

# States Move to Market-Based Sourcing; Sky Does Not Fall

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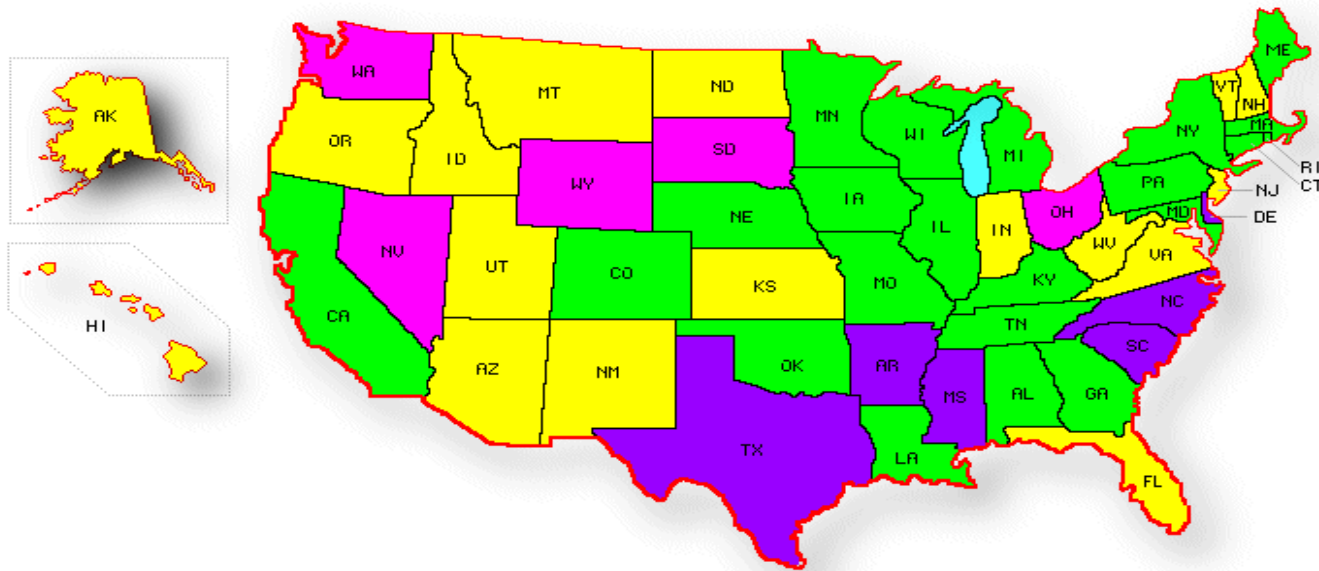
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\*for identification purposes only. The opinions expressed are those of the authors and not necessarily their employers

# Market Based Sourcing is Here:

**Green: Market-based; Yellow: COP; Purple: place of performance/apportioned; Pink: N/A**



# What is Market-Based Sourcing?

- Receipts “ (“Sales”) Factor for services and intangible property sourced to marketplace, not location of “cost of performance.”
- Conforms apportionment rules to historic treatment of receipts from sales of tangible personal property: the “destination” rule;
- Two basic models:
  - (a) where benefit received;
  - (b) where service is “delivered;”

# UDITPA's Sales Sourcing Rules

- UDITPA Section 17 applies to all receipts except receipts arising from **sales** of TPP: services, leases, licenses, intangibles and real property sales
- Sourced according to location of “income-producing activity as measured by cost of performance.”
- UDITPA originally excluded banks, insurance and utilities from coverage, assuming they would be subject to regulation of profits; drafters assumed most other services would be performed locally and thus reflect marketplace.

# UDITPA's Rules for Assigning Receipts from Services and Intangibles

For interstate services, UDITPA provided for “**all or nothing**” approach, sourcing receipts to particular state with greatest income-producing activity.

## *What were they thinking?*

1. It was assumed predominant “cost of performance” would be in market state.
2. Administrative convenience—avoid disputes over office overhead, etc.
3. It was getting late in the day—some hints of impatience to be finished among the old guys.



# The assumptions underlying UDITPA's Section 17 proved faulty:

Service economy grew rapidly; Intangible property became more valuable;

States did not adopt special rules for interstate utilities, banks or broadcasters as expected;

Move to single sales factor made sales sourcing more important;

Creation of Intangible Holding Companies demonstrated that intangibles could be isolated from sale of TPP and services, yet COP hard to locate.

# The Limitations of Costs of Performance Sourcing Quickly Became Evident

- Is it tangible personal property, a service, an intangible, or something else?
  - *Equifax v. Mississippi* (Ms. 2011) credit report delivered by fax or internet
  - Software downloads
- Where is the cost of performance for licensing intangible property?
- What about the use of independent contractors?
  - *Bellsouth Advertising v. Chumley*, 308 S.W.3d 510 (2009)

## States Respond with Alternative Apportionment Regulations and Ad Hoc Variances

1973: MTC adopts model “General Apportionment Regulation” seeking to limit “all of nothing” sourcing results;

- **Thus:** “each aspect of a service constitutes a distinct and separate income-producing activity.”
- **Thus:** “location of income-producing activity... for [exploitation of intangible property] is readily identifiable.” [*we just won't say where that is*]



## Model Regulations Seek to Temper “all or nothing” Results

- 1990's: MTC promulgates regulations for apportioning income of financial institutions, airlines, trucking companies, broadcasters, publishers—but not all states adopt regulations.
- 2005: MTC promulgates “on behalf of” regulation recognizing activities of independent contractors—but few states adopt this regulation.
- 2010: Section 18 regulation eliminates “unique and non-recurring” facts requirement

# Market-based sourcing and cost of performance sourcing, compared

## Multistate cellular telephone network:

- **Cost of performance:** receipts sourced to corporate headquarters or location of central computer switching;
- **Market-based sourcing:** location of retail customers, measured by billing address;

## Broadcast rights to professional sports event:

- **Cost of performance:** location of home games?
- **Market-based sourcing:** location of viewing public?

## ***Boston Professional Hockey Ass'n v. Commissioner of Revenue, 820 N.E.2d 792 (Mass. 2005)***

Preponderance of cost of performance for televising hockey games is in Massachusetts; broadcasting in other states could not be separated from other activities (like high-sticking).



# Amend the Compact!

2008: The MTC asks the Uniform Laws Commission to amend their 1957 uniform law;

2009: The ULC declines, citing concerns that amendments would be too controversial to be widely adopted.

2009: The MTC commences its own project. MBS is the centerpiece.

2014: The amendments to UDITPA (Compact Art. IV) are approved.



## The new Article IV.17:

17. (a) Receipts, other than receipts 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: (1) in the case of sale, rental, lease or license of real property, if and to the extent the property is located in this state; (2) in the case of rental, lease or license of tangible personal property, if and to the extent the property is located in this state; (3) in the case of sale of a service, if and to the extent the service is delivered to a location in this state; and



## The New Article IV.17 (cont.):

(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 intangible property utilized in marketing a good or service to a consumer is “used in this state” if that good or service 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 from a sale of intangible property shall be excluded from the numerator and denominator of the receipts factor.

## The New Article IV.17 (cont.):

(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 receipt 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 receipt shall be excluded from the denominator of the receipts factor.

(d) [The tax administrator may prescribe regulations as necessary or appropriate to carry out the purposes of this section.]

# Principal Components of “New” Section 17

- **Sourcing to the marketplace** is the explicit goal; rules identify where the marketplace is for particular activities/transactions;
- **“If and to the extent”** language throughout signals abandonment of any allocation (“all or nothing”) result.
- **Services sourced based on where “delivered”** to consumer, not place of use/employment/benefit received—thought to allow for more precise and predictable results.
- Assumes states will also adopt **narrower definition of “receipts”** excluding most gross receipts not directly attributed to an identifiable market.



# The New Section 17 Market Based Sourcing Rules, Cont.

## Receipts from Intangibles:

- Licensing receipts sourced to where used (can't be delivered);
- Distinction between “marketing” intangibles and “production” intangibles;
  - **Marketing intangibles** assigned to ultimate consumer location: receipts from Mickey Mouse trademark printed on T-shirt in China sold in Tennessee sourced to Tennessee;
  - **Production Intangibles** assigned to principal place of use in manufacturing: patents, copyrighted book? Operating software loaded on OEM?
- Most receipts from selling intangible property excluded from receipt factor; purpose was to prevent de-aggregation of intangibles from services/TPP.

# Critical Aspects of the new Section 17, Cont.

- **Throw-out** of Receipts where:
  - (1) Place of delivery (or use) cannot be reasonably approximated;
  - (2) Taxpayer lacks nexus in taxing state (or country)  
*Many states, including California, have not adopted a throw-out rule*
- Explicit authority to promulgate regulations;
- Limited circumstances where “look-through” to ultimate marketplace appropriate—
  - electronically-delivered services;
  - marketing intangibles.



# Quiz: how would you source income arising from?

1. Internet advertisement for video game:
2. Software code for search engine:
3. Star Wars merchandizing agreement with apparel manufacturer?
4. Operating software rights licensed to Original Equipment Manufacturer?
5. Brokerage fee charged to pension fund?
6. Accounting service sold to multistate business?
7. Goodwill component of capital gain?

**Reg. IV.17: The Mother of All  
Apportionment Regulations Answers  
All Questions** (or at least most of them).



# The MTC Market-Based Sourcing Regulation Project of 2015-2016

Commission felt detailed regulations would be critical to ensuring states would adopt MBS

2015: After some fitful starts, Uniformity Committee votes to use Massachusetts's 70 page regulation as our template;

- Mass' regulation had undergone extensive hearings and some beta testing;
- Mass' regulation had been well-received by business community and practitioners;
- Included many examples describing application in specific circumstances

# The MTC Market-Based Sourcing Regulation Project of 2015-2016

- Modified to accommodate existing MTC special industry regulations (special industry regulations control);
- Modified for use in separate-entity states by limiting ability to source sales to location of related party business “customers”—look through to location of actual use or ultimate customer, instead of commercial domicile
- Added detail on throw-out rules where taxpayer had “micro-nexus” in foreign country markets.



# The MTC Market-Based Sourcing Regulation 2015-2016

*Three major classifications of services used for determining delivery location:*

- (1) In Person Services: generally, where service is performed;
- (2) Professional Services: generally, where delivered or used, e.g., architectural services where the building will be located;
- (3) Services delivered electronically for or on behalf of a customer: generally, where received by ultimate customer, e.g., advertising and broadcasting.



# Electronically Delivered Services:

- Advertising services “look through” to the ultimate customer
- Other services sourced to where delivered; complex rules for business to business transactions;
- Reasonable approximation key to initial sourcing before other alternatives are used;
- Sales to individuals based on billing address;
- Sales to business often will default to where contract is managed.
- Special rules for pre-written software;

# Market-Based Sourcing: What We Have Learned So Far

- Despite differences between “delivery” and “where used” models, taxpayers have not come forward with examples of inconsistent results or double taxation;
- Litigation has been infrequent: exception: *Microsoft v. Wisconsin*, Wisc. Tax Appeals Bd. Decision no. 13-1-042: holding that “market” for operating sold to OEM was OEM’s headquarters, not ultimate customer;