

Multi-State Apportionment in the Electronic Age - Costs of Performance Sourcing

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Uniform Division of Income for Tax Purposes Act (UDITPA)

- Adopted in 1957 - has not been amended since.
- Fundamental purpose is to provide uniformity among the states with respect to the taxation of multistate corporations.
- Designed to provide a uniform and equitable method for allocating and apportioning the income of a multistate business to the various states in which it conducts economic activity.
- General approach is to separately allocate each item of nonbusiness income and to apportion by mathematical formula all business income.

Formulary Apportionment of Business Income

- UDITPA calls for use of an equal-weighted three factor formula consisting of property, payroll and sales factors.
- Property factor: ratio of in-state property to everywhere property (intended to reflect taxpayer's production activity).
- Payroll factor: ratio of in-state payroll to everywhere payroll (again, intended to reflect taxpayer's production activity).
- Sales factor: ratio of in-state sales to everywhere sales (intended to reflect taxpayer's market activity).
- Apportionment percentage equals average of three factors.
- Business income multiplied by the apportionment percentage equals the amount apportioned to the state.

Shift to Heavier Weighted Sales Factor

Oregon Apportionment Formula History

- Equal-weighted factor (prior to 1991):
33% property; 33% payroll; 33% sales
- Double-weighted sales (01/01/1991 - 04/30/2003):
25% property; 25% payroll; 50% sales
- Super-weighted sales (05/01/2003 - 06/30/2005):
10% property; 10% payroll; 80% sales
- Single sales factor (July 1, 2005 - present):
0% property; 0% payroll; 100% sales

Shift magnifies the sales factor apportionment issues such as costs of performance sourcing.

Costs of Performance Sourcing - UDITPA

UDITPA prescribes how receipts are sourced to states for purposes of determining the sales factor.

- Receipts from sales of tangible personal property are sourced to where the property is delivered (market approach - with throwback exception).
- All other receipts are sourced dependent upon where the income-producing activity (IPA) is performed. If the IPA is performed in a single state the receipts are sourced to that state. However, if the IPA is performed in more than one state the receipts are sourced entirely to the state where the greater proportion of the IPA is performed, based on the costs of performance.

Costs of Performance - Observations

- *State Taxation, Third Edition, Current Through 2014, Walter Hellerstein* - UDITPA's income-producing activity/costs of performance rules are confusing and indefinite, plagued by vagueness, ambiguity, substantial debate, lack of clear guidance, whipsawing, tremendous flexibility - and hence tax planning opportunity, frequent litigation, inconsistency, and confusion for taxpayers and taxing authorities alike.
- *New York Times* article on state taxation 2012-
"technology giants have taken advantage of tax codes written for an industrial age and ill-suited to today's digital economy."

Costs of Performance - Shortcomings

- The drafters of UDITPA intended the sales factor to acknowledge the contribution of the market states to the production of income.
- Today the COP rule does not do what the sales factor is intended to - it does not always reflect the taxpayer's market.
- When the state of performance (or the state with the greater proportion of performance) is not the market state, the intent of attributing receipts to the market state is not achieved.

Income Producing Activity – Defined

Oregon Administrative Rule 150-314.665(4)

[In part] The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit.

Costs of Performance - Defined

Oregon Administrative Rule 150-314.665(4)

[In part] The term "costs of performance" means direct costs of the taxpayer to perform the income producing activity that gives rise to the particular item of income. For purposes of this rule, direct costs do not include costs that are not part of the income producing activity itself, such as accounting or billing expenses.

Income Producing Activity - Compliance Issues

- The term IPA is not defined in UDITPA - the rules and model regulations that define IPA do not provide clear guidance as to what specific transactions constitute the IPA and which do not.
- Globalization and technology advances have made identifying the IPA at issue an increasingly difficult task.
- For example, there is no clear guidance for transactions involving complex web application services. As a result there is confusion as to whether the IPA is the transaction of providing the consumer access to the taxpayer's web applications and as to where the IPA is performed - in only the state where the customer is located or in multiple states which would require a COP analysis.

Costs of Performance - Compliance Issues

COP analysis is required when the IPA is performed in more than one state - the receipts attributable to the IPA are sourced entirely to the state where the greater proportion of the IPA is performed, based on the COP.

- COP analysis is required for each separate item of income and is burdensome on taxpayers and tax administrators.
- The all-or-nothing result of COP has an increased impact for states with a heavier weighted sales factor and provides increased opportunity for manipulation.
- There are mixed opinions as to whether COP should be analyzed under an operational or transactional approach. Awaiting Oregon Supreme Court decision in the appeal of *AT&T Corp v. Department of Revenue*, Oregon Tax Court, TC 4814

Costs of Performance - Looking Ahead

On July 30, the Multistate Tax Commission (MTC) adopted amendments to five provisions of Article IV of the Multistate Tax Compact. Included was an amendment to Section 17 that shifts away from costs of performance sourcing and requires receipts other than receipts from the sale of tangible personal property to be sourced using a market approach.

- The MTC's shift away from IPA/COP sourcing to a market approach is consistent with the recent trend in several states (AL, AZ, CA, GA, IL, IA, ME, MD, MA, MI, MN, NE, OK, PA, UT and WI).

MTC Model Regulations – Article IV, Section 17

The next step in the MTC process is to draft model regulations for the market sourcing provisions. That work is scheduled to begin this month. If you would like information about the process or are interested in participating, you can contact Sheldon Laskin.

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