

Market-Based Sourcing – Looking Through the Looking Glass

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Agenda

- Market-Based Sourcing Overview
- Apportionment Methods
- Illustrative Cases and War Stories
- Best Practices
- Final Thoughts

Market-Based Sourcing Overview

- The goal of apportionment is to compute the percentage of total income attributable to a particular state.
 - State statutes:
 - Establish methods for apportionment of apportionable income.
 - Can apportion less than Constitutionally permitted but cannot apportion more than Constitutionally permitted.
 - Constitutional backstops: (1) states cannot tax out-of-state income or activity; and (2) apportionment must be fair, must not be distortive of the in-state activity, and must not discriminate.

Market-Based Sourcing Overview

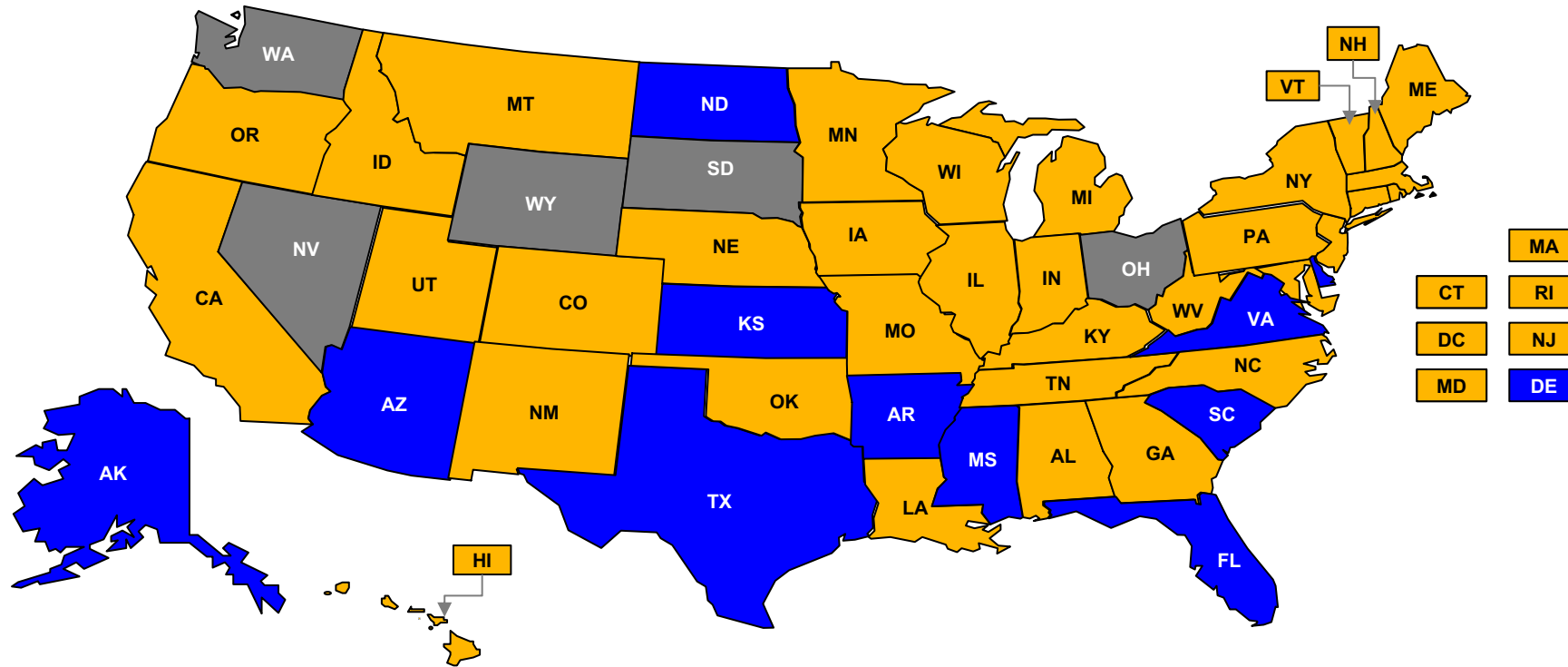
- Historically, Costs of Performance was used to sourced sales of other than TPP. Regulation and litigation provided established analytical frameworks.
- The pre-2014 Multistate Tax Compact (MTC) Article IV apportionment provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA) sourced sales of other than TPP based on the COP method.
- Over the next several years, the MTC proposed methodology shifted from COP to market-based sourcing for sales of other than sales of TPP and many states started adopting a market-based method.

MTC Current Model Regulation
Article IV, Section 17

- The Compact’s market-based sourcing rules provide that “[s]ales, other than sales of tangible personal property...are in this State if the taxpayer’s market for the sale is in this state.”
- “The taxpayer’s market for sales is in this state: ... in the case of sale of a service, if and to the extent the service is delivered to a location in this state. ...” Section 17 of UDITPA.

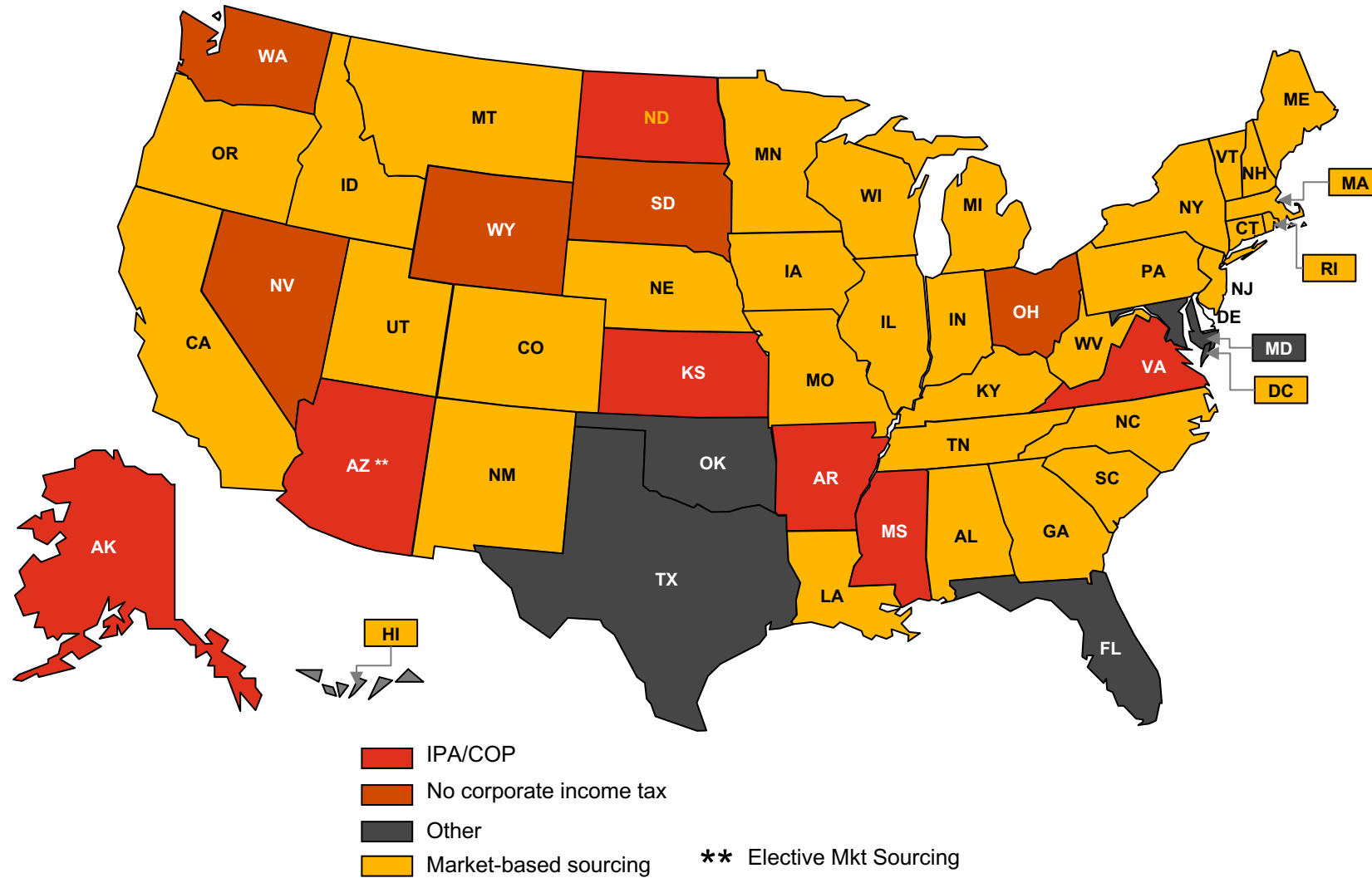
- Some states adopted model regulation.
 - *See, e.g.*, KY, MA (previous adoption), OR, RI, TN, VT, WV
- Market-based sourcing is easy to say, hard to do, and is not uniform

Market Based Sourcing (Services) **Enacted**



- Market Based Sourcing for Services
- Cost of Performance/Other Sourcing
- No corporate income tax
- * Does not address elections

Sourcing Receipts from Intangibles



MTC Model Regulation

Article IV, Section 17

Some issues to address in applying market sourcing under the model regulation:

- What is the service being delivered?
- Classification of the service –
 - In person services
 - Professional services
 - Electronically delivered service
 - How to define when taxpayer's services is a mixture of the above?
- Who is the customer –
 - Individual or Business

Apportionment Methods – Market-Based Sourcing

- Market-based sourcing rules can vary widely across states.
- Where is the “market” for services?
 - Where service received
 - Where benefit of service received
 - Where service delivered
 - Where customer located
- Cascading rules
- “Reasonable approximation”

Under Reg. 25136-2, the benefit of a service is received in California when “the taxpayer’s customer has either directly or indirectly received value from delivery of that service” in the state.

- California Chief Counsel Ruling 2017-01: Services were outsourced administrative services that should be sourced to where the customer would have otherwise performed the services itself (customer’s location).
- FTB issued Legal Ruling 2022-01 (March 2022), which retroactively revoked Chief Counsel Ruling 2017-01: Two examples in the ruling concluded that under those hypotheticals the FTB’s view is that the benefit is received at the location of the taxpayer’s customer’s customer.

- FTB’s formal rulemaking to amend the market-based sourcing regulations
 - No movement yet (6 years in the making);
 - Changes may still be made during the rulemaking process.
- The draft amendments change definitions of key terms and modify sourcing rules to “simplify” rules for sourcing services.

California – Office of Tax Appeals

In the Matter of the Appeal of Janus Capital Group and Subsidiaries, California Office of Tax Appeals, No. 20096605 (7/22/23)

- The Office of Tax Appeals concluded that a mutual fund service provider is required to source its receipts to the location of the funds shareholders and not to the location of the funds themselves, pursuant to Cal. Reg. Sec. 25137-14. “
- The OTA noted that the FTB promulgated another regulation (Sec. 25136-2(g)(3)), which provides that the look through approach of 25137-14 applies to mutual fund service providers despite the later amendment to 25136, which established the purchaser of the service rule.
- The OTA concluded that (1) the FTB properly invoked its rule making authority to cure distortion in relation to the mutual fund service provider industry by promulgating regulation 25137-14 and (2) once a special apportionment regulation is promulgated, that formula becomes the standard unless the party seeking to deviate it shows distortion.
- The taxpayer provided no evidence that its apportionment percentage should have been calculated differently.

Florida – Circuit Court

Billmatrix Corp., et al. v. Florida Department of Revenue, Fla.Cir.Ct (2nd) No. 2020-CA-000435 (3/1/23)

- A Florida circuit court ruled that the Department of Revenue erroneously applied a market-based approach to sourcing taxpayers' service income.
- The court determined that the Department's interpretations contradict the plain language of its sourcing regulation, which requires application of a cost of performance methodology.
- Additionally, the court found that the Department's inconsistent interpretation of its own regulations violates Florida's Taxpayer Bill of Rights.

Florida – Circuit Court

**Target Enterprise Inc. v. Director of Revenue, Fla. Cir. Ct. (2nd) No. 2021-CA-0002158
(11/22/22)**

- A Florida circuit court ruled that the taxpayer (a Target corporation subsidiary) properly sourced its service revenue under the state’s cost-of-performance (COP) rule.
- The court rejected the Department of Revenue’s attempt to source such revenue based on a formula that considered the square footage of Target stores located in the state.
- The court rejected the Department’s assertion of alternative apportionment due to the taxpayer’s purported lack of documentary support.
- In supporting the taxpayer’s use of COP, the court stated that “[f]or provision of the services at issue, the most relevant cost of performance is payroll” and that “the best evidence of the costs to perform these services” was the taxpayer’s apportionment workpapers.

Maine – Business Court

**Express Scripts, Inc. v. Assessor, Me. Bus. Ct. No. BCD-ACP-2019-00003
(1/18/23); oral arguments held, Me. S. Ct., 9/12/23**

- At issue was the proper sourcing of Express Scripts’ revenue from claims adjudication and other pharmacy benefit management services
- “Receipts from the performance of services must be attributed to the state where the services are received.”
- Question whether receipts were generated from multiple (bundled) services or from delivery of drugs to customers’ members
- Argument on appeal that Express Scripts’ receipts should be sourced to the commercial and administrative headquarters of its business customers

New York – Division of Tax Appeals

In the Matter of The Petition of Jefferies Group, LLC & Subsidiaries, , N.Y. Division of Tax Appeals, Nos. 829218, 829219 (8/31/23)

- A New York administrative law judge directed the Division of Taxation to use its discretionary authority to adjust a taxpayer's sourcing of receipts derived from brokerage commissions and other financial transactions and to use a census-based formula because the statutory formula yielded a distorted and unconstitutional result.
- The ALJ also rejected the division's disallowance of the taxpayer's
 - election to treat cash collateral and cash on hand as investment capital
 - claimed investment tax credit and employee investment credit related to various property used by a broker-dealer subsidiary operating in New York City.

New York – Proposed regulations

SubPart 4-1, proposed regulation issued 8/9/23

- Proposed regulations provide that if the required information for determining the sourcing location of digital services is not readily available, a taxpayer must make reasonable inquiries to its business customers. When 250 business customers purchase substantially similar digital products or digital services and no more than 5% of such receipts are from a particular customer, then the primary use location of the digital product or digital service is presumed to be the customer's billing address.
- Proposal (1) eliminates a pre-reform policy that excludes receipts from sales of real, personal, and intangible property that arise from "unusual events", (2) omits guidance from an earlier draft that treated cryptocurrency as a digital product and provided sourcing rules for cryptocurrency receipts; (3) provides that the location where the value of goodwill is accumulated is to be determined using a three-year average of the BAF or other percentage used to apportion or allocate the income to New York of the entity that is sold; (4) provides that a taxpayer must receive permission from the Department prior to the deadline for filing its original return to deviate from the statutory apportionment formula.

Ohio – Supreme Court

Nascar Holdings, Inc. v. McClain

Ohio Supreme Court, No. 2022-OHIO-4131 (11/22/22)

- The Ohio Supreme Court found that a taxpayer’s receipts from granting the “right to use” intangible property were measured based on whether agreements based such right to use property specifically within Ohio.
- The agreements conveyed such use to large geographic areas—most often the United States and its territories—that include Ohio, but they did not specifically reference Ohio.
- Accordingly, the Court found that revenue relating to such intangible property was not situated to Ohio and, therefore, not subject to the Commercial Activity Tax (CAT).

Ohio – Supreme Court

Defender Security Co. v. McClain

162 Ohio St. 3d 473 (Ohio Sept. 29, 2020).

- Who is the customer?
- First major sourcing case in history of Ohio CAT
- Catch-all provision for “gross receipts not otherwise situated:
Purchaser’s benefit in OH / Purchaser’s Benefit everywhere
- Lower levels: Look through to ADT’s Ohio customers’ locations

Ohio – Supreme Court

- Defender Ohio Supreme Court:
 - Physical location where purchaser ultimately uses or receives benefit (i.e., where ADT used or received benefits of contract rights; not where it fulfilled the contracts)
 - Location was at ADT facilities; not customer location

Pennsylvania – Supreme Court

Synthes USA HQ, Inc. v. Commonwealth of Pennsylvania, Pa. Sup. Ct., No. 11 MAP 2012 (2/22/23)

- The Pennsylvania Supreme Court ruled that service revenue for pre-2014 tax years is sourced based on a benefit-received method rather than a costs of performance method.
- The Court noted that:
 - there exists a legislative intent to measure the sales factor by a customer’s activity of buying a good, service, or other product
 - the state’s 2013 statutory amendments incorporating market-based sourcing did not alter the general framework for sourcing sales, but rather clarified the sourcing of service revenue to the point of delivery to the consumer and acquiesced to the Department of Revenue’s policy
 - applying the benefit-received method provides continuity for taxpayers as the Department’s consistent application of destination sourcing for similarly situated taxpayers prior to 2014 will continue for taxpayers in 2014 and after.

Note: For tax years prior to 2014, Pennsylvania required that service revenue be sourced to where the greater proportion of income-producing activity is performed, based on costs of performance

Pennsylvania - Legislation

H.B. 1342 (Act 53), signed 07/8/22

- Applicable to tax years beginning after December 31, 2022, legislation repeals costs of performance for intangible income and generally applies the following sourcing rules:
 - *Lease or license of intangible property*: Gross receipts are sourced to Pennsylvania “if and to the extent the property is used” there.
 - *Sale of intangible property involving activity in a specified geographic area*: Gross receipts are sourced to Pennsylvania “if and to the extent the property is used in or otherwise associated with” the state.
 - *Sale, redemption, maturity, or exchange of securities*: If the securities are held by the taxpayer primarily for sale to customers in the ordinary course of business, gross receipts are sourced to customer location.
 - *Interest, fees, penalties from credit card receivables*: Gross receipts are sourced to cardholder billing address.

Pennsylvania – Legislation (cont'd)

H.B. 1342 (Act 53), signed 07/8/22

- Applicable to tax years beginning after December 31, 2022,
 - *Interest, fees, penalties from unaffiliated entities or individuals*: For interest, fees, and penalties received by a taxpayer that regularly lends funds to unaffiliated entities or individuals.
 - *Generally, if the loan is secured by real property*: gross receipts are sourced to the location of the real property.
 - *Generally, if the loan is secured by tangible personal property*: gross receipts are sourced to the state where the property is delivered or shipped to a purchaser.
 - *For all other loans to unaffiliated entities or to individuals not described above*: gross receipts are sourced to location of the borrower.
 - Gross receipts from interest not otherwise described in the statute are sourced to the lender's commercial domicile.
 - Gross receipts from intangible property not otherwise described in the statute are excluded from the numerator and denominator of the sales factor.

Texas – Supreme Court & Court of Appeals

Sirius XM Radio, Inc. v. Hegar, Tx. Sup. Ct. No. 20-0462 (3/25/22); 3rd Dist. App. Ct., No. 03-18-00573-CV (11/14/22)

- The Texas Supreme Court held that receipts received for Sirius XM’s radio satellite services are sourced to where services are performed rather than to where services are received.
- Texas law provides that service revenue is sourced to where services are “performed.”
- The Comptroller argued that such performance is located where the “end-product act” occurs, which is at the location of the customer where the radio signal is decrypted.
- The Court disagreed and found that the performance of the service is located where the taxpayer’s personnel or equipment is physically doing useful work for the customer.
- The case was remanded to the appellate court for proceedings consistent with the Court’s decision.
- **Update:** On November 14, 2022, the appellate court on remand held that Sirius XM’s costs-of-performance analysis was sufficient to support a determination regarding the location of the “fair value” of its services.
- The absence of cost-of-performance language in Texas law does not preclude taxpayers from using such an approach to support the location of “fair value.”

Texas - Regulation

34 TAC §3.591(e); 48 Tex. Reg. 10 (3/10/23)

- On March 10, Texas amended rule 3.591(e)(26), removing references to the “receipts-producing, end-product act” to determine the location of where a service is performed for sourcing purposes.
- The Comptroller states that the amended rule interprets the Supreme Court’s phrase in the *Sirius XM* decision “useful work for the customer” to mean “work that the customer hired the taxable entity to perform,” and that the phrase does not include “activities that enable the taxable entity to do business in general or are not directly used in the provision of a service to the customer.”
- The amended rule adds the following language: “a service is performed at the location or locations where the taxable entity's personnel or property are doing the work that the customer hired the taxable entity to perform. Activities that are not directly used to provide a service are not relevant when determining the location where a taxable entity performs a service.”

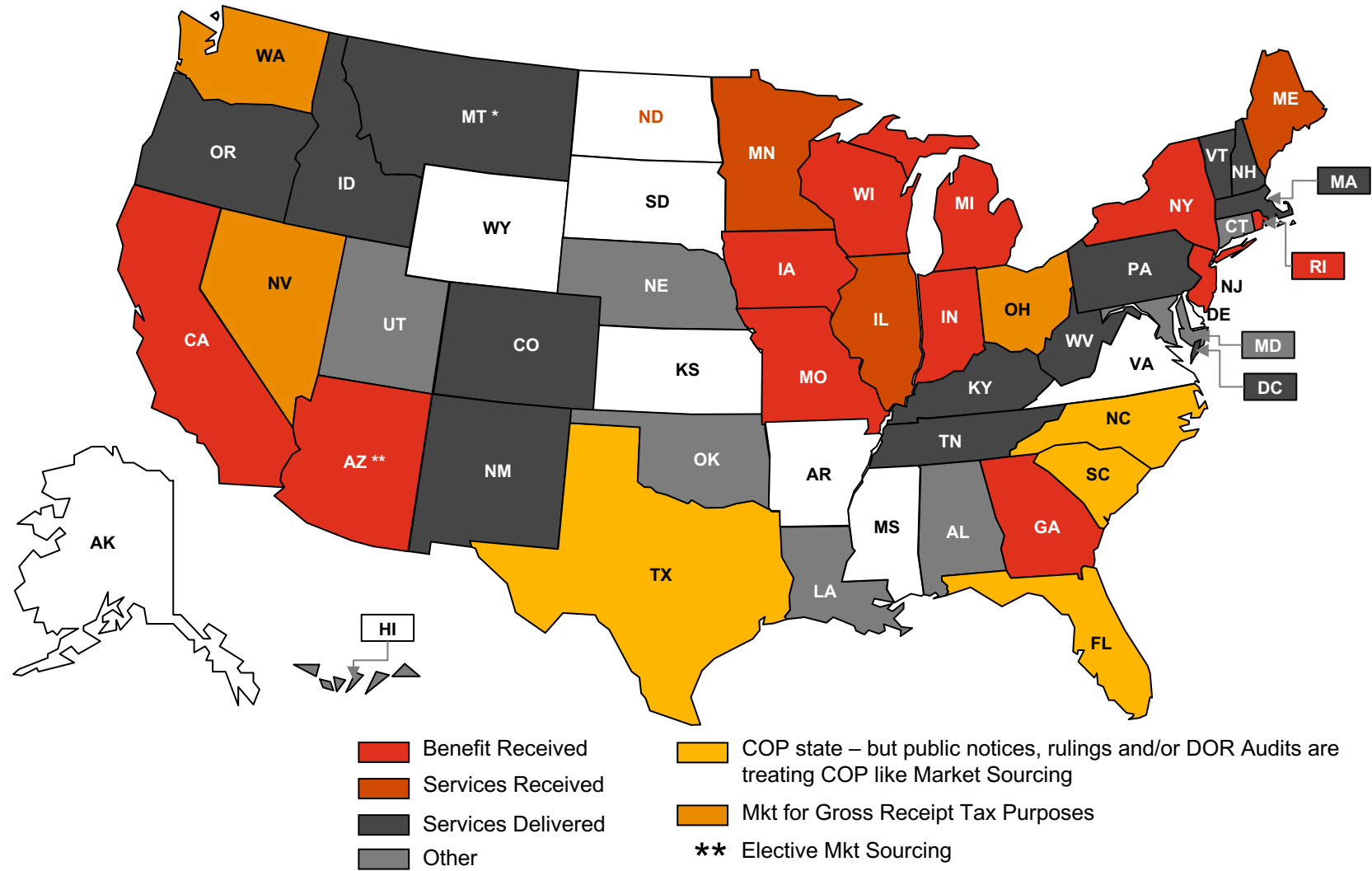
Washington - LendingTree

- *LendingTree, LLC v. State of Wash, Dep't of Revenue*, 460 P.3d 640 (Wash. Ct. App. Mar. 30, 2020).
- Lenders paid Lending Tree for referrals to prospective borrowers.
- Lending Tree sourced its receipts to the location of its clients (the lenders) because the business activity related to Lending Tree's service was the lender's receipt and evaluation of the lending referrals – which occurred at their respective business locations.
- The Department argued that the benefit was actually received at the location of the prospective borrower.
- Washington Court of Appeals disagreed, finding that the benefit of Lending Tree's service was received at the lender's business locations, not the location of the prospective borrowers.

Technical Challenges

- Not all market-based sourcing rules are the same. States have adopted variations of market-based sourcing rules that differ in how they define what a taxpayer’s “market” entails, including:
 - Where the service is received
 - Where the purchaser receives the benefit of the service
 - Where the service is delivered
 - The location of the customer
- Traditional cost of performance states are applying a “transactional” approach to the sourcing of service receipts
- The methodology for sourcing of receipts has become the real nexus test for many taxpayer’s in many states

Service Sourcing – Vagaries of Market-Based Sourcing



Practical Questions

- Is sourcing based on billing address a reasonable proxy for the taxpayer's facts and circumstances?
- How readily available is customer information in the taxpayer's books and records?
- Is publicly-available information such as census or population a reasonable approximation?
- Is look-through sourcing reasonable?
- What does the "market" mean for different industries?
- How should intercompany service fees be determined pursuant to market sourcing provisions?
- Should alternative apportionment approaches be considered?
- What are the pros/cons of reporting sourcing positions on originally filed returns vs refund claims?

War Stories

Not Yet Covered and Considerations

- Data may be more readily available than believed (i.e., work with IT)
- Is there an opportunity to clarify the service being provided to the customer in the contract?
- Evaluate publicly available data if look-through sourcing is employed
- Consider pursuing a ruling or other guidance from the state regarding reasonable sourcing methodologies
- Perform a risk assessment analysis

Questions? Thank you.

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