
42 See e.g., Calif. Code Reg., tit. 18, section 25136-2(g)(1) (providing that “in assigning sales to the sales factor numerator pursuant to Revenue and Taxation Code section 25136(b), the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information, as well as the resources of taxpayer seeking to obtain this information, and may accept a reasonable approximation when appropriate, such as when the necessary data of a smaller business cannot be reasonably developed from financial records maintained in the regular course of business”); but cf Mass. Reg., tit. 830, section 63.38.1(9)(d)(1)(d)(i) (stating that “a taxpayer’s application of 830 CMR 63.38.1(9)(d) [market-based sourcing rules] shall be based on objective criteria and shall consider all sources of information reasonably available to the taxpayer at the time of its tax filing including, without limitation, the taxpayer’s books and records kept in the normal course of business. A taxpayer’s method of assigning its sales shall be determined in good faith, applied in good faith, and applied consistently regarding similar transactions and year to year. A taxpayer shall retain contemporaneous records that explain the determination and application of its method of assigning its sales, including its underlying assumptions, and shall provide such records to the Commissioner upon request”).
• Consider whether large company contracts need to be updated — when appropriate from a business standpoint — to incorporate language sufficient to document the benefit or location of delivery for the subject services. For example, a contract governing a sale of services could include a statement that discusses what services will be provided, who will provide them, and the location where they — or the benefit therefrom — will be received.

• Consider updating invoices, payment receipts and confirmations, and other relevant documents to include details about the nature of the transaction and where the transaction occurs (for example, where the service is or will be performed, etc.).

C. Third, Establish Processes, Procedures, and Systems To Enhance Compliance

The third step is for the company to consider — based on the above — establishing processes, procedures, and systems that it may use to enhance compliance with each state’s rules, and to monitor whether relevant company employees are following these processes and procedures. To assist in this process, it may be helpful for companies to consider the following suggestions:

• determine which employees will be involved in monitoring whether the processes, procedures, and systems implemented to enhance compliance with market-based sourcing rules are being followed;

• require those employees to follow those policies and procedures, and regularly monitor and confirm that employees are in compliance;

• create templates that employees can use for each revenue stream to document how it was sourced and how the market for it was determined;

• develop robust questionnaires that can be distributed to and completed by the company’s subsidiaries and divisions to determine whether employees are complying with the policies and procedures; and

• periodically monitor for needed tweaks based on changes in facts and guidance.

D. Knowing the Destination: A Market Approach

The importance of these processes, procedures, and systems can be illustrated with the following example involving Payroll Services Corp.’s provision of services to Customer Corp.

Let’s assume that Payroll Services Corp. is located in California. Customer Corp. has its headquarters in New York, but also has a corporate office in California from which it handles its West Coast sales, but does not handle any of the typical functions one would find at the corporate headquarters. Let’s further assume that Customer Corp.’s headquarters handles all of a corporation’s typical headquarters functions, including managing all contracts for services, sales, and other corporate activities. However, to maintain the customer relationship with Customer Corp., Payroll Services Corp. typically engages with Customer Corp.’s California employees because they are local.

If Payroll Services Corp. does not maintain documentation showing that Customer Corp.’s administrative functions (which would typically include payroll functions or contract management) are performed from its New York headquarters, states such as California could use the “reasonable approximation” standard to source the sales to California. For example, if the FTB finds some indication in Payroll Services Corp.’s records that it engages with Customer Corp.’s California office, or obtains publicly available information indicating that Customer Corp. has a California office from which it conducts a substantial amount of business, the FTB could source the sales to California. Because this standard is so broad and states generally have wide discretion to use whatever information they can find to approximate the taxpayer’s market, companies lacking proper analysis and documentation may be required to apply a state tax authority’s determination.

If a company does not invest significant time and effort to determine the proper method for sourcing its sales, it could find itself stuck with whatever method it initially chose to apply.

Moreover, if a company does not invest significant time and effort to determine the proper method for sourcing its sales, it could find itself stuck with whatever method it initially chose to apply. As noted, in states like California and Massachusetts, taxpayers are required to use the first method they apply; and if a company is audited, the auditor may take the position that the company has no right to offer evidence that its market is elsewhere and that he now has sole discretion to make that determination. Because reasonable approximation and other governing statutory and regulatory language are ambiguous and leave significant room for states to challenge a company’s method, failure to properly analyze and document sourcing methods can result in an unanticipated detrimental tax effect and possibly costly and time-consuming litigation. However, by implementing
V. Preparation Is Important to the Journey

While it may be expedient to take "any road" as Lewis Carroll says, companies that do so may find themselves "through the looking glass" without proper advance consideration. The rules governing market-based sourcing for sales other than sales of tangible personal property are generally written so broadly — and in many cases lack sufficient accompanying explanatory guidance — that it leaves significant room for state revenue departments to challenge a company's sourcing method, which may expose that company to audits and related tax deficiency assessments.

However, a company can be proactive and consider establishing policies, procedures, and systems to strengthen its case so that if a state audits the method, the company is prepared to defend its position. At least in the case of business customers, the customer's billing address is almost never going to be the right answer in the eyes of the state tax agencies. Moreover, the reasonable approximation standard provides justification for those agencies to expect that companies at least make a good-faith effort to comply with the other applicable rules and provisions instead of immediately applying this last resort. With proper advance planning, implementation, and monitoring, a company may enhance its ability to defend its sourcing position on audit.