THE SHIFTING LANDSCAPE
TRANSFORMATIONAL CHANGES IN STATE TAXATION

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

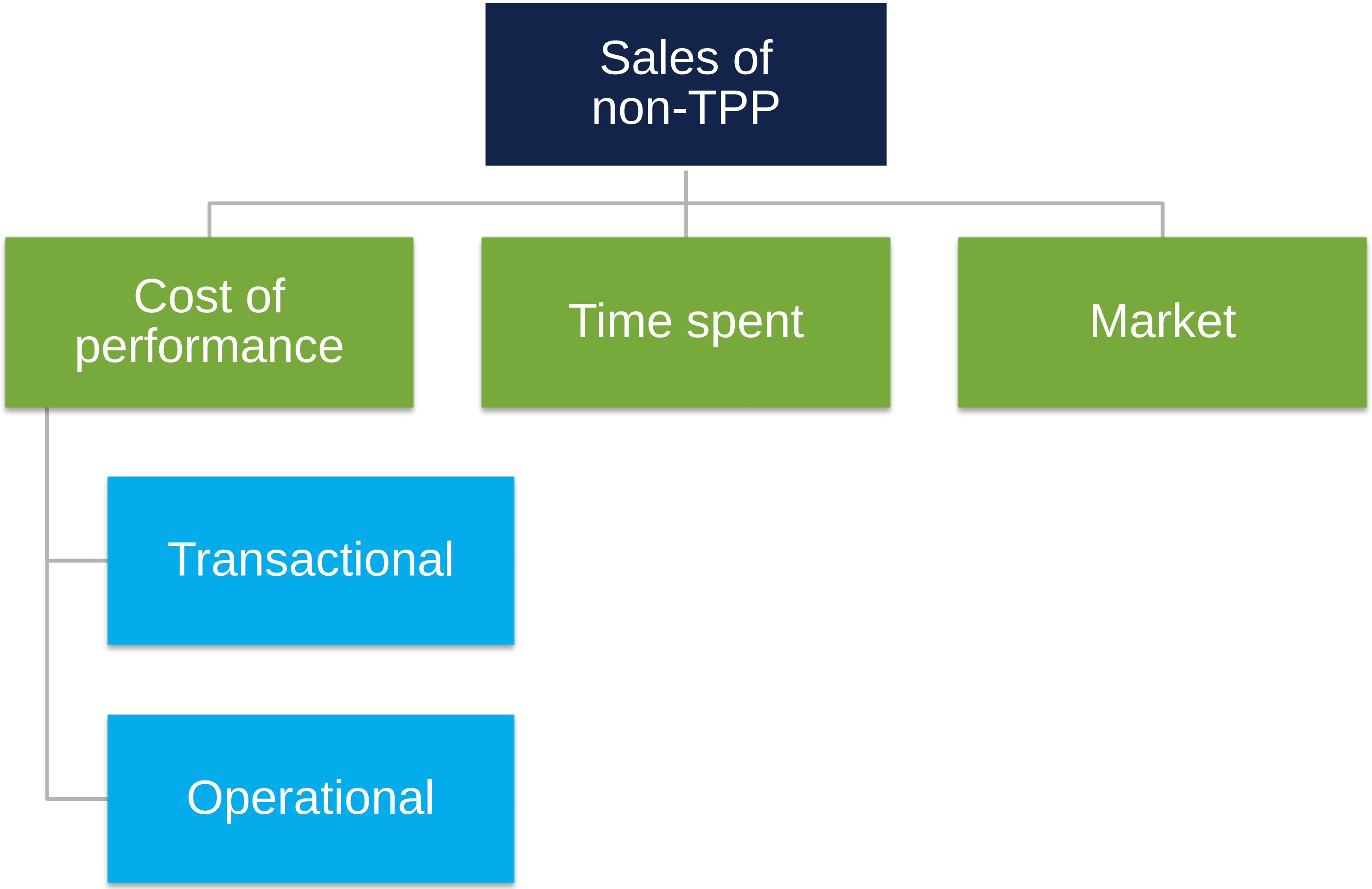
Apportionment—emerging trends

- 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 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.

UDITPA § 18

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?

UDITPA § 18

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.

UDITPA § 18

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

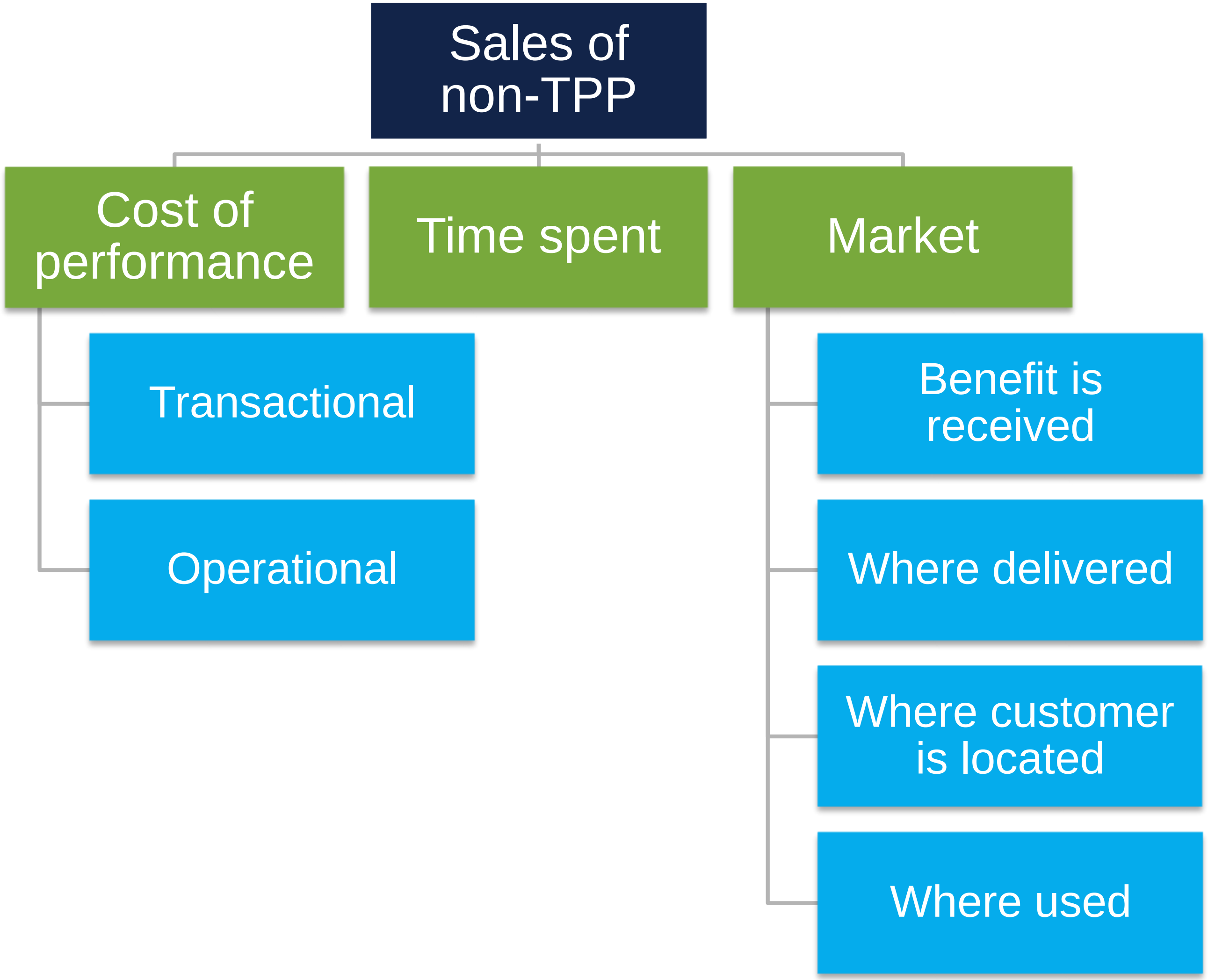
Due to the adoption of a single sales factor by a number of states, the option to use the standard 3-factor apportionment formula in such states becomes an attractive alternative method for out-of-state taxpayers.

- 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



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)

19

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?

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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