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In this edition of Noonan's Notes, the authors discuss New York's market-based sourcing rules for the sale of services, which they compare with rules from other states. They conclude that taxpayers will have a high bar to prove that they correctly apportioned their receipts and predict market-based sourcing issues will be featured in audits in coming years.

As most practitioners know, New York state (and New York City) recently enacted a new corporate tax structure. As part of the overhaul of its apportionment regime, New York expanded market-based sourcing for essentially all receipts, including sales of tangible property, services, and intangible goods such as royalties. But rather than taking the lead as it often does with tax issues, New York jumped on a train that left the station over a decade ago. When its market-based sourcing rules took effect in 2015, New York became one of approximately 20 states to have adopted those sourcing rules for some or all their receipts. Since 2015 an additional three states have passed market-based sourcing and an additional three or four states are considering legislation in 2017. In other words, market-based sourcing is the new normal.

Market-based sourcing rules seek to tax a receipt based on where a customer receives or benefits from the product or service rather than on the location of the taxpayer. In that sense, a state won't penalize a corporation for locating its headquarters or office in that state. For states that still use some version of a three-factor apportionment formula (based on property, payroll, and receipts), market-based sourcing of receipts means that the sales factor no longer tracks property and payroll by sourcing sales where the work is being performed. For single-factor, receipts-only states like New York, the physical location of a company's offices now has little or no effect on its apportionment percentage. Conversely, states can tax corporations with no physical presence in the state so long as they have nexus; thus, there is a much bigger set of taxable corporations.[1] With many states adopting economic and factor-presence nexus, the ability to tax nonresident corporations is that much easier.

That said, market-based sourcing rules are not all cut from the same cloth. There is fairly wide variation in how states have approached these rules, particularly in the context of service receipts. Some hew closely to the model rules developed by the Multistate Tax Commission, whereas others take their own approaches. As a relative latecomer to market-based sourcing, New York has drawn on sourcing rules developed by the MTC and states such as Massachusetts and California, while including its own personal touches, as practitioners have come to expect from New York.

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[1] Unlike New York, which has different apportionment rules for partnerships, many states apply the same sourcing rules to corporations and flow-through entities.

In this article, we'll lay out some of the variations in the market-based sourcing rules for service receipts developed by the states and how New York fits with them. With most corporations having filed only one or two tax returns under the new regime, and with regulations still in draft form, it remains to be seen how New York's sourcing rules will operate in practice both for longtime New York filers and for corporations newly subject to the state's corporate franchise tax.

The MTC Rules and Variations on That Theme

In 2014 the MTC released a model market-based apportionment regime.[2] It based the sourcing of receipts for anything other than tangible property on whether the taxpayer's "market for the sale is in [the] state," and defined the location of the market by delivery location. If delivery location cannot be determined, a taxpayer is permitted under MTC rules to reasonably approximate its location. The MTC also included a throwout rule, excluding any receipts from the numerator and denominator of the apportionment fraction if it is sourced to a state where the taxpayer is not subject to tax or if the delivery location cannot be determined or reasonably approximated.

State apportionment rules for service receipts are variations on the MTC theme, with states like New York and California going further to define how specific service receipts should be sourced, but still providing taxpayers the ability to reasonably approximate the location of the market in some circumstances. Other states have simply laid out a basic apportionment framework, leaving any nuances in sourcing specific receipts to be hashed out between taxpayers and the state.

What Is the Market?

Market-based sourcing, as the name suggests, looks to impose tax based on the location of the market for the product or service. New York, as well as states such as California, define the location of the market as where the "benefit of the service is received."[3] In its draft regulations, New York defines the benefit of a service as where a customer derives value from a purchased service.[4] For most services, that's not any easier to define than where the benefit is received, so New York is in the process of writing and finalizing detailed regulations defining where the benefit is received.

Other states use a simpler definition of where the market is located. Alabama, Massachusetts, and Pennsylvania source receipts to their states if they are delivered to a location in the state.[5] Similarly, Maine and Illinois assign service receipts to their states if they are received in the state.[6]

Minnesota has one of the narrower definitions for sourcing receipts to the state — assigning only those services if they are received at a customer's fixed place of business in the state.[7] Georgia also requires that a customer have either a regular place of business in the state or a Georgia billing address.[8]

Even states that rely primarily on a billing address to determine location treat in-person services differently and equate delivery with the location where the service is performed. Thus, for services performed on real property, the receipt is typically sourced to the location of the property, even if the customer's billing address is elsewhere.

Hierarchical Sourcing Rules

Depending on the type of service being sold, it's not always easy to determine where its benefit is received. New York, like California, applies a hierarchy of definitions for taxpayers to follow. That hierarchy varies depending on whether the customer is a business or an individual. We've outlined that hierarchy in the table.

[2] Multistate Tax Compact, Uniform Division of Income for Tax Purposes Act, section 17. In 2017 the MTC adopted regulations governing market-based sourcing.

[3] N.Y. Tax Law section 210-A(10(a).

[4] 20 NYCRR 4-2.15(c) (draft, Oct. 19, 2016).

[5] Ala. Admin. Code r. 810-27-1-.17(2); Mass. Gen. Laws ch. 63 section 38(f); and Pa. Stat. Ann. 72 section 7401(3)(2)(a)(16.1)(c).

[6] Me. Rev. Stat. Ann. section 5211(16-A)(A); Ill. Admin. Code 100.3380; and ILCS Chapter 35 section 5/304(a)(3)(C-5)(iv).

[7] Minn. Stat. section 290.191 subd. 5(j).

[8] Ga. Comp. R. & Regs. 560-7-7-03(c)(6)(ii).

New York's Hierarchy For Sourcing Service Receipts

	Business Customer	Individual Customer
Where the customer receives the benefit of the service	As indicated by the books and records of the taxpayer without regard to billing address or through reasonable inquiries to the customer; otherwise, use reasonable approximation	Billing address or reasonable approximation
Delivery destination	Where the contract of sale is managed by the customer; otherwise billing address	Sales records or other evidence available to the taxpayer
Prior year's sourcing for same type of receipts	Cannot apply this method in first tax year on or after January 1, 2015, or first tax year in New York	Cannot apply this method in first tax year on or after January 1, 2015, or first tax year in New York
Sourcing for current tax year	Use apportionment percentage from other services or business activities that can be sourced using other levels of hierarchy	Use apportionment percentage from other services or business activities that can be sourced using other levels of hierarchy

If the customer is a business, the benefit is presumed to be where the company's books and records are located, without regard to the billing address.[9] Perhaps that doesn't provide much clarity unless a taxpayer decides to state in its records that "Customer X receives the benefit of our widget-design service at its Nebraska office" (a potential planning opportunity!). If the books and records do not clearly indicate where the benefit is received, the taxpayer must make reasonable inquiries. In other words, the taxpayer could email Customer X and ask, "Can you please confirm if you use or receive the benefit of our widget-design service at your Nebraska office?" An affirmative answer should permit the taxpayer to source that receipt to Nebraska.

The draft regulations give numerous examples to clarify that when the receipt is from an in-person service (for example, medical or repair services or services to real property, but not legal, accounting, or financial services), the benefit is received where the customer receives the service. For example, an interior design company that is paid a flat fee to design workspaces in offices in two states can use the square footage of each office to source the receipt to each state.[10]

Absent information from its books or directly from the customer as to where the benefit of a service is received, if the customer is an individual, the taxpayer can use the billing address as a proxy for where the benefit is received.[11] If the location of the benefit of the service cannot be determined and the taxpayer cannot reasonably approximate it, the taxpayer can go to the next level of the hierarchy and use delivery destination. For a business customer, that is where the contract of sale is managed by the customer, or the billing address. If the first two levels of the hierarchy do not determine where the market for the service is, the taxpayer should use either the prior year's sourcing for that type of service or, as a last resort, the current year's apportionment percentage for receipts that can be sourced using the first two levels of the hierarchy. It's clear that New York would like taxpayers to rely on the first or second level in most cases. And New York's draft regulations direct taxpayers to use due diligence to properly source a receipt before moving down a level in the hierarchy.[12] Asking whether the taxpayer tried hard enough before moving down the hierarchy could be a fun inquiry during an audit.

California also uses a hierarchical approach and differentiates between business and

[9] 20 NYCRR 4-2.15(c)(ii) (draft, Oct. 19, 2016).

[10] 20 NYCRR 4-2.15(c)(4) (Example 2) (draft, Oct. 19, 2016).

[11] 20 NYCRR 4-2.15(c)(i) (draft, Oct. 19, 2016).

[12] 20 NYCRR 4-1.3(a) (draft, Sept. 30, 2016).

individual customers.[13] If the customer is a business, California starts with the location where the benefit is received per the contract. If that is unclear, the taxpayer can reasonably approximate that location. Should that fail, the benefit is received where the customer places the order for the service or, as a last resort, the customer's billing address. If the customer is an individual, the taxpayer should also start with the contract to determine where the benefit of the service is received. Otherwise, the taxpayer should look to the billing address or, if the taxpayer shows that the billing address does not reflect that the service was delivered, the taxpayer can reasonably approximate.

Many states use a primary sourcing rule but also offer an alternative approach if the necessary information for the first method is unavailable, rather than using a multitiered approach like New York. Pennsylvania, for example, sources receipts based on where the service is delivered. If that information is unavailable, the service is deemed delivered to an individual customer at the billing address, or for a business customer, the location from which the service was ordered or otherwise, the billing address.[14]

Reasonable Approximation

Almost all states' sourcing rules permit some level of approximation for the location of the market on the assumption that some services — consulting, legal, investment management, and strategic planning — are not clearly delivered to a specific location. The differences lie in when a taxpayer may reasonably approximate a customer's location and whether reasonable approximation is defined in the law or regulations.

New York's draft regulations permit reasonable approximation to determine where the benefit of a service is received.[15] Like most states, New York requires that reasonable approximation must be fair and consistent. But it goes further by specifying that taxpayers may not use population to reasonably approximate and that the commissioner may substitute another method if the taxpayer's approximation is unreasonable.

The draft regulations provide examples of reasonable approximation. In one, a company provides consulting services regarding the safety of train tracks that run through five states, including New York, for a flat fee. On reasonable inquiries, the company cannot obtain information as to the relative value or benefit received among the five states. The example concludes that the company should reasonably approximate the percentage of the receipts to allocate to New York by multiplying the total receipts from the customer by a fraction corresponding to the number of miles of track examined in New York over the total miles of track examined in the five states.[16]

Massachusetts also provides a reasonable approximation formula in its regulations. A taxpayer must approximate "in good faith, on a consistent basis from year to year, and based on all sources of information available to the taxpayer."[17] The taxpayer must also maintain records to substantiate the method and the assumptions underlying it. But once a taxpayer establishes a method of reasonable approximation, it is assumed to be correct and cannot be changed unless the taxpayer requests a change and receives approval from the commissioner.

Tennessee, in its new market-based sourcing regulations, permits reasonable approximation if a taxpayer has insufficient information regarding the state or states where the service is delivered.[18] For individual customers, if that information is unavailable, a taxpayer may use the billing address to reasonably approximate. For business customers, other than those falling within the safe harbor (see below), reasonable approximation looks more like the cascading rules in New York and California: Taxpayers should first look to where the contract is managed, then look to where the order for the service was placed, and finally, the billing address. If a customer accounts for more than 5 percent of the taxpayer's sales, the

[13] Cal. Code Regs., tit. 18, section 25136-2.

[14] Pa. Stat. Ann. section 7401(16.1)(c).

[15] 20 NYCRR 4-2.15(c)(iv) (draft, Oct. 19, 2016).

[16] 20 NYCRR 4-2.15(c)(4)(Example 9) (draft, Oct. 19, 2016).

[17] 830 CMR 63.38.1(d)(i).

[18] Tenn. Comp. R. & Regs. 1320-06-01-.42.

taxpayer must reasonably approximate the location of the market by determining where the contract is managed.

Look-Through Sourcing

New York has included complex rules for determining whether a taxpayer should source its sales to the purchaser or further downstream to the purchaser's customer (the consumer). That's because if we are looking to determine where the benefit is received, when the purchaser is simply an intermediary it doesn't receive the benefit. Thus, New York has created a separate set of rules for intermediary transactions, when the consumer receives the benefit rather than the purchaser. But the draft regulations limit intermediary transactions to those in which the taxpayer either provides the service directly to the consumer at the direction of the intermediary or the intermediary resells a service regarding tangible property and the taxpayer continues to provide a substantial portion of the service after delivery. The regulations state that the taxpayer only need obtain information from the purchaser, and not directly from the consumer, as to where the consumer is receiving the benefit of the service.[19]

That is both broader and more limited than the MTC model regulation, which simply defines an intermediary transaction as one in which a service is delivered electronically to another party or parties for a purchaser, such as an advertising service, or a service is delivered to a consumer through the customer. In that case, the benefit is received at the location of the ultimate recipient and population may be used to approximate where the benefit is received.[20]

Throwout

As with any apportionment method, market-based sourcing can result in a receipt not being subject to tax because it is sourced to a state where the taxpayer does not have nexus and is not required to file. States are pursuing a variety of means to avoid missing out on that revenue, such as economic nexus rules. Some states also have included throwout rules in their apportionment regulations, so that sales that are sourced to states where the taxpayer is not subject to tax are either in the numerator or thrown out altogether from the apportionment formula. Some states also remove from the formula any sales that cannot be sourced under their rules.

Massachusetts, for example, eliminates from the apportionment formula any sales of services that cannot be sourced under its rules or are sourced to a state where the taxpayer is not subject to tax. Louisiana throws out sales of services from the apportionment formula if the taxpayer is not subject to tax in the state where the sale is sourced.[21]

New York has chosen not to include a throwout rule, permitting a taxpayer to include all receipts in its denominator, with only some receipts from intangibles excluded from the apportionment formula. In fact, New York states that for S corporations, all items of income and gain received in the regular course of business must be in the apportionment formula.[22] That is an unusual provision among states and may result in significantly more income ending up in the denominator, and a lower apportionment percentage for S corporations than for other corporations.

Safe Harbor

Numerous states have chosen to include a safe harbor in their regulations for determining where the benefit of a service is received by a business customer — but New York is not one of them. For example, Massachusetts permits a taxpayer with more than 250 customers receiving substantially similar professional services or services delivered electronically to reasonably approximate where the benefit is received by using the billing address.[23] Of course, taxpayers should still use the information in their records to determine where a customer received the benefit of the service, but billing address can serve as a proxy.

Similarly, in Tennessee, if a taxpayer cannot determine or reasonably approximate where a professional service or an electronically delivered

[19] 20 NYCRR 4-2.15(g) (draft, Oct. 19, 2016).

[20] MTC Regs. IV.17.(a)(3).

[21] 830 CMR 63.38.1(3)(a).

[22] 20 NYCRR 4-3.1 (draft).

[23] 830 CMR 63.38.1(2)(d).

service should be sourced, it can rely on the billing address of the customer if the taxpayer has more than 250 customers receiving substantially similar services and none of them constitutes more than 5 percent of the total sales.[24]

However, New York does have an inquiry safe harbor in its draft regulations, using the same 250 customers and 5 percent sales thresholds as Tennessee. Rather than require a taxpayer to make reasonable inquiries from its business customer as to where it receives the benefit of the service, a taxpayer can either reasonably approximate or move to the next level of the sourcing hierarchy to source its receipts if they fall within the safe harbor thresholds.[25] But it still cannot rely on the billing address of a business customer to determine where the benefit is received.

What Next?

New York's apportionment rules share similarities with other states' approaches to market-based sourcing. But if there is a unique attribute to New York's approach, it is its attempt to provide specific rules for different types of receipts and industries through its statutes, regulations, and examples, with unique rules for digital products, financial instruments, in-person services, consulting services, and commingled receipts. Also, it seems New York has endeavored to avoid simple proxies, such as billing address or population, to determine where the benefit of a service is received, particularly by a business customer. With detailed rules outlining a taxpayer's responsibility to exercise due diligence in obtaining information from customers, taxpayers will have a heavy burden to demonstrate that they have correctly apportioned receipts. It remains to be seen how that burden will play out on audit. We expect the market-sourcing issue to be one of the more important issues in the coming waves of audits under the new corporate tax reform rules. ■

[24] Tenn. Comp. R. & Regs. 1320-06-01.42(4)(c).2.(ii)(II).IV.

[25] 20 NYCRR 4-2.15(c)(ii)(A)(2) (draft, Oct. 19, 2016).