Sales Factors Based on Benefit Received
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Scope of the Topic

A new trend in apportionment and the determination of the numerator of the sales factor for other than the sale of tangible personal property (in other words, services), is to assign gross receipts to the numerator based upon where the benefit of the service is received.

1) Examples include California, Georgia, Wisconsin, Michigan, Ohio and Washington.

2) Despite statutory and regulatory provisions, the concept of determining where the benefit is received may be elusive.

3) Examine these provisions and the guidance provided by the states, and try to make sense of it.

4) Raise issues about the fairness and constitutionality of such a method or component of the apportionment factor.

Number of industries covered

While many businesses provide services and may consider themselves to be primarily service providers, the way they perform and deliver services can differ widely. Consider the following examples:

1) Health care providers;
   a. Third party payment administrators (TPAs)
   b. Pharmacy benefit management companies (PBMs);

2) Financial institutions;
   a. Broker-dealers;

3) Investment advisers;

4) Telecoms;

5) Contract manufacturers;

6) Providers of analytical and investigatory services;
7) General contractors; 
8) On-line universities;
9) Systems consultants;
10) Contract research organizations; and
11) Professional service firms – (law and accounting).

**Single sales factor**
The emphasis being placed on the sales factor by many states, including single-factor, double-weighted sales and other disproportionately weighted sales factors schemes, make the correct sourcing of service revenue for sales factor purposes of increased importance.

**The Importance of Operational Data**
It is an undeniable fact that under many market sourcing rules are administered in accordance to the facts that the service provider has about its client (billing address, office from which the order was placed, commercial domicile of the customer, specific contract provisions pertaining to the provision of the service, and where the benefit of the service should be deemed to be received).

The lack of availability of certain data may impact the sourcing analysis under various rules.

**Impact of Changing Nexus Standards**
Under a cost of performance (COP) regime, many remote sellers of services were somewhat indifferent as to whether their activities within a COP state caused nexus as under COP they typically had a small sales factor numerator in the destination state.

Under the convergence of economic nexus, factor presence nexus, and expanded views of agency nexus, sellers of services may have crossed nexus thresholds which, in market-based sourcing states, will cause serious tax liabilities.

**Background**
1) The United States has evolved into a service-based economy;
2) The economic impact of the apportionment sourcing of service revenue has received increased scrutiny, which has led to the adoption of market-based sourcing regimes for service revenue;
3) The following states have adopted market-based sourcing for service revenue: California (beginning in 2011 for certain taxpayers); Alabama, Georgia; Iowa; Illinois; Maine; Maryland; Michigan; Minnesota; Ohio; Oklahoma; Utah; Washington; and Wisconsin.
4) There are several reasons why states are moving away from the traditional COP rules and adopting market-based sourcing.
a. Proponents of market-based sourcing claim that such a methodology serves the purpose of the sales factor by balancing the origin-based property and payroll factors.\(^1\)

b. Some believe that market-based sourcing results in an increased level of certainty for taxpayers selling services and intangibles;

c. COP has been criticized as too difficult to determine, penalizing in-state companies and unfair when using an all-or-nothing approach; and

d. State departments of revenue dislike the occurrence of “nowhere sales” that can result from COP

i. However, depending on a taxpayer’s facts, the adoption of the recent market-based sourcing regimes is not likely to prevent nowhere sales in some instances or prove to be “fair” to taxpayers in others.

**The Trend Toward Market-Based Sourcing of Services**

Section 17 of the Uniform Division for Income Tax Purposes Act (UDITPA) sources sales, other than sales of tangible personal property (including services), by looking at the taxpayer’s COP.

1) Under this method, service revenue in particular is sourced to a state if:

a. the income-producing activity is performed in such state; or
b. 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 COP.\(^2\)

2) Typically, states that use COP for service revenue use one of two methods to source service revenue:

i. preponderance (all-or-nothing); or
ii. proportionate (pro rata).

3) Under the preponderance method, which is followed by a significant number of states, sales from services are sourced solely to the state in which the plurality of COP occurs. The determination of where the greatest proportion of the income-producing activity is performed is also made based on the costs associated with the performance of the income-producing activity.

3) In contrast to the preponderance method, under the proportionate method, sales from services are sourced to each state in which COP occurs, or by some other measure of the service provider’s activity.

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\(^1\) Traditionally, the sales factor gave the market state representation when the items sold were classified as tangible personal property, as most states use destination sourcing for such sales. The new market sourcing regimes for the sale of services seem to be, in part, an attempt to restore that historical balance among the apportionment factors.

\(^2\) UDITPA §17.
4) **For certain services** - Some states follow a “time spent” method, under which sales from services are sourced to each state in which personnel perform services. This method is particularly popular when the service is characterized as a personal service (in which capital is not a significant income-producing factor).

### The Influence of the MTC’s (Attempted) Revision of UDITPA § 17

The Multistate Tax Commission (MTC) has followed a long-standing regulation that it adopted interpreting Section 17 of UDITPA.

1) This regulation provides significant detail for determining the sourcing treatment of sales other than sales of tangible personal property. According to the regulation, “income-producing activity:”
   a. Applies to each separate item of income and means the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income. Such activity includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor.

2) It should be noted that the inclusion of independent contractor activities in this calculation was a relatively new development adopted by the MTC in 2007. Historically, such activities were explicitly excluded from the analysis.
   a. Under the regulation, income-producing activity includes, but is not limited to:
      i. the rendering of personal services by employees or by an agent or independent contractor acting on behalf of the taxpayer or the utilization of tangible or intangible property by the taxpayer or by an agent or independent contractor acting on behalf of the taxpayer in performing a service;
      ii. the sale, rental, leasing, licensing or other use of real property;
      iii. the rental, leasing, licensing or other use of tangible personal property; and
      iv. the sale, licensing or other use of intangible personal property. The mere holding of intangible personal property is not considered an income-producing activity.
   b. The regulation defines COP as “direct costs determined in a manner consistent with GAAP and in accordance with accepted conditions or practices in the trade or business of the taxpayer to perform the income-producing activity which gives rise to the particular item of income.” The remainder of the MTC regulation recites the preponderance COP approach endorsed by UDITPA, and addresses certain special rules with respect to sales of items other than tangible personal

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3 MTC Regulation Art. IV.17.
4 MTC Regulation Art. IV.17(2). (Emphasis added.)
5 Id.
6 Id.
7 MTC Regulation Art. IV.17(3). (Emphasis added.)
property, including an alternative rule for “personal services” based on “time spent.”

3) Currently, the MTC is considering more radical changes to its interpretive regulation, and is considering adopting a market-based sourcing approach.

a. However, since the changes it has made to the COP regulation have not been largely followed by the states within the Multistate Tax Compact to date, it remains to be seen how many traditional COP states will conform to changes that the MTC suggests involving the utilization of market-based sourcing.

Traditional Market-Based Sourcing Rules

Historically, states that adopted market-based sourcing for service revenue sought to source service revenue, for purposes of the sales factor, based on the location of the service provider’s customers, or on the location where the customers received benefit from the service provided, rather than the location where the service provider performed the services. The following is a brief description of some of the long-standing service revenue market-based sourcing rules in Georgia, Iowa, Maryland and Minnesota, the first four states that adopted this concept.

Georgia

1) Georgia adopts a customer location/benefit service revenue sourcing rule with the following language, “… the receipts are in [Georgia] if the receipts are derived from customers within this state or if receipts are otherwise attributable to the state’s marketplace.”

   a. This gross receipts factor is designed to measure the marketplace for the taxpayer’s goods and services.

2) The Georgia regulations go into significant detail in defining the applicable terminology used. For example, the Georgia regulations define “customers within this state” as:

   a. A customer that is engaged in a trade or business and maintains a regular place of business within [Georgia]; or

   b. A customer that is not engaged in a trade or business whose billing address is in [Georgia].

   c. In turn, the Georgia regulations define “regular place of business” as an “office, factory, warehouse or other business location at which the taxpayer carries on its business in a regular and systematic manner and which is continuously maintained, occupied and used by employees, agents or representatives of the taxpayer.”

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8 MTC Regulation Art. IV.17(4)(B).
9 GA. CODE ANN. § 48-7-31(d)(2)(C); GA. COMP. R. & REGS. r. 560-7-7-.03(5)(c)(1).
10 GA. COMP. R. & REGS. r. 560-7-7-.03(5)(c)(1).
11 GA. COMP. R. & REGS. r. 560-7-7-.03(5)(c)(3). (Emphasis added.)
12 GA. COMP. R. & REGS. r. 560-7-7-.03(5)(c)(4).
d. The Georgia regulations define the term “billing address” as “the location indicated in the books and records of the taxpayer as the address where any notice, statement and/or bill relating to a customer’s account is mailed.” Finally, the Georgia regulations define the term “attributable to this state’s marketplace” for a variety of income streams.

3) With respect to services, “all gross receipts from the performance of services are included in the numerator of the apportionment factor if the recipient of the service receives all of the benefit of the service in Georgia.”

   a. “If the recipient of the service receives some of the benefit of the service in Georgia, the gross receipts are included in the numerator of the apportionment factor in proportion to the extent the recipient receives benefit of the service in Georgia.”

Iowa

1) The Iowa statute affords the Director of the Department of Revenue the power to adopt rules for sourcing income derived from businesses other than the manufacture or sale of tangible personal property.

2) The Department has adopted regulations attributing these types of sales to Iowa in the proportion in which the Iowa gross receipts bear to total gross receipts.

3) Iowa gross receipts include receipts from services where the service recipient receives the benefit in Iowa.

   a. In addition, the explanation of the benefit rule, and the accompanying examples used in the regulation, trace Georgia’s analysis.

Maryland

1) While the Maryland statute is silent on how to source receipts from services, a Maryland regulation adopts a customer location/benefit service revenue sourcing rule, stating that “gross receipts from contracting or service-related activities shall be included in the numerator if the receipts are derived from customers within the state of [Maryland] . . . .”

   a. The term “customer within the state” includes individuals and business enterprises.

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13 GA. COMP. R. & REGS. r. 560-7-7-.03(5)(c)(5).
14 GA. COMP. R. & REGS. r. 560-7-7-.03(5)(c)(6).
15 GA. COMP. R. & REGS. r. 560-7-7-.03(5)(c)(6)(ii). (Emphasis added.)
16 Id.
17 IOWA CODE § 422.33.2.b(3).
18 IOWA ADMIN. CODE r. 701 54.6(422).
19 Id.
20 IOWA ADMIN. CODE r. 701 54.6(422)(1).
21 MD. REGS. CODE § 03.04.03.08.C.(3)(e).
22 MD. REGS. CODE § 03.04.03.08.D.(2)
b. “A business enterprise shall be considered a customer within … [Maryland] … if the business enterprise is domiciled in [Maryland].”

c. Further, “[i]f the customer is a business enterprise, then the domicile is the state in which is located the office or place of business that provides the principal impetus for the sale.”

d. “If an office or place of business cannot be identified as providing the principal impetus for the sale, then the domicile shall be the state in which the headquarters or principal place of business management of the customer is located.”

e. The regulation includes examples which further explain how to apply this concept.

f. Maryland is the only state that endorses the “impetus of the sale” method of sourcing services.

   i. What exactly does the term “principal impetus of the sale” mean?

      1. Is it where the customer receives the benefit of the sale, or where the customer makes the decision on whether the transaction moves forward?

      2. The first example in the regulations relies on where the transaction is providing a benefit to the customer, and so it is possible to conclude that the “principal impetus of the sale” is akin to where the benefit of the service is received, not necessarily the location that the customer made the decision to commit to receiving the service.

      3. Even if it is determined that the definition of “principal impetus of the sale” requires looking at where the customer is benefiting from such service, additional issues arise in relatively commonplace transactions.

         a. How is the location of the “principal impetus of the sale” determined in the situation where the impetus of the sale occurs partly in Maryland and partly in other states?

         b. Should the sale be sourced to Maryland and to other states on essentially a pro rata basis, or in the alternative, should the taxpayer try to determine in which state the majority (or even the plurality) of the impetus of the sale occurred and then source the sale in an all-or-nothing manner to one state?

23 MD. REGS. CODE § 03.04.03.08.D(2)(b)(ii).
24 MD. REGS. CODE § 03.04.03.08.D(2)(b)(iii). (Emphasis added.)
25 Id. (Emphasis added.)
26 Id., Examples 3 and 4.
c. It appears that the use of the term “principal” would require some kind of all-or-nothing calculation, but that is not entirely clear from the regulations.

d. If the Comptroller has no clearly stated policy on this issue, does the taxpayer have a duty to choose one type of sourcing method and be consistent with it, or can the taxpayer make its own determination on how to proceed on a year-to-year basis?

e. All of these potential issues with the Maryland market-sourcing standard are made more serious when trying to deal with the underlying problem with using a market-based standard, which is the difficulty for the taxpayer to obtain customer information regarding where the impetus of a particular sale took place.

**Minnesota**

1) Minnesota adopts a customer location/benefit service revenue sourcing rule through the following statute:

   a. Receipts from the performance of services must be attributed to the state where the services are received.

      i. For the purposes of this section, receipts from the performance of services provided to a corporation, partnership, or trust may only be attributed to a state where it has a fixed place of doing business.

   b. If the state where the services are received is not readily determinable or is a state where the corporation, partnership or trust receiving the service does not have a fixed place of doing business, the services shall be deemed to be received at the location of the office of the customer from which the services were ordered in the regular course of the customer’s trade or business.

   c. If the ordering office cannot be determined, the services shall be deemed to be received at the office of the customer to which the services are billed.\(^2\)

\[d. \text{Note that the Minnesota statute provides for a cascading rule and a requirement that the initial sourcing determination be made with relation to the customer’s fixed place of doing business, unlike several of the other long-standing market-based sourcing rules.}\]

\(^2\) Minn. Stat. § 290.191.5(j).
New State Market-Based Sourcing Rules

A number of states have recently switched from the traditional COP rules to some form of market-based sourcing. The new regimes put in place are not homogenous and contain significant nuances which create, for large multijurisdictional taxpayers, complexities and uncertainties in implementing the rules, as well as the continued risk of duplicative taxation.

Alabama

1) The Alabama Governor signed legislation that amends the apportionment formula to double-weight the sales factor and requires market sourcing for sales other than sales of tangible personal property.28

2) The law is effective retroactively for tax years beginning on or after December 31, 2010.29

3) Alabama historically has used an equally-weighted three-factor formula to apportion business income. The new legislation retains the payroll and property factors for purposes of the apportionment formula, but provides for double weighting of the sales factor.30

4) The new law adopts market-based sourcing rules for sales other than sales of tangible personal property.

5) Sales will now be sourced to Alabama if the taxpayer’s market for the sale is in Alabama.
   a. The legislation provides rules in determining when a taxpayer’s market for such sales will be in Alabama.
      i. Sales from the rental, lease or license of real or tangible personal property, and sales of real property are sourced to the location of the property.
      ii. Sales of services are sourced to the location where the service is delivered.
      iii. Sales resulting from the lease or license of intangible property, and the sale or other exchange of intangible property if the receipts from the sale or exchange derive from payments that are contingent on the productivity, use, or disposition of the property are sourced to the location where the intangible is used.
         1. However, sales from intangible property used in marketing a good or service to a consumer is sourced to the location where the consumer purchased the good or service.
         2. Where the property sold is a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area, such sales are sourced to the location where the intangible is used or otherwise associated.
         3. Sales from other types of intangible property not otherwise described in the sourcing rules are excluded from the numerator and the denominator of the sales factor.31

6) In the event that the sourcing location cannot be determined by the above rules, the law authorizes a reasonable approximation of where the sale should be sourced.32

29 Id.
a. If the taxpayer is not taxable in a state to which a sale is assigned under the market sourcing rules, or if the state of assignment cannot be determined under the market sourcing rules or reasonably approximated, then the sale will be excluded from the denominator of the sales factor.\textsuperscript{33}

7) The change in the weighting of the sales factor and sourcing provisions are likely to affect most taxpayers’ expected 2011 Alabama corporate income tax liabilities by causing a potentially substantial increase or decrease in their apportionment factors.

8) The sourcing of the sales of services. Alabama will now require a taxpayer to source receipts from the sale of services based on the location where the service is delivered.

a. There is no definition provided in the statute for the term “delivered” and therefore determining where the sale of a service took place could be difficult.

b. If a state cannot be fairly determined, the law calls for approximation. Determining a reasonable approximation could also be difficult.

c. The law provides no guidance on making a reasonable approximation and it may be necessary for the state to pass a regulation to interpret the provision.

\textbf{Alabama’s Proposed Regulations}

Alabama in drafting (and sought practitioner input on) regulations addressing market-based sourcing which will presumably address some of the issues identified above.

\textbf{California}

1) California historically has followed preponderance COP principles.\textsuperscript{34} Beginning in the 2011 taxable year, the COP methodology is replaced with an elective single-factor market-based sourcing rule, so that sales from services are sourced to California to the extent the purchaser of the service received the benefit of the service in California.\textsuperscript{35}

2) This new sourcing rule is only available to taxpayers who elect to use a single sales factor apportionment formula when that election is available beginning in 2011.\textsuperscript{36}

3) Taxpayers who do not elect to use a single factor apportionment formula will continue to use the preponderance COP rule.\textsuperscript{37}

\textsuperscript{32} ALA. CODE § 40-27-1, Art. IV, 17(b).
\textsuperscript{33} ALA. CODE § 40-27-1, Art. IV, 17(c).
\textsuperscript{34} CAL. REV. & TAX. CODE § 25136(a).
\textsuperscript{35} CAL. REV. & TAX. CODE § 25136(b)(1)-(4).
\textsuperscript{36} CAL. REV. & TAX. CODE § 25136(b)(5). On November 2, 2010, California voters rejected an initiative, Proposition 24, the Repeal Corporate Tax Loopholes Act, which would have repealed the single sales factor election, and would have caused the sourcing of services to revert to the COP rule for all taxpayers.
1) The California Franchise Tax Board is in the process of promulgating a regulation that explains how to source services under the new market-based sourcing rule.\(^{38}\)

2) The regulation defines certain important terms.

   a. The regulation defines the term “benefit of a service is received” as the location where the taxpayer’s customer has either directly or indirectly received value from delivery of that service.\(^{39}\)

   b. The sourcing rules are different for a taxpayer’s individual customers versus its corporate customers.

3) For a taxpayer’s individual customers, under the draft regulation, there is a presumption that the location of the customer’s billing address is where the customer received the benefit, but this presumption can be overcome, resulting in sourcing according to the location of contract, books or records, or even a reasonable approximation when nothing else is conclusive.\(^{40}\)

4) For a taxpayer’s corporate customers, there is a presumption that the location designated by a contract or the taxpayer’s books and records is the location of benefit, but this presumption can be overcome, resulting in sourcing according to reasonable approximation, the customer’s ordering location, or the customer’s billing address when nothing else is conclusive.\(^{41}\)

   i. Numerous specific terms are defined – for example:\(^{42}\)

      1. The term “cannot be determined” means that the taxpayer’s records or the records of the taxpayer’s customer which are available to the taxpayer do not indicate the location where the benefit of the service was received or where the intangible property was used.\(^{43}\)

      2. "Reasonably approximated" means that, considering all sources of information other than the terms of the contract and the taxpayer’s books and records kept in the normal course of business, the location of the market for the benefit of the services or the location of the use of the intangible property is determined in a manner that is consistent with the activities of the customer to the extent such information is available to the taxpayer. Reasonable approximation shall be limited to the jurisdictions or geographic areas where the

\(^{37}\) CAL. REV. & TAX. CODE § 25136(a).
\(^{38}\) CAL. CODE REGS. tit. 18, § 25136-2. This regulation is pending final approval.
\(^{39}\) CAL. CODE REGS. tit. 18, § 25136-2(b)(1).
\(^{40}\) CAL. CODE REGS. tit. 18, § 25136-2(b)(2)(E).
\(^{41}\) CAL. CODE REGS. tit. 18, § 25136-2(c).
\(^{42}\) CAL. CODE REGS. tit. 18, § 25136-2(b)(1)(D), (2)(E).
\(^{43}\) CAL. CODE REGS. tit. 18, § 25136-2(b)(2).
customer or purchaser, at the time of purchase, will receive the benefit of the services or use of the intangible property to the extent such information is available to the taxpayer. If population is a reasonable approximation, the population used shall be the U.S. population as determined by the most recent U.S. census data. If it can be shown by the taxpayer that the benefit of the service is being substantially received or intangible property is being materially used outside the U.S., then the populations of those other countries where the benefit of the service is being substantially received or the intangible property is being materially used shall be added to the U.S. population.\textsuperscript{44}

ii. For customers who are individuals, one set of cascading rules applies;\textsuperscript{45} and

iii. For customers which are business entities, another set of cascading rules applies.\textsuperscript{46}

**Illinois**

1) Illinois historically followed a majority COP rule, under which a sale was sourced to Illinois if the income-producing activity was entirely performed in Illinois, or more of the income-producing activity was performed in Illinois than in all other states, based on COP.\textsuperscript{47}

2) For tax years ending on or after December 31, 2008, Illinois adopted a market-based sourcing approach for sourcing sales of services.\textsuperscript{48}

3) The market-based sourcing method in Illinois generally sources sales of services to Illinois if the benefit of the service is realized in the state.\textsuperscript{49}

4) The new law also adopts a “throw-out” rule, whereby service revenues received by customers in states where the taxpayer is not taxable are “thrown out” of the apportionment calculation entirely.\textsuperscript{50}

5) Under Illinois law, gross receipts from the performance of services provided to a corporation, partnership, or trust may only be attributed to a state where that corporation, partnership, or trust has a fixed place of business.\textsuperscript{51}

   a. If the state where the services are received is not readily determinable or is a state where the corporation, partnership, or trust receiving the service does not have a fixed place of business, the services shall be deemed to be received at the location of

\textsuperscript{44}CAL. CODE REGS. tit. 18, § 25136-2(b)(5).
\textsuperscript{45}CAL. CODE REGS. tit. 18, § 25136-2(b)(5).
\textsuperscript{46}CAL. CODE REGS. tit. 18, § 25136-2(e)(1).
\textsuperscript{47}Former 35 ILL. COMP. STAT. 5/304(a)(3)(C).
\textsuperscript{48}P.A. 95-707 (S.B. 783), Laws 2007.
\textsuperscript{49}35 ILL. COMP. STAT. 5/304(a)(3)(C-5)(iv).
\textsuperscript{50}Id.
\textsuperscript{51}Id.
the office of the customer from which the services were ordered in the regular course of the customer's trade or business.\textsuperscript{52}

b. If the ordering office cannot be determined, the services are deemed to be received at the office of the customer to which the services are billed.\textsuperscript{53}

i. The Department is directed to adopt rules prescribing where specific types of service are received, including, but not limited to, publishing, and utility service.\textsuperscript{54}

Illinois Draft Regulations

1) The Illinois draft market-based sourcing rules would be a modification to the Illinois Administrative Code, Title 86, § 100.370(a)(5)(D).

2) General rule. Gross receipts from services are assigned to the numerator of the sales factor to the extent that the receipts may be attributed to services received in Illinois.\textsuperscript{55}

a. Examples of services received in a state are also provided based on the locus of the subject matter of the service.\textsuperscript{56}

3) Nuanced cascading rules are also provided.\textsuperscript{57}

Maine

1) Maine historically followed preponderance COP principles.\textsuperscript{58}

2) For tax years beginning after 2006, receipts from the performance of services must be attributed to the state where the services are received.\textsuperscript{59}

   a. If the state where the services are received is not readily determinable, the services are deemed to be received at the customer’s home or, in the case of a business, the customer’s office from which the services were ordered in the regular course of the customer’s trade or business.

   b. If the ordering location cannot be determined, the services are deemed to be received at the customer’s home or office where the services are billed.

   c. If the purchaser is the federal government or the receipts are otherwise attributable to a state where the taxpayer is not taxable, the receipts are attributable to Maine if a

\textsuperscript{52} Id.
\textsuperscript{53} Id.
\textsuperscript{54} At the date of this writing, the Illinois Department of Revenue has drafted proposed rules for the market-based sourcing of services. Those rules have been released to some members of the practitioner community for comment.
\textsuperscript{55} ILL. ADMIN. CODE tit. 86 §100.3370(a)(5)(D)(i) (draft).
\textsuperscript{56} ILL. ADMIN. CODE tit. 86 §100.3370(a)(5)(D)(ii) (draft).
\textsuperscript{57} ILL. ADMIN. CODE tit. 86 §100.3370(a)(5)(D)(iii) (draft).
\textsuperscript{58} Former ME. REV. STAT. ANN., tit. 36, § 5211.16.
\textsuperscript{59} ME. REV. STAT. ANN., tit. 36, § 5211.16-A.A.
greater proportion of the income-producing activity is performed in Maine than in any other state based on COP.60

**Michigan**


2) The new Michigan corporate income tax (CIT) will use single sales factor apportionment.62

3) For CIT purposes, Michigan will generally source sales from services based on where the benefit of the service is received. The sourcing provisions for the CIT are identical to those of the MBT. Special sourcing rules are provided for financial, transportation, telecommunications and media broadcasting services.

   a. It should be noted that a comprehensive technical correction bill for the MBT was enacted and could have implications for sourcing and other areas of the new CIT structure.63

4) All receipts from the performance of services are included in the numerator of the apportionment factor if the recipient of the services receives *all* of the benefit of the services in Michigan.64

5) If the recipient of the services receives some of the benefit of the services in Michigan, the receipts are included in the numerator of the apportionment factor in proportion to the extent that the recipient receives benefit of the services in Michigan.65

6) Specific rules apply for sales derived from securities brokerage services, as well as sales of services derived from the sale of management, distribution, administration or securities brokerage services to or on behalf of a regulated investment company or its beneficial owners.66

   a. The Michigan Department of Treasury released Revenue Administrative Bulletin (RAB) 2010-5, addressing how taxpayers that provide services should determine the location where the benefit of the service is received.67

   b. The RAB discusses a variety of related topics, including:

      i. Situations where only a portion of the benefit received is in Michigan;

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60 Id.
61 Previously, the state used the COP method to source services. See Mich. Comp. Laws § 208.53.
62 2011 PA 38 §§ 661, 663.
63 See Act 312 (H.B. 4949) and Act 313 (H.B. 4950), Laws 2011
ii. Whether the recipient of the services can be different from the purchaser of the services;

iii. How the guidance will be applied in practice; and

iv. What a taxpayer should do if it cannot determine where the recipient of the service received the benefit.

v. Note, that while an RAB expresses the Department’s views on the interpretation of a statute, it does not carry the authority of a formal rule (which may be promulgated by the Department in the future).

1. In the RAB, the Department has taken the position that the benefit of a service will be considered 100 percent in Michigan in any of these situations:
   a. The service relates to real property located entirely in Michigan.
   b. The service relates to tangible personal property that is either –
      i. owned or leased by the purchaser and located in Michigan at the time the service is received, or
      ii. delivered to the purchaser or the purchaser’s designee(s) in Michigan.
      iii. The service is provided to a purchaser who is an individual physically present in Michigan at the time the service is received.
   c. The services are –
      i. personal services (i.e. consulting, counseling, training, speaking or entertainment),
      ii. received in Michigan, and
      iii. typically of the type that are conducted or performed first-hand, on a direct, one-to-one, or one-to-many basis.
   d. The service is provided to a purchaser engaged in a trade or business in Michigan relating only to that Michigan trade or business.
   e. The service relates to the use entirely within Michigan of intangible property such as computer software (not canned/prewritten), licenses, designs, processes, patents and copyrights.
   f. The services are professional services (i.e. legal or accounting) provided to either individuals domiciled in Michigan or a purchaser with exclusive Michigan business operations.68

68 RAB 2010-5, Section III.
2. If the services at issue are only partially received within Michigan, then pursuant to the MBT, receipts included in the sales apportionment factor will be “[i]n proportion to the extent that the benefit of the services is received in [Michigan].” Accordingly, the benefit of the services is received in Michigan to the extent the property or business operations related to the service is located, used or occurs in Michigan.

3. The RAB lists a second series of rules to be utilized where the services are partially received within Michigan.
   
a. If the service relates to real property located in Michigan and in one or more other states, the benefit of the service is received in Michigan to the extent that the real property is located in Michigan.
   
b. If the service relates to tangible personal property that (a) is owned or leased by the purchaser and located in Michigan and in one or more other states at the time that the service is received, or (b) is delivered to the purchaser or the purchaser’s designee(s) in Michigan and in one or more other states, the benefit of the service is received in Michigan to the extent that the tangible personal property is located in Michigan, or is delivered to the purchaser or the purchaser’s designee(s) in Michigan.
   
c. If the service is provided to a purchaser that is engaged in a trade or business in Michigan and in one or more other states, and the service relates to the trade or business of that purchaser in Michigan and in one or more other states, the benefit of the service is received in Michigan to the extent that it relates to the trade or business of the purchaser in Michigan.

7) If the service relates to the use of intangible property such as computer software (other than prewritten computer software), licenses, designs, processes, patents, and copyrights, which is used in Michigan and in one or more other states, the benefit of the service is received in Michigan to the extent that the intangible property is used in Michigan.

8) If the services provided are professional in nature, such as legal or accounting services, and are provided to a purchaser with business operations in Michigan and one or more other states, and the services relate to the purchaser’s operations both in Michigan and in one or more other states, the benefit of the services is received in Michigan to the extent that the services relate to the purchaser’s Michigan operations.70

9) The RAB highlights the fact that by referring to the “recipient of the services,” the statute indicates that the recipient of the services may be someone other than the

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70 RAB 2010-5, Section III.
actual purchaser of the services. While the recipient and purchaser will usually be the same person or entity, the RAB acknowledges that this is not required by the statute.

10) The RAB includes 13 nonexclusive examples of how the Department will apply these rules. Specifically, the examples outline how the Department plans to interpret the market-based sourcing rules under various fact patterns. The rules contain some interesting analysis and are informative to taxpayers sourcing services in Michigan.

11) In the RAB, the Department reminds taxpayers that they have a duty to maintain adequate documentation to support their determination where the benefit of a service is received.

   a. Taxpayers must use reasonable means or methods that are uniformly and consistently applied to support their conclusions.

12) An MBT statute provides special sourcing rules for various specific types of services, which also contain default sourcing provisions.

   a. If a taxpayer cannot determine the customer’s location, the MBT statute provides that the customer’s address is presumed to be the location of the branch office that generates the transactions.

   b. When the MBT does not specifically address a situation with a special sourcing rule, it provides a “last resort” statute sourcing the sale either to the location where the benefit of the customer is received or to the customer’s location.

13) In the RAB, the Department cautions that a taxpayer cannot use the customer’s location contained in the “last resort” statute to source a sale of services without first making an effort, based on its books and records, to determine the location where the benefit of the service is received.

   a. Moreover, the RAB provides that sales are not excluded from the apportionment factor if the location of the benefit cannot be determined.

14) For most large corporate purchasers of services, specifically those having significant multi-state operational footprints, it would seldom be the case that “all” the benefit of services provided in a given transaction would be in Michigan.

   a. Service providers may be challenged to determine, from a practical as well as a tax-planning perspective, where customers receive the proportionate value of the services provided.

   b. The determination of when or how a recipient of services “receives benefit of services” within Michigan may prove problematic.

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71 Id.
72 R-AB 2010-5, Section II.
73 R-AB 2010-5, Section IV.
74 Id.
75 MICH. COMP. LAWS § 208.1305(2).
76 MICH. COMP. LAWS § 208.1305(2)(b).
77 MICH. COMP. LAWS § 208.1311.
78 R-AB 2010-5, Section V.
c. A catch-all provision was included in the MBT statutes providing that all other receipts not otherwise sourced under the MBT are sourced based on where the benefit to the customer is received, or, if where the benefit to the customer is received cannot be determined, to the customer’s location.\textsuperscript{79}

i. This appears to require the seller to either determine the location of benefit or the “customer’s location.”

\textbf{Oklahoma}

1) Historically, Oklahoma’s statutes and administrative rules were silent on the sourcing of service revenue.\textsuperscript{80}

2) In recent years, following the national trend, Oklahoma auditors have been informally trying to push taxpayers toward market-based sourcing.

3) Effective July 11, 2010, the Oklahoma Tax Commission amended an apportionment rule providing that for purposes of the sales factor, taxpayers must report revenues from the performance of services in the sales factor numerator essentially on a market-based sourcing basis.\textsuperscript{81} The amended Oklahoma rule is the first official guidance the Oklahoma Tax Commission has provided on the subject.

4) Oklahoma’s newly amended rule addresses the sourcing of service revenue for sales factor purposes.

5) The newly amended rule states that “[r]eceipts from the performance of services shall be included in the numerator of the [sales factor] fraction if the receipts are derived from customers within this state [Oklahoma] or if the receipts are otherwise attributable to this state’s marketplace.”\textsuperscript{82}

6) Under the rule, a “customer within Oklahoma” is either “a customer that is engaged in a trade or business and maintains a regular place of business in Oklahoma,”\textsuperscript{83} or “a customer that is not engaged in a trade or business whose billing address is in Oklahoma.”\textsuperscript{84}

7) Under the revised rule, “billing address” means “the location indicated in the books and records of the taxpayer as the address of record where the bill relating to the customer’s account is mailed.”\textsuperscript{85}

\textsuperscript{79} MICH. COMP. LAWS § 208.1311.
\textsuperscript{80} Unlike the apportionment statutes in many states, the Oklahoma apportionment statute does not contain a provision for sourcing sales other than sales of tangible personal property. See OKLA. STAT. tit. 68, § 2358(A)(5)(c).
\textsuperscript{81} OKLA. ADMIN. CODE § 710:50-17-71. The amended rule is contained in the Oklahoma Register, Vol. 27, No. 20, July 1, 2010.
\textsuperscript{82} OKLA. ADMIN. CODE § 710:50-17-71(1)(A)(ii).
\textsuperscript{83} OKLA. ADMIN. CODE § 710:50-17-71(1)(A)(ii)(I).
\textsuperscript{84} OKLA. ADMIN. CODE § 710:50-17-71(1)(A)(ii)(II).
\textsuperscript{85} Id. (emphasis added)
8) As the Commission is considering this to be a clarification of existing policy rather than a change, the amendment of this rule may have a retroactive effect.

a. The broad and inclusive definition of what is a “customer within Oklahoma” is significant, as a customer engaging in a trade or business and maintaining a regular place of business in Oklahoma, or a company whose billing address is in Oklahoma based on the taxpayer’s billing address information will both meet this standard.

b. Note, this differs significantly from the more common market-based sourcing rule which typically provides for sourcing of service revenue based on where the customer receives the benefit of the services performed.

Utah

1) Utah historically followed preponderance COP principles,86

2) For taxable years beginning on or after January 1, 2009, receipts from the performance of a service are sourced to Utah if the purchaser receives a greater benefit of the service in Utah than in any other state.87

3) In December 2011, the Tax Commission promulgated rules to prescribe the circumstances under which the purchaser of a service receives a greater benefit of the service in Utah than in any other state.88

a. The service relates to tangible personal property and is performed at a purchaser’s location in Utah;

b. The service relates to tangible personal property that the taxpayer directly or indirectly delivers to a purchaser in Utah after the taxpayer performs the service;

c. The service is provided to an individual who is physically present in Utah at the time the service is received;

d. The service is provided to a purchaser exclusively engaged in business in Utah and the service relates to the purchaser’s business;

e. The service is provided to a purchaser that is present in Utah and the service relates to the purchaser’s activities in Utah;

f. The service is received in more than one state and it can be "readily determined" that Utah is the state where the greater benefit of the service is received "using reasonable and consistent methods of analysis" and "supported by the service provider's business records at the time the service was provided," and

86 Utah Code Ann. § 59-7-319(2).
87 Utah Code Ann. § 59-7-319(3)(a).
g. If the service is received in more than one state and it cannot be "readily determined" the greater benefit of the service is received in a state, the service is sourced using a sequential rule looking at (i) the office from which the purchaser placed the order and (ii) the purchaser's billing address. If neither office from which the service was ordered nor the billing address can be determined, the service is sourced to Utah.

**Wisconsin**

1) In 2005, Wisconsin became a market-based sourcing state. Gross receipts from services are sourced to Wisconsin if the purchaser of the service received the benefit of the service in Wisconsin.  

2) The benefit of a service is received in Wisconsin if:
   a. The service relates to real property that is located in Wisconsin;
   b. The service relates to tangible personal property that is located in Wisconsin at the time that the service is received or tangible personal property that is delivered directly or indirectly to customers in Wisconsin;
   c. The service is provided to an individual who is physically present in Wisconsin at the time that the service is received; or
   d. The service is provided to a person engaged in a trade or business in Wisconsin and relates to that person’s business in Wisconsin.

3) For purchasers of services that receive the benefit of a service in more than one state, the gross receipts from the performance of the service are included in the numerator of the sales factor according to the portion of the service received in Wisconsin.

**New State Market Sourcing Rules (Gross Receipts Taxes)**

While Ohio and Washington do not impose corporation income taxes, their gross receipts taxes utilize market-based sourcing rules that borrow heavily from the concepts adopted by other states.

**Ohio**

1) In 2005, Ohio enacted the Commercial Activity Tax (CAT), which is a gross receipts tax on entities that replaced the Ohio Corporation Franchise Tax (CFT) over a five-year period.

2) For purposes of the CAT, gross receipts from the sale of services are sitused to Ohio in the proportion that the purchaser's benefit in Ohio with respect to what was purchased bears to the purchaser's benefit everywhere.

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3) The physical location where the purchaser ultimately uses or receives the benefit of what was purchased is paramount in determining the proportion of the benefit in Ohio to the benefit everywhere.\textsuperscript{93}

4) In a regulation issued by the Ohio Department of Taxation, the situs of a wide variety of services to Ohio is generally based on this physical location rule discussed above.\textsuperscript{94}

5) The Ohio rule specifies sourcing mechanics for 54 specifically enumerated services.\textsuperscript{95}
   a. With regard to services that pertain to customers that have locations both within and without Ohio, the gross receipts may be sitused to Ohio using any reasonable, consistent, and uniform method of apportionment that is supported by the service provider's business records as they existed at the time the service was provided or within a reasonable time thereafter.\textsuperscript{96}
   
   b. The Ohio administrative guidance provides that, depending on the type of services provided (if the customer has facilities benefiting from the services both within and without Ohio), the taxpayer (the provider of the services) can use any reasonable, consistent and uniform method of apportionment, provided that the taxpayer maintains supporting records created at the time of the transaction.\textsuperscript{97}

\textbf{Washington}

Washington substantially amended its Business and Occupation (B&O) tax provisions in 2010, including the adoption an economic nexus standard and single receipts factor apportionment for certain services and other apportionable activities (not, e.g., retailing or wholesaling).\textsuperscript{98} The new law replaces Washington's cost-based apportionment. Effective June 1, 2010, taxpayers meeting the new economic nexus standard are required to apportion their gross income from service and other apportionable activities by multiplying their worldwide gross income from each apportionable activity by a receipts factor. The receipts factor for each apportionable activity is equal to the gross income

\textsuperscript{93} \textit{Id.} Note that the rule under the CFT, for tax years ending after December 11, 2003, was very similar to the rule that is used for the CWT: "Receipts from the sale of services . . . shall be sitused to this state in the proportion to the purchaser's benefit, with respect to the sale, in [Ohio] to the purchaser's benefit, with respect to the sale everywhere. The physical location where the purchaser ultimately uses or receives the benefit of what was purchased shall be paramount in determining the proportion of the benefit in [Ohio] to the benefit everywhere." See OHIO REV. CODE ANN. § 5733.05(e)(ii); Corporation Franchise Tax Information Release IT-CFT 2004-01, Ohio Department of Taxation, April 19, 2004, page 6.

\textsuperscript{94} OHIO ADMIN. CODE § 5703-29-17. According to the rule, the Tax Commissioner will not require taxpayers to upgrade their systems in order to comply with the general provisions of this rule as long as the taxpayer makes a good faith effort to situs receipts from services in a reasonable, consistent, and uniform method that is supported by the taxpayer's business records as they existed at the time the service was provided or within a reasonable time thereafter. In the event the Commissioner disagrees with a taxpayer's reasonable, consistent, and uniform method of situsing its gross receipts, a penalty will not be imposed if the situsing was found to be made in good faith. While different methods may be used for different types of services, the same method must be consistently used for all types of similar services. OHIO ADMIN. CODE § 5703-29-17(B)(2)(b).

\textsuperscript{95} OHIO ADMIN. CODE § 5703-29-17(C)(4)(d).

\textsuperscript{96} For example, OHIO ADMIN. CODE § 5703-29-17(C).

\textsuperscript{97} \textit{Id.}

\textsuperscript{98} Ch. 23 (S.B. 6143), Laws 2010, First Special Session. For tax reporting periods beginning after 2005, the sourcing of services for purposes of the Washington B&O tax was governed by a rule authorized by the Washington Department of Revenue providing taxpayers with the ability to use separate accounting or cost apportionment, depending upon the particular facts and circumstances of each taxpayer. WASH. ADMIN. CODE § 458-20-194.
attributable to the state divided by the taxpayer's gross income everywhere. Under the new law, apportionable income is attributed to a state, for purposes of the receipts factor calculation, based primarily on where the customer received the benefit of the service. A taxpayer will need to analyze new sourcing provisions to determine the allocation of gross income subject to B&O tax. The sourcing provisions are as follows:

1. Source the income to the state where the customer received the benefit of the service or used the intangibles;
2. If the above is in multiple states, then source to the state in which the customer primarily received the benefit or primarily used the intangibles. The Department has somewhat questionably interpreted this sourcing provision to apply only if the "taxpayer is unable to separately determine the benefit of the services in specific states" under the preceding rule. The Department is currently working on an elaborate and controversial set of rules that would apportion the benefit received among states rather than relying on the all-or-nothing result under the "primarily received" rule;
3. If unable to source as above, then source to the state where the customer ordered the service, or the state of the customer's office from which the royalty agreement with the taxpayer was negotiated;
4. If unable to source as above, then source to the state to which the billing statement or invoice is sent;
5. If unable to source as above, then source to the state from which the customer sends payment;
6. If unable to source as above, then source to the customer's location (as reflected in business records kept in ordinary course or obtained during the transaction); and
7. If unable to source as above, then source to the state of the seller's commercial domicile.

The numerator of the receipts factor is the gross income attributable to Washington. The denominator is worldwide gross income. A separate receipts factor and apportionment calculation must be performed for each classification of apportionable income. This effectively results in an allocation or separate accounting of gross income, except in the narrow circumstances where the taxpayer has apportionable income that is thrown out of the denominator because it is attributable to a state in which the taxpayer does not have nexus under new Washington economic nexus standard.

**Other State Tax Authorities’ Attempts to Adopt Market-Based Sourcing**

Some state tax authorities have not waited on a change in statutes or revised their regulations to assert market-based sourcing of service revenue. Instead, they have asserted a market-based sourcing theory at the audit level and sought to enforce such theory via litigation. For example, state tax authorities have been invoking alternative apportionment to achieve market-based sourcing where COP sourcing results in zero sales being attributed to the state. In some instances, state tax authorities have tried to change the characterization of an item from the sale of a service sourced by COP to the sale of

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100 Id.
101 Id.
tangible personal property sourced by the location of the marketplace. Finally, state tax authorities have argued that depending on the facts and circumstances of a taxpayer, COP does not properly reflect a taxpayer’s income, particularly if the sales are not included in any state’s sales factor numerator. Assessments based on these methodologies have been successful at the litigation phase of a controversy to the extent a given court is unwilling to understand and apply statutory COP methodologies to taxpayers who are clearly soliciting and interacting with customers in the state but not performing a preponderance of the services in question in the state. The following section examines some recent litigation in this area.

**Wisconsin Ameritech Case**

1) The Wisconsin Court of Appeals affirmed a decision by the Wisconsin Tax Appeals Commission holding that all of a taxpayer’s income generated from local telephone directory advertising be apportioned to Wisconsin because all of its income-producing activity was performed within the state. For purposes of apportionment, the taxpayer’s income-producing activity was defined as furnishing access to a Wisconsin audience by advertisements placed in the telephone directories. Facts:

   a. The taxpayer was a publisher incorporated in Delaware and located in Michigan that sold advertising for placement in telephone directories. Advertising income was generated from local accounts consisting of Wisconsin-based businesses and national accounts. Local advertising was solicited by sales representatives from offices located in Indiana, Michigan, Ohio, and Wisconsin. The taxpayer had national account sales offices located in Michigan and Illinois. Representatives from both within Wisconsin and outside the state solicited sales for advertising in the Wisconsin telephone directories. The taxpayer contracted for the publication and delivery of the telephone directories on behalf of the local telephone company.

   b. For tax years 1994 through 1996, prior to Wisconsin’s adoption of market-based sourcing for service revenue, the taxpayer timely filed Wisconsin corporate income returns and used an apportionment method that sourced sales based on the geographic distribution of the telephone directories. The taxpayer later filed an amended return that lowered its tax liability and apportioned its Wisconsin income based on the cost of performing the advertising services. The taxpayer continued to use the COP method on its return for the 1997 tax year.

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102 Likewise, state tax authorities have tried to change the characterization of an item from the sale of a service sourced by preponderance COP to the sale of a personal service sourced by “time spent” or other proportionate COP rule.

103 Further, many states have adopted market-based sourcing for sales by specific industries, sales of specific types of services, and sales of intangibles (location of use), including: (i) broker-dealers; (ii) mutual fund service providers; and (iii) financial institutions. While very detailed rules are applicable to distinct revenue streams for these industries, the trend is to look at the taxpayer’s market, and not where the taxpayer incurred COP.

104 *Ameritech Publishing, Inc. v. Department of Revenue*, Wisconsin Court of Appeals, No. 2009AP445, June 24, 2010. The court noted that this case is not recommended for publication in the official reports.
iii. The Wisconsin Department of Revenue denied the taxpayer's specific utilization of the COP method. While the Tax Appeals Commission held that the taxpayer's sale of telephone directory advertising was the sale of a service and not the sale of tangible personal property, the Commission held that performance of the taxpayer's directory advertising services in Wisconsin constituted income-producing activities source to Wisconsin.

iv. The circuit court affirmed the Commission, the taxpayer appealed to the Court of Appeals.

v. For the tax years at issue, 1994-1997, Wisconsin used a three-factor apportionment formula with a double-weighted sales factor. For purposes of the sales factor, sales of items other than tangible personal property, such as services, were in Wisconsin if the income-producing activity was in the state. Sales of services and other non-tangible property performed both within and outside Wisconsin were subject to the COP method of apportionment.

c. The substantive issue addressed in this case was whether the income-producing activity associated with the telephone directory advertising services was performed in Wisconsin, or performed both within and outside Wisconsin. The taxpayer argued the Commission should have apportioned sales according to actual costs of performance, which would include the various activities performed by the taxpayer within and outside Wisconsin. The directory advertising income was dependent on a series of integrated activities, beginning with the solicitation of the sale, continuing with ad layout and production, and delivery of directory ad copy to the printer, and concluding with the distribution of the directories to the final users. Many of these activities were performed primarily in Michigan, with some services performed in Indiana, Ohio and Illinois, as well as Wisconsin. The taxpayer argued that the Commission should not have based its assessment solely on the last activity in its chain of service activities, the distribution of the directories. In fact, according to the

105 Former WIS. STAT. § 71.25(6). Beginning in the 2008 tax year, Wisconsin has been using a single sales factor apportionment formula.
106 Former WIS. STAT. § 71.25(9)(d). Effective January 1, 2005, Wisconsin has been using a market-based method for sourcing service income.
107 Id.
108 The main procedural issue addressed in the case was the appropriate standard of review to be applied by the Court of Appeals in interpreting the Wisconsin sales factor statute. The Court of Appeals had three options to consider: (i) a de novo review of the statute, under which the Court of Appeals would interpret the statute without considering the Department's interpretation of the statute; (ii) a great weight deference standard, under which the Department's interpretation would be upheld as long as it was reasonable and not contrary to the statute's clear meaning, even if the Court of Appeals found a different interpretation to be more reasonable; and (iii) a due weight deference standard, under which the Department's interpretation of the statute would be upheld if it comported with the purpose of the statute, and no alternative interpretation was more reasonable than the Department's interpretation. See Wisconsin Department of Revenue v. A. Gagliano Co., Inc., 702 N.W.2d 834 (Wis. 2005). The taxpayer requested de novo review, while the Department requested great weight deference. The Court of Appeals concluded that a due weight deference standard was appropriate.
taxpayer, the distribution of the directories should not have been considered an income-producing activity at all because it was performed by a third party.\footnote{109}

2) The Department responded that the taxpayer’s argument was unreasonable because it would allow large amounts of income-producing activity to virtually escape taxation in Wisconsin, where all of the advertising occurred. The Court of Appeals agreed with the Tax Appeals Commission and circuit court that all of the taxpayer’s income-producing activity was performed in Wisconsin. In reaching its decision, the Court of Appeals discussed a case, \textit{The Hearst Corporation v. Department of Revenue},\footnote{110} relied on by the Commission. In \textit{Hearst}, the Commission considered whether advertising income received from the operator of a television station was properly included in the numerator of the Wisconsin sales factor. As in \textit{Hearst}, the Commission concluded that the income-producing activity of advertising services was performed in Wisconsin when the advertisement reached its intended audience.

3) The Court of Appeals found that the taxpayer’s view that part of its income-producing activity was performed outside Wisconsin was reasonable, but it was not more reasonable than the interpretation of the statute by the Commission and Department.\footnote{111} The taxpayer’s argument failed to consider the fact that its primary income-producing activity was furnishing access to a Wisconsin audience.

4) This case provides insight concerning the application of the COP rule to source service income. Wisconsin no longer uses the COP approach, but this case provides useful guidance for taxpayers in the many states that continue to source service revenue based on COP.

a. The approach used in this case resembles a market-based method used by a growing number of states, because the Court of Appeals considered where the benefit of the service, the distribution of the advertising, was received. This approach was adverse to the taxpayer because all of the revenue for the telephone directory advertising was sourced to Wisconsin, without accounting for the income-producing activities that were incurred in other states.

b. Had the taxpayer separately sourced components of its revenue such as advertisement design and advertisement placement, perhaps a different result would have been reached.

\textbf{Tennessee BellSouth Case}

1) The Tennessee Court of Appeals held that the Tax Commissioner correctly used an alternative apportionment method instead of the statutory COP method in a case involving a telephone

\footnote{109} During the tax years at issue, Wisconsin’s regulation indicated that “activities performed on behalf of the taxpayer, such as those conducted on its behalf by an independent contractor” were not included in the “income producing activity.” Wis. ADMIN. CODE § 2.39(6)(c)3.
\footnote{111} Under the due weight standard applied by the Court of Appeals, a reasonable position by the taxpayer was not enough to change the Commission’s determination. Query whether the result would have been the same if a \textit{de novo} standard were used.
directory publisher that incurred all of its costs outside Tennessee but earned its advertising revenue from the distribution of directories within the state.\textsuperscript{112}

a. Under Tennessee law, sales, other than sales of tangible personal property, are in the state if the earnings-producing activity is performed (1) in the state or (2) both in and outside the state and a greater proportion of the activity is performed in Tennessee, based on costs of performance.\textsuperscript{113}

b. A taxpayer or the Department of Revenue may request a variance from the standard apportionment provisions if they do not fairly represent the taxpayer’s activities in the state.\textsuperscript{114}

2) During the years at issue, the taxpayer produced and caused to be distributed over 23 million telephone directories in Tennessee. Almost all of the taxpayer’s revenues were derived from the sale of advertising in the directories. The taxpayer’s annual revenues during the period at issue were between $160 million and $200 million. The advertising services were performed outside Tennessee. The taxpayer used the statutory COP method to source a relatively small amount of revenue to Tennessee. The Tax Commissioner exercised her discretion and used an alternative apportionment method based on where the telephone directories were distributed because the COP method did not fairly represent the extent of the taxpayer’s business activities in the state.

3) The trial court found in favor of the taxpayer and determined that the variance from the statutory COP apportionment method was not justified. According to the trial court, the Tax Commissioner did not satisfy the statutory requirement of proving that the standard apportionment formula did not fairly represent the extent of the taxpayer’s business activity in the state. The sole fact that a significant amount of revenue was received from the sale of advertising in Tennessee that was not apportioned to Tennessee did not justify the variance. The Tax Commissioner failed to identify that a greater proportion of the taxpayer’s earnings producing activity was performed in Tennessee.

4) The Tennessee Court of Appeals reversed the trial court and held that the Tax Commissioner correctly used an alternative apportionment method. The Court of Appeals agreed with the Tax Commissioner that computation of the tax using the COP formula did not reasonably reflect the taxpayer’s business activity in Tennessee. Using the COP method, the taxpayer paid only $296,140 of taxes on income of over $897 million during the five years at issue. The Tax Commissioner argued that it was “patently absurd” to contend that the tax payment was commensurate with the business that the taxpayer conducted in Tennessee. Also, the Tax Commissioner cited to the concern of the authors of UDITPA to the application of the COP formula to income from advertising in publications. Based on these arguments, the Court of Appeals held that application of the COP formula did not fairly represent the taxpayer’s business in the state and the variance was appropriate.


\textsuperscript{113} TENN. CODE ANN. § 67-4-2012(8). The tax years at issue were 1997 to 2001. The Tennessee statutes were substantially revised in 1999, but the provisions relevant to this case remained substantially the same.

\textsuperscript{114} TENN. CODE ANN. § 67-4-2014(a); TENN. COMP. R. & REGS. 1320-6-1-.35.
a. The Court of Appeals rejected the taxpayer’s argument that the Tax Commissioner may use the variance provision to ignore the COP formula when the results are unfavorable to the state. Despite this potential for the Tax Commissioner to misuse the variance provision, the legislature provided the Commissioner with the authority to permit or require a departure from the standard apportionment formula when application of the formula does not fairly represent the taxpayer’s activity in the state.

**A Plethora of Proposed Market Based Sourcing Regulations**

A number of states that have adopted market-based sourcing are now getting around to drafting regulations to help in administering the rule. Alabama, California, and Illinois were addressed above.

**New Jersey**

New Jersey has historically been a proportionate cost of performance state for the sourcing of service revenue.

1) New Jersey is seeking to move from percentage COP to market-based method;

2) The Department of Taxation has shared a draft regulation with the practitioner community;

   a. The mechanics of the regulation non-financial services resembles the Washington B&O market-sourcing rules.

**Points of Analysis**

1) As the number of market-based sourcing states continues to grow, the mechanics of the rules adopted by these states will take on greater importance.

2) The definitions of “market” vary substantially across the states.

3) In states where a “benefit received” test is used, a number of issues are likely to arise, including who should be considered the purchaser of record, where is the benefit actually received (commercial domicile, office taking the order, billing location of customer, service provider’s billing address, or other location), and where the service is received, performed and delivered.

4) It will not always be easy for a taxpayer to determine the location of its market, particularly if the “benefit of services received” sourcing rule is used.

5) The following is a list of questions practitioners might ask:

   a. What is the primary sourcing rule?

      i. Where the benefit of the service is received?

      ii. The location of the impetus of the sale?

      iii. Is it important where the customer “directly or indirectly receives” the benefit of the service?

      iv. Is the location or billing address of the customer the determinative consideration as opposed to where the benefit of the service is received?

      v. Does it matter if the customer is an individual or a business?

   b. Is there a fall-back rule if the taxpayer’s records do not indicate where the customer receives the benefit of the service?
c. Are there a set of cascading or ordering rules that provide how a taxpayer should determine where to market-source revenue?

d. Is the “benefit of the service rule” an all-or-nothing determination based on a set of cascading rules for determining location of the benefit; or can the service revenue be apportioned between states when the customer receives the benefit of the service in more than one state?

e. Does it matter whether the services related to real property, tangible personal property or intangible property?

f. Does the state have industry-specific rules for applying market-based sourcing rules to services?

g. Will bundled transactions of services and tangible personal property have to be bifurcated to be properly sourced?

h. Will market-based sourcing rules require enhanced recordkeeping?

i. Is there a throwback or throwout rule in play for services in a given state?

j. Are there any state presumptions within the rules, and if so, how do they apply?

6) Does existing guidance provide any specific examples as to the application of a state’s rules?

7) Is further guidance forthcoming?

8) Could definitional rules cause service revenue to be sourced in multiple market-based states (for example in situations when a customer within a state is defined as being engaged in a trade or business within the state or having a billing address within the state)?

9) Depending on the services at issue, will COP states choose to selectively use an “equitable” form of market sourcing?

10) Is the “time-spent” analysis for personal services still relevant in states that have adopted market-based sourcing, and if so, to what extent?