

This Little Piggy Went to Market...

Trends and Developments with Market-Based Sourcing

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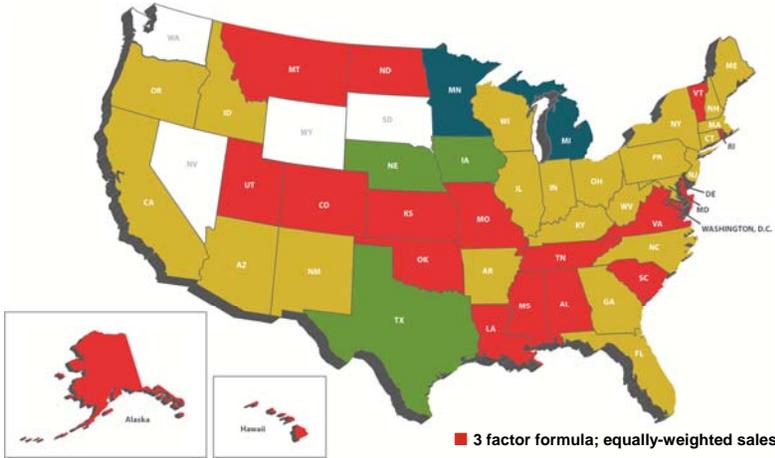
Overview

- Changing Landscape
- Issues with Costs of Performance
- Emerging Market Based Sourcing Methods
- Services, Marketing Intangibles, Other Intangibles
- Alternative Apportionment
- Q & A



State Apportionment Formulas*

1998



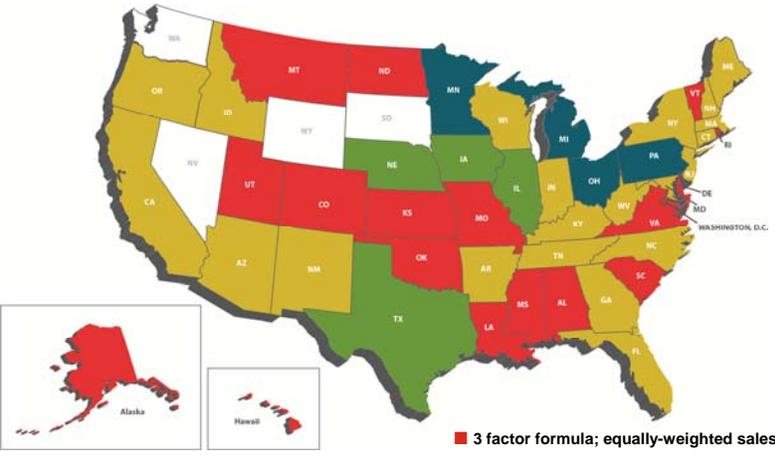
* Not including industry-specific or optional formulas

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- 3 factor formula; equally-weighted sales factor
- 3 factor formula; double-weighted sales factor
- 3 factor formula; triple-weighted sales factor
- single (sales) factor formula

State Apportionment Formulas*

2003



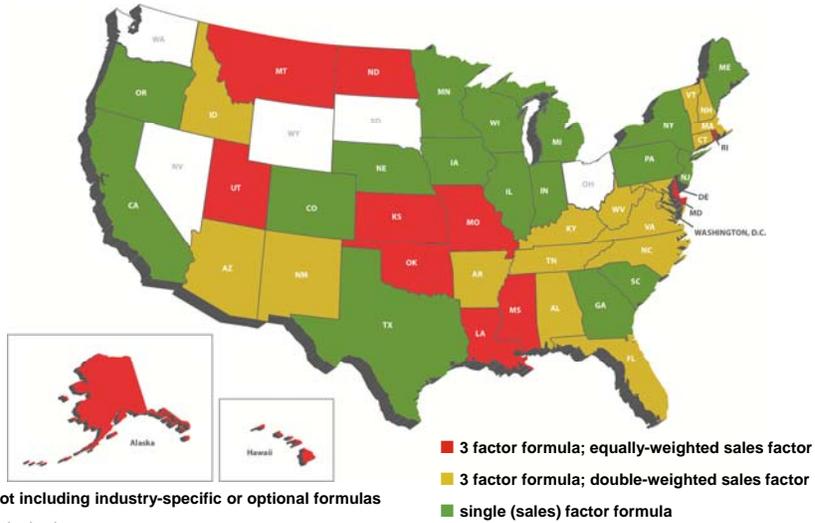
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State Apportionment Formulas*

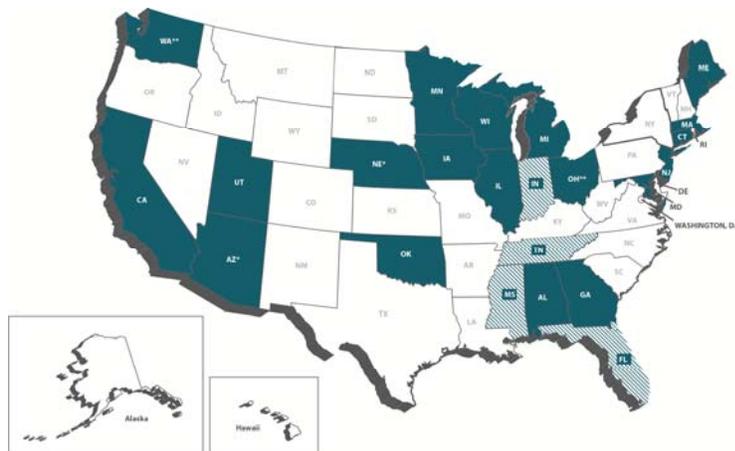
2013



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Market-Based Sourcing States



* Beginning 2014
 ** For business gross receipts taxes (no corporate income tax)

■ By statute
▨ Case law or audit

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Issues with Costs of Performance Sourcing

- Identifying “income-producing activities”
 - By revenue stream
 - Intangibles may produce revenue without activity
 - Sales of assets/lines of business
- Identifying and geographically sourcing the costs of performing the activity
- All or nothing approach for most states
- Proportionate approach can be administratively burdensome (annual determination)
- Direct or indirect costs; use of independent contractors
- Costs of performance tend to mirror property and payroll factors
- Viewed as inconsistent with single sales factor trend

Application of Market-Based Sourcing

- Divergence; lack of uniformity
 - “Traditional” - customer based or where service received model
 - “Newer” – where benefit of service received model
 - MTC – where service delivered model
- Consumers vs. business customers
- Intangibles
 - where used
 - marketing intangibles included/other intangibles excluded
- Throwout rules



Business Customers

- General sourcing priority
 - Fixed or regular place of business
 - If no fixed place of business or not reasonably determinable
 - Place where order was placed
 - Billing address
- Benefit of the service received (e.g., California) –
 - Sourcing based on contract terms or reasonable approximation if location cannot be determined
 - Order location
 - Billing address
- Delivered in the state (e.g., Alabama, MTC)
 - Customer's commercial domicile is Alabama
 - Service connected to a specific geographic area
 - Reasonable approximation

Intangibles

- Use
- Marketing intangibles
 - where the goods or services are purchased by consumers (Alabama, MTC)
 - location of ultimate retail customer or reasonable approximation of use (California)
- Manufacturing intangibles
 - contract
 - billing address
- Throwout rules (sales of intangibles, location of use cannot be determined)



Fundamental Issues with Market-Based Sourcing

- Where is the benefit of the service when the recipient is a multistate business?
- Where are intangibles used?
- Varying state approaches to sourcing, approximation, throwout, etc.
- The nexus issue
- Multistate B2B: proportional sourcing or another all or nothing approach?
- Multi-step or “wholesale” service/intangible transactions: look through to the ultimate consumer?
- Whipsawing – two or more states applying inconsistent sourcing methods

Alternative Apportionment – Judicial Imposition of Market-Based Sourcing

- *Bellsouth Advertising & Publishing Corp. v. Chumley*, 308 S.W. 3d 850 (Tenn. App. 2009)
 - Excise tax in relation to income derived from distribution of advertising directories was not fairly related to that activity
 - Use of statutory formula (costs of performance) rejected in favor of market-based sourcing
 - Facts and circumstances (tax in relation to TN revenue) justified resort to variance, but DOR was not also required to prove market-based sourcing was reasonable
- *Vodafone Americas Holdings, Inc. v. Roberts*, No. 07-1860-IV (Tenn. Chancery 2013)
 - Disparity in sales factor: COP sourcing resulted in sales factor that was 89% less than DOR’s alternative market/customer address sourcing = “unusual fact situation”
 - Taxpayer’s filing history worked against it

Alternative Apportionment – Judicial Imposition of Market-Based Sourcing (con't)

- *Schoeneckers, Inc. v. Dept. of Treasury*, No. 313311 (Mich. Ct. App., Jan. 28, 2014)
 - Similar to *Vodafone*, service-provider on audit realized it should have filed using COP sourcing; original returns used market-based sourcing
 - State treated as an evidentiary challenge, not alternative apportionment challenge
 - Taxpayer prevailed
- *Equifax, Inc. v. Dept. of Revenue*, 125 So. 3d 36 (Miss. 2013)
 - COP = zero apportionment factor on taxpayer's original returns
 - DOR imposed market-based sourcing as an alternative apportionment method on audit
 - Under MS judicial review statute, burden of proof is on the taxpayer
 - Standard of review: taxpayer must show agency decision is unsupported by substantial evidence, was arbitrary and capricious, was beyond the power of the agency to make, or violated the taxpayer's statutory or constitutional rights

Alternative Apportionment – Judicial Imposition of Market-Based Sourcing (con't)

- Compare to:
 - *Microsoft Corp. v. Franchise Tax Board*, 39 Cal. 4th 750 (2006)
 - *General Mills, Inc. v. Franchise Tax Board*, 208 Cal. App. 4th 1290 (2012)
 - *Media General Communications, Inc. v. Dept. of Revenue*, 694 S.E. 2d 525 (S.C. 2010)

Questions & Answers
