STATE APPORTIONMENT UPDATE
Sourcing of Services and Market-based Sourcing

Laura Holmes
Senior Director - BDO USA
February 16, 2016

TEI Houston Chapter Tax School
EXPERIENCE SUMMARY
Laura leads the Southwest Region’s income and franchise tax practice. She has over 21 years of experience in state income, franchise and gross receipt taxes. Her primary focus is assisting clients with planning and restructuring of multi-state businesses, audit controversy and appeal, nexus studies, voluntary disclosure agreements, multistate income tax compliance, Texas franchise tax planning, and due diligence.

Prior to joining BDO, Laura worked in the multistate practice for almost 14 years at Deloitte as well as over 4 years in industry focusing on state an local taxation at a large chemical company with over 15 entities doing business in over 30 states.

PROFESSIONAL AFFILIATIONS
American Institute of Certified Public Accountants
Texas Society of Certified Public Accountants

EDUCATION
B.B.A. in Accounting, University of Texas, Austin, Texas, 1992
Agenda

- Sales factor
- Services and intangible sourcing
- Apportionment trends
- Alternative apportionment
- Legislative update
Apportionment Formula

- Uniform Division of Income for Tax Purposes Act ("UDIPTA") (1950s)
  - Model law relating to the apportionment of income among the states for corporations that do business in multiple states
- Three Factors
  - Percentage of property located in a state
  - Percentage of payroll paid in a state
  - Percentage of sales in a state
  - Equally weighted - 3 Factors
- Trend towards increased or single sales factor
Single Sales Factor
2015 Tax Year

- California
- Colorado
- District of Columbia
- Georgia
- Illinois
- Indiana
- Iowa
- Maine
- Michigan
- Minnesota
- Mississippi
- Nebraska
- New Jersey
- New York
- Oregon
- Pennsylvania
- Rhode Island
- South Carolina
- Texas
- Wisconsin

Industry Specific
Connecticut
Arguments For Single Sales Factor

- Economic development
- Encourages investment and job creation
- Rewards companies that increase share of property and payroll in
- Exports the tax burden to out-of-state companies that use the state as a market rather than as a location for their jobs, investment, and production activity
- Consistency
Arguments Against Single Sales Factor

- Shifts the tax burden from capital to consumption
- Policy change will result in big winners and losers in both income and franchise tax
- If NC share of company sales is more than NC share of company property and payroll, tax liability increases
- Ignores why businesses pay tax
- Property and employees = demand for government services
- Create less competitive market
- Ignores the investment and production activity that occurs in the state
SERVICE AND INTANGIBLE SOURCING
Sales Factor

Historical Perspective

- UDITPA provided that sales are sourced in the following manner:
  - Tangible personal property ("TPP") - Destination sourcing
  - Other than TPP (services or intangibles) - Cost of Performance
  - Currently, many states use the “costs-of-performance” method for sourcing receipts from sales of services
Sales Factor - Cost of Performance

General Rule

General Rule (UDITPA, Article IV, Section 17):
• Sales, other than sales of tangible personal property, are in this State if:
  • (a) the income producing activity is performed in the State; or
  • (b) the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance.

How is “Costs of Performance” defined?
• Costs determined consistent with GAAP or the taxpayer’s trade or business.
• Direct vs indirect costs.
• Common costs are wages, materials used, depreciation, taxes, etc.
• Not uniform across the states.
Sales Factor
Update UDITPA

• 2012
  • The MTC Executive Committee approved public hearing for proposed amendments to UDITPA

• 2013
  • Report from a public hearing recommended replacing the “all-or-nothing” approach with a proportionate approach (March)
  • Executive Committee discussed report and sent back the suggested revisions (December)
Sales Factor
Update UDITPA

2014
- MTC Uniformity Committee sends original recommendations back to the Executive Committee (March)
- Executive Committee voted to circulate the proposed revisions, excluding the equitable apportionment proposals, to the states as a survey (May)
- MTC amends UDITPA and incorporates all five revisions and charges the Uniformity Committee with drafting model regulations (July)
- The Uniformity Committee voted to use the draft package of rules proposed in Massachusetts when designing the market-based sourcing model (Dec.)

2015
- MTC moved forward on two proposed amendments to UDITPA and gave an update for the ongoing efforts to draft the market-based sourcing model (July)
MTC Revisions to UDITPA §17

(a) Sales other than sales described in Section 16, are in this State if the taxpayer’s market for the sales is in this state. The taxpayer’s market for sales is in this state:

********

(4) In the case of intangible property,

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

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

(A) a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area is “used in this state: if the geographic area includes all or part of this state;
(B) receipts from intangible property sales that are contingent on the productivity, use, or disposition of the intangible property shall be treated as receipts from the rental, lease or licensing of such intangible property under subsection (a)(4)(i); and

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

(b) If the state or states of assignment under subsection (a) cannot be determined, the state or states of assignment shall be reasonably approximated.

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

Cost of Performance

• Sourcing is based on the income-producing-activity ("IPA") method and the "cost of performance" rule, i.e., the receipts are sourced to the state where the greater cost of performing the income-producing activity is incurred.

• Costs typically determined in accordance w/ GAAP and exclude independent contractors
  - Majority of the states use an “all-or-nothing” approach vs. a pro-rata allocation
  - Different rules for personal services
Cost of Performance

Terms

• **Income producing activity** applies to each separate item of income and means the transactions and activity engaged in by the taxpayer...for the ultimate purpose of producing that item of income.

• **Costs of performance rule** means direct costs of the taxpayer to perform the income producing activity which gives rise to the particular item of income.
IPA - Determine the State’s Portion

- **Preponderance Approach** (greater than any other state = 100% of revenue)
  - Receipts attributed to the state if greater proportion of income-producing activity is performed in the state than in any other state (UDITPA)
    - Ex: Taxpayer’s costs incurred are 40% in state A, 30% in state B and 30% in state C. The entire receipts will be sourced to state A.

- **Majority of Costs Approach** (more than 50% of costs = 100% of revenue)
  - Receipts attributed to the state if greater proportion (greater than 50%) of income-producing activity is performed inside the state than (total) outside the state.
    - Ex: Taxpayer’s costs incurred are 60% in state A, 10% in state B and 30% in state C. The entire receipts will be sourced to state A.
IPA - Determine the State’s Portion (cont’d)

• **Proportional Approach** *(25% of costs = 25% of revenue)*
  • Receipts attributed to the state based on the ratio of direct costs performed in the state to the direct costs in all other states
    • Ex: Taxpayer’s costs incurred are 35% in state A, 40% in state B and 25% in state C. Receipts will be sourced based on the percentage in the state.
Costs of Performance
Considerations

- Potential to subject more than 100% of a corporation's revenues to tax
- Taxpayers have difficulty tracking and localizing costs
- Costs of performance tends to overweight the sales factor for service providers operating in a state. May be viewed as a disincentive for service providers considering investment in the state.
State Apportionment

Market-based Sourcing

• Receipts are in the state if the customer receives the benefit of the service in the state
  - States’ rules vary regarding the measurement of the benefit
• Receipts are in the state if the customer is located in the state
  - “Customer” can be defined differently for individuals versus business customers
• Receipts are in the state if the service is performed in the state
  - Connecticut, New Jersey, Rhode Island (through 2014) and Texas
  - More like a cost-of-performance state
• Receipts are in the state if the intangible is used in the state
Market Sourcing
Benefit Received

• Some states source receipts from sales of services within their state if the customer *receives the benefit of the service within the state*
• With this methodology, it is often difficult to determine where the benefit of a service is received
  • Generally where the customer has either directly or indirectly received the value from delivery of the service
Market Sourcing

Customer Based

• Several states source receipts from the sales of services to where the customer base is located
  - Oklahoma, Maryland, and Minnesota
  - Under its regulation, Oklahoma sources receipts from services to the state if the receipts are “derived from customers” within the state or if the receipts are otherwise attributable to the state’s marketplace

• Maryland defines “customer” in several ways:
  - If an individual, Maryland looks to the domicile of the individual
  - If a business, Maryland looks to the state in which the office or place of business that provides the “principal impetus” for the sale
Market Sourcing

Other Rules

• There are several states that source receipts based on where the services are “performed”
• Focus on where the service provider performs the services instead of location of the customer
Market-based Sourcing

Considerations

- Difficulty defining terms
  - Where is a customer located (its billing address, its headquarters, or place where service is received)?
  - Where is benefit received?
    - Typically, the person with superior information is the buyer of the service, not the seller; and buyer may not wish to share such information.
    - “Look-through” sourcing makes sense, but such information is not always available.
- Specific rules for market-based sourcing can vary widely from state to state and, within a particular state, may vary by industry
- May result in economic nexus, especially in light of states adopting “factor presence” nexus standards
Market-based Sourcing
Considerations (cont’d)

• What if benefit of service is received in multiple states?
• Primarily benefits in-state companies
• Shifts tax burden to out-of-state companies
• Risk of double - taxation
• Ignores where the work is performed
• More accurately reflects the customer base for taxpayer’s services
Cost of Performance

Example

• Service Company has nexus in States A, B, and C
• States A, B, and C source sales of services in accordance with the COP approach
• 40% of the company’s income producing activity occurs in State A,
• 30% in State B, and 30% in State C
• Under a COP approach all sales are sourced to State A, because a greater proportion of the income producing activity occurs there than in any other state

• Under this scenario, 100% of sales factor would be apportioned for corporate taxes
Market-based Sourcing

Example

• Service Company has nexus (does business) in States A, B, and C
• States A, B, and C source sales of services using a market-based approach
• 20% of company’s sales are to customers in State A, 40% of sales are to customers in State B, 40% are to customers in State C
• Under a market-based approach, the respective sales into each state (A, B, and C) are attributable to each state for apportionment purposes

• Under this scenario, 100% of the sales factor would be apportioned for corporate taxes
Cost of Performance and Market-based Sourcing Together

- Service Company has nexus in States A, B, and C
- State A sources sales of services in accordance with the COP approach, States B and C source sales of services using a market-based approach
- 40% of the company’s income producing activity occurs in State A, 30% in State B, and 30% in State C
- 20% of sales are made to customers in State A, while 40% of sales are made to customers in State B and 40% of sales are made to customers in State C
Cost of Performance and Market-Based Sourcing Together - Results

- Under competing sourcing rules, each state applies its respective apportionment formula:
  - State A claims 100% of sales based on cost of performance,
  - State B claims 40% of sales based on its market-based approach, and
  - State C claims 40% of sales based on its market-based approach
- The company is now subject to state taxes based on 180% of its intangible sales factor
- Because not all market-based states have the same statute, causing variations in apportionment
- Differences in double or single weighting of the sales factor may also cause variations
## Market-Based Sourcing

### Summary Chart

<table>
<thead>
<tr>
<th>Market-Based Sourcing Where Benefit Receive</th>
<th>Market-Based Sourcing Where Service Received</th>
<th>Market-Based Sourcing Where Service Delivered</th>
<th>Market-Based Sourcing Where Customer Located</th>
</tr>
</thead>
<tbody>
<tr>
<td>AZ (election)</td>
<td>IL</td>
<td>AL</td>
<td>GA</td>
</tr>
<tr>
<td>CA</td>
<td>ME</td>
<td>DC</td>
<td>MD</td>
</tr>
<tr>
<td>IA</td>
<td>MN</td>
<td>MA</td>
<td>NE</td>
</tr>
<tr>
<td>MI</td>
<td></td>
<td>PA</td>
<td>NY (2015)</td>
</tr>
<tr>
<td>RI (2015)</td>
<td></td>
<td></td>
<td>OK</td>
</tr>
<tr>
<td>UT</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WI</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Market-based Sourcing

Intangibles

- Alabama - MTC statute, look to place of use
- California - generally place of use and based on the sale of the underlying goods and services
- Georgia - state where the intangible is used by the purchaser
- Illinois - place of utilization
- Kentucky - possession, control, or use in business
- Michigan - use
- New York - use
- Washington - use
Market-based Sourcing - Intangibles
Considerations

• Difficult to source the sale or license of intangible property because intangibles do not have a definite geographical location.
• Where are the intangibles utilized?
  • Where the licensee is located?
  • Where the licensee sells product?
  • Where the licensee manufactures product?
• What if the taxpayer/licensee is not taxable where the intangibles are utilized?
• What if the location of utilization cannot be determined?
STATE SPECIFIC RULES
Alabama - Where the Service is Delivered

- Receipts from services are included if the service is delivered to a location within Alabama.
- If the locality where the service was delivered cannot be determined, if it is reasonably approximated to Alabama, then it is includible in Alabama.
- Throw-out rule applies
California - Where the Benefit is Received

- Individual customers: the benefit of the service is presumed to be received at the customer’s billing address.
- Businesses: the benefit of the service is first presumed to be received at the customer’s location indicated in the contract or according to the taxpayer’s books and records.
- There are various ways for businesses and individuals to overcome these assumptions using preponderance of evidence.
Minnesota - Where the Service is Received

- Services are assigned to Minnesota if they are received at the customer’s fixed place of business in the state.
- If this is not readily determinable or the customer does not have a fixed place of business, the services are deemed to be received at the office from which the customer ordered from the service.
Oklahoma - Where the Customer is Located

- Receipts from services are assigned to Oklahoma if the receipts are derived from customers within Oklahoma or if the receipts are attributable to the state’s marketplace.
- “Customers within the state” means maintaining a regular place of business within or Oklahoma or, in the case of individual customers, having an Oklahoma billing address.
Market-based Sourcing Planning

• Situate service centers in market-sourcing state
  • Minimizes costs in states applying cost-of-performance rule
  • No effect in market-sourcing state

• Closely evaluate differences among states’ market-sourcing rules
  • Proportionate or all-or-nothing approach?
  • Does state use tiered/cascading sourcing rules, *e.g.* billing address as proxy for location of customer?
BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms.

BDO is the brand name for the BDO network and for each of the BDO Member Firms.

Service provision within the international BDO network of independent member firms (‘the BDO network’) is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium with its statutory seat in Brussels. Each of BDO International Limited (the governing entity of the BDO network), Brussels Worldwide Services BVBA and the member firms is a separate legal entity and has no liability for another such entity’s acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BVBA and/or the member firms of the BDO network. BDO is the brand name for the BDO network and for each of the BDO member firms. Source: Brussels Worldwide Services BVBA