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Sales Factor Sourcing

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Sales Factor

- Sales factor sourcing to a state depends on the type of revenue and specific rules in the state
- Many states have an "occasional sale" rule
  - Exclude from the sales factor in order to prevent apportionment distortion
  - Net gain/loss is still included in the apportionable tax base as business income

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Sales Factor

- Destination sourcing (TPP)
  - General rule for sales of inventory
- Market sourcing (services or intangibles)
  - Based on where the customer receives the benefit
- Cost of performance sourcing (services or intangibles)
  - Based on costs of income-producing activity in the state

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Market-Based Sourcing

- For services and intangibles, how do you define the "market"?
  - Receipts are included in the numerator of a taxpayer's sales factor based on location of either:
    - Where customers derive benefits from the service
    - Where services are performed
    - Where intangibles are used
    - Where customers are located

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Market-Based Sourcing

- Delivery v. Receipt v. Benefit of a service
  - Are they different?
- What happens when the market for a service or an intangible is not identifiable?
  - Reasonable approximation
- States with Market Rules:
  - Alabama, California, D.C., Georgia, Illinois, Iowa, Maine, Maryland, Massachusetts, Michigan, Minnesota, Nebraska, New York, Oklahoma, Pennsylvania, Rhode Island, Utah, and Wisconsin

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Benefits and Limitations

- Benefits
  - Belief that "market sourcing is more aligned to the intended purpose of the sales factor"
    - Reflection of the contribution of the market to the taxpayer's income
  - May favor in-state businesses
    - Based on Activity level, taxpayer would not have to source income to the headquarter state
    - Shift of the tax burden to out-of-state taxpayers

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Benefits and Limitations

- Limitations
  - States have different mechanics defining the term "Market"
  - Likely to create administrative problems and lack of state uniformity
  - Difficulty determining where the customer receives the benefit of the service

Cost of Performance Sourcing

- Sales, other than sales of tangible personal property, are in this state if:
  - The income-producing activity is performed in this state; or
  - The income-producing activity is performed both within and outside this state and a greater proportion of the activity is performed in this state than any other state based on costs of performance

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Income-Producing Activity

- As defined by the MTC, the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining profit
- Transactional approach – review costs of each individual sales transaction (i.e., OR)
- Operational approach – review operations and income streams (i.e., MA)

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Understanding COP Methods

- Two General Methods
  - Preponderance Method
    - All-or-nothing
  - Proportionate Method
    - Pro-Rata
- How do you measure these methods? What costs are included?
- States with COP Rules:
  - Alaska, Colorado, Florida, Hawaii, Kansas, Missouri, North Dakota, Tennessee, Virginia

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Comparing COP Methods

- Alaska has a cost of performance "all-or-nothing" approach and over **50%** of the costs of income-producing activities are in Alaska
- Colorado has a cost of performance "pro-rata" approach and **30%** of the costs of income-producing activities are in Colorado
- In summary,
  - 100% of the receipts are sourced to Alaska
  - 30% of the receipts are sourced to Colorado

  = **130%** total state-sourced receipts

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Direct and Indirect Costs

- *Direct*: costs that are related specifically to the performance of services under a contract or other arrangement
  - Includes direct material and labor, plus variable overhead incurred in producing a product
- *Indirect*: costs not readily identifiable with production of specific contracts or services, but applicable to production
  - Includes overhead allocation for administrative activities

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Benefits and Limitations

- Time Consuming
  - Based on the amount of income line items to be reported
    - Specify related income-producing activity
    - Determine location of the income-producing activities and the related costs
  - Independent contractors and limited records may cause issues
  - But if a proper system is created to capture this information, may become a favorable state tax Benefit

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Benefits and Limitations

- Limitations
  - Cost of Performance Method may not be appropriate for a wide range of industries, including:
    - Publishers
    - Airlines
    - Construction Contractors
    - Financial Institutions, etc.

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Sales Factor Updates

- CT and LA Single-Sales Factor as of tax year 2016
- DE phasing in Single-Sales Factor through 1/1/20
- NC phasing in Single-Sales Factor through 1/1/18
- NM phasing in Single-Sales Factor through 1/1/18 for manufacturers

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Sourcing of Receipts Updates

- CT and LA market-based sourcing as of tax year 2016
- NC expected to enact market-based sourcing for tax year 2017
  - On 2/16/17, the Rules Review Committee approved the proposed market-based sourcing rules
- NM S.B.274 would adopt market-based sourcing as of 1/1/18
- OR H.B. 2048 and 2274 would replace COP rule with market-based sourcing effective 1/1/18

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