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The Implementation of 'Market' Sourcing Rules: Practical Concerns

by Pilar Mata and Melissa J. Smith

Pilar Mata Melissa J. Smith

California is the most recent state to develop market-based rules to source receipts from the sale of services and intangibles. In this Pinch of SALT, we survey the various methods states use to apply market-based sourcing to service and intangible income and address how California and the Multistate Tax Commission are proposing to tackle market-based sourcing and the associated problems. We conclude that while market sourcing offers a principled way to source receipts from the sale of services and intangibles, in practice, market-sourcing rules are likely to create a variety of administrative problems and will not advance uniformity. These challenges are particularly concerning in states that weight the sales factor more heavily or use a single-sales-factor apportionment formula.

Costs of Performance

Of the 46 states with corporate income taxes, 23 states have adopted the Uniform Division of Income for Tax Purposes Act, and most others have adopted a similar method to apportion the business income of multistate taxpayers. Approximately 30 states use the costs-of-performance method to source receipts from sales of services or sales or licenses of intangibles.[1]

Under the standard UDITPA rule, receipts from sales other than sales of tangible personal property are sourced to the state if "the greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance."[2] Thus, the costs-of-performance method requires the taxpayer to identify individual lines of income, determine the income-producing activities for each income line, and determine where the income-producing activities (and associated costs) take place. Although taxpayers and auditors may disagree on how a company's income lines should be broken down or on which income-producing activities are associated with each income line, the benefit of this method is that taxpayers generally have access to relevant cost data — or can design systems to capture that information — because the costs-of-performance method considers the taxpayer's activities.

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[1]*See, e.g.,* Ala. Code section 40-27-1, Art. IV, 17; Alaska Stat. section 43.19.010, Art. IV, 17; Ariz. Rev. Stat. section 43-1147; Ark. Code Ann. section 26-51-717; Cal. Rev. & Tax. Code 25136 (a) applicable until 2011; Colo. Rev. Stat. section 24-60-1301, Art. IV, 17; D.C. Code Ann. section 47-1810.02(g)(3); Fla. Admin. Code r. 12C-1.0155(2)(e)2.a (services only); Hawaii Rev. Stat. section 255-1, Art. IV, 17; IDAPA 35.01.01.550.04; Ind. Code section 6-3-2-2(f); Kan. Stat. Ann. section 79-3287; Ky. Rev. Stat. Ann. section 141.120(8)(c)3; Mass. Regs. Code tit. 830, section 63.38.1(9)(d)1; Mich. Comp. Laws section 206.123; Miss. Reg. 35 III.8.06(III)402.9(3)(d); Mo. Rev. Stat. section 32.200, Art. IV, 17; Mont. Code Ann. section 15-31-311(2); Neb. Rev. Stat. section 77-2734.14(3); N.H. Rev. Stat. Ann. section 77-A:3(I)(c); N.M. Stat. Ann. section 7-4-18; N.C. Gen. Stat. section 105-130.4(l)(3) (services only); N.D. Cent. Code section 57-38.1-17; Ore. Rev. Stat. section 314.665(4); 61 Pa. Code section 109.5(c)(3)(iv); S.C. Code Ann. section 12-6-2295 (services only); Tenn. Code Ann. section 67-4-2012(i); Vt. Stat. Ann. Tit. 32, section 5833(a)(3); Va. Code Ann. section 58.1-416; W.Va. Code section 11-24-7(e)(12).

[2]UDITPA Rule 17.

That said, the costs-of-performance method has been criticized on several fronts. The purpose of the sales factor is to reflect the contribution of the market to the taxpayer's income. This objective may not be achieved under the costs-of-performance method if the income-producing activities required to generate income take place in states other than where the taxpayer's customers are located. This problem is particularly acute in states that use the standard all-or-nothing UDITPA rule, which sources receipts to the state only if the preponderance of the income-producing activities occur within the state, as opposed to a "proportionate" costs-of-performance method that sources sales based on the relative proportion of income-producing activities taking place in each state.[3]

In practice, market-sourcing rules are likely to create administrative problems and will not advance the goal of uniformity.

Further, as the drafters of UDITPA have acknowledged, the costs-of-performance rule may not be appropriate for some types of industries. As a result, the MTC has promulgated (and some states have adopted) industry-specific rules for apportioning the income of airlines, construction contractors, financial institutions, railroads, telecommunications companies, trucking companies, television and radio broadcasters, and publishers.[4]

Current Market-Sourcing Rules

Concerns about the costs-of-performance method have been raised more frequently as the economy has shifted away from the primarily mercantile-based economy that was in existence when UDITPA was adopted toward today's more heavily service- and technology-based economy. This factor, as well as the recognition that a market-based sourcing rule may favor in-state businesses, has led several states to consider market-based sourcing rules. The MTC's Income and Franchise Tax Uniformity Subcommittee has a task force under way to design a new market-based sourcing model statute.

Yet the question remains, how does one measure the market's contribution to a taxpayer's income from sales other than sales of tangible personal property? That question raises several more issues, including how best to ascertain the existence and location of a "market."

Services

In contrast to the costs-of-performance method, which focuses on where the income-producing activities are performed, market-based sourcing rules typically focus on where the market — or customer base — is located. For instance, Oklahoma sources income 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.[5] Maryland sources income from contracting or service-related activities to the state if the income is "derived from customers" within Maryland.[6] Minnesota sources income from services to the location where the services are "received."[7]

These rules are most easily applied when the customer is an individual who receives the service (or the benefit of the service) in the state of residence. For example, Maine sources income to the state if the services are received in the state; if the state in which the services are received cannot be determined, the services are deemed to be received at the customer's home address; if the customer's home address cannot be determined, the services are deemed to be received at the address to which the services are billed.[8]

It is often difficult to determine where the benefit of a service is 'received,' particularly if a customer is a business with locations in multiple states.

Other states focus on where the customer receives the benefit of the service. Georgia,[9] Iowa,[10] and Michigan[11] use this market-based approach. However, it is often difficult to determine where the benefit of a service is "received," particularly if a customer is a business with locations in multiple states or if the benefits from the service transcend operations in a single state. In such cases, many states, using variable assumptions, will attempt to proportionately distribute the receipts among all states in which the benefits are received.

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[3] Four states use a proportionate costs-of-performance method: Arkansas, Mississippi, North Carolina (services only), and South Carolina (services only). *See,* Ark. Code Ann. section 26-51-717; Miss. Reg. 35III.8.06(III)402.9(3)(d); N.C. Gen. Stat. section 105-130.4(1)(3); S.C. Code Ann. section 12-6-2295(A).

[4] *See* Model Apportionment Regulations, *available at* http://www.mtc.gov/Uniformity.aspx?id=496.

[5] Okla. Stat. 68 section 2358(A)(5).

[6] Md. Regs. Code section 03.04.03.08(C)(3)(c); Md. Regs. Code section 03.04.03.08(D)(3).

[7] Minn. Stat. section 290.191(5)(j).

[8] Maine Rev. Stat. Ann. Tit. 36 section 5211(16-A).

[9] Ga. Comp. R. & Regs. 560-7-7-.03(5)(c)(6)(ii).

[10] Iowa Admin. Code section 701—54.6(a).

[11] Mich. Comp. Laws section 208.1305(2)(a).

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Some states provide specific guidance to determine where the benefit of a service is "deemed" to be received.[12] For example, Ohio law states:

> The physical location where the purchaser ultimately uses or receives the benefit of what was purchased is paramount in determining the proportion of the benefit in Ohio.[13]

Wisconsin provides that the benefit of the service is received in Wisconsin for services relating to real property located in the state, for services relating to tangible personal property located in the state when the services are received, for services relating to tangible personal property delivered to customers in the state, for services provided to individuals physically present in the state when the services are received, and for services provided to a buyer engaged in a trade or business in the state that relate to that trade or business.[14]

Some states that may claim to apply a market-sourcing method actually source income from services that are 'performed' within their state.

Finally, it bears noting that some states that appear to apply a market-sourcing rule actually source income from services that are "performed" within their state. For example, Connecticut,[15] New Jersey,[16] Rhode Island,[17] and Texas[18] use that approach. This method more closely reflects the costs-of-performance method because it focuses on where the service provider's activities are being performed rather than on the location of the taxpayer's customers.

Intangibles

Determining the market associated with the use of intangibles is particularly difficult because intangibles generally have no geographical location or scope. The sourcing of income related to intangibles generally comes in two forms: the income from the licensing of intangibles (for example, royalties) and the income from the sale of intangible assets. Many states address those situations individually.

States differ greatly in how they source the gain or loss from the outright sale of an intangible asset. Some states, such as Connecticut, will source the receipt to the state from which the intangible asset is managed or controlled.[19] Texas sources income from the sale of an intangible asset to the location of the payer.[20] Wisconsin sources the income from the sale of an intangible asset to Wisconsin if the buyer uses the intangible in the regular course of business at a Wisconsin location, and will divide the income proportionately among states if the intangible is used at locations within and outside the state.[21]

For royalties or income earned from the licensing of an intangible, many states, including Connecticut and Georgia, source the income to the location where the intangible is used, based on the proportion of the use taking place within the state.[22] Some states address the determination of where the use takes place, and specify that the relevant use is that of the licensee rather than the licensor.[23] For example, Minnesota provides that an intangible is used in the state if the purchaser of the intangible property used the property in the regular course of its business operations in Minnesota.[24] Delaware provides more specific guidance, with a focus on the manufacturing state, stating that:

> Patent and copyright royalties (less applicable or related expenses) shall be allocated proportionately to the states in which the product or process protected by the patent is manufactured or used or in which the publication protected by the copyright is produced or printed.[25]

Finally, it should be noted that when sourcing income from intangibles to the state where they are used, some states, such as Minnesota,[26] will throw out the income if it cannot be determined where the intangible is used. Michigan, for purposes of the Michigan business tax, also has a throwout rule.[27] This type of provision acknowledges the difficulty inherent in sourcing income from the use of an intangible. Also, if a significant amount of royalty income is "thrown out" because it cannot be determined where the intangible is being used or what proportion of its use occurs in state, the result can be a sales factor that does not accurately reflect the extent of the taxpayer's in-state activity.

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[12] Ohio Rev. Code section 5733.05(B)(2)(c).
[13] *Id.*
[14] Wis. Stat. section 71.25(9)(dh).
[15] Conn. Gen. Stat. section 12-218(c)(3).
[16] N.J. Stat. Ann. section 54:10A-6(B)(4).
[17] R.I. Gen. Laws section 44-11-14(a)(2)(ii).
[18] 34 Texas Admin. Code section 3.557(e)(33).
[19] Conn. Gen. Stat. section 12-218(c)(3).
[20] 34 Texas Admin. Code section 3.557(e)(25)(B).
[21] Wis. Stat. section 71.25(9)(dk); Wis. Admin. Code Tax section 2.39(2)(cm).
[22] Conn. Gen. Stat. section 12-218(c)(3); Ga. Comp. R. & Regs. 560-7-7-.03(5)(c)(6)(viii).
[23] La. Rev. Stat. Ann. section 47:287.93(A)(3); La. Admin. Code section 61:I.1130(A)(3)(a); Maine Rev. Stat. Ann. Tit. 36 section 5211(16-B).
[24] Minn. Stat. section 290.191(5)(i).
[25] Del. Code Ann. Title 20 section 1903(b)(2).
[26] Minn. Stat. section 290.191(5)(i).
[27] Mich. Comp. Laws section 208.1305(1)(e).

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The Multistate Tax Commission's Proposal

The MTC on July 15 held its most recent meeting regarding revisions to Model Compact Art. IV.17 (Model Rule 17), which is the existing costs-of-performance rule. Under the most recent version of the draft rule, costs-of-performance is replaced with a rule that sources receipts from sales of services to the state "if and to the extent that the service is delivered to a location in the state," and will then use a reasonable approximation in the event that that location cannot be determined. Receipts from the sale, lease, or license of an intangible will be sourced to a state "if and to the extent the intangible property is used by the payor in this state," and will then use a reasonable approximation if the location of that use cannot be determined. The MTC rejected the option of using a cascading rule to determine how receipts are to be sourced under these provisions and remains committed to sourcing receipts to states on a proportional basis to the extent that the service is received or the intangible is used in multiple states. Moreover, the MTC intends to throw out receipts to the extent that those receipts would be sourced to a location where the taxpayer does not have nexus with the state or where the sourcing location is not determinable.

California's Market-Sourcing Approach

Effective in 2011, California Revenue and Taxation Code section 25136 will require taxpayers to source the following receipts to California:

> [s]ales from services . . . to the extent the purchaser of the service received the benefit of the service in this state, "[s]ales from intangible property . . . to the extent the property is used in this state," and sales of marketable securities "if the purchaser is in this state."

On July 19 the California Franchise Tax Board held its second interested parties meeting to receive comments on proposed Regulation 25136, which will interpret the new law. The proposed regulation provides a set of cascading rules that come into effect serially if the proper location cannot be determined under the prior rule.

To determine when the purchaser receives the benefit of a service, the proposed regulation differentiates between sales to individuals and sales to business entities. For individuals the benefit of the service is deemed to be received in the following order:

- according to the location set forth in the contract;
- according to the purchaser's billing address unless the taxpayer provides evidence showing that the service was not delivered to the billing address; or
- based on a "reasonable approximation."[28]

When the purchaser is a business entity, the benefit of the service is deemed to be received in the following order:

- according to the location set forth in the contract, based on a "reasonable approximation";
- according to the location where the purchaser placed the order for the service; or
- according to the purchaser's billing address.[29]

> ***To determine when the purchaser receives the benefit of a service, the proposed California regulation differentiates between sales to individuals and sales to business entities.***

When there has been a complete transfer and sale of intangible property rights, receipts are to be sourced in the following order:

- if the purchaser used the property in a single state, to the state where the purchaser exclusively used the property at the time of the purchase;
- based on the "extent of the purchaser's location in this state as compared to the purchaser's locations everywhere";
- based on a "reasonable approximation"; or
- according to the billing address of the purchaser.[30]

In contrast, the licensing, leasing, rental, or other use of intangible property is to be sourced in the following order:

- based on the extent to which the property is used in the state by the taxpayer's purchaser under the contract;
- based on the proportion of sales of tangible personal property sold by the taxpayer's purchasers in the state that gives rise to the receipts;
- based on a "reasonable approximation"; or
- according to the commercial domicile of the taxpayer's purchaser.[31]

Practical Concerns

As the above sections illustrate, there are many ways to determine market sourcing and little agreement about the best way to approach the issue. California's decision to use a cascading rule and the MTC's rejection of that approach is but one of the differences that market-sourcing states have. These

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[28]Proposed Cal. Reg. 25136(c)(1)(A).
[29]Proposed Cal. Reg. 25136(c)(1)(B).
[30]Proposed Cal. Reg. 25136(d)(1).
[31]Proposed Cal. Reg. 25136(d)(2).

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fundamental differences will undermine the goal of uniformity among states. Also, there are many common problems and practical issues with market-based sourcing rules for services and intangibles.

First, many complications arise because of the sheer breadth of those statutes. Unlike industry-specific rules, which take into account common business arrangements and provide taxpayers with clear guidance as to how specific types of receipts are to be sourced, market-sourcing rules applied to all sales "other than sales of tangible personal property" reach a broad range of taxpayers and transaction types. Thus, there is a tension between developing a rule that can be applied to "most" taxpayers while ensuring that the rule is applied in a consistent manner among similarly situated taxpayers.

Defining standard terms and concepts — such as what is meant by the delivery or receipt of a service (that is, does this refer to physical or contractual delivery or receipt?); what is meant by the "benefit" of a service; what constitutes a "use" of an intangible; and whether the "customer" refers to the taxpayer's customer or the ultimate consumer — will help to advance this objective. Because of the wide variety of taxpayers and transaction types, detailed examples will be necessary to demonstrate how a market-sourcing rule should be applied in different situations.

Fundamental differences among states over market sourcing will undermine the goal of uniformity.

Second, market-based sourcing rules are difficult to apply to taxpayers making sales of services or intangibles to multistate businesses. In many cases, if a multistate business purchases a service or licenses an intangible that benefits its business generally, there will be no clear state (or states) in which the service is received or intangible is used. Although the customer's billing address, commercial domicile, or principal place of business may provide a relatively easy answer to that question, sourcing receipts to a single location under those circumstances would create an arbitrary all-or-nothing result, not unlike the result reached using a preponderance-based costs-of-performance rule.

Many market-sourcing rules contemplate sourcing those receipts to more than one state; however, it is often unclear how those receipts should be distributed among various states. For example, should sourcing be based on the customer's locations, the customer's marketplace, or some other proxy? Under what circumstances should such receipts be thrown out of the taxpayer's sales factor numerator and denominator? And although throwout may enable taxpayers and taxing authorities to avoid such quandaries, it will do nothing to advance the cause of reflecting the contribution of the market to the taxpayers' income from services and intangibles.

Third, a market-based sourcing rule is particularly difficult to apply to the license of intangibles because it will often raise the question whether the taxpayer's customer or the ultimate consumer should be considered when determining the location of the use of the intangible. For example, suppose a taxpayer owns a patent to manufacture a widget. If the taxpayer licenses the patent to a manufacturer located in State A, and the manufacturer sells the finished product to a distributor located in State B, and the distributor sells to a retailer whose warehouses are located in states C and D, and then ultimately sells the product through stores located in E, F and G, how should income from the taxpayer's license of the patent be sourced? On the one hand, the taxpayer's customer — and thus the taxpayer's "true" market — is located in State B. On the other hand, the market for the patented product is located in states E, F, and G. At present, the MTC and California have proposed that the taxpayer should "look through" to the location of the ultimate consumers, rather than simply relying on the manufacturer's location in State B.

Using the location of the ultimate consumer raises many practical issues. Often it is true that a licensor/taxpayer will know where its licensee/manufacturer is entitled to use or distribute products, and may be able to negotiate the right to obtain that information from the licensee when it enters into the license agreement. However, when it sells its products to its distributor, the licensee/manufacturer may not know the specific states in which its products are ultimately sold, just as the distributor may not know the breakdown of sales among the retailers' various locations. When forced to source based on "downstream" sales, the question then becomes: Should the licensor/taxpayer use the last-known information (here, that the taxpayer/licensor has licensed products to the manufacturer/licensee located in State B) or should it use an approximation of the jurisdictions in which the products ultimately may be sold, based on population estimates? These policy decisions should be made and communicated by taxing jurisdictions in advance so that taxpayers source those receipts consistently.

Fourth, nearly all market-sourcing rules acknowledge these concerns and limitations by permitting the taxpayer, under some circumstances, to either move to the next prong of the cascading rule, to use a reasonable approximation, or to throw out the receipt when the appropriate location cannot be determined. Guidance must be provided to taxpayers regarding when it is appropriate to advance to the next alternative.

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California proposes to define "cannot be determined" to mean that "the taxpayer's records do not indicate where the benefit of the service was received or where the intangible property was used" and states that the FTB "shall consider the effort and expense required to obtain the necessary information." Despite assurances made by the FTB at the most recent interested parties meeting, auditors will likely apply those rules inconsistently. How those determinations ultimately play out during audits remains to be seen, particularly if the taxpayers and the FTB interpret core terms differently.

Finally, there is the question of what is meant by a "reasonable approximation." California has defined reasonable approximation to mean that "considering all sources of information, including publicly available information, the location of the market for the benefit of the services or the location of the use of the intangible property was determined in a manner that is consistent with the business of the purchaser." No doubt taxpayers and auditors will use different sources of information when answering sourcing questions and will have conflicting interpretations about how receipts should be sourced to be "consistent with the business of the purchaser."

The practical solutions that will be applied in a market-sourcing method will do no more than the costs-of-performance method to advance the reflection of the market in the sales factor.

In an example in California's proposed regulation, Accounting Corp. provides nationwide tax advice to Car Corp., which does business throughout the United States. The example first suggests that the taxpayer use the terms of the contract to determine how receipts from the accounting services should be sourced, and then suggests that if the contract does not break down the fees by state, the receipts should be reasonably approximated using available public information indicating the market of Car Corp. in the state. Needless to say, contracts of this type rarely address the locations benefited *and* the relative amount of the benefit to be allocated to each state in advance of an engagement, so reference to the contract is unlikely to be helpful. Similarly, Accounting Corp. should not have to search through vast amounts of publicly filed documents regarding Car Corp.'s presence in each state in order to source the appropriate percentage of receipts from this particular contract to individual states.

If a market-sourcing regime is to be successful, taxpayers attempting to comply with new market-sourcing rules need assurances that auditors will accept reasonable efforts, information, and approximations.

Conclusion

Although market sourcing is appealing in theory, it is far more complicated to source receipts from sales of services and intangibles in a principled way. States will thus have to balance the quest for accuracy against the practical realities of gathering and reporting this information. Ironically, the practical solutions that will be applied will do no more than the costs-of-performance method to advance the reflection of the market in the sales factor and are likely to create conflicts on audit. Such limitations should be acknowledged before states make the decision to move to market sourcing. ✰

Pilar Mata and Melissa J. Smith are associates with Sutherland Asbill & Brennan LLP's State and Local Tax Practice.

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