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STATE AND LOCAL TAX FORUM

VANDERBILT UNIVERSITY LAW SCHOOL

Market-Based Sourcing, the Continuing Conundrum

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Agenda

1. Historical Perspective: Cost-of-Performance Sourcing
2. Shift to Market-Based Sourcing
3. Sourcing Receipts from Intangible Property
4. Sourcing Receipts from Services
5. Problems with Reasonable Approximation
6. MTC Narrow Receipts Definition
7. Common Market-Based Sourcing Audit Issues
8. Developing a Multistate Strategy

Historical Perspective: Cost-of-Performance Sourcing

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Sourcing Methodologies Employed by States & Localities

- Greater Cost of Performance (COP)
 - All-or-nothing; place of production
 - Origin focused (labor and capital)
- Proportionate COP/Relative Value
 - Proportionate cost basis; split among places of production
 - Origin focused (labor and capital)
- Market-Based Method
 - Location of customer; non-cost based
 - Destination focused (sales)
 - What's the market?

Cost of Performance Basics

4 key questions when applying COP statutes and regulations:

- What are the particular items of income (i.e., revenue streams)?
- What are the income-producing activities associated with the particular items of income?
 - Are the income-producing activities located in more than one state?
- What are the direct costs incurred by the taxpayer in providing these income producing activities?
- Where are these direct costs incurred?

Problems with Cost of Performance Methodology

- Typically, “all-or-nothing” approach
- Complexity of determining source of receipts from income-producing activities located in more than one state
- Administrative burden to determine COP
- Inconsistent with purpose of sales factor – COP does not attribute revenue to the “market” that contributes to the taxpayer’s income
- Untenable for certain industries (e.g., publishers, airlines, telecom companies)

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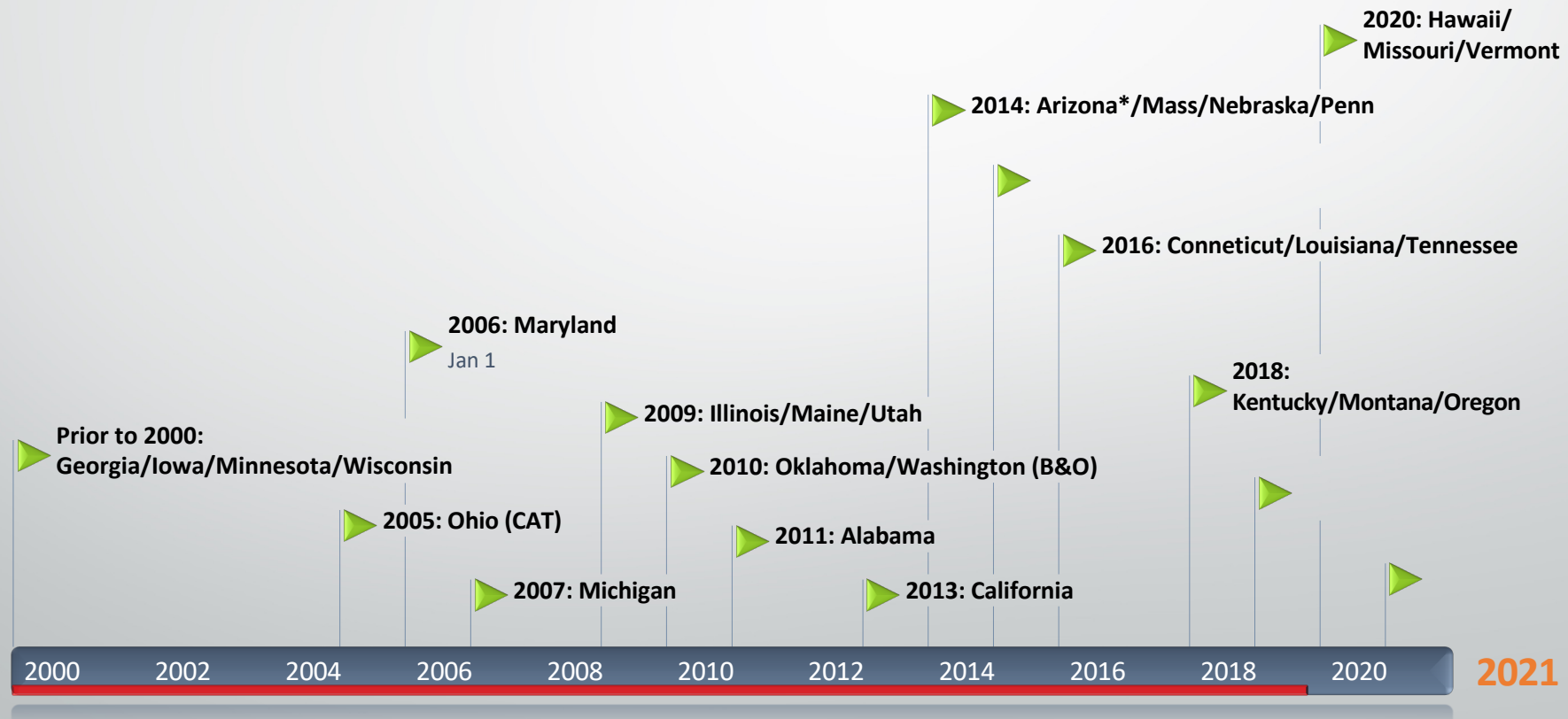
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Shift to Market-Based Sourcing

Market-Based Sourcing Adoption Timeline

- Over 34 jurisdictions have adopted market-based sourcing, 22 since 2014.



What is market-based sourcing?

- States approaches to interpreting the “market” can vary

“Market” for intangibles

- Location where the intangible is used
- Location of primary use
- Location of customer’s commercial domicile
- Location of owner’s domicile

“Market” for Services

- Location where the service is received or used
- Location where the benefit of the service is received
- Location where the service is delivered or performed
- Location where the customer is located

“Look- through” approach

- Based on location of the customer’s customer

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Sourcing Receipts from Intangible Property

Sourcing Receipts from Intangibles: General Rules

- Sales from intangible property are in this state to the extent the property is used in this state (CA)
- Place of utilization or customer commercial domicile (CO)
- Primary use location (NY)
- Taxable situs of intangible (commercial domicile of owner) (NJ)
- If property is used in the state (MTC Model Regs.)

Sourcing Receipts from Intangibles: Marketing vs. Non-Marketing Intangibles

- Many states distinguish between receipts from a “marketing intangible” versus a “non-marketing intangible.” For example, in California these terms are defined by CCR§25136-2(b)(4)(A)-(B) as:
 - A “marketing intangible” includes, but is not limited to, the license of a copyright, service mark, trademark, or trade name where the value lies predominantly in the marketing of the intangible property in connection with goods, services or other items.
 - A “non-marketing and manufacturing intangible” includes, but is not limited to, the license of a patent, a copyright, or trade secret to be used in a manufacturing or other non-marketing process, where the value of the intangible property lies predominately in its use in such process.
- Who is the customer? When is a “look through” approach required?
 - The rules for marketing intangibles generally look to the location of the ultimate customer. See CCR §25136-2(d)(2)(A).
 - The rules for non-marketing and manufacturing intangibles generally look to the location of direct customer use of the intangible property. See CCR§25136-2(d)(2)(B).

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Sourcing Receipts from Services

Sourcing Receipts from Services: General Rules

- Sales from services are in this state to the extent the purchaser of the service received the benefit of the services in this state (CA)
- Delivery to a location in this state (AL, CO)
- If the customer receives the benefit of the service in state (GA, NY hierarchy (1))
- If the market for the service is in this state. The taxpayer's market for services is in state if the service is used at a location in the state (CT)
- If the services are received in this state (IL, IN)
- If and to the extent the service is delivered to a location in this state (MTC Model Regs.)

Sourcing Receipts from Services: Where Is the Benefit Received?

- Generally, the benefit is received at the customer's location
- Who should be considered the customer or purchaser of record?
- 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
- How far and when does the taxpayer look through its customer to its customer's customer and beyond in order to find the "market"?
 - Should there be a "look through" to the ultimate customer or beneficiary?

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Problems with Reasonable Approximation

Reasonable Approximation

- Hierarchy of reasonable approximation rule in states' and the MTC's market-based sourcing cascading rules
- Purpose of reasonable approximation rule
- Broad purpose vs. narrow application in practice
- Rigidity in states' approach to reasonable approximation
- Consistency requirements
- Burden of proof issues

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MTC Narrow Receipts Definition

MTC Art. IV.1(g) – Narrowed Receipts Factor

- “Receipts” means all gross receipts of the taxpayer that are not allocated under paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer’s trade or business; except that receipts of a taxpayer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded
- The exclusion for transactions not in the regular course of trade/business is significantly different than items that previously would have been considered nonbusiness income
- Receipts from lending, hedging, and security transactions are excluded – even if they comprise the majority of the taxpayer’s regular trade/business
- MTC REG. IV.18.(c) provides a special rule to determine the receipts factor if the taxpayer’s receipts are less than 3.33 percent of the taxpayer’s gross receipts

Significant Impact on Financial Organizations

- Excluding from the receipts factor interest on lending and receipts on investments and trading that are part of the taxpayer's regular trade or business is perplexing for the financial service industry and the industry segment with the greatest potential for apportionment incongruity are bank holding companies and their subsidiaries
- The "financial institution" definition under MTC's Formula for the Apportionment and Allocation of the Net Income of Financial Institutions Model Statute includes bank holding companies and corporations that are directly or indirectly more than 50% owned by a bank holding company (i.e., the broad definition of financial institution)
- Under the MTC financial institution apportionment provision, interest from lending, as well as receipts from security and hedging transactions, are included in the receipts factor
- MTC Reg. IV.18. (k) – Bank Holding Companies & Subsidiaries provides that "[f]or any corporation or other business entity registered under state law as a bank holding company or registered under the Federal Bank Holding Company Act of 1956, as amended, or registered as a savings and loan holding company under the Federal National Housing Act, as amended, and any entity more than 50 percent owned [directly or indirectly] by such holding companies, receipts are included in the receipts factor denominator and assigned to the receipts factor numerator in this state to the extent those receipts would be included in the denominator and assigned to this state under the MTC's 17 Formula for the Apportionment and Allocation of the Net Income of Financial Institutions Model Statute 18 (as adopted July 29, 2015)."
 - If entity does not fall under the definition of a bank or is not owned by a Bank Holding Co. or the state doesn't have special financial organization apportionment provisions, interest on lending and security and investment receipts are excluded

Adoption of Narrowly Defined Receipts

- Significant audit risk
 - When auditors see that a large percentage of taxpayers' receipts are excluded from the receipts factor, audit time and scrutiny will be increased
 - Will auditors want to pick and choose receipts to include in the calculation to increase percentage attributable to their states?
- Request for alternative apportionment may be a good route for some taxpayers
- Colorado - tax years beginning after 2018
- Kentucky - tax years beginning after 2017
 - Bank Holding Company & Subs provision adopted
 - Proposed amended 103 KAR 16:270 would adopt the MTC model financial organization apportionment provisions with the broad definition

Adoption of Narrowly Defined Receipts

- Missouri - tax years beginning after 2019
 - Draft regs effective for 2021 would adopt a modified version of the MTC model financial organization apportionment provisions with a limited definition
 - According to DOR, for 2020 tax year the specified receipts must be excluded
- Montana - January 1, 2018
- Oregon - tax years beginning after 2017
 - Specifically provides that narrow definition does NOT apply to taxpayers that apportion their income under ORS 314.280 (financial institutions)
- Vermont - tax years beginning after 2019
 - Proposed amended Reg. §1.5833 would adopt the MTC model financial organization apportionment provisions with the broad definition

Electricity Producers

- Colorado is the first state to address the need to adjust the narrow receipts factor for electricity producers
 - Draft Special Rule 9A. Apportionment of Income for Electricity Producers would prescribe the inclusion of certain receipts of electricity producers from hedging transactions in the receipts factor

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Common Market- Based Sourcing Audit Issues

Common Market-Based Sourcing Audit Issues

1. Who is the customer?
2. What are you selling (service, intangible, mixed sales)?
3. Does look-through sourcing apply?
4. When to apply reasonable approximation and whose approximation is more reasonable?
5. Location of “use” cannot be determined for intangibles, including sales of software.
6. Disagreement on what to do when benefits of service to customer are received in multiple states – little to no guidance on proportionate versus “all-or-nothing” sourcing.

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Developing a Multistate Strategy

Developing a Multistate Strategy

- Imperative to address early in the audit process
 - Need a strategy that comprehensively analyzes available company sales data and customer information with state MBS rules
 - Prioritize jurisdictions
 - Analyze for conflicts with COP states
- State information sharing has increased the likelihood of multiple state assessments
 - MTC is auditing and submitting for assessment tax challenges on a multistate basis
 - States routinely share audit information

Developing a Multistate Strategy (cont.)

- Coordination with company's indirect and federal tax audit/compliance teams is imperative
 - How are the sales in question being treated for sales/use and federal tax purposes? Examine for inconsistencies and similarities.
 - Oversimplified responses in federal or indirect tax audits can be problematic for income tax apportionment purposes
- Company tax audit/compliance groups should consult regarding disclosure of information and documentation
 - Disclosure to IRS or another jurisdiction will waive attorney-client privilege protection
 - State tax audit group may not be aware of potential federal tax issues/consequences

Thank you!
Questions?

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