Determining In-State Sales for Services and Intangibles

Presented to:

The Interim Revenue Stabilization and Tax Policy Committee

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NMTRI Principles of Good Tax Policy

N.M. Tax Research Institute is a non-profit, non-partisan member-supported organization dedicated to advancing the following principles of good tax policy in New Mexico:

Adequacy

- Revenues should be sufficient to fund needed services

Efficiency

- Interference with the private economy should be minimized

Equity

- Taxpayers should be treated fairly

Simplicity

- Laws, regulations, forms and procedures should be as simple as possible

Comprehensiveness

- All taxes should be considered when evaluating the system

Accountability

- Exceptions should be rare and should be carefully evaluated and justified

Background

- Multistate business income must be "fairly apportioned" to be constitutional
  - Does not mean states have to have the same rules, but if other states imposed the same rule it must not tax the same income

- "Uniform Division of Income for Tax Purposes Act"
  - From the 50's brought to you by the people who gave you the Uniform Commercial Code (UCC), NCCUSL
  - Codified by most states with income taxes resulting in somewhat consistent rules
  - Provides rules for apportionment of business income
    - Policy Question – who gets what?
    - Tradition 3 Factor Formula
      - » Property
      - » Payroll
      - » Sales

UDITPA's Formula

Property Factor =

Property in State ÷ Property Everywhere

Payroll Factor =

Payroll in State ÷ Payroll Everywhere

Sales Factor =

Sales in State ÷ Sales Everywhere

Apportionment Factor =

(Property Factor + Payroll Factor + Sales Factor) ÷ 3

Note – Revisions to UDITPA do not require uniform factor weighting.

State Corporate Income Tax-Calculation

Because it takes all elements (a*b*c) to calculate the personal or corporate income tax, no one element of the corporate income tax can be analyzed separately from the other elements – they all matter.

Tax Due = Filing Group Taxable Income x State % x Tax Rate

The apportionment for a given state, "State X", is typically computed as follows (std. 3 factor formula):

$$\text{State\%} = \frac{\dfrac{\text{State X Property}}{\text{Total Property}} + \dfrac{\text{State X Payroll}}{\text{Total Payroll}} + \dfrac{\text{State X Sales}}{\text{Total Sales}}}{3}$$

Single Weighted Sales Factor: $\text{State \%} = \dfrac{\text{State X Sales}}{\text{Total Sales}}$

"Equitable Apportionment"

No single formula can be appropriate in all situations

UDIPTA Sec. 18 –

- Grants discretion to tax agency to use different allocation/apportionment to more fairly reflects income in state
- Grants taxpayers the ability to request different allocation/ apportionment, as well

Two uses of Sec. 18 authority –

- Special industry regulations
- *Ad-hoc* (taxpayer by taxpayer) application

duplicate

Recent Developments

2006 – The MTC asked the Uniform Law Commission to take up needed revisions.

June 2009 – The ULC declined

July 2009 – The MTC took up revisions to five sections:

- Sec. 1(a) – “business” and “nonbusiness” income (“apportionable” and “non-apportionable”)
- Sec. 1(g) – “sales” (or “receipts”)
- Sec. 9 – factor weighting
- Sec. 17 – sourcing of sales other than sales of tangible personal property
- Sec. 18 – equitable apportionment

2013 – The Hearing Officer for the project – Professor Richard Pomp, conducted a hearing, soliciting substantial input from taxpayers, business groups, practitioners, etc.

Current Status

First set of revisions adopted by the Commission in July 2014

Second set of revisions involving recommendations of the Hearing Officer to Section 18 and conforming amendments will be on the agenda of the Commission meeting in 2015

All the revisions are available on the MTC website – MTC.gov

MTC Uniformity Committee is now drafting regulations – starting with sourcing for services (Section 17) and definition of receipts (Section 1(g)).

Changes to Section 17 – Sourcing for Sales Other than Tangible Personal Property

OLD:

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

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

(b) the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance.

Changes to Section 17 – Sourcing for Sales Other than Tangible Personal Property

NEW – Sales of Services:

Receipts, other than receipts described in Section 16, are in this State if the taxpayer’s market for the sales is in this state. The taxpayer’s market for sales is in this state:

[rental, etc] . . .

(3) in the case of sale of a service, if and to the extent the service is delivered to a location in this state; and

Changes to Section 17 – Sourcing for Sales Other than Tangible Personal Property

NEW – Sales of Intangibles – (Part 1)

(4) in the case of intangible property,

(i) that is rented, leased, or licensed, if and to the extent the property is used in this state, provided that intangible property utilized in marketing a good or service to a consumer is "used in this state" if that good or service is purchased by a consumer who is in this state; and

Changes to Section 17 – Sourcing for Sales Other than Tangible Personal Property

NEW – Sales of Intangibles (Part 2)

(ii) that is sold, if and to the extent the property is used in this state, provided that:

(A) a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area is "used in this state" if the geographic area includes all or part of this state;

(B) receipts from intangible property sales that are contingent on the productivity, use, or disposition of the intangible property shall be treated as receipts from the rental, lease or licensing of such intangible property under subsection (a)(4)(i); and

(C) all other receipts from a sale of intangible property shall be excluded . . . .

Changes to Section 17 – Sourcing for Sales Other than Tangible Personal Property

NEW – Reasonable Approximation and Throw-Out Rules

(b) If the state or states of assignment under subsection (a) cannot be determined, the state or states of assignment shall be reasonably approximated.

(c) If the taxpayer is not taxable in a state to which a receipt is assigned under subsection (a) or (b), or if the state of assignment cannot be determined under subsection (a) or reasonably approximated under subsection (b), such receipt shall be excluded from the denominator of the receipts factor.

Changes to Sec. 1(g) – Definition of “Receipts”

OLD: (g) "Sales" means all gross receipts of the taxpayer not allocated under paragraphs of this Article.

(g) “Receipts” means all gross receipts of the taxpayer that are not allocated under paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer’s trade or business; except that receipts of a taxpayer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.

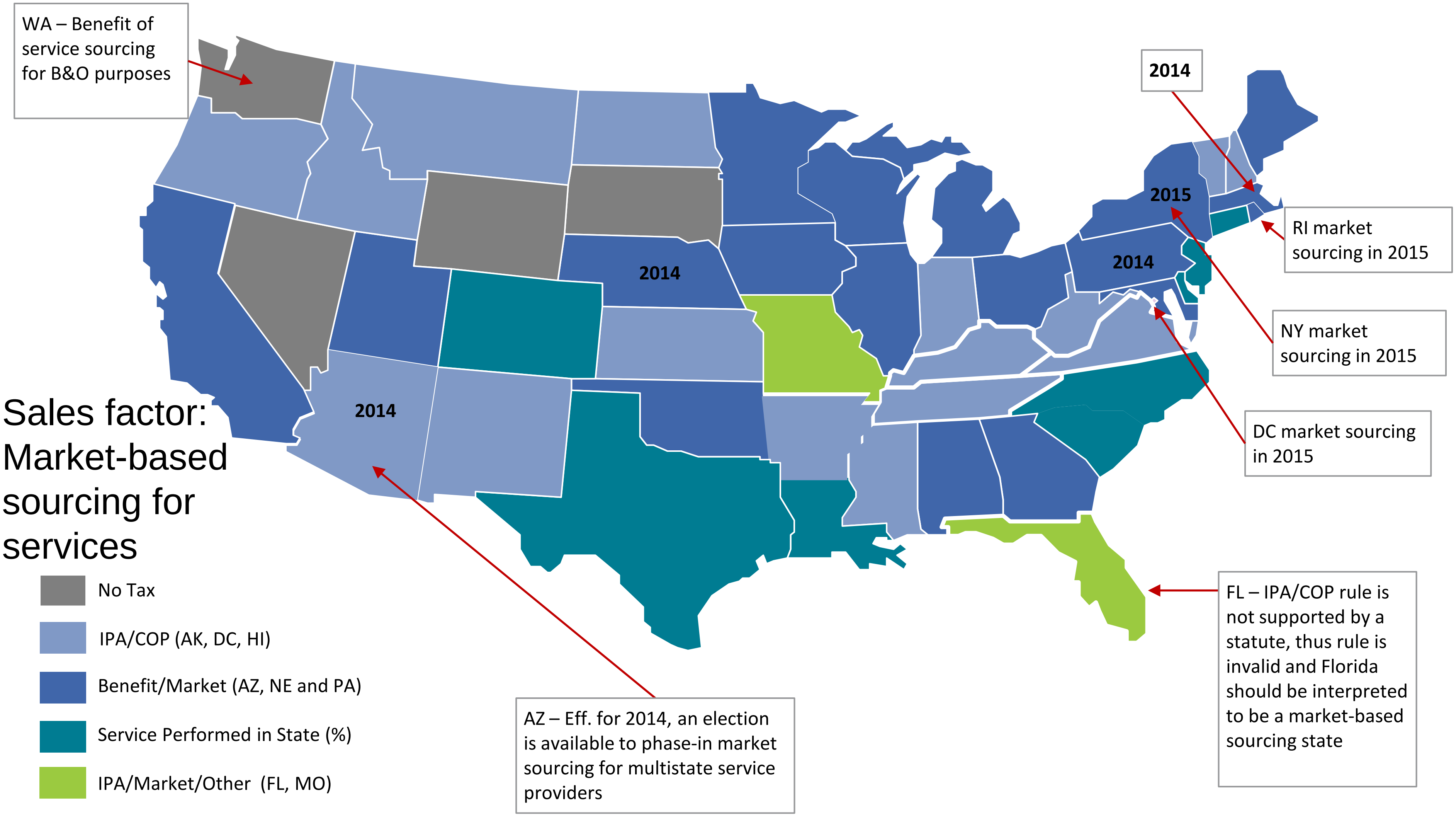
While UDITPA Revisions were Being Considered

About 19 states have moved to an apportionment formula that double-weights (or greater) the sales factor and uses market sourcing of services or intangibles, instead of predominant cost-of-performance or similar sourcing rules.

The states are divided in terms of the theory of market-sourcing – with delivery, benefit received and receipt of service being the primary theories used for services and use or benefit being the primary theories used for sourcing of intangibles.

Only slightly less than half of the states that have gone to market-sourcing have any kind of detailed regulations.

In addition, state tax administrators have argued that market sourcing is necessary to “fairly represent” the activities of businesses in the state under Sec. 18.



Sales factor: Market-based sourcing for services

- No Tax
- IPA/COP (AK, DC, HI)
- Benefit/Market (AZ, NE and PA)
- Service Performed in State (%)
- IPA/Market/Other (FL, MO)

NOTE: Different sourcing rules may apply to intangibles

Regulation Project

MTC Workgroups meeting weekly/bi-weekly

- Seeking to achieve:
  - Consistency -- in the sourcing result
  - Harmonizing existing rules
  - Reliability -- in preventing mis-sourcing or manipulation
  - Simplicity -- so that:
    - The sourcing rules achieve the same result, as often as possible, regardless of how the sale is characterized;
    - The records required or relied on are generally available; and
    - Sales in similar industries or under similar circumstances are sourced similarly.
- Adaptability -- from general to specific rules
- Certainty -- to prevent unexpected issues
- Compatibility -- with rules used in sourcing sales for other state tax purposes

Regulation Project

MTC Research & Analysis

- Complied related statutes & rules from the states that have adopted market sourcing
- Studied differences in statutory language used
- Studied "outcomes" – specific sourcing results depending in states that have specific rules
- Considered input from states that have adopted market sourcing rules
- Consensus that Massachusetts regulations could serve as a possible template for MTC regulations

Market-sourcing regulations - Specifically

MTC Uniformity Committee Decision – December 2014:

- Use Massachusetts Regulations as a Starting Point
  - Mass. has adopted the MTC's market-sourcing approach (delivery)
  - Has had hearings on its draft regulations for the last year
  - Recently issued final regulations

Format

General Rules

- General Principles of Application; Contemporaneous Records
- Rules of Reasonable Approximation
- Rules with respect to Exclusion of Sales from the Sales Factor
- Changes in Methodology; Commissioner Review

Sale of a Service

- General Rule
- In-Person Services
- Services Delivered to the Customer or on Behalf of the Customer, or Delivered Electronically Through the Customer
- Professional Services

License or Lease of Intangible Property

- General Rules
- License of a Marketing Intangible
- License of a Production Intangible
- License of a Mixed Intangible

Market Sourcing Issues to be Considered

General concepts

- Consistency
- Ease of administrability/compliance
- Safe-harbors
- Default rules

Issues

- Professional services
  - Reasonable approximation – what are the guidelines
  - Exceptions to the general default rules
  - Characterization of the sale (tangible, service, intangible) – where do the rules distinguish in treatment or sourcing results

Definition of “Receipts” – Issues to be Considered

Definition of terms

- hedging transactions; and
- maturity, redemption, sale, exchange, loan or other disposition of cash or securities.

Conforming existing regulations

- Not all receipts that give rise to “apportionable” (business) income now would be included

Overlap with potential Sec. 18 issues

- When might receipts that are otherwise not included need to be included to achieve fair representation?