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Understanding the Concepts of Apportionment & Sourcing

Theodore Bots, Baker McKenzie
Theodore.Bots@bakermckenzie.com

Mike Carchia, Capital One
michael.carchia@capitalone.com

Karl Frieden, COST
kfrieden@cost.org

Jeff Vesely, Pillsbury Winthrop Shaw Pittman
jeffrey.vesely@pillsburylaw.com

Aaron Young, Reed Smith
ayoung@reedsmith.com

Constitutional Restraints

- States may tax "fair share" of profits earned from activity conducted within their borders using apportionment

  Underwood Typewriter, 254 U.S. 113 (1920)

- Unitary Business Principle is the linchpin of apportionability in the field of state income taxation

  Mobil Oil, 445 U.S. 425 (1980)

- Burden cannot be excessive, unreasonable and arbitrary

  Hans Rees', 283 U.S. 123 (1931)

  Norfolk & Western Railway, 390 U.S. 317 (1968)

Constitutional Restraints

Modern test used by Court found in *Complete Auto*,

430 U.S. 274 (1977) – a sales tax case

State's ability to impose a tax requires that:

- The activity taxed has substantial nexus with the state
- The tax is fairly apportioned – *Jefferson Lines*,

  514 U.S. 175 (1995)

- The tax does not discriminate against interstate commerce
- The tax is fairly related to services provided by the state

Business versus Nonbusiness Income

Taxpayer’s Income is separated into two categories of income:

Business Income (apportionable or operational income)—”Income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations”

Nonbusiness Income (allocable or non-operational income)—”All income other than business income”

Business income is apportioned among the jurisdictions in which the taxpayer conducts business activities, by use of an apportionment formula consisting of property, payroll and sales factors

Nonbusiness income is allocated to a specific geographical location. Certain classes of income have different rules. For example, dividends, interest and capital gains allocated to the taxpayer’s commercial domicile. Sales of real or tangible personal property allocated to the location of the asset

UDITPA and MTC

Uniform Law Commission (“ULC”) promulgated Uniform Division of Income for Tax Purposes Act ("UDITPA") in 1957 to provide uniform rules for states to assign taxable income of multistate corporations

The Multistate Tax Commission ("MTC") was created by the Multistate Tax Compact in 1967 and provides guidance to members through model regulations, specifically Allocation and Apportionment Regulations (for purposes of this discussion)

UDITPA and MTC

The Multistate Tax Compact’s apportionment regulations are contained within Article IV of the Compact and is a near verbatim adoption of UDITPA

The standard apportionment methodology of UDITPA and the Multistate Tax Compact is an equally weighted three factor formula comprised of; (1) a property factor, (2) a payroll factor, and (3) a sales factor

Property Factor

UDITPA Section 10:

"The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period."

Property Factor

Average value:

$$\text{Property factor} = \frac{(\text{In-state BOY} + \text{In-state EOY})/2^{*}}{(\text{Total BOY} + \text{Total EOY})/2}$$

Monthly average may be used in unusual circumstances

*Also includes annual rent paid times 8 in the taxing state over annual rent paid times 8 everywhere

Payroll Factor

UDITPA Section 13

"The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period."

$$\text{Payroll factor} = \frac{\text{In-state compensation}}{\text{Total compensation}}$$

Sales Factor

UDITPA Section 15:

“The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.”

$$\text{Sales factor} = \frac{\text{In-state sales}}{\text{Total sales}}$$

What Has Happened Since UDITPA?

Not all states adopted UDITPA

Some states have adopted only parts of UDITPA

Many states changed their apportionment statutes to include a hyper-weighted sales factor

Some states like Iowa and Texas have used a single sales factor for many years

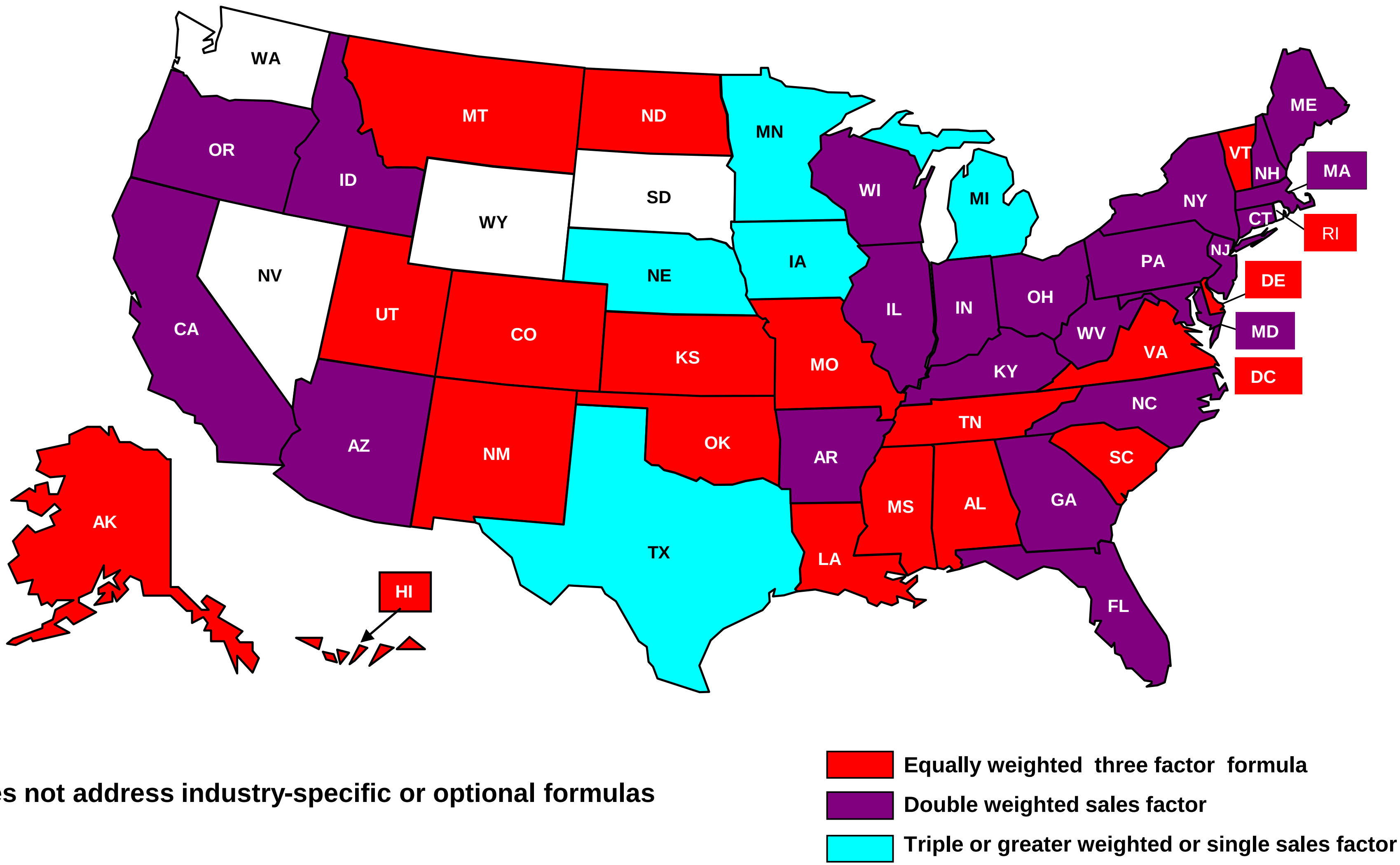
- *Moorman Mfg. Co. v. Bair* (1978)

Other states more recently enacted a single sales factor

Nationwide Trends – Allocation and Apportionment

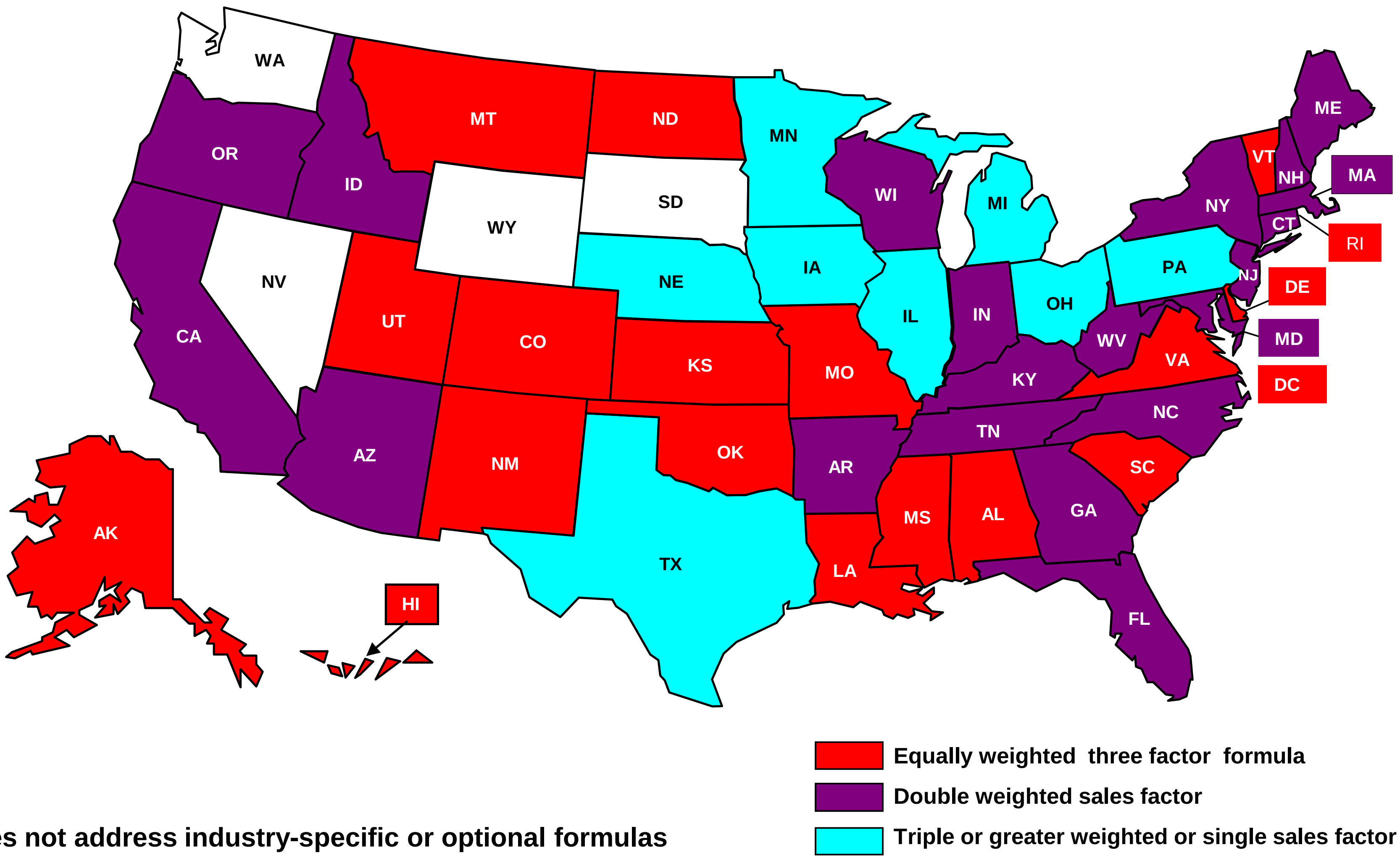
- **Apportionment Trends**
  - Shift in factor weighting
  - Single sales factor
  - Use of discretionary authority to adjust formula (UDITPA Sec.18)

Apportionment Formulas* - 1998



*Does not address industry-specific or optional formulas

Apportionment Formulas* - 2016



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Sourcing – General Rules

Sourcing determined by the nature of what is sold

Sourcing receipts from sales of tangible personal property

- Generally sourced to state of delivery

Sourcing receipts from sales of services or from "sales other than sales of TPP"

- Cost of performance
- Trend toward market-based sourcing

Sourcing – Exception

"Throwback"

In states that have a throwback rule, sales of tangible personal property shipped to a state in which the seller is "not taxable" are included in the sales factor numerator of the state from which the product is shipped

Sourcing
– Cost of Performance

Costs of performance (“COP”) of the income producing activity

- Means “direct costs” determined consistent with GAAP and in accordance with conditions/practices of taxpayer’s trade or business
- Use of cost accounting

Sourcing
– Income Producing Activity

Income from sales of services generally sourced to state if "income-producing activity" takes place there

If income-producing activity is performed in more than one state

- Generally where greater portion of the income-producing activity is performed based on COP
- Some states use "greater proportion" (i.e., more than 50%)
- Some states avoid all or nothing result by sourcing based on percentage of income-producing activity performed in each state

Sourcing
– Income Producing Activity

Income-producing activity generally:

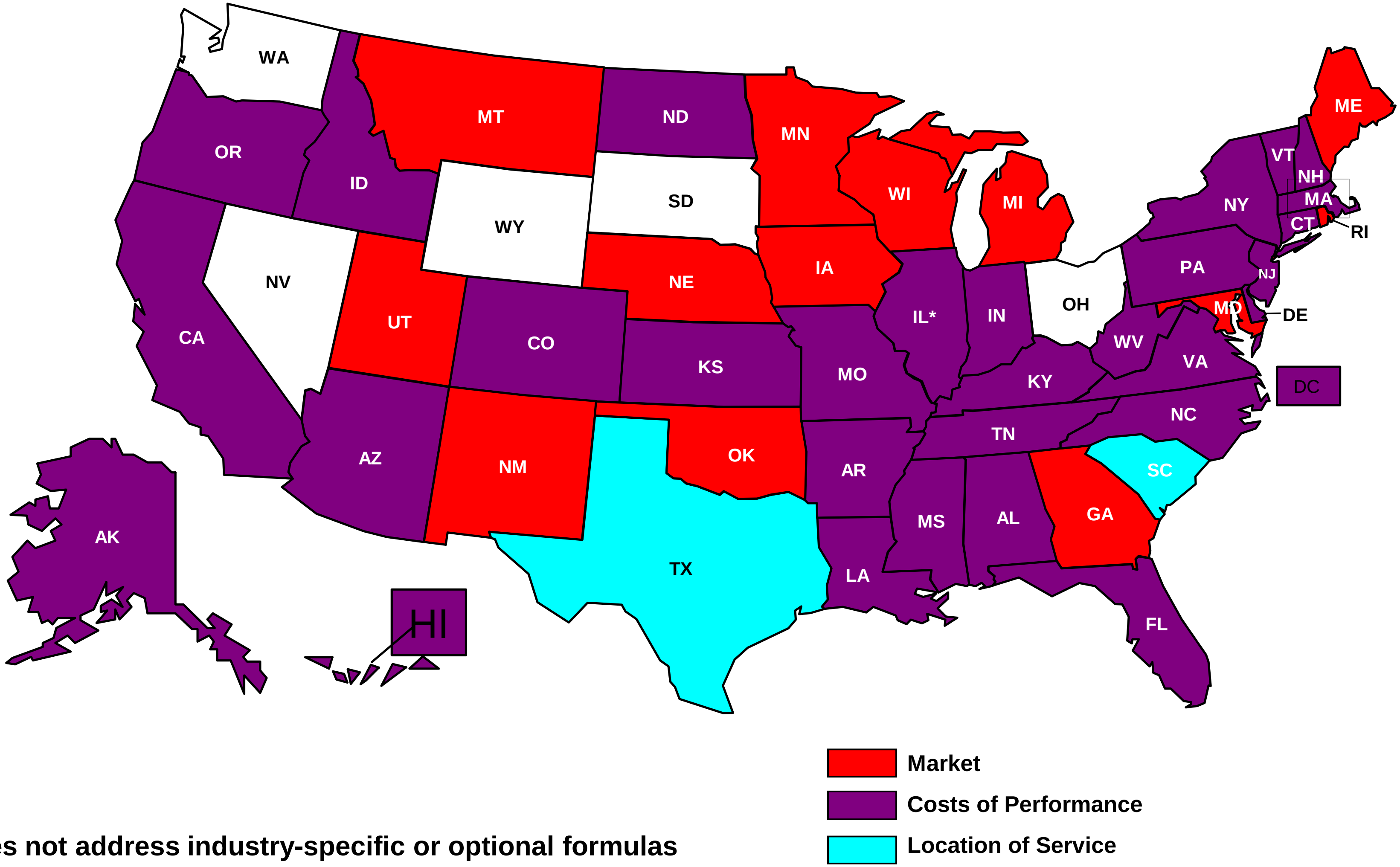
- Applies to each separate item of income
- Means transactions and activity directly engaged in by the taxpayer in the regular course of trade or business for the ultimate purpose of obtaining profit
- If income-producing activity occurs solely in state, never reach COP

Sourcing
COP Issues

COP Issues

- Determining “income-producing activity” or activities
  - If multiple IPAs, each activity is evaluated separately
  - Can IPA cross company lines in unitary group?
- Determine if IPA is performed in more than one state
- Determine location of “performance costs” (i.e., the direct costs that are necessary to conduct the IPA)
  - Which costs are “direct”?
  - Do third party costs count?
- Transactional v. operational approach

Sourcing Non-TPP Receipts* - 2009



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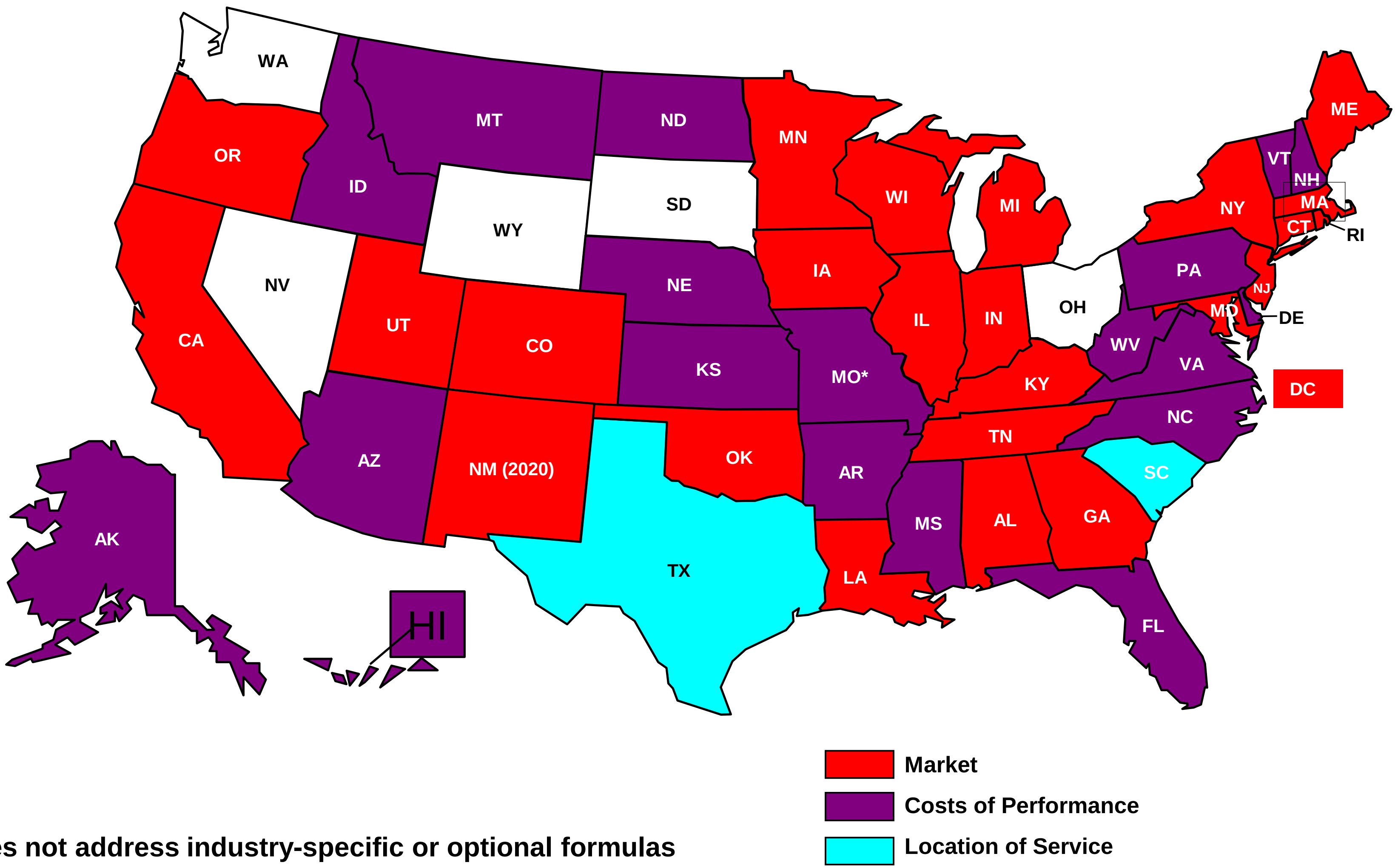
Sourcing Non-TPP Receipts* - 2019



*Does not address industry-specific or optional formulas

Sourcing

Market-Based Sourcing for Services

No consistent definition of what is “market” for sales of other than tangible personal property.

Services hierarchy

- Where delivered or received
- Where purchaser received the benefit
- Where indicated in contract or books and records
- Where performed
- Where customer located (e.g., billing address, HQ, etc.)
- If derived from buyer within the state
- Proxies (e.g., relative population, other statistics)
- Other

Sourcing

Market-Based Sourcing for Intangibles

Sales/licenses of intangibles (patents, copyrights, trade secrets, etc.)

Sourced to where the intangible is used

Specific rules regarding different types of intangibles

- Marketing intangibles
- Production intangibles
- Mixed intangibles
- Intangibles resembling sales of goods and services

Cascading approach for determining where the intangible is used

- Terms of contract
- Taxpayer’s books and records
- Reasonable approximation
- Customer/licensee billing address

Sourcing

– Market Based Sourcing

Some states with IPA/COP sourcing statute, adopting market-based sourcing in regulations or administrative practice

- New Jersey proposed a regulation for services: statute provides that receipts would be assigned to “where performed”
  - New Jersey Failed
- Indiana applied an audience factor methodology, without promulgating a regulation, under which receipts of a broadcaster would be assigned to where the audience is located
  - Indiana Failed

Sourcing
– Market Based Sourcing

Default or safe-harbor provisions

- Cascading approach
- "Readily determinable" versus "reasonable approximation"
- Maine: Office of customer from which the service was ordered

  Me. Rev. Stat. Ann. 36 § 5211(16-A)

If receipts related to multiple states, pro-rata based on benefit/use?

- Utah: If the purchaser of the service receives a greater benefit of the service in Utah than in any other state. Utah Code Ann. § 59-7-319(3); Utah Admin. R. § R865-3C-1(2)(a)

Sourcing

– Market Based Sourcing

Lack of Uniformity

The unique approaches to market-based sourcing often producing dramatically different results

- PA and CA have examined the same fact pattern, with divergent results:
  - The PA department draft guidance contains the following example:
    - Taxpayer is a provider of third-party payroll processing services for Company A. Half of Company A's employees are located in PA and half are located in NY. Company A's headquarters and human resources functions are located in PA. Taxpayer sources all of the payroll services to PA
  - The PA result is directly contrary to California's regulation, which provides that the payroll servicing company should assign its receipts by determining the ratio of employees of the customer in California compared to all employees of the customer and assign that percentage of the receipts to California. Cal. Code Regs. 25136-2(b)(1)

Throw-Out Rule

If the state or states of assignment cannot be determined, they must be reasonably approximated.

Throw-Out Rule: If the taxpayer is not taxable in a state to which the sale is sourced, or if state of assignment cannot be determined or reasonably approximated, the receipts must be excluded from the numerator and denominator of the sales factor.

In-Person Services

In-Person Services

- Service physically provided by taxpayer on customer or customer's property (includes "on behalf of" transactions)

Sourced to Where Service is Received

- If performed on body of customer or physical presence of customer: location where service received
- If performed on customer's real property, TPP at customer's residence or TPP in customer's possession: location of property
- If performed on customer's TPP that is shipped to customer: location where customer receives property

Services Delivered to or on Behalf of Customer/Electronic Delivery

Services delivered to or on behalf of a customer / electronic delivery

Delivery by physical means: Location where service is delivered

Electronic transmission to customers

- Individual customers
- Business customers (note safe harbor provision)

Services delivered electronically through or on behalf of customer

- Location of end-user / third-party recipient (whether customer is individual or business)

Professional Services

Professional Services

- Services requiring specialized knowledge and may require professional certification
- If significant in-person contact, services should be classified as in-person services, not professional services
- Professional services classification trumps "services delivered to or on behalf of a customer / electronic delivery"
- Different rules for individual and business customers
- Safe harbor for certain business customers

Alternative Apportionment

- U.S. Constitutional Aspects

Moorman Mtg. Co. v. Bair, 437 U.S. 267 (1978).

- For a taxpayer to demonstrate that the statutory apportionment formula is unconstitutional, the burden is on the taxpayer to prove "by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in that State', or has 'led to a grossly distorted result.'"

Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 123 (1931).

- Distortion of more than 250% held unconstitutional.

Norfolk & W. Ry. Co. v. Mo. State Tax Comm'n., 390 U.S. 317 (1968).

- Distortion of approximately 165% held unconstitutional.

Alternative Apportionment

- Overview

Generally permits the use of one or more alternative methods if the apportionment provisions “do not fairly represent” on "fairly reflect" the taxpayer’s business activity in the state

References separate accounting, exclusion/inclusion of one or more factors, or “employment of any other method to effectuate an equitable allocation and apportionment” of taxpayer’s income

Availability

Special election/procedure

Current Issues

- When is alternative apportionment appropriate?
- Who bears the burden when raising alternative apportionment?

Alternative Apportionment

A number of states have determined that alternative apportionment may only be required in unusual cases (based on an older iteration of MTC model rules)

- *Appeal of Crisa Corp.,* No. 2002-SBE-004 (Cal. St. Bd. Equal. 6-20-02); *Union Pacific Corp. v. Idaho State Tax Commissioner*, 83 P.3d 116 (Idaho 2004)

States have also recognized that alternative apportionment is an exceptional remedy

- *St. Johnsbury Trucking v. State*, 385 A.2d 215 (N.H. 1978)

Alternative Apportionment

Vodafone Americas Holdings, Inc. v. Roberts, No. M2013-00947-SC-R11-CV (TN Sup.Ct. 2016)

- Taxpayer's historic use of customer billing address to source receipts was used against it when it applied for refunds based on statutory COP, which would have reduced receipts by 89%

Increasing use of alternative apportionment in COP states to produce market-based sourcing

- *Ameritech Publishing, Inc. v. Wisconsin Dep't of Revenue*, 788 NW2d 383 (Wisc. Ct. App. 2010); *Bellsouth Adver. & Publishing v. Chumley,* 308 SW3d 350 (Tenn. App. 2009)

Alternative Apportionment

CarMax Auto Superstores West Coast, Inc. v. South Carolina Dept. of Rev., 767 S.E.2d 195 (S.C. 2014).

- The South Carolina Supreme Court held that there are two burdens of proof in alternative apportionment cases:
  - (1) the party seeking alternative apportionment (here, the Department) bears the burden of proving that the statutory apportionment formula does not fairly represent the taxpayer's in-state business activity; and
  - (2) if the first burden is satisfied, then the party seeking alternative apportionment must then prove that its alternative method is reasonable
- "While there is substantial evidence . . . that the Department's alternative accounting method was reasonable, the Department failed to prove the threshold issue that the statutory formula does not fairly represent [the taxpayer's] business activity within South Carolina"

Significance of standard statutory approach

Questions?

Thank you!

Theodore Bots, Baker McKenzie
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