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Apportionment & Market-Based Sourcing

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Background on Apportionment

- Apportionment = How much of the Corporate Income pie can a particular State tax?

- Historical apportionment formula consisted of equally weighted
  - Property factor,
  - Payroll factor, and
  - Sales factor
Background on Apportionment

• Sales factor is increasingly important
  – States commonly moved to double-weighted sales factor
  – Increasingly, States have been enacting single sales factor apportionment formulas

• Sales factor distinguishes between sales of tangible personal property (TPP) and non-TPP
  – TPP sourcing has been specific → Source to the market
  – Non-TPP sourcing has long been more hazy
    • Not a lot of attention paid to intangibles/services during UDIITPA formulation
    • UDIITPA focused on location of income-producing activity
Agenda

• This presentation will focus on sourcing of non-TPP, in particular:
  – Revenue from performance of services
  – Revenue from licensing/sale of intangibles

(1) Trend toward market-based sourcing (MBS)
(2) Experience/issues in States that have adopted MBS
  – Massachusetts example
(3) Considerations for States considering moving from focus on income-producing activity to MBS – New Hampshire example
UDITPA Section 17
Income-Producing Activity/Cost of Performance (IPA/COP) Rule

Sales other than the sales of tangible personal property, are in this State if:

(a) the income producing activity is performed in this State; or

(b) the income producing activity is performed both in and outside this State and a greater proportion of the income producing activity is performed in this State than in any other State, based on cost of performance.
Applying IPA/COP

There are several key questions that need to be addressed when applying IPA/COP statutes and related regulations:

- What are the particular items of income?
- What are the income-producing activities associated with the particular items of income?
  - Is the income-producing income located in more than one State?
- What are the direct costs incurred by taxpayer in providing these income-producing activities?
- Where are these costs incurred?
Market-Based Sourcing Trend

• Rationales for trend
  – Difficulties with applying IPA/COP methodology
    • Undefined key terms, e.g., “income-producing activity”; “cost of performance”
    • Problematic “all or nothing” aspect
    • Numerous State court cases probing the application
  – Notion sales factor should not replicate property/payroll factors
  – Shift towards statutory emphasis on sales factor
  – Economic development
Predominant Methods for Sourcing Services/Intangibles

Three alternative sourcing methods currently prevail among the States, with Market-Based Sourcing clearly on the rise:

- **Greater Cost of Performance (IPA/COP)**
  - All-or-nothing; place of production;
  - Origination focused;
  - Alternative analysis would view the income-producing activity transaction by transaction, which may then result in a method approximating a market approach

- **Proportionate Cost of Performance (IPA/COP)**
  - Proportionate cost basis; split among places of production
  - Origination focused

- **Market-Based Method**
  - Location of customer; non-cost based
  - Destination focused
Market-Based Sourcing Trend

• After lengthy process, MTC model statute approved July 2014
• MTC model regulations adopted February 2017
• Trend towards MBS...
  – 2009 or earlier: GA, IL, IA, MD, ME, MI, MN, OH, UT, WI
  – 2010-2015: OK, WA, AL, CA, AZ, NE, MA, PA, NY, RI, DC, MO, TN
  – 2016-2017: CT, OR, MT (OR and MT substantially adopted the MTC model)
Market-Based Sourcing Trend

Cost of performance (services & intangibles)

Legislation introduced in 2017

Effective 1/1/2018

2014 - for service receipts only

2014 - for multistate service providers
Market-Based Sourcing Trend

NESTOA States

- Cost of performance (services & intangibles)
- Market-based sourcing (services & intangibles)

2014 - for service receipts only
Market-Based Sourcing - Alternatives

There are a number of alternatives for defining the "market" for services:

- Where benefit of services is received by customers;
- Where services are performed; or
- Where the customers are located

General uniformity for licensing of intangibles:

- Where intangibles are used
Recent Developments

• MTC model statute
  – Defines the “market” differently depending on the type of sales:
    • Services = location of “delivery”
    • Licenses of IP = location of “use”
    • Sales of IP = location of geographic connection, where applicable; otherwise thrown out
  – Rules of “reasonable approximation”
  – Throw-out where cannot assign/approximate sale location OR not taxable in state of assignment

• MBS adopted by each state can be different based upon how the “market” is defined
Recent Developments

• MA/MTC regulatory approach that applies to specific types of transactions/classes of services:
  – In-person services
  – Services delivered to a customer (physically or electronically)
  – “Professional services”
    – May be distinguished by business and non-business customers

• Cascading rules – if a taxpayer cannot comply with the threshold rule then move down the chain of rules

• General uniformity regarding licensing rules
State Differences

• COP versus MBS

• Different state approaches to MBS
  – E.g., service assigned to location of “benefit received” as opposed to service “delivery”
  – Do MBS rules allow for flexible approach either through cascading rules, or rules of reasonable approximation, or both?

• State regulations can result in variable treatment under MBS
  – Industry specific regulations

• Even if all states were to adopt an MBS system there is still the prospect for double tax based on statutory and regulatory nuance
Practical Considerations

- How specific is the state guidance as to specific industries, transactions?
- How do the rules apply to professional services and e-services (including digital goods and cloud computing?)
- How do you assign sales of IP (e.g. goodwill, securities)?
- Relationship to alternative apportionment?
Practical Considerations

• New taxpayers - Does MBS create need for filing in case where previously there may have been nexus, but no in-state factors?

• What records are necessary for compliance?

• Is there ever a “look-thru” assignment rule and does TP have information necessary to comply?

• Relationship to SSF?
New Hampshire Legislative Study

- Senate Bill 343 (2016), establishes a commission to study the apportionment of gross business profits under the Business Profits Tax.
- Senate Bill 16 (2017), reauthorized the Commission through November 1, 2018.

- Membership
  - 3 House members and 2 Senate members
  - 2 members of the business community
  - President of the NH Bar Association (or designee)
  - President of NH Society of CPAs (or designee)
  - Commissioner of DRA (or designee)
  - Commissioner of Resources and Economic Development (or designee)
  - The Attorney General (or designee)

- Report of the commission’s findings is due 11/1/2018.
New Hampshire MBS Legislative Study

- Study arose because taxpayers have seen a change in their tax liabilities owed surrounding States that have recently changed to MBS.
- Substantial time has been spent educating the legislative members of the Commission on apportionment generally.
- Input received from constituents who would see their tax liability in New Hampshire increase or decrease if NH went from COP to some form of MBS.
- Substantial time and resources spent trying to better understand the fiscal impact to the State of going from COP to MBS.
- Difficulty separating the fiscal impact issue from the tax policy issue.
Alternatives for New Hampshire

• **No Action**
  - Recent changes to the apportionment statutes of surrounding States should not affect NH revenues or the application of surrounding law.
  - The transition to MBS in surrounding States will impact the tax liability owed by taxpayers to other States and could result in taxpayers paying more or less tax in other States.
  - The impact will be realized by NH businesses that sell intangibles and services doing business in MBS States.
  - There is no impact on businesses that sell tangible products.

• **Legislative Action**
  - Adopt some form of Market Based Sourcing*
  - Statutory change to Proportionate Share Cost of Performance
  - A credit for taxes paid

* This option is the primary focus of the Study Commission
Alternatives for New Hampshire

Adopting Market-Based Sourcing

- Unknown fiscal impact to State revenues
- Unknown tax impact to individual NH businesses
  - There will be “winners and losers”
  - Getting all businesses to exactly 100% is not possible
- This type of statutory change may require other changes, such as a throw-out rule (if the company does not have nexus in a State, it does not include those sales in the denominator)
- Substantial rulemaking will be required to implement MBS
  - The NH Constitution has unique provisions governing differential treatment of taxpayers that may prevent industry-specific treatment
- Would MBS be coupled with a change to single sales factor?
Fiscal Impact of MBS

• The Business Profits Tax makes up a substantial portion of total State revenue and thus, the risk of a revenue decrease is a primary concern.

• Legislative desire to insulate “New Hampshire businesses” from harm.

• There is a lack in uniformity of MBS statutes and rules which makes it difficult to rely on other States’ estimates or experience.

• New Hampshire includes the taxation of pass-thru entities in the Business Profits Tax.
Conclusions

• Trend toward market-based sourcing
  – 25 States and D.C. have adopted MBS
  – MTC model statute increasingly followed

• In a State evaluating a change from COP to MBS, competing political, revenue, and policy considerations make coming to agreement on a change difficult.

• However, making no change is in itself a tax policy decision that has the potential to impact taxpayers.
Questions?

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