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STATE AND LOCAL TAX FORUM

Check Your Receipt: An Update on Sales Factor Apportionment Issues

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Agenda

- Cost of Performance Means Market, Right?
- Who is the Customer?
- What is an Income-Producing Activity?
- What's in Your Denominator?

Cost of Performance Means Market, Right?

Florida

Target Enterprise, Inc., v. Dep't of Revenue, Fla. Cir. Ct (2nd), No. 2021-CA-002158 (Nov. 22, 2022)

- The Florida 2nd Circuit Court ruled that the taxpayer, a Target corporation subsidiary ("TEI"), properly sourced its service revenue under the state's cost-of-performance ("COP") rule. The court rejected the Florida Department of Revenue's ("DOR") attempt to source such revenue based on a market-based-sourcing-like formula that considered the square footage of Target stores located in the state.
- TEI argued that it performed the relevant activities primarily in Minnesota and, accordingly, under the state's COP rule, that the costs to perform those activities were not incurred in Florida.
- The DOR argued that TEI failed to provide sufficient documentation to support the use of its COP under the administrative rule. Therefore, the department asserted that it was entitled to create a new method to source TEI's receipts under its alternative apportionment provisions.
- The court disagreed, finding that TEI provided sufficient evidence, as the most relevant costs of performing the services in this case were the payroll costs, which were overwhelmingly attributable to Minnesota, as demonstrated by the payroll cost information provided by TEI.
- Further, the court held that even if the DOR was entitled to use an alternative apportionment method, the method it used bore no relevant relationship to TEI's activities in the state because the method conflated TEI's business with that of Target. TEI is distinct legal entity separate and apart from Target.

Florida, cont.

Billmatrix Corp, et. al v. Florida Dep't. of Revenue, Fla. Cir. Ct (2nd), No. 2020 CA 000435 (Mar. 1, 2023)

- The Florida 2nd Circuit Court ruled that the Department incorrectly applied a market-based ("MBS") approach to source taxpayers' services income and determined that the Department's interpretations contradict the plain language of its sourcing regulation, which requires application of a cost of performance ("COP") methodology.
- Taxpayers consisted of related out-of-state corporations that provide financial technology services to businesses across the country.
- Taxpayers filed based on COP and the Department assessed based on MBS for 2015-2017. The Department did not disagree with Taxpayers' classification of the revenue streams at issue as service revenue includible in the "Other Sales" provision of the regulation, that requires sourcing based on COP.
- However, the Department viewed the "income producing activity" as the obligation to provide various services to their customers and determined that these activities occur entirely in Florida when the customer is located in Florida.
- The court viewed the Department's method as MBS rather than conforming to the "well-established COP method," and determined that the "plain language" of the COP Rule unambiguously requires the use of the COP method.

Pennsylvania

Synthes USA HQ, Inc. v. Commonwealth, 289 A.3d 846 (Pa. 2023)

- Prior to 2014, Pennsylvania law incorporated the former UDITPA service receipts sourcing provision, which applied costs of performance sourcing; the Pennsylvania legislature enacted explicit market-based sourcing provisions in 2014.
- The Department asserted during audits that taxpayers' income-producing activity occurred where the customer received the benefit of the service (a so-called "benefits-received method").
- Ultimately, the case became a dispute between the state attorney general, who agreed with the taxpayer, and the Department over the meaning of "income-producing activity."
- The Pennsylvania Supreme Court held that the Department's position was correct because the customer's location is where the service is fulfilled and the income produced; the 2014 legislation was simply a clarification, the court said.

Who is the Customer?

New York

In Matter of Jefferies Group LLC & Subs., DTAs Nos. 829218 and 829219 (Aug. 31, 2023)

The New York Division of Tax Appeals ("DTA") reversed determinations by the New York Division of Taxation ("Division") on various broker-dealer specific issues related to the taxpayer's corporate tax filings under Article 9-A.

- In doing so, the DTA:
  - Upheld the taxpayer's election under Tax Law former Section 208(7)(a) to treat cash on hand or on deposit (i.e., cash collateral used in connection with its securities lending transaction, interest rate swap transactions and its cash on deposit with a futures trading business) as investment capital and the resulting income as investment income;
  - Directed the Division to exercise its discretionary authority and use US Census data to source the taxpayer's receipts from, among other receipts, its brokerage commissions, principal transactions, margin interest, management and clearing fees to prevent the distortion caused by the application of the Division's sourcing method;
  - Found that application of the Division's sourcing method resulted in an unconstitutional distortion of the taxpayer's income that does not accurately reflect how the income is generated; and
  - Determined that the Division improperly disallowed a substantial portion of the taxpayer's claimed investment tax credits and employment incentive credits.

Ohio

Jones Apparel Group/Nine West Holdings v. McClain, Case Nos. 2020-53, 2020-54 (Ohio Bd. Tax App. Sept. 15, 2023)

- Held: Neither the statute nor the case law have imposed a requirement of contemporaneous knowledge of the ultimate destination at the time of transportation.
  - Commissioner had argued that the purchaser receives the property in Ohio when the last destination known by the taxpayer is located within Ohio.
  - Nine West, on the other hand, argued that it could show through additional evidence that the goods were ultimately received outside Ohio regardless of whether it knew of such a destination at the time the goods shipped.
- While Nine West *could* show that the goods were received outside of Ohio, the Board of Tax Appeals ("BTA") held that they did not do so here.
  - Sample of data used was outside of the refund period and failed to establish the goods shipped to Ohio during the tax period were ultimately received outside Ohio.
- BTA declined to rule on constitutional arguments raised by Nine West as it was outside of its authority to do so.

Texas

NuStar Energy, L.P. v. Hegar, No. 03-21-00669-CV (Tex. Ct. App., Dec. 21, 2023)

- A company that transports and stores crude oil argued that the Texas apportionment regulation was facially invalid because it was contrary to the underlying statute.
- The company asserted that the statute sources sales based on buyer's location and the regulation sources sales based on place of transfer.
- The Court of Appeals concluded that the statute was unambiguous and that its only reasonable construction was that the sales of tangible personal property are apportioned based on where the property is delivered/shipped, not where the buyer is ultimately located, even if the buyer is outside Texas.
- On September 27, 2024, the Texas Supreme Court requested briefs on the merits be filed no later than October 28, 2024.

Indiana

Express Scripts, Inc. v. Ind. Dep't of State Revenue, No. 19T-TA-00018 (Ind. Tax Ct. 2021)

- The Indiana Tax Court upheld a pharmacy benefit management company's sourcing of its receipts under Indiana's costs of performance rules for sales of services.
- The court rejected the Department's position that the receipts instead should have been sourced according to the rules for sales of tangible personal property.
- Based on the taxpayer's designated affidavits and contracts stating that its clients engage it and pay for the provision of services and that it does not purchase any drugs for resale or ever acquire possession or title of any drugs sold to its insurer client's members, the tax court found that the taxpayer properly apportioned its income as a service provider and granted summary judgment in favor of the taxpayer.

What is an Income-Producing Activity?

Indiana

Univ. of Phoenix, Inc. v. Ind. Dep't of State Revenue, 88 N.E.3d 805 (Ind. Tax Ct. 2023)

- The Indiana Tax Court held that the income-producing activities of the taxpayer, a provider of online educational services, consisted of (i) an eCampus platform, (ii) online classroom instruction, (iii) curriculum development, and (iv) a graduation team.

- The court rejected the Department's argument that the taxpayer's only income-producing activity was providing the opportunity to attend a class online in return for payment and an in-state resident agreeing to do so.

Maine

Express Scripts Inc. v. State Tax Assessor, 2023 Me. 68 (Nov. 27, 2023)

- Express Scripts requested a refund of taxes paid in 2011 based on application of the "market client basis" apportionment, arguing that:
  - The services were received at its clients' commercial and administrative headquarters, not at the location of the retail pharmacies where members filled prescriptions.
  - If the location where its services were received is not readily determinable, those receipts should be attributed to its clients' commercial and administrative headquarters because those were the locations from which its clients ordered the services.
- Under Section 5211(16-A)(A), income must be apportioned to the location where the service is received.
- Court held that:
  - The record repeatedly controverts Express Scripts' contention that clients are the recipients of its PBM services.
  - Express Scripts failed to point to specific facts that affirmatively show the existence of an authentic factual dispute to support their contention that the receipts at issue include charges for PBM services other than processing member claims at retail pharmacies.

South Carolina

MasterCard International Inc. v. S.C. Dep't of Revenue, Dkt. No. 20-ALJ-17-0008-CC (June 3, 2024)

- The case centered on South Carolina's income-producing activity test used to apportion receipts from services.
  - Taxpayer operates a network permitting cardholders to buy goods and services and withdraw money.
  - The DOR asserted that the taxpayer maintained, operated and regulated a network for cardholders in the state and thus should be taxed.
- The ALJ upheld the DOR's position, stating that the taxpayer's income-producing activity occurred in the state.
- The ALJ rejected the taxpayer's argument that its income-producing activities take place on out-of-state data centers.

South Carolina, cont.

U.S. Bank National Association v. S.C. Dep't of Revenue, Dkt. No. 20-ALJ-17-0168-CC (June 25, 2024)

- Taxpayer, a bank, earned income from a variety of sources including interest from mortgages and loans and interest and fees from credit cards.
- After an audit, the DOR issued an assessment, determining that the taxpayer should have sourced mortgage loan and credit card receipts to the state because it was intangible property.
    - The taxpayer argued that the receipts were from services and use should be sourced to where the income-producing activity occurs (in this case, outside of the state).
- The ALJ ruled in favor of the DOR, noting that intangible property is defined as all property other than tangible property and the definition of tangible property specifically excludes evidences of debt which was broad enough to include the receipts from mortgages.
    - The ALJ also found that the credit card receipts were accounts receivables that fell within the definition of intangible property.

What's in Your Denominator?

California

***In re Microsoft Corp. & Subsidiaries,* Cal. Office of Tax Appeals,** 21037336 (July 27, 2023) (Pet. for Rehearing denied Feb. 14, 2024)

- Microsoft Corporation and Subsidiaries filed a claim for refund for the taxable year ending June 30, 2018, arguing that the foreign dividends it deducted from income, per the authority of Revenue and Taxation Code section 24411, should be fully included in its sales factor.
  - Microsoft took the deduction under rules for treatment of dividends for taxpayers that have made a California water's edge election, which excludes foreign affiliates from their combined report.
  - The State argued that all or some of the dividends must be excluded from the sales factor because the company took a 75% California deduction for the proceeds.
- California OTA held that Microsoft was entitled to include 100 percent of its foreign dividends in its sales factor denominator, including the portion that qualified for a 75 percent deduction from income under California law.

Minnesota

E. I. DuPont de Nemours and Company & Subsidiaries v. Commissioner, Dkt. No. 9485-R (Minn. Tax Ct. June 24, 2024)

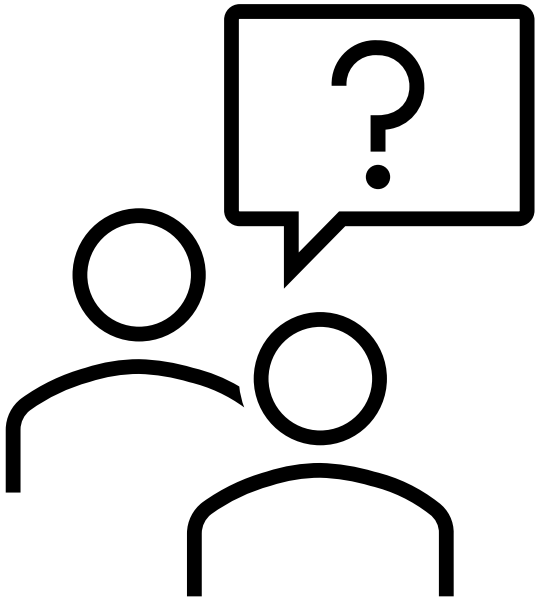
- Taxpayer, a science and technology company, bought and sold forward exchange contracts to offset its foreign currency exchange exposure.
  - For the relevant tax years, the net income from these contracts was $60M, $650M, and $408M. However, the gross receipts were roughly $65B for two years and $50B for the third.
- The Commissioner sought to apply an alternative apportionment method that included the net income from the contracts but not the gross receipts in the sales factor denominator.
- The Tax Court agreed, stating that “including [the contract’s] gross receipts in the calculation of the general apportionment factor does not accurately show to a full degree or extent, DuPont's income arising from its taxable business activities in Minnesota.”

Texas

Conagra Brands, Inc. v. Hegar, Dkt. No. 03-21-00111-CV (Tex. Ct. App., Aug. 24, 2022)

- The Texas Court of Appeals ruled that a packaged food company may only include the net proceeds from its sale of non-inventory securities, not the gross proceeds, in its franchise tax apportionment factor denominator.
- Conagra bought and sold commodity futures contracts and options to manage risk associated with price fluctuations in the materials it purchased and sought to include the gross proceeds of those securities in its apportionment factor denominator.
- Conagra identified the transactions as hedging transactions for federal income tax purposes.
- The gross proceeds of securities held for inventory are includible in the franchise tax apportionment factor denominator under Tex. Tax Code § 171.106(f).
- The court rejected Conagra's position that the securities were inventory, finding that they were not held as inventory for federal income tax purposes and the securities were not purchased or sold to customers in the ordinary course of Conagra's business.

Questions



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