

**The Shift to Market Based Sourcing for Apportioning Service Revenue:
Public Interest Implications**

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ABSTRACT

In this article, we undertake an examination of the laws of the 50 states and the District of Columbia regarding the apportionment of professional service fees. We categorize the approaches taken by the states into 5 groups and analyze each in turn. We also provide analysis of variances between the states in each group and demonstrate issues inherent in these approaches. We also point out issues of the constitutionality of different provisions and the inherent risk of double taxation.

The Shift to Market Based Sourcing for Apportioning Service Revenue: Public Interest Implications

Introduction

The two major trends in state corporate income taxation are the adoption of market-based sourcing rules for sales of services and the adoption of a single-factor sales apportionment formula. The trend toward market-based sourcing rules accelerated after the Multistate Tax Commission's (MTC) 2014 revision to the Uniform Division of Income Tax Purposes Act's (UDITPA) original cost-of-performance rule. However, the MTC lagged behind the market-based sourcing trend, with 13 states adopting market-sourcing rules for services by 2012.¹ As a result of states using their own interpretation of market-based sourcing rules, there is not a consistent application of market-based sourcing approaches.

This article analyzes the different approaches currently used by states for the apportionment of revenue from professional services. We divided the methods into the following five categories and discuss each in turn: (1) place of performance; (2) place of delivery method; (3) place used-benefit received method; (4) place received method; and (5) derived from customers in state method. Table 1 provides a list of the states using each method. We first provide an overview of the history of UDITPA and the revision of Article IV, Section 17 and related regulations. We then review the adoption of market-based sourcing rules by some states prior to the UDITPA revision in 2014. This is followed by a discussion of the current status of state corporate income taxation of services with a focus on professional services. We also discuss the potential for double taxation and issues regarding the violation of the internal consistency test associated with some approaches.

[Insert Table 1 here]

UDITPA History

The Uniform Division of Income for Tax Purposes Act² (UDITPA) addresses the division of the tax base among the multiple states in which a taxpayer does business. Developed by the

¹ Shadewald, M. (2012). Apportionment Using Market-Based Sourcing Rules: A State-by-State Review. The Tax Adviser. November.

² UDITPA is a model law for assigning the taxable income of multistate corporations among the states where they do business. As originally adopted, UDITPA Section 9 provided a three factor approach to apportion income, the property factor, payroll factor and sales factor. UDITPA Section 15 defined the sales factor as a fraction, the numerator of which is total sales of the taxpayer in the state during the tax period and the denominator of which is the total sales of the taxpayer during the tax period. UDITPA Section 16 provides rules for the apportionment of sales of tangible personal property and UDITPA Section 17 provides rules for the apportionment of sales other than tangible personal property.

National Conference of Commissioners of Uniform State Laws in 1957, the Act was adopted by the Multistate Tax Commission (MTC) as Article IV of the Multistate Tax Compact, effective August 1967. UDITPA's Section 17 sourced revenue from services to the state where "the income-producing activity [was] performed."³ If the income-producing activity was conducted in more than one state, UDITPA sourced all of the revenue to the state where a greater proportion of the income-producing activity was performed based on costs of performance (COP).⁴ This method of apportioning service revenue focused exclusively on where the costs of performance were incurred and sourced all revenue for services to the state where a greater proportion of the costs attributable to those services were incurred.

In 1973, the MTC adopted Allocation and Apportionment Regulations relating to the sales factor.⁵ Those regulations introduced guidance for the sourcing of receipts from personal services and sourced these to the state where such services *are performed*.⁶ Services relating to a single item of income performed in more than one state were attributable to that state where the greater portion of the services were performed based on COP.⁷

Perhaps the most significant contribution to the apportionment of personal service income by the 1973 regulations was the introduction of the provision that "when services are performed partly within and partly outside the state, the services performed in each state *will* constitute a separate income producing activity."⁸ In such cases, the regulations provide that "the gross receipts for the performance of services attributable to [a] state shall be measured by the ratio which the time spent performing the services in [the] state bears to the total time spent in performing services everywhere."⁹ This special apportionment language in the 1973 regulations cured one of the most often cited criticisms of the UDITPA's COP method – attributing all revenue from an activity conducted in multiple states to the state where the greater costs of performance were incurred.

The original UDITPA drafters acknowledged that the COP rule was not going to be satisfactory in many situations. William Pierce, the primary drafter, indicated that those involved believed that the Section 17 provisions were "the best that could be designed to cover the greater proportion of the cases" (Pierce 1957). The lack of attention to the service provision reflects the time period. In 1957, the US economy was largely manufacturing and mercantile. The fact that

³ UDITPA §17(a).

⁴ UDITPA §17(b).

⁵ Multistate Tax Commission, Allocation and Apportionment Regulations (Adopted February 21, 1973, as revised through July 29, 2010) available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocationandApportionmentReg.pdf

⁶ Id., Reg. IV.17(4)(B)(c)

⁷ Id.

⁸ Id. (*emphasis added*)

⁹ Id.

UDITPA excluded the two major service industries, financial organizations and public utilities, also reflects the low level of importance given to the service sector.

Although the 1973 regulations addressed the “all or nothing” issue regarding service revenue, the COP focus remained. Over the years, growth in the service sector has increased much faster than other sectors. For example, the percentage of all nonfarm workers in manufacturing declined from 24 percent in March 1973 to 10 percent in March 2007, and workers in the service sectors went from 70 percent to 83 percent (Population Reference Bureau, 2008). The increasing importance of the service sector and the states’ increased reliance on sales in their apportionment formulas led the National Conference of Commissioners on Uniform State Laws (NCCUSL) to create a drafting committee to revise UDITPA.

The impetus for the UDITPA revision arose mainly from the dissatisfaction with Section 17’s treatment of sales of services and intangibles in the sales factor used to apportion income. (McLure 2009). Critics voiced concerns that the COP focus did not fulfill the purpose of the sales factor to reflect the contribution to market states. Instead, the COP rule tended to source receipts to production states, thus duplicating the function of the payroll and property factors. They also noted the administrative difficulties in determining an “income producing activity” and identifying the costs associated with each activity (Huddleston and Sicilian, 2009). The NCCUSL disbanded the committee after being informed that the MTC had undertaken a project to revise Article IV. (McLure 2009).

In July, 2014, the MTC adopted the modified UDITPA provisions in Article IV, Section 17 to provide that receipts or revenue from sales, other than the sales of tangible goods, be sourced to a state “...if the taxpayer’s market for the sales are in [the] state.”¹⁰ Section 17(a)(3) specifically addresses the sale of services, sourcing services to a state “to the extent the service is delivered to a location in [the] state.”

Article IV, Section 17 Regulations

On July 31, 2014, the MTC Executive Committee directed the Uniformity Committee to draft regulations to implement the market-based sourcing apportionment methodology. The Uniformity Committee submitted a proposed draft to the Executive Committee in December 2015. On February 24, 2017, after public hearings and multiple revisions, the MTC adopted regulations providing guidance for the implementation of market-based sourcing for “sales other than sales of tangible personal property”¹¹ (hereinafter the “Regulations”). The Regulations include provisions for the sale of services, licenses or leases of intangible property, sale of

¹⁰Multistate Tax Commission, *Model Compact art. IV, §17(a)* (as revised July 29, 2015), available at <http://www.mtc.gov/getattachment/Uniformity/Article-IV/Model-Compact-Article-IV-UDITPA-2015.pdf.aspx>

¹¹ Multistate Tax Commission, *Model General Allocation and Apportionment Regulations* (as adopted February 24, 2017) available at <http://www.mtc.gov/getattachment/Events-Training/2017/Special-Meeting/FINAL-APPROVED-2017-Proposed-Amendments-to-General-Allocation-and-Apportionment-Regulat.pdf.aspx> (hereinafter sometimes referred to as the “Art. IV Regs”).

intangible property and special assignment rules for software transactions and the sale or license of digital goods and services.

The “sale of a service” rules subdivide the sale of a service into three categories: in-person services, services delivered to customers by physical means or by electronic transmission, and professional services.¹² Regulation Section 17(d)(4) provides guidance regarding professional services. It defines “professional services” as “services that require specialized knowledge and in some cases require a professional certification.”¹³ Examples of professional services include management services, bank and finance services, investment and brokerage services, tax preparation, payroll and accounting services, credit card services, legal services, consulting services, video production services, engineering services, and architectural services.¹⁴

In the case of professional services, the Regulations acknowledge that there are multiple ways “...to characterize the location of delivery...by emphasizing different elements of the service provided, no one of which will consistently represent the market for the services.”¹⁵ The result is that no general rule of determination can be applied and reasonable approximation must be used.¹⁶ The assignment of receipts from professional services depends on whether the customer is an individual or business customer. If the taxpayer acting in good faith cannot reasonably determine which category the customer falls into, the taxpayer shall treat the customer as a business customer.¹⁷ The Regulations define the customer as “the person that contracts for the service, irrespective of whether another person pays for or also benefits from the taxpayer’s services.”¹⁸

When professional services are delivered to an individual customer, receipts must be assigned to the customer’s state of primary residence. If the state of the customer’s primary residence cannot be identified, the fees must be sourced to the customer’s billing address. If, however, the taxpayer derives more than 5% of its receipts from services from an individual customer, the taxpayer must identify state of primary residence and source the sales to that state.¹⁹

When professional services are delivered to a business customer, the taxpayer shall apportion the receipts as follows. First, to the state where the contract of sale is principally managed by the customer. Second, if the principal place of management cannot be reasonably determined, to the customer’s place of order. Third, if the first two locations are not determinable, then to the customer’s billing address. Like with individual customers, if a taxpayer derives greater than 5%

¹² Id., Reg. IV.17.(d).

¹³ Art. IV Regs, Section 4(A)

¹⁴ Id.

¹⁵ Id., Section 2(C)

¹⁶ Id.

¹⁷ Id.

¹⁸ Id.

¹⁹ Id., Section 2(C)(1)(a)

of its receipts from sales from a business customer, the place of principal management of the contracts must be determined.

The Regulations also provide a billing address safe harbor. The taxpayer may use a customer's billing address as the "place of delivery" of professional services if the following conditions are satisfied. First, the taxpayer engages in substantially similar services with more than 250 customers, whether individual or business. Second, the taxpayer does not derive more than 5% of its receipts from sales of all services from that customer.

State Adoption of Market Based Sourcing Rules

The MTC lagged behind the changing landscape as individual states increased reliance on the sales factor in their apportionment formulas and the economic importance of the services sector continued to grow. The trend toward heavily weighting the sales factor intensified the importance of determining how to source receipts from the growing services sector. Table 2 shows the growth in revenue, by state, in Service Sector 54, Professional, Scientific, and Technical Services from 2002 to 2017. The 74% increase in Sector 54 revenues from 2002 to 2012 compared to the overall increase in total U.S. revenues of 49% indicates the growing significance of service revenues in the U.S. economy.

[Insert Table 2 here]

Individual states began changing their reliance on sales in their apportionment formulas in the 1990's. By 1995, five states had enacted a single sales factor formula for manufacturers (Iowa, Massachusetts, Missouri, Nebraska, and Texas). By 2001, three additional states, Connecticut, Illinois, and Maryland, adopted the single sales factor for manufacturers.²⁰ In 2011, 18 states allowed a single sales factor for all companies (includes California with an optional single sales factor); Minnesota and Pennsylvania weighted sales at 90%; and Arizona weighted sales at 80%. Only eight states and the District of Columbia (DC) continued to use the equally weighted formula for sales, property and payroll. For tax year 2020, 27 states and DC use a single sales factor for apportioning business income. Table 3 provides a comparison of the 2011 and 2020 apportionment factors by state.

[Insert Table 3 here]

With the economy's shift from manufacturing to service, a number of states began to unilaterally address the issues with UDITPA Section 17's methodology for allocating sales. States began to move away from UDITPA's COP provision, adopting a form of market-based sourcing rules, and did so in a non-uniform manner. By 2009, the year the MTC began its project to revise

²⁰ <https://www.cbpp.org/archives/3-27-01sfp.htm> Mazeroy, M. "The single sales factor formula for state corporate taxes: A boon to economic development or a costly giveaway?"

Section 17, 14 states had adopted a form of market-based sourcing. Six states adopted a “where benefits received” approach (California, Georgia, Michigan, Ohio, Wisconsin and Utah); two states adopted a “where service received” approach (Maine and Minnesota); and six states adopted a “where service is performed” approach (Connecticut, New Jersey, New York, Rhode Island, South Carolina and Texas) (Huddleston and Sicilian, 2009).

The MTC approved the revised Section 17 regulations in February 2017. By this time, many states already adopted market-based sourcing methods that do not completely align with the MTC regulations. By 2020, 33 states have adopted some variation of market-based sourcing for services. As mentioned earlier, we divide the methods for sourcing services into five categories and discuss and analyze each method: (1) place of performance; (2) place of delivery; (3) place used-benefit received method; (4) place received method; and (5) derived from customers in state method

PLACE OF PERFORMANCE

The place of performance method is based on the 1973 MTC Regulations. Under this method, taxpayers apportion service revenue to a state based on the actual work performed in that state related to the services. States that continue to source receipts for professional services based on place of performance include Alaska,²¹ Arizona (unless the taxpayer is a multistate service provider that elects market based sourcing),²² Arkansas,²³ Delaware,²⁴ Florida,²⁵ Idaho,²⁶ Kansas,²⁷ Mississippi,²⁸ New Hampshire (for tax years beginning prior to December 31, 2021),²⁹ North Dakota,³⁰ South Carolina,³¹ Texas,³² Virginia,³³ and West Virginia.³⁴ Most of the states

²¹ Alaska Stat. §43.19.010, Article IV(17) and Alaska Admin. Code. tit. 15, §19.301

²² Ariz. Rev. Stat. Ann. §43-1147 (effective for tax years beginning on and after December 31, 2019). ARS §43-1147(A) sources income for professional services using the model in the MTC’s Allocation and Apportionment Regulations adopted February 21, 1973. ARS §43-1147(C) allows a multistate service provider to make election to source services based on where the purchaser *received the benefit of the service*. A “multistate service provider” is a taxpayer that derives more than 85% of its sales from services or intangibles provided to a purchaser that receives the benefit of the service outside the state. ARS §43-1147(E)(3). If the election is made, it remains binding on the taxpayer for five consecutive years unless terminated upon the acquisition or merger of the taxpayer or with the permission by Arizona’s Department of Revenue and Taxation. ARS §43-1147(C)(1)(b)

²³ Ark. Corp. Inc. Tax Regs. §1.26-51-717

²⁴ Delaware Department of Revenue, 2019 Form 1100 Instructions – Corporation Income Tax Return, Schedule 3(C), ¶2

²⁵ Fla. Admin. Code. Ann. Rule 12C-1.0155.

²⁶ Idaho Admin. Rules 35.01.01.550.05.d.

²⁷ Kan. Admin. Regs. 92-12-100

²⁸ Miss. Admin. Code Reg. 35.III.8.06.402.09.3.f.iii.

²⁹ N.H. Rev. Stat. Ann. §77:A:3 (for tax periods beginning prior to December 31, 2021)

³⁰ N.D. Cent. Code §57-38.1-17 and N.D. Admin. Code 81-03-09-31(4)(c).

³¹ S.C. Code Ann. 2295(A)(5) and §2290(6)

³² Texas Admin. Code Rule 3.591(e)(26) provides “receipts form a service are apportioned to the location where the service is performed....If performed both inside and outside Texas, on the basis of the fair value of the services that are rendered in Texas.”

³³ Va. Admin. Code 10-120-230

³⁴ W.Va. Code §11-24-7(e)(12) and W. Va. Code Reg. §110-24-7.7.1.4

using this method continue to reference the “cost of performance” language for determining the apportionment of service revenue. However, a few states look to place of performance without regard to COP.

A simplistic example involves an accounting firm with a client in State A that billed \$150,000 for services. The client work takes 1,000 hours with 600 of the hours actually completed in State A. The total cost to complete the work is \$100,000, with \$50,000 of the costs incurred in State A. Under the cost of performance approach, the accounting firm apportions \$75,000 of the \$150,000 fee to State A. However, in a state that looks to place of performance, the accounting firm apportions \$90,000 (60%) to State A based on hours worked in the state.

Delaware,³⁵ South Carolina and Texas source receipts from services based on place of performance without regard to costs of performance. South Carolina law provides that “all income from personal services received by a resident individual...and by a nonresident individual for services rendered in this state is allocated to this state.”³⁶ Other receipts from services are apportioned to South Carolina if the entire income-producing activity is within the state and apportioned among states if performed partly within and outside the state “to the extent the income producing activity is performed within the state.”³⁷ In an unpublished opinion, the South Carolina Court of Appeals held that the costs of performance language is specifically excluded from South Carolina’s apportionment language and plays no part in sourcing service receipts in South Carolina.³⁸ The Court also stated that South Carolina is not a market-based sourcing state. The Court focused on the location where the client received the service, in this case a dish satellite signal. The decision emphasizes that South Carolina for services other than personal services seeks to determine what a taxpayer's income-producing activity is and where that activity occurs to source service receipts.

Likewise, Texas law provides that “receipts from a service are apportioned to the location where the service is performed. If performed both inside and outside Texas, the revenue is apportioned based on the fair value of the services that are rendered in Texas.”³⁹ Administrative rulings by Texas’s Comptroller of Public Accounts ignore the location where the costs to deliver services are incurred and focus on the location where customers received the service.⁴⁰ In May 2020, the Texas Third Court of Appeals ruled in *Hegar v. Sirius XM Radio* that revenues received from subscription-based satellite-radio programming be sourced to the subscriber’s location.⁴¹ The

³⁵ Delaware Department of Revenue, 2019 Form 1100 Instructions – Corporation Income Tax Return, Schedule 3(C), ¶2

³⁶ S.C. Code Ann. §12-6-2290(6)

³⁷ S.C. Code Ann. §12-6-2295(A)(5)

³⁸ *Dish DBS Corporation v. South Carolina Department of Revenue*, 2018 S.C. App. Unpub. LEXIS 401 (Ct. App. 2018)

³⁹ Texas Admin. Code Rule 3.591(e)(26)

⁴⁰ Texas Comptroller of Public Accounts, Hearing No. 41,115 (April 16, 2004) and 46,585 (September 21, 2006) and Letter No. 200404513L (April 7, 2004)

⁴¹ *Hegar v. Sirius XM Radio, Inc.*, 2020 WL 2089132 (Tex. App.—Austin 2020)

Court narrowly defined the scope of “performance” as the final act that gets the service to the customer, ignoring all the costs that went into producing the service up to that point. This approach effectively obtains a market-based sourcing result.

Similar to the *Sirius XM* decision in Texas, the Florida Department of Revenue also sourced receipts based on the final customer step, effectively interpreting the cost of performance statutory language to produce a market-based sourcing result.⁴²

Apply to professional services

Need paragraph to summarize how state interpretations of the law are moving the state away from the historic cost of performance rules without a change in the statute.

PLACE OF DELIVERY

The Article IV, Section 17 Regulations adopted in February 2017 (discussed above) interpret the place of delivery language under the MTC’s modified UDITPA provisions. The District of Columbia⁴³ and the following states have adopted the Place of Delivery Method: Alabama,⁴⁴ Colorado,⁴⁵ Kentucky,⁴⁶ Louisiana,⁴⁷ Massachusetts,⁴⁸ Missouri,⁴⁹ Montana,⁵⁰ New Hampshire (for tax periods ending on or after December 31, 2021),⁵¹ New Mexico,⁵² North Carolina,⁵³ Oregon,⁵⁴ Pennsylvania,⁵⁵ Tennessee,⁵⁶ and Vermont.⁵⁷ For example, Massachusetts assigns a sale to in-state sources if the “service is delivered to a location” in the state. The administrative guidance and rulings of each state must be evaluated to determine how a particular state has

⁴² See Fla. Dep’t of Revenue, Technical Assistance Advisement 20C1-001, 01/13/20

⁴³ D.C. Code Ann. §47-1810.02(g)(3)(A)

⁴⁴ Ala. Admin. Code 810-27-1-.17(2)

⁴⁵ Colo. Rev. Stat. §39-22-303.6(6)(a)

⁴⁶ Ky. Rev. Stat. Ann. §141.120(11)(a)(3) and Ky. Admin. Regs. 16:270(7) and (10)

⁴⁷ La. Rev. Stat. §47:287.95(L)(3)(a)

⁴⁸ Mass. Regs. Code 63.38.1(9)(d)

⁴⁹ Mo. Rev. Stat. §143.455.12.(1)(c). Beginning in 2020, Missouri has adopted sourcing of receipts for services based on the location of the taxpayer’s market. The market is deemed to be in Missouri “if and to the extent the ultimate beneficiary of the service is located in this state.” As of the date of this article going to publication, Missouri has not issued regulations implementing market-based sourcing. Given that the place of delivery method theoretically focuses on the location of the customer and Missouri’s statutory language focusing on the location of the delivery of the service, we place Missouri in the place of delivery category. However, given the different approaches states have used to implement market-based sourcing until regulations are issued what Missouri’s approach will be remains uncertain.

⁵⁰ Mont. Code Ann. §15-1-601, Article IV, 17(a)(iii)

⁵¹ N.H. Rev. Stat. Ann. §77:A:3 (for tax periods beginning on or after to December 31, 2021)

⁵² N.M. Stat. Ann. 1978 §7-4-18 (effective 1/1/2020)

⁵³ N.C. Admin. Code 5G.0701 et seq. and 5G.1001, et seq.

⁵⁴ Or. Admin. R. 150-314-0435(4)

⁵⁵ 72 Pa. Stat. Ann. §7401(3)2(a)(16.1)(C)

⁵⁶ Tenn. Comp. R. & Regs. 1320-06-01-.42(2)

⁵⁷ Vt. Stat. Ann. §5833(a)(3)(B)(iii)

implemented place of delivery sourcing. Several states have yet to write regulations implementing the “delivery of service” provision including Colorado, the District of Columbia, Missouri, New Hampshire, and New Mexico.

Application to Professional Services

As discussed earlier, the Art. IV Regulations regarding professional services acknowledge that there are multiple ways “...to characterize the location of delivery...by emphasizing different elements of the service provided, no one of which will consistently represent the market for the services.”⁵⁸ The Regulations adopted a sourcing method based exclusively on the location of the customer irrespective of the delivery location of the services. As discussed later, one can argue that this results in a disconnect between the locality required to provide the government services and infrastructure to support professional service engagements from the place where the receipts are sourced.

Under the Regulations, the deemed location of the customer depends on whether the customer is an individual or business customer with a default to treat the customer as a business customer.⁵⁹ The Regulations define the customer as “the person that contracts for the service, irrespective of whether another person pays for or also benefits from the taxpayer’s services.”⁶⁰ The focus on the location of the contracting person may result in an illogical sourcing of professional service receipts.

For example, in many situations a law firm defends a lawsuit for an in-state customer but the contract is with an out-of-state insurer. From the law firm’s perspective, both the insurance company and the insured are considered clients to whom obligations of confidentiality and professional due diligence are owed. The factual scenario is further complicated when the lawsuit may actually be pending in yet another state. Identifying who is the “taxpayer’s customer” for purposes of the Art. IV Regs may not necessarily align with the identity of taxpayer’s client under a state’s legal ethics rules or laws of legal responsibility. Unfortunately, the Art. IV Regs provide no guidance on determining the identity of the “taxpayer’s customer” in this very common situation other than the general statement that the client contracting for the service is the customer.

When the taxpayer provides professional services to an individual customer, receipts must be assigned to the customer’s state of primary residence. A simple example will illustrate a situation where this method of apportionment results in a disconnect between the jurisdiction bearing the burden of the service being provided and the apportionment of the fees. John Smith

⁵⁸ Id., Section 2(C)

⁵⁹ Id.

⁶⁰ Id.

is a resident of State A. While on vacation in State B he enters into a contract to purchase a painting at an art gallery for \$150,000. After getting back home he reneges on his contract and refuses to pay for the purchase. Smith is then sued in state court in State B for breach of contract and engages the services of Michael J. Slick, with the Professional Law Corporation of Slick & Slippery, to defend him in the suit. Under the Art. IV Regs, the professional fees earned by Slick & Slippery would be apportioned to State A, the state of primary residence of John Smith, although the purchase contract for the art, the lawsuit, and all services provided by Mr. Slick arise from the activity by John Smith in State B. State B will bear the entire cost of providing the infrastructure for the business engaged in by John Smith in that state and the judicial infrastructure required to settle the dispute, but State B receives none of the state income tax dollars generated by Attorney Slick's professional services rendered in the state. In addition, most states do not collect sales tax on professional services. This leaves other taxpayers bearing the cost of providing the governmental infrastructure needed to support Slick & Slippery's business.

When the taxpayer provides professional services to a business customer, the Art. IV Regs apportion the receipts as follows. First, to the state where the contract of sale is being principally managed by the customer. Second, to the customer's place of order if the place of principal management of the contract cannot be reasonably determined. Third, to the customer's billing address if the first two are not determinable.

Turning back to the example of John Smith's vacation to State B. Assume that while in State B Mr. Smith runs a red light causing severe personal injuries to Susan Unfortunate. Susan files suit in State B against John Smith and his insurer, High Risk Specialties, whose administrative office for handling all lawsuits nationwide is in State X. High Risk contracts with Slick and Slippery to represent John Smith and High Risk in the suit. Because adequate coverage exists to cover the potential amount of damages being sought in the lawsuit and High Risk does not contest coverage, Slick and Slippery can represent both parties.

Under the Art. IV Regs, Slick and Slippery's customer would appear to be High Risk since it contracted it to represent it and Mr. Smith. Accordingly, the professional fees earned from the engagement by Mr. Smith would be sourced to State X, a state whose only connection or involvement with the subject matter of the litigation is that it is the location where High Risk's contract with Slick and Slippery is "principally managed." Again, the state being required to provide the infrastructure to support the provision of the legal services derives no tax revenue from the legal fees on the engagement.

The language of the market-based sourcing regulations in Kentucky, Massachusetts, Montana, North Carolina, Oregon, Tennessee and Vermont closely resembles the Art IV Regulations.

Some states (Kentucky, Massachusetts, Oregon and Vermont) provide two professional services examples involving a law firm.

The Massachusetts Regulations provide the following two examples for law firms providing services to individual and business clients:

Example 4. Law Corp provides legal services to individual clients who are resident in Massachusetts and in other states. In some cases, Law Corp may prepare one or more legal documents for its client as a result of these services and/or the legal work may be related to litigation or a legal matter that is ongoing in a state other than where the client is resident. Assume that Law Corp knows the state of primary residence for many of its clients, and where it does not know this state of primary residence, it knows the client's billing address. Also assume that Law Corp does not derive more than 5% of its sales of services from any one individual client. Where Law Corp knows its client's state of primary residence, it shall assign the sale to that state. Where Law Corp does not know its client's state of primary residence, but rather knows the client's billing address, it shall assign the sale to that state. For purposes of the analysis it is irrelevant whether the legal documents relating to the service are mailed or otherwise delivered to a location in another state, or the litigation or other legal matter that is the underlying predicate for the services is in another state. *See* 830 CMR 63.38.1(9)(d)4.d.ii(B) and iii(A)1.

Example 6. Law Corp provides legal services to several multistate business clients. In each case, Law Corp knows the state in which the agreement for legal services that governs the client relationship is principally managed by the client. In one case, the agreement is principally managed in Massachusetts; in the other cases, the agreement is principally managed in a state other than Massachusetts. Where the agreement for legal services is principally managed by the client in Massachusetts the sale of the services shall be assigned to Massachusetts; in the other cases, the sale is not assigned to Massachusetts. In the case of the sale that is assigned to Massachusetts, the sale shall be so assigned even if (1) the legal documents relating to the service are mailed or otherwise delivered to a location in another state, or (2) the litigation or other legal matter that is the underlying predicate for the services is in another state. *See* 830 CMR 63.38.1(9)(d)4.d.ii(B) and iii(A)2.

Comment on MA regs

Alabama and Louisiana's Substantial Connection Location of Customer Method

While Alabama and Louisiana adopt the location of delivery of services to identify the taxpayer's market, they adopt different criterion to identify the delivery location for services to a business entity. Both states source service revenue to the "specific geographic location" with a substantial connection to the services provided.⁶¹ The statute in both states provides that "if the service receipts have a substantial connection to geographic locations in more than one state, the

⁶¹ Ala. Admin. Code 810-27-1-.17(2) and La. Rev. Stat. §47:287.95(L)(3)(a)

sales shall be reasonably sourced between those states.”⁶² Unlike the Art. IV Regulations that allocate all of the service revenue to one state, Alabama and Louisiana law provides for apportionment of service revenue to multiple states.

When there is not a substantial connection between the service provided to a business customer and a specific geographic location, the Alabama and Louisiana sourcing rules require the taxpayer to source the receipts to the customer’s “commercial domicile.”⁶³ Alabama defines a business’s commercial domicile as the location of “the nerve center of the business” while Louisiana defines it as “the principal place from which the business is directed or managed.”⁶⁴ Both tests likely generate the same result. If the commercial domicile is unknown or is cost prohibitive to determine, Alabama requires the taxpayer to “source the sale to the ‘principal address of the entity as noted on the public records of the corporations section of the Alabama Secretary of State or the equivalent in the taxpayer’s state of domicile.’”⁶⁵

The approach taken by Alabama and Louisiana for professional services delivered to individual customers is similar to the Art. IV Regs Place of Delivery Method. Both states require the taxpayer to source professional service fees to the customer’s billing address.⁶⁶ Neither state distinguishes between individuals that are business customers and those that are not. The fees from professional services are all sourced based on customer’s billing address.

For both individual and business enterprises in Alabama and Louisiana, if the statutory method of apportionment fails to reflect the taxpayer’s market in the state the taxpayer may utilize, or the respective Department of Revenue may require the use of, other criteria or methodologies that will reasonably approximate the taxpayer’s market.⁶⁷ Both states require the taxpayer to include information regarding the alternative method in its tax return. Alabama and Louisiana also allow a taxpayer to petition for non-binding mediation by its Department of Revenue and other state tax authorities when a taxpayer is subject to different sourcing methodologies for services.⁶⁸

Pennsylvania Place of Delivery Variation

Pennsylvania’s statutory language also sources service receipts based on “if the service is delivered to a location in the state.”⁶⁹ In applying the statutory language, Pennsylvania uses the location where the services are *actually delivered* rather than the *location of the customer* like

⁶² Id.

⁶³ Ala. Admin. Code 810-27-1-.17(2)((b)(3) and La. Rev. Stat. §47:287.95(L)(3)(b)

⁶⁴ Ala. Admin. Code 810-27-1-.17(2)((b)(3) and La. Admin. Code §61:1135(H)(4)(b)(ii)

⁶⁵ Ala. Admin. Code 810-27-1-.17(2)((b)(3)

⁶⁶ Ala. Admin. Code 810-27-1-.17(2)((a)(2) and La. Rev. Stat. §47:287.95(L)(2)(b). The Louisiana regulations refer to these as non-direct personal services which they define to include management services, bank and financial series, financial custodial services, investment and brokerage services, fiduciary services, tax preparation, payroll and accounting services, lending services, legal services, engineering services, and architectural services.

⁶⁷ Ala. Admin. Code 810-27-1-.17(2)(a)(3) and (b)(4); and La. Admin. Code §61:1135(H)(4)(b)(ii)

⁶⁹ Pa. Stat. Ann. §7401(16.1)(C)

⁶⁹ Pa. Stat. Ann. §7401(16.1)(C)

other states using similar language. A 2014 Pennsylvania Department of Revenue Informational Notice provides the simple rule that sales from services are to be sourced to the state where the service was delivered and if delivered in multiple states only the portion “based upon the percentage of total value of the services delivered to a location in this state” shall be apportioned to Pennsylvania.⁷⁰ If the taxpayer cannot determine the place of delivery, then the services are “deemed to be delivered” for an individual customer at their billing address and to other customer’s “at the location from which the services were ordered in the customer’s regular course of operations.”⁷¹

Unlike the Art. IV Regulations which automatically default to a deemed location, the Alabama, Louisiana and Pennsylvania approaches focus on sourcing service receipts based on actual delivery before defaulting to a location for administrative convenience.

PLACE USED-BENEFIT RECEIVED

⁷⁰ Pa. Department of Revenue, Informational Notice NO. Corporation Income Tax 2014-01 (12/12/2014), Section 2, Rule #1

⁷¹ Id., Section 2, Rule #2

California,⁷² Georgia,⁷³ Indiana,⁷⁴ Iowa,⁷⁵ Michigan,⁷⁶ New Jersey,⁷⁷ Ohio,⁷⁸ Rhode Island,⁷⁹ Utah,⁸⁰ Washington,⁸¹ and Wisconsin⁸² define the market of a service provider as the state(s) where the customer “received the benefit of the service.” As discussed earlier, Arizona law allows a multistate service provider to elect market-based sourcing based on the where the benefit of the service is received.⁸³ Connecticut⁸⁴ and Hawaii⁸⁵ adopt a similar standard by defining the market for services as the place where the service is used. New York provides a hierarchical order of assigning the source of income with the place the customer received the benefit being first and the delivery destination being second.⁸⁶

⁷² Cal. Code Regs. 25136-2(c) (“to the extent the customer of the taxpayer receives the benefit of the service in this state”)

⁷³ Ga. Comp. R. & Regs. 560-7-7-.03(4)(d)(5)(c)(6)(ii) (“to the extent the recipient receives the benefit of the service in Georgia)

⁷⁴ Ind. Code §6-3-2-2(f)(3) (“to the extent the benefit of the service is received in this state”). While Indiana’s statute provides that it adopts sourcing based on where the benefit of the service is received, it also provides that administrative rules “must be consistent with the Multistate Tax Commission model regulations for income tax apportionment as in effect on January 1, 2019.” Ind. Code §6-3-2-2(v). These provisions seem inconsistent with the MTC’s model regulations (the Art. IV Regs) adopt the place of delivery as the sourcing method rather than the place where the benefit of the service is received.

⁷⁵ Iowa Admin. Code 701-54.6(422) (“to the extent the recipient receives the benefit of the service in Iowa.”)

⁷⁶ Mi. Comp. Laws Ann. §206.665. The Michigan Business Tax (MBT), which was signed into law by Governor Jennifer M. Granholm July 12, 2007 and was replaced by Michigan’s corporate income tax for most taxpayers by legislation signed into law on May 25, 2011. In connection with the MBT, the Department of the Treasury issued Revenue Administrative Bulletin No. 2010-5 (5/20/2010) that included a specific provision relating to the sourcing of professional service receipts (Section III, ¶12) and an example of how it applied in the context of legal fees (Section IV, Example M). Revenue Administrative Bulletin No. 2015-20 (10/16/2015) relating to the corporate income tax is virtually a duplicate of Bulletin No. 2010-5 except for the exclusion of the special provisions regarding professional fees in the 2010 bulletin.

⁷⁷ N.J. Rev. Stat. §54:10A-6(B)(4) (“benefit of the service received at a location in this state”)

⁷⁸ Ohio Rev. Code Ann. 5733.05(B)(2)(c)(ii) (“in the proportion to the purchaser’s benefit...in this state to the purchaser’s benefit with respect to the sale everywhere”) and Department of Taxation, CAT Information Release No. 2005-06 (December, 2006)

⁷⁹ R.I. Gen. Laws §44-11-14(b) and R.I. Reg. CT 15-04(Rule 8) (“if and to the extent that the recipient of the service receives the benefit of the service in Rhode Island.”)

⁸⁰ Utah Admin. R. §R865-6F-8(10)(g)(i) (“if the purchaser of the services receives a greater benefit of the service in this state than in any other state”)

⁸¹ Wash. Rev. Code § 82.04.462(3)(b)(i) (“to the state where the customer received the benefit of the taxpayer’s service”) SEE EXAMPLES IN REGS

⁸² Wis. Stat. §71.25(9)(dh)(3) (“according to the proportion of the service received in this state.”)

⁸³ Ariz. Rev. Stat. Ann. §43-1147 (effective for tax years beginning on and after December 31, 2019). ARS §43-1147(A) provides the cost of performance method for services. ARS §43-1147(C) allows a multistate service provider to make election to source services based on where the purchaser *received the benefit of the service*. A “multistate service provider” is a taxpayer that derives more than 85% of its sales from services or intangibles provided to a purchaser that receives the benefit of the service outside the state. ARS §43-1147(E)(3). If the election is made, it remains binding on the taxpayer for five consecutive years unless terminated upon the acquisition or merger of the taxpayer or with the permission by Arizona’s Department of Revenue and Taxation. ARS §43-1147(C)(1)(b)

⁸⁴ Conn. Gen. Stat. §12-218

⁸⁵ Hi. Rev. Stat. §235-37(2) (“to the extent the service is used or consumed in this State”)

⁸⁶ N.Y. Stat. §210-A.10(a) New York requires the taxpayer to exercise due diligence and make reasonable inquiry to determine the place that the benefit of the service is received before moving to the delivery destination as the place it is sourced.

States adopting this sourcing method generally provide that fees for services are apportioned “in proportion to the extent that the recipient receives the benefit of the services in this state.” Ohio law specifically states that “the physical location where the purchaser ultimately uses or receives the benefit...shall be paramount in determining the proportion of the benefit in this state to the benefit everywhere.”⁸⁷ Rather than focusing on the place of the relationship with the customer that generated the contract like the Place of Delivery Method does, the Placed Used – Benefit Received Method identifies the location where the client actually receives the service.

Georgia and Iowa. The approach taken to identify the location where the customer receives the benefit of the service varies by state. Georgia and Iowa do not provide clear-cut articulated standards. Their regulations simply provide that service receipts are sourced based on the place where the benefit of the service is received in proportion to the extent that the recipient receives the benefit of the service in the respective state.⁸⁸ Georgia’s regulations provide the following examples for guidance:

Georgia Example 1: A corporation from State A contracts with a computer software company from State B to develop and install custom computer software for a business office located in Georgia of the corporation from State A. The software will only be used by the business office in Georgia. The software development occurs in State B. All of the gross receipts from the software development and installation are attributable to Georgia and are included in the numerator of the apportionment factor because the recipient of the service received all of the benefit of the service in Georgia.⁸⁹

Georgia Example 2: A corporation from State A contracts with a computer software company from State B to develop and install custom computer software for the corporation from State A. The software will be used by the corporation from State A in a business office in Georgia and in a business office in State A. The software development occurs in State B. The gross receipts from the software development and installation are included in the numerator of the apportionment factor in proportion to the extent the software is used in Georgia.⁹⁰

Georgia Example 3: A corporation located in Georgia performs direct mail activities for a customer located in State A. The direct mail activities include the preparation and mailing of materials to households located throughout the United States. The corporation located in Georgia performed some activities related to the direct mail contract in State A. One percent of the direct mailings were sent to addresses within Georgia. One percent of the gross receipts related to this direct mail contract are thus attributable to Georgia and included in the numerator of the apportionment factor because the recipient of the service received 1 percent of the benefit of the service in Georgia.⁹¹

Georgia Example 4: A corporation located in State A, who otherwise does business in Georgia, performs direct mail activities for a customer located in State B. The direct mail

⁸⁷ Ohio Rev. Code Ann. §5733.05(B)(2)(c)(ii)

⁸⁸ Ga. Comp. R. & Regs. 560-7-7.03 and Iowa Admin. Code 701-54.6

⁸⁹ Ga. Comp. R. & Regs. 560-7-7.03(d)(5)(c)(6)(ii)-Example (III)

⁹⁰ Id., Example (IV)

⁹¹ Id., Example (V)

activities include the preparation and mailing of materials to households throughout the United States. The corporation located in State A printed and mailed the direct mail materials to households on a mailing list prepared by the corporation in State A. Five percent of the direct mailings were sent to addresses within Georgia. Five percent of the gross receipts related to this direct mail contract are thus attributable to Georgia and included in the numerator of the apportionment factor.⁹²

The Iowa regulations contain examples similar to Georgia Example 1 and Georgia Example 3.⁹³ As each example illustrates, the relevant factor is the place of receipt of the service. While these examples do not involve professional services, they can certainly be used by analogy for those type of services.

California, Connecticut, and New Jersey. California law provides that receipts from sales of services are sourced based on where the purchaser “received the benefit of the services.”⁹⁴ Both California and Connecticut Regulations define the location where the benefit of service is received as the location where the customer either directly or indirectly received value from the service.^{95, 96}

If the service customer in California is an individual, it is presumed that the customer receives the benefit of the service at their billing address and if the taxpayer uses this method of sourcing California’s Franchise Tax Board will accept it.⁹⁷ The taxpayer may overcome the presumption by showing that either the contract with the customer or other books and records kept by the taxpayer establish the extent to which the benefit is received at a location in California.⁹⁸ Connecticut uses a substantially similar approach for individual customers.⁹⁹

If the customer is a corporation or a business entity, the California regulations provide an order for determining where the benefit of the service is received. If the customer is a corporation or a business entity, the California regulations presume that the benefit of the service is received at the place indicated in the customer contract or the taxpayer’s books and records.¹⁰⁰ The presumption may be overcome by a preponderance of evidence by either the taxpayer or the Franchise Tax Board.¹⁰¹ If the contract or books and records do not indicate the place of benefit (or the presumption is not overcome), the location(s) where the benefit is received shall be reasonably approximated.¹⁰² If the place of benefit cannot be reasonably approximated, the place

⁹² Id., Example (VI)

⁹³ Iowa Admin Code 701-54.6 (422)

⁹⁴ Cal. Rev. & Tax. Cd. §25136(a)(1)

⁹⁵ Cal. Code Regs. 25136-2(b)(1)

⁹⁶ Connecticut Department of Revenue Services, Special Notice No. 2017(1) (4/17/2017), Section V, ¶2

⁹⁷ Cal. Code Regs. 25136-2(c)(1)

⁹⁸ Id.

⁹⁹ Connecticut Special Notice No. 2017(1) (4/17/2017)

¹⁰⁰ Cal. Code Regs. 25136-2(c)(2)(A)

¹⁰¹ Id.

¹⁰² Cal. Code Regs. 25136-2(c)(2)(B)

of benefit is presumed to be the location from which the customer placed the order.¹⁰³ If the location from which the order was placed cannot be determined, the place of benefit shall be the customer's billing address.¹⁰⁴

Connecticut Special Notice No. 2017(1) takes a similar approach as California for business customers. It provides that "the service is deemed to be used in [Connecticut] to the extent that the service relates to the business customer's activities in this state."¹⁰⁵ Under the Special Notice, the taxpayer determines the location where a business customer uses a service by applying the same sequential order as California. The Connecticut Special Notice provides that a taxpayer should use reasonable approximation when (1) the location where the service is used cannot be determined or obtaining the location where the service is used would require the taxpayer to expend undue effort and expense, and (2) the taxpayer has sufficient information to estimate the location(s) where the service is used.¹⁰⁶ The Special Notice provides numerous examples demonstrating the place of use based on a taxpayer's books and records and using reasonable approximation.

California's apportionment regulations provide the following examples of apportionment for legal services and audit services delivered by a CPA firm .

California Example 1. Law Corp located in State C has a Client Corp that has manufacturing plants in this state and State B. Law Corp handles a major litigation matter for Client Corp concerning a manufacturing plant owned by its client in this state. All gross receipts from Law Corp's services related to the litigation are attributable to this state because Law Corp's books and records kept in the normal course of business indicate that the services relate to Client Corp's operations in this state.¹⁰⁷

California Example 2. Audit Corp is located in this state and provides accounting, attest, consulting, and tax services for Client Corp. The contract between Audit Corp and Client Corp provides that Audit Corp is to audit Client Corp for taxable year ended 20XX. Client Corp's books and records kept in the normal course of business, as well as Client Corp's internal controls and assets, are located in States A, B and this state. As a result, Audit Corp's staff will perform the audit activities in States A, B and this state. Audit Corp's business books and records track hours worked by location where its employees performed their service. Audit Corp's receipts are attributable to this state and States A and B according to the taxpayer's books and records which indicate time spent in each state by each staff member.¹⁰⁸

The Connecticut Special Notice provides the following example of the application of the place used approach to apportionment:

Connecticut Example 1. Customer is a business that is headquartered in Connecticut and

¹⁰³ Cal. Code Regs. 25136-2(c)(2)(C)

¹⁰⁴ Cal. Code Regs. 25136-2(c)(2)(D)

¹⁰⁵ Connecticut Department of Revenue Services, Special Notice 2017(1) (4/17/2017), Section V(a), Business Customers

¹⁰⁶ Id., Section V(a), Reasonable Approximation

¹⁰⁷ Cal. Code Regs. 25136-2(c)(2)(E), Example 1

¹⁰⁸ Id., Example 3

has multistate operations. Customer's operations in California have been underperforming compared to the operations in other states. Customer's senior management team in Connecticut engages Management Consultant to perform a review of the California operations and make recommendations for improvement. Management Consultant performs the review of the operations in California and sends its report to the senior management team in Connecticut. Management Consultant also sends its invoice to the Customer's headquarters in Connecticut for payment. The report and related recommendations are read by the senior management team in Connecticut who share the findings with the management team in California responsible for day-to-day operations in the state. The California management team implements several of the recommendations made by the Management Consultant.

The receipts from the services provided by Management Consultant should not be sourced to Connecticut because its records indicate that the service is used solely at the operations in California where the recommendations are implemented.¹⁰⁹

New Jersey also adopts an approach somewhat similar to California. However, it moves to the presumption only after the location where the benefit is received cannot be determined or reasonably approximated. Only after that point is an individual customer deemed to have received the benefit of the service at their billing address. For all other customers, the benefit is deemed received at the location where the services were ordered, or if not determinable, the customers' billing address.¹¹⁰

Ohio. Ohio's apportionment rules focus on "where the purchaser ultimately uses or receives the benefit" of the purchase and emphasizes that "physical location where the purchaser ultimately uses or receives the benefit of the purchase [is] paramount in determining the proportion of the benefit received in Ohio."¹¹¹ In CAT Information Release 2005-06, the Department of Taxation provided guidance for the sourcing of fees for accounting and legal services. The Release includes the following sourcing rules for accounting services:

- If performed for a purchaser only located in Ohio, all accounting fees are sourced to Ohio regardless of where the services are performed
- If performed for a client with operations in Ohio and other states, the fees are sourced to Ohio if the services performed are of benefit to specific operations located in Ohio
- If accounting fees relate to Ohio and other states, the fees may be sourced to Ohio using any reasonable, consistent, and uniform method of apportionment using the taxpayer's business records as they existed at the time the service was provided or within a reasonable time thereafter
- At the election of the taxpayer (service provider), as long as applied in a reasonable, consistent, and uniform manner, accounting fees may be sources based on (i) the purchaser's principal place of business (i.e., where the business primarily maintains its

¹⁰⁹ Connecticut Special Notice 2017(1), Example 16 (4/17/2017)

¹¹⁰ N.J. Rev. Stat. §54.10A-6(B)(4)(i)

¹¹¹ Ohio Department of Taxation, CAT Information Release 2005-06 (12/1/2006)

operations) or (ii) if an individual with no business locations outside of Ohio at the individual's residence.¹¹²

Virtually identical rules are provided for sourcing fees for legal services with one variation, if “legal services are performed that relate to Ohio, all of the fees are sourced to Ohio regardless of where the services are performed.”¹¹³

The Information Release provides the following examples of the application of these rules to accounting and legal services:

Ohio Example 1 – Accounting Services. A Kentucky sole proprietor with only one retail store in Kentucky engages the services of an Ohio accountant to prepare its financial statements. The gross receipts from this service are sourced to Kentucky because the customer's business is only located in that state.

Ohio Example 2 – Accounting Services. A national retailer hires an Ohio accounting firm to address an inventory problem that exists at its Ohio stores. The gross receipts from this service are sourced to Ohio.

Ohio Example 3 – Legal Services. An attorney drafts a will for a client residing in Kentucky. The gross receipts from the services are situated to Kentucky since the services relate to a Kentucky estate. Similarly, if an attorney drafts a will in Kentucky for a client who resides in Ohio, the gross receipts from the service will be situated to Ohio since the services relate to an Ohio estate.

Ohio Example 4 – Legal Services. A company located solely in Michigan sends its treasurer to Ohio for a meeting. The treasurer is involved in an accident on a highway in Ohio and the company hires an Ohio law firm to represent the treasurer and the company in a proceeding in federal district court in Ohio. The gross receipts are sourced to Ohio since the services relate to an Ohio tort.

Ohio Example 5 – Legal Services. An attorney prepares a corporation's (client's) case at the Ohio Board of Tax Appeals. As part of the preparation, the attorney travels to the corporation's (client's) Tennessee location to interview the client's employees. All of the legal fees from the engagement, including those related to interviewing the client's employees in Tennessee, are source to Ohio since the engagement relates exclusively to Ohio.

Ohio Example 6 – Legal Services. An attorney makes an appearance in the U.S. Court of Appeals for the 6th Circuit in Cincinnati, Ohio for a client located solely in Tennessee concerning the client's federal income taxes. All of the legal fees for the engagement are sourced to Tennessee.

Hawaii. Effective for tax years beginning after December 31, 2019, Hawaii sources receipts from services to the place used or consumed by the customer.¹¹⁴ In Tax Information Release No. 2018-06, the Hawaii Department of Taxation provides guidance regarding the sourcing of

¹¹² Id., Section 1, Accounting Services. Regarding determining the “primary place of business” of a business customer of accounting services, a list of locations are provided in the Information Release that must be applied in sequential order.

¹¹³ Id., Section 32

¹¹⁴ Hi. Rev. Stat. §235-37(2)

receipts from specific types of services, including legal services. It also provides general guidance that: (1) services provided to individuals are used or consumed where the individual resides and (2) services provided to a business that relate to business activities are considered used or consumed at the customer's principal place of business.¹¹⁵

Regarding legal fees, the Release provides if they arise from a judicial or administrative action or proceeding, arbitration, mediation, or other method of dispute resolution that the legal services are used or consumed where the case or matter is filed.¹¹⁶ If the action or proceeding is not pending, or the customer is not a party to a pending action or proceeding, the legal fees are sourced based on whether the client is an individual, business, or military or government. Legal services are deemed to be used and consumed at the following locations for the respective type of client:

- Individual: Where the individual resides
- Military or government: Where the benefit of the services is received
- A business and legal services relate to its business activities: Where the client's related business activities occur
- A business and legal services are unrelated to its business activities: Where the client's principal place of business is located¹¹⁷

Rhode Island. Rhode Island law provides that its market-based sourcing is based on "the state where the recipient of the service receives the benefit of the service."¹¹⁸ However, for professional services, it has adopted the Art. IV Regs taking a place of delivery approach based on the location of the customer (i.e. for business customer to place where contract is principally managed, then place of order; and last to customer's billing address). While statutorily Rhode Island belongs in the "place benefit received group," by regulation and in practice it belongs in the place of delivery group.

Rhode Island varies from the Art IV Regs pertaining to professional services by its adoption of a special provision requiring that all fees for legal services relating to a judicial or administrative proceeding in Rhode Island be sourced to Rhode Island.¹¹⁹ Its regulations provide the following legal services examples:

Rhode Island Example 1. Law Corp provides legal services to individual clients who are resident in Rhode Island and in other states. In some cases, Law Corp may prepare one or

¹¹⁵ Hawaii Department of Taxation, Tax Information Release No. 2018-06 (6/25/2018)

¹¹⁶ Hawaii Department of Taxation, Tax Information Release No. 2018-06, Section 5, Legal Services (6/25/2018)

¹¹⁷ Id.

¹¹⁸ R.I. Reg. CT 15-04, Rule 8(f)

¹¹⁹ R.I. Reg. CT 15-04, Rule 8(i)(8)(B)(iii)(b)(III) reads as follows:

Legal services are professional services within the meaning of this section. As an exception to the general rules for assignment of such receipts, however, receipts for the sale of professional services involving the initiation, defense or maintenance of a judicial or administrative proceeding within this state shall be assigned to this state.

more legal documents for its client as a result of these services and/or the legal work may be related to litigation or a legal matter that is ongoing in a state other than where the client is resident. Assume that Law Corp knows the state of primary residence for many of its clients, and where it does not know their state of primary residence, it knows the client's billing address. Also assume that Law Corp does not derive more than 5% of its receipts from sales of services from any one individual client. Where Law Corp knows its client's state of primary residence, it shall assign the receipts to that state. Where Law Corp does not know its client's state of primary residence, but rather knows the client's billing address, it shall assign the receipts to that state. For purposes of the analysis it is irrelevant whether the legal documents relating to the service are mailed or otherwise delivered to a location in another state, or the litigation or other legal matter that is the underlying predicate for the services is in another state.

Rhode Island Example 2. Law Corp provides legal services to several multistate business clients. In each case, Law Corp knows the state in which the agreement for legal services that governs the client relationship is principally managed by the client. In one case, the agreement is principally managed in Rhode Island; in the other cases, the agreement is principally managed in a state other than Rhode Island. Where the agreement for legal services is principally managed by the client in Rhode Island, the receipts from sale of the services shall be assigned to Rhode Island; in the other cases, the receipts are not assigned to Rhode Island. In the case of receipts that are assigned to Rhode Island, the receipts shall be so assigned even if (1) the legal documents relating to the service are mailed or otherwise delivered to a location in another state, or (2) the litigation or other legal matter that is the underlying predicate for the services is in another state.

These examples are modified versions the Art. IV Reg examples and demonstrate the Art IV Regs's place of delivery method rather than the place of benefit approach statutorily adopted by Rhode Island.

Of greater concern is the special provision relating to fees associated with litigation pending in Rhode Island being sourced to Rhode Island without providing that fees associated with litigation pending in another state being sourced to that state. This causes the potential for double taxation, which in and of itself does not violate any constitutional restrictions on state taxation.¹²⁰ However, it also potentially raises an issue regarding violation of the internal consistency test as articulated by the United States Supreme Court in *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. 542 (2015). The following example illustrates the point:

Rhode Island Example 3. Company X is defending a lawsuit in Rhode Island. It engages a law firm (taxpayer) to represent it in the lawsuit. Company X's corporate headquarters and place of managing its contract with Taxpayer is in State A. The law firm is also located in State A. State A has sourcing rules identical those of Rhode Island for legal

¹²⁰ VIRGINIA CASE

services. Accordingly, the fees earned by the law firm from the engagement in this interstate transaction will be sourced as follows:

- State A: All fees sourced to State A where the contract is managed
- Rhode Island: All fees sourced to Rhode Island because the suit is pending there

If all of the parties are located in Rhode Island, the legal fees will be sourced only to Rhode Island. The result is that interstate transaction where the law firm and the company are in a different state from the litigation (i.e. interstate) will be taxed more heavily than if the litigation and all of the parties are in the same state (i.e. intrastate). On its face, one could certainly argue that this violates the internal consistency test articulated in *Wynne*.

Michigan, Utah, Washington and Wisconsin. Michigan, Utah, Washington and Wisconsin provide specific guidance for taxpayers regarding the location where the benefit of services they provide are received. In general terms, their regulations or administrative guidance specify that services are to be sourced as follows:

- If related to real property, where the real property is located.¹²¹
- If related to tangible personal property, where the tangible personal property is located and/or intended to be located, such as delivery to the purchaser after performing services.
- If not related to real or tangible personal property and provided to a customer engaged in business, if related to a customer's trade or business then where the customer's related business activities occur.
- If not related to real or tangible personal property and provided to a nonbusiness customer or is unrelated to a customer's business activities, then to the physical location where the services relate or, if not related to a physical location, then where the customer resides.
- If delivered in person to an individual that is physically present at the time, to the state where the individual is physically located when the service is delivered.

Michigan further provides that professional services to an individual customer are deemed provided at the individual's place of domicile and if a business customer at the location of the purchaser's business operations.¹²²

Washington provides the following additional guidance for services not related to the purchaser's trade or business:

- (1) If the service requires that the customer be physically present (i.e., medical exams, hospital stays, haircuts, and massage services), the benefit is received where the customer is located when the service is provided.

¹²¹ The Utah administrative regulations do not contain a provision specifically relating to services delivered in the state that relate to real property located there. Utah Admin. Regs. R865-6f-8

¹²² Michigan Revenue Administrative Bulletin No. 2010-5, Section 3, 7 (5/20/2010)

- (2) If the service is related to a specific, known location, the benefit is received at that location (i.e. wedding planning, receptions, and preparing and/or filing state and local tax returns).
- (3) If neither (1) or (2) apply, the benefit is received where the customer resides (i.e. drafting a will, preparing and/or filing federal tax returns, selling investments, and blood testing).¹²³

Michigan, Washington and Wisconsin provide that only the portion of the fees associated with services received in their state be sourced there. Washington law provides that if the portion of services where the customer received the benefit of the services cannot be reasonably determined all of the revenue must be attributed to the state in which the benefit of the service was “primarily received.”¹²⁴ As discussed later, Utah uses an “all or nothing” approach in all cases.

Michigan’s Revenue Administrative Bulletin No. 2010-5¹²⁵ provides the following rules for the application of its place of benefit approach.

10) If the service is provided to a purchaser that is engaged in a trade or business in this state and in one or more other states, and the service relates to the trade or business of that purchaser in this state and in one or more other states, the benefit of the service is received in Michigan to the extent that it relates to the trade or business of the purchaser in Michigan.¹²⁶

12) If the services provided are professional in nature, such as legal or accounting services, and are provided to a purchaser with business operations in Michigan and one or more other states, and the services relate to the purchaser's operations both in Michigan and in one or more other states, the benefit of the services is received in Michigan to the extent that the services relate to the purchaser's Michigan operations.¹²⁷

Under these provisions, there is an affirmative obligation on the taxpayer to determine the location that the customer received the benefit of the service:

A taxpayer may not simply use the customer's location to source a sale of services without first making a reasonable and demonstrable effort, based on its books and records, to determine the location where the recipient of the service received the benefit of that service.¹²⁸

The Revenue Administrative Bulletin provides an example of these rules applied in the context of professional services rendered by a law firm:

Michigan Example 1. A law firm located in Michigan has a corporate client that is headquartered in Michigan, but also has manufacturing plants in States A and C. The law

¹²³ Wash. Admin. Code 458-20-19402- (303)

¹²⁴ Wash. Rev. Code 82.04.462(3)(a)(i) and (ii)

¹²⁵ Michigan Revenue Administrative Bulletin No. 2010-5 (5/20/2010)

¹²⁶ Id., Section 3, Paragraph 10)

¹²⁷ Id., Section 3, Paragraph 12)

¹²⁸ Id., Section 5

firm handles a major litigation matter for the client concerning a manufacturing plant owned by the client in State A. Lawyers from the law firm travel to State A for depositions and the lengthy trial is also conducted in State A. All of the gross receipts from the law firm's services related to the litigation are attributable to State A, because the services are professional in nature, and they relate to the client's operations in State A. See guideline 12 above.¹²⁹

Under Alabama and Louisiana's substantial connection test, the revenue would likely be sourced to State A. Under the Art. IV Regs place of delivery method, the law firm would likely source these fees to the state of Michigan since the contract would likely be managed from the client's corporate headquarters in Michigan. The place of benefit method and substantial connection test both result in sourcing the income to the place where the services were actually delivered to the client by the professional unlike the Art. IV Regs method which appears to focus on administrative ease.

Michigan Example 1 also highlights the **incongruent** results by having different approaches being used by different states. Assume in the example that State A uses the Art. IV Regs method to apportion income. In that situation, the law firm's fees would not be included in the sales factor in either State A (which sources the income to Michigan) or Michigan (which sources the income to State A). The taxpayer would not complain in that situation.

There is ambiguity in Michigan's Revenue Administrative Bulletin No. 2010-5 relating to professional services delivered to an individual not engaged in business operations. Michigan Comp. Laws Ann. §206.665(2) does not draw a distinction between individuals and those engaged in business (whether as a business entity or a sole proprietorship). It simply provides that fees for services are sourced to Michigan "to the extent that the recipient receives the benefit of the services in this state."¹³⁰ However, Administrative Bulletin No. 2010-5 provides:

7) The services provided are professional in nature, such as legal or accounting services, and are provided to a purchaser that is an individual domiciled in this state, or to a purchaser with business operations only in Michigan.

For individual customers, this language would appear to source professional service revenue to an individual's place of domicile. At the same time, Section 3, Paragraph 12) of the Administrative Bulletin only addresses professional fees that relate to a purchaser's business operations. It does not address professional fees relating to nonbusiness matters of an individual when the benefit is received out of state (i.e., defense in out-of-state lawsuit for personal injury claim while on personal trip). The Administrative Bulletin is arguably in conflict with the statutory language in this situation. The issue is whether the statutory provision requiring apportionment based on where the benefit is received would override the Administrative Bulletin

¹²⁹ Id., Section IV, Example M

¹³⁰ Mich. Comp. Laws Ann. §206.665(2)

sourcing an individual's nonbusiness related professional service receipts to their place of domicile.

Washington Examples and *Arup Labs v. Dept. of Revenue*. Washington's administrative code provides the following examples of its approach for sourcing accounting and legal fees:

Washington Example 1. Manufacturer hires Law Firm to defend Manufacturer in a class action product liability lawsuit involving Manufacturer's Widgets. The benefit of Law Firm's services relates to Manufacturer's widget selling activity in various states. A reasonable method of proportionally attributing receipts in this case would be to attribute the receipts to the locations where the Manufacturer's Widgets were delivered, which relates to Manufacturer's business activities.¹³¹

Washington Example 2. A Washington couple hires a Washington attorney to prepare a last will and testament for Daughter who lives in California. Daughter is a third-party beneficiary and receives the benefit of the attorney's services in California because that is where Daughter lives. Washington Attorney must attribute the fee to California.¹³²

Washington Example 3. Washington accountant prepares a Nevada couple's Arizona and Oregon state income tax returns as well as their federal income tax return. The benefit of the accountant's service associated with the state income tax returns is attributed to Arizona and Oregon because these returns relate to specific locations (states). The benefit associated with the federal income tax return is attributed to the couple's residence. The fees for the state tax returns are attributed to Arizona and Oregon, respectively, and the fee for the federal income tax return is attributed to Nevada.¹³³

Washington Example 4. A Washington couple hires a California accountant to prepare their joint federal income tax return. Because the couple does not have to be physically present for the accountant to perform services and services are not related to a specific location, the Washington couple receives the benefit of the accountant's services at their residence in Washington. California accountant must attribute its fee for this service to Washington.¹³⁴

The recent Washington Court of Appeals decision in *ARUP Labs v. Department of Revenue*¹³⁵ also provides guidance on the application of the "benefit of the service" sourcing approach. *ARUP Labs* involved medical lab testing services provided by a business located in Utah. Out of state medical providers would collect specimens for testing and forward it to the lab in Utah. The lab would conduct the test, generate a written report of the results, and provide the report to the medical providers. The taxpayer, ARUP Labs, argued that the testing service revenue should be sourced to Utah because the samples were tangible personal property located in Utah when

¹³¹ Wash. Admin. Code 458-20-19402- 304, Example 16

¹³² Id., Example 29

¹³³ Id., Example 27

¹³⁴ Id., Example 30

¹³⁵ *ARUP Labs v. Department of Revenue*, 457 P.3d 492, 2020 Wash. App. LEXIS 307 (Wash. Ct. App. 2020)

the tests were conducted. The Court rejected ARUP's position. The Court observed that the purpose of the "benefit received" approach to sourcing fees is to "determine where the customers receive the helpful or useful effect of the services."¹³⁶ In this case, ARUP's services assisted medical providers in diagnosing their patients resulting in the receipt of the benefit at the medical provider's location. While the samples tested were tangible personal property, the purpose of the service was to obtain the results to aid in medical treatment rather than to repair, improve or enhance the use of the sample itself.¹³⁷ Accordingly, the testing fees for medical providers located in Washington should be sourced to Washington.¹³⁸

Utah uses an "all or nothing" approach allocating all the service revenue from an engagement to the state where the greater benefit was received.¹³⁹ Unlike UDITPA which uses costs of performance to determine the place that service revenue is sourced, Utah focuses on the state where the greater benefit is received. If the location where the greater benefit of the service "cannot otherwise be readily determined," sourcing of the receipts are applied in the following sequential order: (1) customer's location of placing the order; (2) customer's billing address; and (3) sourced to Utah if the location or billing address cannot be determined.

Utah Administrative Regulations provide the following examples if the application of its greater benefit test:

Utah Example 1: A company headquartered and primarily conducting business in Utah contracts for general accounting services with an accounting firm located in another state. The receipts for the accounting service are sourced to Utah regardless of where the services are performed, since the greater benefit of the services is received in this state.

Utah Example 2: A multistate company hires a Colorado firm to perform an appraisal of its business properties in Utah and Colorado. The company has several locations in Utah. However, the headquarters of the company is in Colorado and the value of its properties located in Colorado exceed the value of its properties in Utah. The appraisal fee is not broken down by location of the assets or properties of the company. Use of the property values for each state to determine where the greater benefit of the appraisal services occurred is a reasonable method to determine where the appraisal service fees should be sourced and the service would be sourced to Colorado. However, if the appraisal fees are broken out separately for Colorado and Utah properties or the billing information by state is known, the appraisal fees pertaining to the Utah properties are sourced to Utah and the appraisal fees pertaining to the Colorado properties are sourced to Colorado.

Utah Example 3: A California law firm is retained to represent multiple plaintiffs in

¹³⁶ *ARUP Labs v. Department of Revenue*, 457 P.3d at ¶34

¹³⁷ *Id.*, at ¶38 and ¶39

¹³⁸ An unnamed lab requested a letter ruling from the Utah Tax Commission presenting virtually identical facts. Like the Court in *ARUP Labs*, the Utah Tax Commission concluded in Private Letter Ruling 12-005 (11/28/2012) that the lab's out-of-state customers receive the greater benefit of the laboratory testing. Because the "market for the services and the client's locations are outside of Utah" the fees from those services were not properly sourced to Utah.

¹³⁹ Utah Admin. R. R865-6F-8(g)(iv)

a class action lawsuit filed against a Utah corporation in a Utah court. Receipts received by the firm for the legal services are sourced to Utah notwithstanding the fact that some of the services were performed outside Utah. The greater benefit of the services is received in Utah since the lawsuit was filed against a Utah corporation in a Utah court.

PLACE RECEIVED METHOD

The states of Illinois,¹⁴⁰ Maine,¹⁴¹ and Minnesota¹⁴² define the place that “services are received” by the customer as the taxpayer’s marketplace. By statute, Illinois and Minnesota provide that services provided to a corporation, partnership or trust receiving the service may only be attributed to a state where it has a fixed place of doing business.¹⁴³

Illinois, Maine and Minnesota first provide that receipts from services are sourced to the state where the services are received. If the state where services are received is not readily determinable, or in the case of Illinois and Minnesota is a state where a business entity does not have a fixed place of business, the services are deemed received at the location of the customer’s office from which the services were ordered.¹⁴⁴ If the location where the services were ordered cannot be determined, the income is sourced to the customer’s office billing address.¹⁴⁵ If the customer is an individual, the individual’s residential address should be used if different from the billing address.¹⁴⁶

DERIVED FROM CUSTOMERS IN STATE METHOD

Maryland¹⁴⁷, Nebraska,¹⁴⁸ and Oklahoma’s¹⁴⁹ market-based sourcing method apportion receipts from services if derived from customers in the respective state. Under Maryland law, an individual and business enterprise are considered a customer within Maryland only if domiciled there.¹⁵⁰ For a business enterprise, it is considered domiciled in Maryland if (1) the state in which the office is located or place of business that provides the principal impetus for the sale, or (2) if the location of principal impetus for the sale cannot be located the state in which the

¹⁴⁰ Ill. Comp. Stat. 5/304 and Ill. Admin. Code 100.3370(D)

¹⁴¹ Me. Rev. Stat. Ann. §5211-16-A.A and Me. Code R. 801 (18-125 CMR 801) .06(B)(3)

¹⁴² Minn. Stat. §290.191, Subdivision 5(j)

¹⁴³ Ill. Comp. Stat. 5/304(C-5)(iv) and Minn. Stat. §290.191, Subdivision 5(j)

¹⁴⁴ Ill. Comp. Stat. 5/304(C-5)(iv), Me. Rev. Stat. Ann. §5211-16-A.A, and Minn. Stat. §290.191, Subdivision 5(j)Id.

¹⁴⁵ Id.

¹⁴⁶ Ill. Comp. Stat. 5/304(C-5)(iv) and Me. Rev. Stat. Ann. §5211-16-A.A

¹⁴⁷ Md. Code Regs. .03.04.03.08(C)(3)(c)

¹⁴⁸ Neb. Rev. Stat. 77-2734-14(3)(a)

¹⁴⁹ Okla. Admin. Code §710:50-17-71(1)(A)(ii)

¹⁵⁰ Md. Code Regs. .03.04.03.08(D)(2)

headquarters or principle place of business management is located.¹⁵¹ The term business enterprise includes a proprietorship or any other entity engaged in business.¹⁵²

Oklahoma also uses a bright line, clear cut approach in determining whether a customer is located there. It sources receipts from the performance of services to Oklahoma if its customer is within the state.¹⁵³ It limits the definition of a “customer within Oklahoma” to: (1) a customer that is engaged in a trade or business and maintains a regular place of business in Oklahoma¹⁵⁴ and (2) a customer that is not engaged a trade or business whose billing address is in Oklahoma.¹⁵⁵ The customer’s billing address is the address of record in the books and records of the taxpayer where the bill relating to the customer’s account is mailed.¹⁵⁶

Nebraska’s standard for determining whether a sale is derived from a buyer within the state is somewhat more nebulous. If the service is delivered to an individual customer while physically present in Nebraska, it will be sourced to the state.¹⁵⁷ If provided to a buyer engaged in a trade or business in Nebraska and the service relates “to that part of the trade or business then operated in Nebraska,” it will be sourced to Nebraska.¹⁵⁸ If provided to a trade or business and the customer uses the service in Nebraska and other states, the receipts are to be apportioned to the states in proportion to the use of the service in each state.¹⁵⁹

In addition, the Nebraska apportionment law contains a general catchall provision that receipts from fees “must be sourced as to fairly represent the extent of the taxpayer’s business activity in this state.”¹⁶⁰ This provision certainly eliminates the bright line rules approach reflected in the “derived from customers in the state” approach used by Maryland and Oklahoma. The catchall provision states that sourcing to fairly represent the taxpayer’s activity in Nebraska will be met if: (i) a sale is sourced at an individual customer’s billing address; and (ii) a sale is sourced to a business customer’s location from which the order was placed or the business customer's billing address if that place of order cannot be readily determined.¹⁶¹

Lack of Uniformity Issues

The MTC’s shift from the historic cost-of-performance approach to the market-based sourcing approach followed the movement to market-based sourcing by numerous states including California and New York. The MTC’s revised approach requires sourcing to the location where the services are delivered to the customer, an approach currently used by 15 states and the

¹⁵¹ Md. Code Regs. .03.04.03.08(D)(2)(b)(ii)

¹⁵² Md. Code Regs. .03.04.03.08(D)(2)(b)(i)

¹⁵³ Okla. Admin. Code §710:50-17-71(1)(A)(ii)

¹⁵⁴ Okla. Admin. Code §710:50-17-71(1)(A)(ii)(I)

¹⁵⁵ Okla. Admin. Code §710:50-17-71(1)(A)(ii)(II)

¹⁵⁶ Id.

¹⁵⁷ Neb. Rev. Stat. Ann. §77-2734.14(3)(a)(iii)

¹⁵⁸ Neb. Rev. Stat. Ann. §77-2734.14(3)(a)(iv)

¹⁵⁹ Id.

¹⁶⁰ Neb. Rev. Stat. Ann. §77-2734.14(3)(k)

¹⁶¹ Neb. Rev. Stat. Ann. §77-2734.14(3)(k)

District of Columbia. Thirteen states continue to use the “old” cost-of performance approach and the remaining states adopted market-based sourcing rules for services based on an approach other than the MTC’s location where delivered to the customer approach.

The variety of approaches that states continue to use to source services will continue to challenge taxpayers and state authorities alike. We identified four potential issues that will remain a concern given the lack of uniformity across states. The issues include double taxation, a disconnect between the jurisdiction being apportioned the revenue and the jurisdiction providing the infrastructure and bearing the governmental costs of delivering the service, the treatment of sales receipts from sole proprietors, and a concern regarding internal consistency.

Double Taxation: The lack of uniformity across states results in situations where taxpayers providing similar services may be treated very differently. An extreme example is Maryland and Virginia. Virginia continues to source services under the cost-of-performance approach and Maryland uses the market-based sourcing approach. Assume that Alpha Corporation and Beta Corporation are in the same service industry and receive all of their revenue from that one service. Both companies operate out of one main office with Alpha Corporation located in Virginia and Beta Corporation located in Maryland. Assume that 75% of each company’s sales are to customers located in Virginia and 25% of their sales are to customers located in Maryland.

Beta Corporation, located in Maryland, uses Maryland’s market-based sourcing rules based on where the benefit is derived. Assuming the benefit is derived at the customer’s location, 25% of Beta Corporation’s sales are allocated to Maryland. Beta Corporation will use Virginia’s all-or-nothing cost-of-performance sourcing rules, resulting in a 0% sales factor in Virginia. With Maryland phasing into a single sales factor by 2022, Beta Corporation will likely pay corporate state income tax on only 25% of its taxable income.

Alpha Corporation, located in Virginia, does not fair nearly as well. Alpha will use the same market-based sourcing rules for its Maryland sales, resulting in a 25% sales factor in Maryland. Under Virginia’s all-or-nothing cost-of-performance rules, assuming the vast majority of Alpha’s costs are in Virginia, Alpha will likely have a 100% Virginia sales factor. Since Virginia’s apportionment formula is payroll, property, and double-weighted sales, Alpha’s overall apportionment percentage will be close to 100%. In total, Alpha will likely pay state income tax on close to 125% of its taxable income (25% to Maryland and 100% to Virginia).

In *Corporate Executive Board Co. v. Virginia Department of Taxation*,¹⁶² the Virginia Supreme Court addressed a similar situation to Alpha Corporation. Corporate Executive Board Co. (CEB), is a multi-jurisdictional, Virginia-based advisory firm. CEB’s “core product” provides clients with electronic access to research and data stored on servers located in Arlington, Virginia. Most of its employees work at its headquarters and its costs of performance are incurred within the

¹⁶² *Corporate Executive Board Co. v. Virginia Department of Taxation*, Record No. 171627, February 7, 2019.

state. However, less than 5% of CEB's customers had a Virginia billing address. On its return as originally filed, CEB sourced 100% of its sales to Virginia. CEB filed an amended and petitioned the Department to use an alternative apportionment method that would better reflect its level of activity and benefits received by its customers in Virginia. After the Department denied CEB's request and the Circuit Court of Arlington County ruled against them, the Virginia Supreme Court heard the case.

The Virginia Supreme Court held that the use of the statutory formula to apportion CEB's income did not violate the Due Process or Commerce Clauses of the U.S. Constitution. The Court found that CEB could not prove that the statutory formula was inequitable, even though they showed that double taxation resulted from Virginia's statute and those in other states. CEB could not prove that the inequality was attributable to Virginia's statute rather than to the fact that other states have unique allocation and apportionment methods.

Infrastructure Burden: As previously discuss, the differing methods of apportioning services can result in a disconnect between the jurisdiction bearing the burden of the service being provided and the apportionment of the service revenue. This is likely to be a common occurrence with regard to legal fees. Legal fees are often paid by a third party insurance company located in one state, on behalf of an insured client that may be located in another state, to defend a suit that may be filed and litigated in a third state. The state where the lawsuit is filed and litigated will bear the entire cost of providing the judicial infrastructure. However, depending on the method of sourcing sales adopted by the state, the state may be apportioned none of the professional service fees associated with the lawsuit.

Sole Proprietors: Many states do not address businesses that are operated by sole proprietors. Many states provide guidance regarding sourcing of services to individual customers and business customers. However, they do not distinguish between individuals that are business customers and those that are not. Therefore, the fees from professional services provided to an individual related to their sole proprietorship will be sourced using the individual customer guidance. For example, Alabama's regulations provide guidance for the sourcing of receipts from individuals and business enterprises. The regulations defines "business enterprise" to include "any person other than an individual."¹⁶³

Internal Consistency under Wynne: As previously discussed, the Rhode Island provision relating to fees associated with litigation pending in Rhode Island may violate the internal consistency test articulated in *Comptroller of the Treasury of Maryland v. Wynne*.¹⁶⁴ Specifically, the RI provision sources fees associated with litigation pending in RI to RI without providing that fees associated with litigation pending in another state are sourced to that state. When the law firm and the company are in a different state from the litigation (i.e. interstate),

¹⁶³ Alabama Section 810-27-1-4-.17.01 - Sales Factor: Sourcing Sales Derived From Services Rendered To Individual And Unrelated Business Customers

¹⁶⁴ *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. 542 (2015).

then the legal fees will be taxed more heavily than if the litigation and all of the parties are in the same state (i.e. intrastate). It could be argued that this scenarios violated the internal consistency test in *Wynne*.

States and taxpayers alike will continue to struggle with the challenges of apportioning revenues from services. Many of the states that have not adopted the market-based sourcing approach continue to evaluate the revenue impact of changing from the cost-of-performance approach. Taxpayer will continue to argue the issue of double taxation with state taxation departments and we believe it is only a matter of time until the internal consistency issue is raised.

Table 1: State Sourcing Method for Sales from Services

<u>Place of Performance</u>	<u>Place of Delivery:</u>	<u>Used/Benefit Received:</u>
Alaska	Alabama	Arizona (if elected)
Arizona	Colorado	California
Arkansas	District of Columbia	Connecticut
Delaware	Hawaii	Georgia
Florida	Kentucky	Hawaii
Idaho	Louisiana	Indiana
Kansas	Massachusetts	Iowa
Mississippi	Missouri	Michigan
New Hampshire (through 12/31/2020)	Montana	New Jersey
North Dakota	New Hampshire (effective 1/1/2021)	New York
South Carolina	New Mexico	Ohio
Texas	North Carolina	Rhode Island
Virginia	Oregon	Utah
West Virginia	Pennsylvania	Washington
	Tennessee	Wisconsin
	Vermont	
<u>Place Received:</u>	<u>Benefit Derived:</u>	
Illinois	Maryland	
Maine	Nebraska	
Minnesota	Oklahoma	

**Table 2: NCAIS 54, Professional, Scientific, and Technical Services Revenue
2002 - 2017**

State	2017	2012	2007	2002	% Increase '07 to '17	% Increase '02 to '12
Total U. S.	1,953,118,341	1,584,614,020	1,381,680,393	911,568,291	41.36%	73.83%
Alabama	19,528,855	16,138,394	14,111,475	8,792,699	38.39%	83.54%
Alaska	3,150,567	3,080,539	1,738,977	1,386,008	81.17%	122.26%
Arizona	23,878,893	19,618,988	18,844,308	12,174,615	26.72%	61.15%
Arkansas	5,813,363	4,730,900	4,108,660	2,612,531	41.49%	81.08%
California	303,074,509	250,283,495	308,293,677	150,090,122	-1.69%	66.76%
Colorado	37,539,959	35,050,847	29,081,071	20,742,648	29.09%	68.98%
Connecticut	23,345,061	21,873,775	17,011,636	14,766,982	37.23%	48.13%
Delaware	8,070,592	6,371,630	4,353,877	3,210,990	85.37%	98.43%
D. C.	38,252,343	32,587,021	25,731,354	18,008,119	48.66%	80.96%
Florida	89,926,902	77,390,246	65,725,910	44,305,563	36.82%	74.67%
Georgia	54,875,181	42,530,567	34,944,275	25,890,350	57.04%	64.27%
Hawaii	3,724,075	3,512,910	3,169,772	2,296,858	17.49%	52.94%
Idaho	4,894,035	4,443,289	3,957,153	2,313,102	23.68%	92.09%
Illinois	89,304,844	74,037,253	63,680,592	47,700,033	40.24%	55.21%
Indiana	21,607,431	16,500,192	11,844,646	9,382,603	82.42%	75.86%
Iowa	8,718,789	7,572,709	5,789,249	3,690,791	50.60%	105.18%
Kansas	11,678,832	10,393,818	8,140,083	6,356,174	43.47%	63.52%
Kentucky	10,307,242	7,826,010	8,801,131	5,350,407	17.11%	46.27%
Louisiana	16,888,379	14,322,744	11,487,008	8,284,656	47.02%	72.88%
Maine	3,878,085	3,434,055	3,158,677	2,252,263	22.78%	52.47%
Maryland	55,377,796	51,409,864	44,130,907	28,082,123	25.49%	83.07%
Massachusetts	78,510,050	65,302,961	50,778,983	38,185,632	54.61%	71.01%
Michigan	42,457,042	38,705,887	29,957,472	26,617,811	41.72%	45.41%
Minnesota	36,563,996	25,173,617	21,364,960	15,072,455	71.14%	67.02%
Mississippi	4,777,809	3,987,159	4,293,681	2,881,354	11.28%	38.38%
Missouri	30,561,126	25,816,442	19,771,332	17,351,493	54.57%	48.79%
Montana	2,204,782	2,350,331	1,895,251	1,248,335	16.33%	88.28%
Nebraska	5,910,802	8,286,877	4,694,716	3,042,217	25.90%	172.40%
Nevada	10,429,496	8,784,067	9,039,935	5,704,902	15.37%	53.97%
New Hampshire	5,288,655	3,891,099	3,777,042	2,877,342	40.02%	35.23%
New Jersey	68,125,019	64,426,752	53,887,124	38,429,647	26.42%	67.65%
New Mexico	10,020,426	9,064,988	6,175,056	3,284,449	62.27%	176.00%
New York	261,197,121	140,881,235	115,147,193	84,322,144	126.84%	67.08%
North Carolina	41,544,672	35,620,845	27,223,919	17,634,608	52.60%	101.99%
North Dakota	2,712,059	1,915,765	1,188,762	834,273	128.14%	129.63%
Ohio	43,544,004	39,838,365	33,881,054	24,355,984	28.52%	63.57%
Oklahoma	12,745,677	9,489,522	8,607,382	6,045,857	48.08%	56.96%
Oregon	14,131,875	15,986,793	10,115,254	7,035,357	39.71%	127.23%
Pennsylvania	62,722,500	57,341,542	48,844,852	37,010,673	28.41%	54.93%
Rhode Island	3,702,898	3,590,807	2,769,767	2,181,347	33.69%	64.61%

South Carolina	17,323,798	12,783,736	9,682,020	7,498,330	78.93%	70.49%
South Dakota	2,012,684	1,323,721	1,163,508	940,425	72.98%	40.76%
Tennessee	19,584,550	16,371,295	12,960,030	11,228,007	51.12%	45.81%
Texas	158,730,611	131,175,420	96,036,969	63,760,866	65.28%	105.73%
Utah	14,477,150	10,919,835	8,675,265	4,899,869	66.88%	122.86%
Vermont	1,762,276	1,916,275	2,075,421	1,092,352	-15.09%	75.43%
Virginia	101,176,404	96,026,865	66,998,395	41,557,130	51.01%	131.07%
Washington	42,130,036	30,521,176	25,534,934	17,186,170	64.99%	77.59%
West Virginia	2,925,061	3,200,657	2,740,008	1,845,815	6.75%	73.40%
Wisconsin	20,444,763	15,550,576	13,145,378	9,096,388	55.53%	70.95%
Wyoming	1,565,266	1,260,164	1,150,292	657,422	36.08%	91.68%
United States, all revenues	36,579,575,611	32,495,262,387	29,058,828,476	21,836,249,354	25.88%	48.81%

Table 3: State Apportionment of Corporate Income: Tax Years 2011 and 2020

	2011	2020		2011	2020
Alabama	Double Weighted	Double Weighted	Montana	Equal Weighted	Equal Weighted
Alaska	Equal Weighted	Equal Weighted	Nebraska	Sales	Sales
Arizona	80% Sales	Sales	Nevada	No Corp Tax	No Corp Tax
Arkansas	Double Weighted	Double Weighted	New Hampshire	Double Weighted	Double Weighted
California	Double Weighted ¹	Sales	New Jersey	Double Weighted	Sales
Colorado	Sales	Sales	New Mexico	Equal Weighted	Sales
Connecticut	Double Weighted	Sales	New York	Sales	Sales
Delaware	Equal Weighted	Sales	North Carolina	Double Weighted	Sales
D. C.	Equal Weighted	Sales	North Dakota	Equal Weighted	Equal Weighted ¹
Florida	Double Weighted	Double Weighted	Ohio	Triple Weighted	
Georgia	Sales	Sales	Oklahoma	Equal Weighted	Equal Weighted
Hawaii	Equal Weighted	Equal Weighted	Oregon	Sales	Sales
Idaho	Double Weighted	Double Weighted	Pennsylvania	90% Sales	Sales
Illinois	Sales	Sales	Rhode Island	Double Weighted	Sales
Indiana	Sales	Sales	South Carolina	Double Weighted	Sales
Iowa	Sales	Sales	South Dakota	No Corp Tax	No Corp Tax
Kansas	Equal Weighted	Equal Weighted	Tennessee	Double Weighted	Triple Weighted
Kentucky	Double Weighted	Sales	Texas	Sales	Sales
Louisiana	Sales	Sales	Utah	Double Weighted	Sales
Maine	Sales	Sales	Vermont	Double Weighted	Double Weighted
Maryland²	Double Weighted /Sales	71.4% Sales /Sales	Virginia	Double Weighted	Double Weighted ¹
Massachusetts	Double Weighted /Sales	Double Weighted /Sales	Washington	No Corp Tax	No Corp Tax
Michigan	Sales	Sales	West Virginia	Double Weighted	Double Weighted
Minnesota	90% Sales	Sales	Wisconsin	Sales	Sales
Mississippi	Sales	Sales	Wyoming	No Corp Tax	No Corp Tax
Missouri	Sales	Sales			

¹ Optional Single Sales ² MD: Single sales for Manufacturers; phasing in single sales after 2022