

Market Sourcing v. Cost of Performance: Potential Over or Under Reporting of State Tax Liabilities (Multi-state Service Providers)

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I. BACKGROUND

The recent budget shortfalls have led states to pursue corporate tax dollars more aggressively. Taxpayers are aware that the state-tax enforcement, specifically on sales apportionment, is getting stricter these days. A CFO Tax Survey shows that approximately 16% of the 151 tax directors and finance executives said “apportionment and related issues were their biggest worry in terms of state taxation.”² This issue is a major concern for multi-state companies, especially service-based businesses, because they are not protected under Public Law 86-272 (hereafter P.L. 86-272). According to P.L. 86-272, 15 U.S.C. 381-384, a state is restricted from “imposing a net income tax [and franchise tax measured by net income] on income derived within its borders from interstate commerce if the only business activity of the company within the state consists of the solicitation of orders for sales of tangible personal property” P.L. 86-272 further clarifies that the delivery of any type of service that is not conducted for the purpose of facilitating the solicitation of orders is not considered protected activities.

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² See Katz, David M. "Tax Apportionment Shift Hits Multistate Companies - Tax - CFO.com." Tax Apportionment Shift Hits Multistate Companies - Tax - CFO.com. CFO Acquisitions LLC, 31 Mar. 2011. Web. 01 Feb. 2013.

For multi-state service providers, the various state apportionment methods provide planning opportunities to minimize their overall state income tax liability exposure as well as the maximization of state tax incentives for businesses relocating to different states. However, when an incorrect method of service revenue apportionment is applied, they may potentially over or under report their state tax liabilities.

A. DIFFERENT SERVICE REVENUES APPORTIONMENT METHODS

State taxing authorities use different methodologies to determine how a company must apportion service revenues to their state. The most commonly used methodologies are: (1) cost-of-performance method and (2) market-based method, also known as the market sourcing method.

B. THE SHIFT FROM COST OF PERFORMANCE METHOD TO MARKET SOURCING METHOD

More states are shifting away from the traditional cost-of-performance (“COP”) rules and adopting market-based sourcing rules. The main reason of this shift is the belief that market sourcing method is more aligned to the intended purpose of the sales factor, which is to reflect the contribution of the market to the taxpayer’s income. Unfortunately, even among the states that adopt the same so-called market sourcing method, the states typically have their own mechanics of rules to define the term “market.” Therefore, the market sourcing rules are likely to create a variety of administrative problems and states uniformity would still be difficult to achieve. The benefits and limitations of the two distinguished income sourcing methods are further discussed in the next section.

Through the recent litigation that surfaced, taxpayers can clearly see that the shift to market-based sourcing method is not only preferred on the legislative level, but also the administrative and judicial level. Some state taxing authorities have shifted towards the adoption of the market sourcing rules through the implementation of an alternative apportionment that essentially achieve similar result as the market-based sourcing method. Others argue that the cost-of-performance does not properly reflect the taxpayer’s income,

especially if the sales are not included in the sales factor numerator of any states.³ Of course, this forced implementation typically occurs in states where the cost-of-performance method results in a less favorable outcome for the state.

In *Ameritech Publishing, Inc. v. Wisconsin Department of Revenue*,⁴ the court held that the income-producing activity of advertising services was considered performed in Wisconsin when the advertisement reached its target audience there. The taxpayer is a Delaware corporation which generates sales by placing advertisements in telephone directories. Its national account sales offices were in Michigan and Illinois and its sales representatives solicit local advertising from offices in Indiana, Michigan, Ohio, and Wisconsin. The state of Wisconsin adopted the market-based sourcing rules for service revenue in 1997. The tax years at issue were 1994 through 1997. The taxpayer filed its original 1994-1996 Wisconsin income tax returns and sourced its income based on the geographic distribution of the telephone directories. The taxpayer then amended the 1994-1996 returns to reflect its sales apportioned using the cost-of-performance method and continued to file the 1997 tax return following the same COP method. The majority of the taxpayer's activities starting from sales solicitation, ad layout and production, the delivery of directory ad copy to the printer, through the distribution of the directories to the final users were performed in Michigan, with some services performed in Indiana, Ohio, and Illinois, as well as Wisconsin. However, the Wisconsin Department of Revenue denied the taxpayer's cost-of-performance method and argued that all of taxpayer's income from the sales of the local telephone directory advertising should be allocated to Wisconsin. This case reflects the state's aggressive push towards the market-based sourcing method, even in the years when the state regulations indicate that the cost-of-performance rules should apply.

II. COST-OF-PERFORMANCE METHOD

Under the cost-of-performance method, the sales from services are sourced to a state when: (1) "the income-producing

³ See Sutton, Giles, J. C. Yesnowitz, C. Jones, and Terry F. Conley. "The Nuances of Market-Based Sourcing of Service Revenue: Not All Markets Look the Same." *Journal of Multistate Taxation and Incentives* (WG&L) 21.2 (2011): 6-45. RIA Checkpoint. Web. 1 Feb. 2013.

⁴ See 788 NW2d 383 (Wis. Ct. App., 2010), *rev. dism'd* Wis. S.Ct., 12/13/10.

activity is performed in such state;” or (2) the income-producing activity is performed both within and outside such state and a greater proportion of the income-producing activity is performed in such state than in any other state, based on [cost-of-performance].” Generally, states that use this method apply either the preponderance (all-or-nothing) or proportionate (pro-rata) methods.⁵

According to the preponderance method, as stated by Uniform Division of Income for Tax Purposes Act Section 17, service revenue should be sourced based on the greater proportion of the income producing activity.⁶ In contrast, the proportionate method prescribes that the sales from services should be sourced to each state in which cost-of-performance is incurred or based on the service provider’s activity in the state.⁷

The two cost-of-performance methods can be easily distinguishable in the following example: if a taxpayer’s income-producing activities are conducted in three states (State X, State Y, and State Z), 30% of the costs are incurred in State A and State B and 40% of the costs are incurred in State C, under the preponderance (all-or-nothing) rule, all of the service revenue should be allocated to State C since it has the greatest cost of performance. No income would be apportioned to State A and State B. In contrast, under the proportionate rule, the taxpayer would have to apportion the service revenue pro rata to the State A, State B, and State C.

A. THE BENEFITS AND LIMITATIONS OF THE COST-OF-PERFORMANCE METHOD

The cost-of-performance rules generally require companies to identify the different income line items, specify the related income-producing activity, and determine the location of the income-

⁵ See Sutton, Giles, J. C. Yesnowitz, C. Jones, and Terry F. Conley. "The Nuances of Market-Based Sourcing of Service Revenue: Not All Markets Look the Same." *Journal of Multistate Taxation and Incentives* (WG&L) 21.2 (2011): 6-45. RIA Checkpoint. Web. 1 Feb. 2013.

⁶ See Alaska Stat. § 43.19.010; D.C. Code Ann. § 47-1810.02(g)(3); Fla. Admin. Code Ann. § 12C-1.0155(2)(e); Haw. Rev. Stat. § 235-37 ; Idaho Code § 63-3027(r); Ind. Code § 6-3-2-2(f); Kan. Stat. Ann. § 79-3287; Mass. Gen. L. Chapter 63 § 38(f) ; Mo. Rev. Stat. § 32.200(Article IV)(17); Mont. Code Ann. § 15-31-311(2); N.D. Cent. Code § 57-38.1-17.

⁷ See Ark. Code Ann. §26-51-717; Miss. Administrative Code §35.III.8.06(402.9)(3)(d); N.C. Gen. Stat. §105-130.4(I)(3); S.C. Code Ann. §12-6-2295(A)(5).

producing activities and the related costs. This process may be time-consuming; however, taxpayers generally have access to the relevant cost data necessary to determine where the income-producing activities and associated costs take place. Therefore, the taxpayer only needs to design a system to capture the available information. As depicted by the *Ameritech Publishing, Inc. v. Wisconsin Department of Revenue*⁸, the cost-of-performance method may not be appropriate for certain industries, such as publishers. Similarly, this rule may not suit the following industries: airlines, construction contractors, financial institutions, telecommunications companies, railroads, and television and radio broadcasters.⁹ However, the states believe that the objective of this method is inconsistent with the overall purpose of the sales factor which is to reflect the contribution of the market to the Company's revenue. Therefore, many states have started to move away from this method.

III. MARKET-BASED SOURCING METHOD

Under the traditional market-based sourcing rule, receipts are included in the numerator of a taxpayer's sales factor based on the location of either the service provider's customers or where the customers derive benefits from the service. The first four states that adopted this traditional method include Georgia, Iowa, Maryland, and Minnesota.¹⁰ However, some states have adopted the new market-based sourcing rules which assign income based on the location where the service provider performs the service. The states that have adopted this new regime include California, Illinois, Maine, Michigan, Oklahoma, Utah, and Wisconsin.¹¹

⁸ See 788 NW2d 383 (Wis. Ct. App., 2010), *rev. dism'd* Wis. S.Ct., 12/13/10.

⁹ See Model Apportionment Regulations, *available at* <http://www.mtc.gov/Uniformity.aspx?id=496>.

¹⁰ See Ga. Code Ann. § 48-7-31(d)(2)(A)(i); Iowa Admin. Code § 701--54.6; Md. Regs. Code § 03.04.03.08(C)(3); Minn. Stat. § 290.191, Subd. 5.

¹¹ See Cal. Rev. & Tax. Cd. § 25136; ILCS Chapter 35 § 5/304(a)(3)(C-5); Me. Rev. Stat. Ann. 36 § 5211(16-A); Code Me. R. § 801.06(E); Mich. Comp. Laws Ann. § 206.665(2); Mich. Comp. Laws Ann. § 208.1305(2); Michigan Revenue Administrative Bulletin No. 2010-5, 05/20/2010; Okla. Stat. 68 § 2358(A)(4); Utah Code Ann. § 59-7-319(3); Utah Admin. R. § R865-6F-8(10)(g)(i); Wis. Stat. § 71.25(9)(dh).

A. THE BENEFITS AND LIMITATIONS OF MARKET-BASED SOURCING METHOD

In addition to the fact that the market-based sourcing method's objective is parallel to the overall purpose of the sales factor, many states have realized that the implementation of market-based sourcing rule may favor in-state businesses. For example, a taxpayer who conducts a major portion of its activities within the state would not be required to source its income from out-of-state clients to the headquarter state. The benefits resulting from having to report less income would attract many businesses to the state.

Unfortunately, it is often difficult to determine where the customer receives the benefit of the service. The market sourcing method can be 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, Georgia sources income to the state if the services are received in Georgia. To determine whether the services are received within the state, taxpayers can use the customer's home address or billing address. However, the determination of the location where the services (or the benefits of the service) are received may not be clear when the customer have businesses in various states. For example, many companies would generally place an order from the corporate headquarter and request for an invoice rather than placing an order from different divisions and have the bills sent out to the offices where the service benefits were received. This would not only allow them to have more control of their accounting, but also reduce the administrative burdens. In addition, while the term "market" seems to have a straight-forward definition, the various states are inconsistent in their interpretations.

Additionally, as previously described above, some states adopt the traditional market-based sourcing method and some states follow the new method. This would create additional administrative and cost burden to the companies which conducts businesses in various states. In order to satisfy the specific state requirements, multi-state companies may have to create separate tracking systems for the sales derived from each state.

IV. POTENTIAL OVER OR UNDER REPORTING OF STATE TAX LIABILITIES FOR MULTI-STATE COMPANIES

As more states adopt the market-based sourcing rules, the likelihood for taxpayers to have total multi-state sales factors of more than 100% for service revenue would increase. This situation typically happens when the income-producing activities are performed in a cost-of-performance state and the customer who receives the service (or the benefit of the service) is located at a market-based sourcing state. For example, if a company headquartered in State S (a cost-of-performance state) that performs its services in State T (a cost-of-performance state) have customers located in State U (a market-based sourcing state), and a greater percentage of the income-producing activity is performed in state T, the service revenue generated may need to be apportioned to both State T and State U. In this case, State T would argue that all of the service revenue should be included in State T's sales factor numerator because a greater proportion of the income-producing activities are performed in State T. On the other hand, State U would argue that the taxpayer should source all of its service revenue to State U because the customers that obtain the benefit of the services are located in State U.

Similarly, in the situation where taxpayers conducts businesses in several market-based sourcing states that has different interpretation of the word "market," there is a possibility that the same income would be included in the sales factor numerator of multiple states. An example of a situation that would create this issue is when a service provider obtains a purchase order from a customer headquartered in State O (a traditional market-based sourcing state) and the service provider is deemed to perform the service in State P (a new market-based sourcing state) because the intended target audience is in State P, the taxpayer may have to include the same sales in both State O and State P. State O would argue that since the customer's headquarter is in State O, the income has to be allocated to State O. On the other hand, State P may argue that all of the service revenue should be reported in State P because the income-producing activity of advertising services was considered performed in State P when the benefit reached its target audience there.

A. DIFFERENT STATE INTERPRETATION

Some states may interpret the same revenue sourcing method differently. For instance, the Massachusetts Appellate Tax Board (MA) and Oregon Tax Court (OR) reached opposing conclusions regarding the application of COP method for AT&T Corp. According to MA, AT&T receipts from Massachusetts customers, for making interstate and international calls and data transmissions, should not be included in the numerator of the Massachusetts sales factor because the preponderance of the cost of performance were in New Jersey where its operations were centered.

MA relied on the operational approach and viewed the integrated operation of the overall network as the income producing activity under the state's COP test rather than each separate call or data transmission. MA also determined that local carriers were performing services on behalf of AT&T and such costs are excluded from direct COP.¹²

On the contrary, OR relied on the transactional approach and held that the income producing activity means the transactions and activity directly engaged in by the taxpayer which applies to each separate item of income. The court concluded that the receipts from interstate and international calls made by or to AT&T's Oregon customers are includible in the numerator of AT&T's sales factor. The tax court also claimed that local carriers were not performing services on behalf of AT&T, but providing services to AT&T and such costs are included as direct costs of performance.¹³

B. PLANNING OPPORTUNITIES

The different service revenue sourcing methods adopted by the different states may create potential apportionment whipsaws of greater than 100% apportionment and under or over reporting of aggregate state tax liabilities for multi-state companies. However, it also creates planning opportunities. For example, if a company headquartered in State A (a cost-of-performance state) that performs its services in State B (a market-based sourcing state) have customers located in State C (a cost-of-performance state), and a greater

¹² See *AT&T Corp. v. Comm'r of Revenue*, Rev., Dkt. No. C293831 (Mass. App. Tax Bd. 6/8/2011); *aff'd* by Mass. App. Ct. (7/13/12).

¹³ See *AT&T Corp. v. Dep't of Revenue*, Oregon Tax Court, TC 4814.

proportion of the income-producing activity is performed in state B than any other state, the service revenue generated would not need to be apportioned to any state. Hence, the company would obtain more benefit if states A, B, and C utilize a single-sales factor formula. One point to note is that this is only one of many considerations for state tax planning.

V. CONCLUSION

Taxpayers should anticipate that more states will join the trend of migrating towards market-based sourcing. This is evident from the Multistate Tax Commission continued efforts to amend UDITPA to incorporate market-based sourcing rules. While the UDITPA COP method is generally adopted without modification, states differ on how they define the marketplace for market-based sourcing. Some states who implement the traditional market-based sourcing would source receipts to the location where the customers derive benefits. In contrast, the states that adopt the new method would source receipts to the location where the service is delivered. Accordingly, understanding the mechanics of the rules adopted by the different states is essential.

Taxpayers should work with their tax service providers to quantify the potential changes in tax liability resulting from the transition to market-based sourcing. Additionally, taxpayers should ensure that adequate accounting and business reporting practices are in place to accurately record the sourcing of receipts. Taxpayers should also review their state tax filings to ensure the proper application of the different sourcing laws and properly account for any ASC 740 implications. For more information concerning cost-of-performance and market-based sourcing, contact your local tax advisor.