Conflicting Schemes for Apportionment of Service Businesses

Sarah H. Beard, Esq.
Pierce Atwood LLP
Portland, ME
Phone: (207) 791-1378
E-mail: sbeard@pierceatwood.com

The Multistate Tax Commission's Uniformity Committee has proposed a form of market-based sourcing as the new uniform standard for sourcing services receipts for income apportionment purposes.[1] This proposal comes after several states enacted differing versions of market-based sourcing. Meanwhile, many states continue to adhere to some variation of the "cost of performance" approach found in the Uniform Division of Income for Tax Purposes Act ("UDITPA"). Some use neither approach. This article examines some of the challenges facing multistate businesses attempting to comply with this new and changing landscape for apportionment of services receipts, using as examples three hypothetical multistate services businesses operating in New England.

Background

For tax years beginning on or after January 1, 2014, Massachusetts attributes receipts from sales of services to Massachusetts if the market for the service is in Massachusetts, for corporate income apportionment purposes. Mass. Gen. L. ch. 63 § 38. Previously, Massachusetts attributed receipts from sales of services to the state where the predominance of the income producing activity was located, based on cost of performance. This statutory change to market-based sourcing conforms to the changes currently under consideration by the Multistate Tax Commission ("MTC"). Maine, on the other hand, is one of the several states that previously enacted a different version of market-based sourcing for services.[2]

---

[1] Multistate Tax Compact Article IV Recommended Amendments *As approved for Public Hearing - December 6, 2012*. (available on MTC's website at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Events/2011-12_Committee_Meetings/Proposed%20Model%20Compact%20Article%20IV%20Amendments%20%28as%20approved%20for%20public%20hearing%2012-6-2012%29.pdf.)

[2] In a May 3, 2012 memorandum to the Chair of the MTC Executive Committee explaining the proposed amendments,
(Continued on page 8)

The momentum for the trend toward market-based sourcing has been driven at least in part by each state's goal of encouraging businesses to locate or expand operations in-state by lowering the tax cost associated with in-state property and employees. There are also sound theoretical bases for a market-based approach.[3] MTC's attempt to establish a uniform approach to market-based sourcing for services reasonably assumes that the trend will continue. Meanwhile, sourcing for sales of services is far from uniform and leaves a multistate business facing a confusing array of inconsistent apportionment regimes, and an increased risk of multiple taxation. This risk is magnified by the fact that an increasing number of states no longer use an evenly weighted three-factor formula but instead double-weight the sales factor or use a single sales factor formula.

To illustrate, this article examines the approaches used by New England states to apportion income of three hypothetical multistate service companies: an engineering firm, a company that provides web-based photo editing and storage services, and a broadcaster. We assume that all three are subject to state income tax as corporations.

1. Engineering Firm based in New Hampshire.

The offices of the engineering firm Designit are located in southern New Hampshire. Designit has no property outside of New Hampshire. All of its employees are based in New Hampshire, although one employee telecommutes one day a week from a second home in Connecticut. Most (90%) of Designit's receipts are from projects related to property located in Massachusetts. One of Designit's clients is based in Maine but has hired Designit for a major project related to property located in Massachusetts. Work for the Maine client generates 20% of Designit's receipts during the year in question. Designit's employees meet with clients in the firm's New Hampshire offices and they visit project sites in Massachusetts, Maine, New Hampshire and Vermont.

New Hampshire uses the UDITPA approach to sourcing receipts from services (except with respect to certain specific industries). New Hampshire includes receipts in the sales factor numerator "if a greater proportion of the income-producing activity is performed in this state based on cost of performance." N.H. Rev, Stat. Ann. § 77:3. The greater proportion of the cost of performance of the engineering services for each project is performed in New Hampshire, where Designit's employees are based. As a result 100% of the receipts are included in the sales factor numerator. New Hampshire uses a three-factor formula, with sales double-weighted. With Designit's office in New Hampshire and employees based there, the property, payroll and receipts are all attributed to New Hampshire and 100% of its income is apportioned to New Hampshire.

Massachusetts law provides that receipts from services are included in the Massachusetts numerator if the service is "delivered" at a location in Massachusetts, tracking the language of the MTC's proposal. The MTC's proposal, however, does not elaborate on the meaning of "delivered," and as Professor Pomp has noted, the success of the proposal will depend in part on detailed regulations to follow.[4] The Massachusetts Department of Revenue has recently proposed detailed regulations to implement its market-based sourcing statute. Mass. Regs. Code 830, § 63.38 Working Draft, circulated March 25, 2014 for Practitioner Comment ("Working Draft").[5] *See* Working Draft, § 63.38.1(9)(d) (When Sales Other Than Sales of Tangible Personal Property are in Massachusetts). These are of particular interest because they may provide some prediction of forthcoming MTC regulations interpreting the same language. Working Draft, § 63.38.1(9)(d)(4)(d) covers professional services. Under the proposed *general* rule for professional services sold to business customers, receipts are assigned to the

MTC General Counsel Shirley Sicilian noted that 13 states had adopted some form of market-based sourcing for services: California; Iowa; Michigan; Ohio; Utah; Wisconsin; Alabama; Georgia; Maryland; Oklahoma; Illinois; Maine; and Minnesota. *See* Explanation of Article IV Recommended Amendments, May 3, 2012, at 19-20. (also available on MTC's website at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Events/2011-12_Committee_Meetings/EC%20memo%20-%20Art%20IV%20%20(05-03-2012).pdf.)

[3] Theories advanced in support of market-based sourcing include that the sales factor should serve the role of recognizing the contribution to income of the market state; and sourcing services based on location of income-producing activity puts too much weight on the contribution of the state where employees and property are located. Moreover, alignment of the sourcing for services and intangible property sales with the existing market-based sourcing for tangible personal property sales helps to eliminate the need to make some difficult distinctions. As Professor Pomp has noted, "No theoretical reason exists why the receipts for the delivery of a DVD through the mail of a movie should be assigned to a state differently from the on-line streaming of that movie." Report of the Hearing Officer, Multistate Tax Compact Article IV [UDITPA] Proposed Amendments October 25, 2013 ("Hearing Officer's Report"), at 58. Report available on MTC's website at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Pomp%20final%20final3.pdf.

[4] Hearing Officer's Report, at 87.

[5] Available on the Massachusetts Department of Revenue website, at http://www.mass.gov/dor/businesses/help-and-resources/legal-library/regulations/63-00-taxation-of-corporations/msb-reg.pdf.

(Continued on page 9)

state where the contract of sale is principally managed. Working Draft, § 63.38.1(9)(d)(4)(d)(ii)(A). Under a special rule for receipts from engineering and architectural services, however, the sale of an engineering service is received in Massachusetts if and to the extent that the services are with respect to real or tangible property that is located in Massachusetts. Under that proposed rule, Designit's receipts would be sourced to the location of its client's projects. Because most of those projects are in Massachusetts, a large proportion of its receipts would be sourced to Massachusetts. Massachusetts uses a three-factor formula with a double-weighted sales factor. Because 90% of Designit's receipts are from projects located in Massachusetts, 45% of the company's income would be apportioned there.

Maine sources services to the state where the services are *received*. 36 Me .Rev. Stat. Ann. § 5211(16-A). Maine statutes and rules provide no further guidance on how to determine where professional services are "received," and to date no case law has emerged. Options for Designit, depending on the facts, include where Designit's drawings and reports are handed to its client, the location of the project in question, or where the client obtained access to the drawings by computer. Maine regulations do provide:

> When it is unclear where the services were received, the sale is deemed to have occurred at the office of the business customer where the services were ordered in the regular course of the customer's trade or business. If the ordering location cannot be determined, the sale is deemed to have occurred at the office to which the services were billed.

Code Me. R. § 801.06(E). If Designit concludes that it is unclear where the services were received, or that the services in each case were received at the principal office of its client, 20% of its receipts will be sourced to Maine (and most of the receipts would be sourced to Massachusetts). In that case, because Maine uses a single sales factor formula, 20% of its income will be apportioned to Maine. This illustrates the importance of understanding and documenting the manner in which the services are received. Depending on the facts, Designit may have a strong position that the services are clearly received at a particular location not within Maine.

Vermont sources receipts from services based on the cost of performance approach, using a three-factor formula with a double-weighted sales factor. Vt. Stat. Ann. 32 § 5833(a). Because the greater proportion of the cost of performance is in New Hampshire, and all of the property and payroll are in New Hampshire, Designit would not apportion any income to Vermont.

Connecticut sources receipts from the sale of services to Connecticut if the services are performed in the state. Conn. Gen. Stat. § 12-218(b). A small percentage of the services are performed in Connecticut by the telecommuting employee. Accordingly, some small amount of receipts would be sourced to Connecticut. Whether the employee's presence results in any liability to Connecticut may depend upon whether it is determined that such a limited presence creates nexus in Connecticut for Designit.[6]

Total Tax Burden – In this example, New Hampshire would claim the right to tax 100% of Designit's income, Massachusetts 45% and Maine 20%, for a total tax burden of 165%.

2. Photo Editing Software and Storage Services Company based in Massachusetts

Photoweb has offices in Rhode Island from which it provides photo editing software and storage services to individual customers, 4% of whom have Massachusetts billing addresses, 1% of whom have Rhode Island billing addresses, and 1% of whom have Maine billing addresses (others individual customers have billing addresses outside of New England). Photoweb's services may be accessed through any computer or other device that permits internet access.

From its Rhode Island offices, Photoweb also provides services to a single business customer with a principal office in Massachusetts, a satellite office in Maine and retail locations in other states. The services are used by the customer's employees at all locations, by accessing Photoweb's website, by email or by telephone. Photoweb's services were ordered by one of the customer's employees located at the Maine satellite office but the contract for services has since been managed by the customer's principal office in Massachusetts. The receipts from the sale of services to the business customer represent 50% of Photoweb's total receipts. Photoweb occasionally sends a representative to the Maine and Massachusetts offices of its business customer. It does

6 Some state tax departments have responded to *Bloomberg BNA's 2014 Survey of State Tax Departments* that one telecommuting employee in the state would create nexus. Taxpayers may of course dispute this position. Connecticut DOR did not respond to the question.

(Continued on page 10)

not have a physical presence in states other than Rhode Island, Maine and Massachusetts.

Rhode Island law does not allow Photoweb to apportion its income in the absence of a regular place of business outside of Rhode Island. R.I. Gen. Laws § 44-11-13. As a result Rhode Island would tax 100% of Photoweb's income.

Massachusetts in its proposed regulation with respect to services delivered electronically provides different rules for services delivered to business customers and individual customers. Working Draft, § 63.38.1(9)(d)(4)(c)(ii)(B).

For services delivered to an individual customer, the taxpayer must assign the sale to the state or states where the customer receives the service, if this can be determined. If the service is received by the customer in multiple states, the taxpayer must assign the sale to those states in accordance with the percentage of the service determined to be received in such states. Given the fact that Photoweb's individual customers can access its services through portable devices, the fallback rule will come into play: "If the taxpayer cannot determine the state or states where the customer receives the service but can reasonably approximate the state or states where the service is received it shall assign the sale to that state or states." If the taxpayer cannot approximate where the service is received it must assign the sale to the state of the customer's billing address. Assuming that Photoweb is unable to reasonably approximate where the services are received, it would assign receipts from sales to individual customers by billing address under the proposed rule.

Under the Massachusetts statute, however, a "throw-out" rule applies: receipts that would be assigned to a jurisdiction in which the taxpayer is not subject to tax must be excluded from both the numerator and denominator of the factor. Working Draft, § 63.38.1(d)(1)(c)(ii). In our example, if we assume that Photoweb has no nexus in states other than Rhode Island, Massachusetts and Maine, all but 6% of its receipts from the sale of services to individual customers must be excluded from the denominator of the Massachusetts factor.[7]

For services delivered to a business customer, the principal rule of assignment is the same as for individual customers, but the fallback rule differs. If the taxpayer can neither determine nor reasonably approximate where the services are received, the taxpayer is then required to look first to the state where the contract of sale is principally managed by the customer. If the place where the customer manages the contract is not reasonably determinable, *in most cases* the taxpayer is then required to assign the sale to the state from which the customer placed the order, and finally, if the place of order is not reasonably determinable, to the billing address. Massachusetts places an affirmative obligation on the taxpayer, however, when the receipts from a particular customer comprise more than 5% of its receipts from the sales of its services. In that case the taxpayer must identify the state in which the contract of sale is principally managed. Assuming Photoweb cannot determine or approximate where its customer receives the service, it must determine which office is principally managing the contract. Therefore, it would assign the receipts from its business customer to Massachusetts.

In sum, Photoweb's receipts from individual customers with a Massachusetts billing address, and its receipts from the business customer would be assigned to Massachusetts, with a total of 52% of its receipts assigned to Massachusetts under the proposed regulation. Under our assumption that Photoweb has no nexus outside of Maine, Massachusetts and Rhode Island, however, sales to individual customers outside of those states (94% of the sales to individual customers, which translates to 47% of total Photoweb sales) would be excluded from the sales factor denominator under the proposed throw-out rule. The Massachusetts sales factor would be 52/53 or 98.1%. Applying the three-factor formula with double-weighted sales would result in approximately 49% of Photoweb's income being apportioned to Massachusetts.

Maine law provides that if the taxpayer cannot determine where sales to an individual customer are received, they are deemed received at the home of the customer. 36 Me. Rev. Stat. Ann. § 5211(16-A); Code Me. R. § 801.06(E). Presumably Maine Revenue Services will accept billing address as a reasonable proxy for "home." As a result, 1% of Photoweb's receipts from sales to individuals will be assigned to Maine. Maine's "throw out" rule does not apply to sales of services.

---

7 Note that as long as the Massachusetts DOR takes the position that nexus may be based upon economic presence, the taxpayer should be entitled to assert economic nexus defensively and a significant economic presence in another state should prevent throw out of sales assigned to that state. *See, e.g., Lorillard Licensing Co. LLC v Director, Division of Taxation*, No. A-2033-13T1, 2014 N.J. Lexis 3 (N.J. Tax Ct. Jan. 14, 2014) (letter amplifying bench opinion), *appeal docketed,* No. A-002033-13 (N.J. Super. Ct. App. Div. Dec. 30, 2013).

(Continued on page 11)

The receipts from the sales to Photoweb's business customer would be assigned to the location where they are received, but if this is not "readily determinable," the receipts are assigned to the office of the customer from which the services were ordered. *Id.* In our example, the services were ordered from the customer's office in Maine. Maine has not provided guidance with respect to what is meant by "readily determinable." Assuming that where the services are received is not readily determinable, a total of 50.5% of the company's receipts will be assigned to Maine, (50% from the business customer and .5% from individual customers). Under Maine's single sales factor formula, 50.5% of its income will be apportioned to Maine.

Total Tax Burden – In this example, Rhode Island would claim the right to tax 100% of Photoweb's income, Massachusetts 49% and Maine 50.5%, for a total tax burden of 199.5%. Note that the respective fallback rules that apply in Massachusetts and in Maine when the taxpayer cannot determine where the customer receives the service work against Photoweb in both states.

3. Radio Station based in Massachusetts

Broadcast Station, a radio station with offices in Massachusetts, receives only advertising revenue (to keep our example reasonably simple). Broadcast Station has nexus in Massachusetts, Connecticut, Maine, New Hampshire, and Vermont because its sales force visits advertisers in these states. Its radio broadcasts reach those states only. All of its employees are based in Massachusetts, and all of its property is located in Massachusetts. Of its typical audience, 45% is in Massachusetts, 15% is in Connecticut, 20% is in New Hampshire, and 10% is in each of Maine and Vermont. Broadcast Station's advertisers include national advertisers and New England businesses. Many states that have otherwise not adopted market-based sourcing have special apportionment rules that cover broadcasters, including Connecticut and New Hampshire.

Massachusetts looks to where the service is "delivered" (Mass. Gen. Laws, ch. 63, § 38), but in the case of services that involve or relate to the delivery of advertising to the customer's intended audience, the advertising service is considered to be delivered *on behalf of the taxpayer's customer to the customer's audience* under the proposed regulation. Working Draft, § 63.38.1(9)(d)(4)(c). The proposed regulation assigns revenue from such services to the state where the services are delivered *to the third party recipient*… on behalf of a customer. *Id.* In short, Broadcast Station's sales factor would be its audience in Massachusetts over its total audience everywhere. The three-factor formula is used, but the sales factor (45/100) is double-weighted, with the result that 72% of its income would be apportioned to Massachusetts.

Connecticut apportions income of an over-the-air broadcaster on the basis of a single gross receipts factor, which attributes advertising revenue to the state on the basis of an "audience factor." Conn. Gen. Stat. Ann. § 12-218 (l)(3)(B). The audience factor is the ratio of the audience for the broadcaster's network or station within the state to the total audience for such network or station. The audience is determined based on books and records of the taxpayer or by reference to rating statistics. Of Broadcast Station's income, 15% will be apportioned to Connecticut.

New Hampshire applies special rules to compute both property and sales factors for broadcasters. The property factor includes "outer jurisdictional property" (to capture the value of satellites not located in any state) to the extent used to transmit and receive signals to New Hampshire. Under our simple example, however, all of Broadcast Station's property is in Massachusetts so the special property factor does not come into play. The special sales factor assigns advertising revenue based on an audience factor. Using New Hampshire's double-weighted sales factor, 10% of Broadcast Station's income would be apportioned to New Hampshire.

Maine looks to where the service is "received" by the customer. 36 Me. Rev. Stat. Ann. § 5211(16-A). If the state where the services are received is not readily determinable, they are deemed to be received at the office from which the services were ordered. *Id.* There is no special rule for the broadcasting industry. The customers for the advertising services are the businesses that advertise on the station, some of which are located outside of New England. Maine Revenue takes the position, however, that the advertisers "receive" the advertising services where the broadcaster's audience is located and based on this interpretation Maine Revenue also applies an audience factor approach. Taxpayers have disputed this interpretation. Under Maine Revenue's interpretation, 10% of the advertising receipts would be sourced to Maine, and using the single sales factor 10% of the income will be apportioned to Maine.

Vermont sources receipts from services based on the cost of performance approach, using a three-factor formula with a double-weighted sales factor. Vt. Stat. Ann. 32 § 5833(a). Because the greater proportion of the cost of performance is in Massachusetts, and all of the property and payroll are in Massachusetts, Broadcast Station would have no income apportioned to Vermont.

(Continued on page 12)

Total Tax Burden – In this example, Massachusetts would claim the right to tax 72% of the income, Connecticut 15%, Maine 10%, and New Hampshire 10%, for a total tax burden of 107%.

Conclusion

The examples illustrate the risk of multiple taxation when states use inconsistent apportionment schemes. Other examples could illustrate situations where less than all of a business's income is subject to tax. The examples further illustrate the potential benefit to a business of locating property and employees in states that have adopted a market-based sourcing approach, and conversely, the enhanced risk of multiple taxation that results when the property and employees are located in a "cost of performance" state when other states apply market-based sourcing.

The examples also illustrate the impact of combining use of a single sales factor with market-based sourcing, and conversely the moderating influence of a three-factor formula when used with market-based sourcing for receipts, even when the sales factor is double weighted. States that use a single sales factor formula with market-based sourcing should expect to face more claims by taxpayers that the formula does not fairly reflect the business activity within the state, and that an alternative apportionment formula should or must be used.

Finally, the examples illustrate that, even among states that have adopted market-based approaches, significant differences in assignment of receipts may result depending on the particular rules adopted to implement market-based sourcing. The fallback rules adopted for sourcing of services are particularly important, given the difficulty of determining where services may be received or delivered.