State income tax apportionment—What you need to know now

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Agenda

Trends in state income tax apportionment
• Factor presence nexus and single sales
• Cost of performance updates
• Multistate Tax Commission rewrite
• Throwback and throw-out

Alternative apportionment and Multistate Tax Commission litigation update
• Alternative apportionment
• Multistate Tax Commission litigation

Applying market-based sourcing
• Analysis of revenue stream
• Lack of consistency in market definitions
• Data solutions
Trends in state income tax apportionment
Apportionment—emerging trends

• Factor presence nexus standards
• States are more heavily weighting sales factors as well as moving to 100% sales factors
• Significant focus from states on cost of performance rules and ongoing litigation
• For sales factor sourcing, the trend is that states are moving towards market-sourcing rules
Sales factor considerations

Sales of non-TPP
- Cost of performance
- Market
- Proportional/Time spent

Sales of TPP
- Destination
- Ultimate destination
- Dock
Cost of Performance Update

- Sales of non-TPP
  - Cost of performance
  - Time spent
  - Market
    - Transactional
    - Operational
Sales throwback and throw-out rules

Considerations for throwback and throw-out rules:

• Foreign sales transactions
• Nexus standards
• Origination determinations
• Revenue stream treatment
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 for sales

• **March 2014:** MTC Uniformity Committee (Uniformity Committee) sends its original five recommendations from December back to the Executive Committee

• **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.

• **December 2015:** The Multistate Tax Commission's Uniformity Committee on December 10 approved draft market-based sourcing model rules and definitions for Executive Committee consideration, then formed a work group to address alternative apportionment issues identified during the drafting process.
Alternative apportionment and Multistate Tax Commission
UDITPA § 18

If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer’s business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer’s business activity, if reasonable:

• Separate accounting
  – Identifying the income and expenses earned in a specific jurisdiction.

• Exclude a factor
  – A factor is not material to the income producing elements of the taxpayer’s business or the existence of the factor is negligible.

• Add a factor
  – The additional factor is representative of the activity that generates the income (e.g., extraction factor).

• Other
  – Combined returns.
  – Intangible property included in the property factor.
Who may invoke alternative apportionment?

• The taxing jurisdiction may require the use of an alternative apportionment method.
• A taxpayer may petition for the use of an alternative apportionment method.
  – Generally, the request must be made in advance of filing the original return.
UDITPA § 18

Burden of proof

• Level of proof
  – The burden of proof in most civil cases is the “preponderance of the evidence.”
    • Requires only slightly more evidence in support of a proposition than against it—51%
  – Some tax cases require clear and convincing—“highly probable”—75%-80%

• Which party has the burden?
  – Generally the burden of proof is on the party attempting to deviate from the plain reading of the statute.
  – Is there a different standard depending on which party seeks the alternative method?

• What, if any, impact does the “deemed correctness” of an assessment have on the burden of proof?
UDITPA § 18

Burden of proof: First prong:
• Prove that statutory method is distortive
  – Distortion standard is not the constitutional Due Process distortion standard (i.e., *Hans Rees* 250%)
    • Must the entire formula be distortive or only an individual factor or factors?

• Show that standard method of apportionment fails to “fairly represent taxpayer’s in-state business activity”
  – Is this a “savings clause” used to prove a fair result where the standard formula may not result in a constitutional violation?
What is the standard of proof?

• Unconstitutional result
  – *Twentieth Century Fox v. Oregon Department of Revenue*, 299 Ore. 220 (1985). The Oregon Supreme Court held alternative formula is only applicable to remedy unconstitutional situations or where the UDITPA formula does not fairly represent the business activity of the taxpayer.

• Apportionment method is appropriate:
  – *Kennecott Copper v. State Tax Commission*, 493 P.2d 632. The Utah Supreme Court did not rely on any standard but merely concluded the statute allowed the use of an alternative formula.
Which party bears the burden of proof?

• State requires the use of an alternative formula:
  – Prima facie correctness—Shifts the burden
    • Indiana Department of Revenue v. Rent-A-Center East Inc., 963 N.E. 2d 463.
    • Equifax and Equifax Credit Information Services, Inc. v. Ms. Department of Revenue, MS S.Ct. (June 20, 2013), Pet. for Cert. denied
    • Bell South Adv. & Publishing v. Chumley, 308 So. 3rd 350 (TN App. Ct.).
Multistate Tax Compact Election

Due to the adoption of a single sales factor by a number of states, the option to use the standard 3-factor apportionment formula in such states becomes an attractive alternative method for out-of-state taxpayers.

• May a taxpayer elect to use the standard 3-factor formula under MTC Compact Articles III and IV?
• Is the election the use of an alternative formula?
Applying market-based sourcing
Applying market-based sourcing

Sales of non-TPP considerations

- Cost of performance
  - Transactional
  - Operational
- Time spent
- Market
  - Benefit is received
  - Where delivered
  - Where customer is located
  - Where used
Adoption of market-based sourcing

Approximately two dozen states have currently adopted market-based sourcing rules for sales other than of tangible personal property. States that have recently transitioned to market-based rules include:

• Arizona (elective phase-in 2014-2017)
• California (elective in 2011 and 2012, mandatory as of 2013)
• District of Columbia (2015)
• Massachusetts (2014)
• Missouri (effective August 28, 2015)
• Nebraska (2014)
• New York State (2015)
• New York City (2015)
• Pennsylvania (2014)
• Rhode Island (2015)
• Tennessee (July 1, 2016)
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
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?

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?

What is the revenue stream?

Records are key, so plan ahead!
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