Market Sourcing 101 & Multistate Update on Economic Nexus

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TOPICS

- Economic Nexus
- Market Sourcing 101
- Sourcing Receipts in New York State & New York City
- Categories of Receipts
- Other Hot Topics
- Examples

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TOPICS

ECONOMIC NEXUS

MORE THAN YOU EVER WANTED TO KNOW ABOUT ECONOMIC NEXUS…

…but less than you should know

Nexus is…

- The quality and quantity of contacts a business must have within a state before that state may exercise its taxing jurisdiction over the business.
- It is a developing concept. But traditional nexus was a "presence" concept. If you aren't there, you can't be taxed there.

Development of the Traditional View of Nexus

- The Constitution's Due Process Clause has a "fundamental fairness" concept cooked in. If it is fundamentally unfair (because a lack of contacts within a state makes taxability there unforeseeable or disproportionate to the benefits provided by the state), nexus is not established.
- Due Process nexus is difficult to avoid in current times. In *Mobil Oil (1980)* the U.S. Supreme Court held that the Due Process Clause does not prohibit a state from taxing an out-of-state corporation if there is some "minimal connection" between the company and the state.

Development of the Traditional View of Nexus (Continued)

- The Constitution's Interstate Commerce Clause has been read to have an implicit prohibition against the states passing laws that unduly influence interstate commerce.
- This "Negative" or "Dormant" aspect is being called into question with increasing frequency.
- The traditional approach is to prohibit taxation under the implied prohibition if there is no "substantial nexus" between the business and the state.

Development of the Traditional View of Nexus (Continued)

- In *Scripto* (1960), the Court held that nexus (at least for sales tax) could be created by agents; i.e. independent reps soliciting sales in the state.
- But then in *Quill* (1992), the Court held that there needed to be some sort of physical presence within the state to create the “substantial nexus” required by the dormant interstate commerce clause. Sending in catalogs is not enough. Having a *de minimis* amount of ordering software in the state is not enough.

And then…

- Remote selling really starts to take off.
- Why? Because Americans are cheap. We like to buy at a discount, and we hate to pay taxes (remember all that tea we threw into Boston Harbor?).
- Anyway, after that Al Gore invented the internet, and now everyone is buying “on the line.”

And so…

- The states feel they're missing out on a lot of sales tax revenue.
- Cue the Chris Doyle "well the states should collect it themselves" rant.

Meanwhile, Back at the Income Tax Corral

- About the same time Al Gore has his epiphany, aggressive corporate income tax planners in separate reporting states (e.g. New York) come up with clever plans to legitimately divert earnings to low-tax jurisdictions. The most popular of these is the formation of related intangible holding companies to which an operating business would transfer its valuable intellectual property (trademarks, patents, etc.) and then "rent" it back through the payment of royalties that were deductible by the operating business in high tax states (e.g. New York) and includable in the income of the IHC in no-tax states (e.g. Delaware).

THE EMPIRES STRIKE BACK

Not so long ago

in a tax galaxy not so far away

tax departments joined together

to develop schemes for forcing this

diverted income or sales tax back

into the proper states!

(Cue Star Wars Theme)

In the Presence of *Quill*, Income Taxes Become the Low Hanging Fruit

Geoffrey, Inc. (Supr. Ct. S.C. 1993)

- *Quill* applies only to sales and use tax
- Concludes that “minimal connection” and “substantial nexus” standards can be met without physical presence
- This has evolved into a “find the proxy” approach: what is the substitute for physical presence?
- I call this the substantial economic presence test.
- The Supreme Court of South Carolina said that the presence in the state of the intangible assets was enough to create nexus
- And the US Supreme Court? It’s as invisible as…the Falcons’ Defense in the second half of this year’s Super Bowl.

The Race to the Bottom Begins in the Courts

- Economic Presence = Nexus
- Iowa —*KFC v. Iowa*
- North Carolina —*A & F Trademark v. Tolson*
- Oklahoma —*Geoffrey v. Tax Commission*
- New Mexico —*Kmart v. Dept.*
- Maryland —*SYL v. Comptroller*
- Louisiana —*Dept. of Revenue v. Gap*
- New Jersey —*Lanco v. Division*
- West Virginia —*Tax Commission v. MBNA*

And Continues…

- Missouri —*Acme* and *Gore*
- Ohio —*Couchot*
- Illinois —*Borden Chemicals*
- Washington —*General Motors* and *Lamtec*
- North Carolina —*A&F Trademark*
- Indiana —*MBNA*
- Alabama —*Lanzi*
- Massachusetts —*Capital One v. Comm'r*

But with a Few Holdouts…

- Alabama —*Cerro Copper v. Dept.*
- Texas —*Bandag v. Rylander*
- Montana —*Acme Royalty v. MO*
- Indiana —*MBNA v. Indiana*

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And What about *Statutory* Substantial Economic Presence Tests for Income Taxes?

"Factor Presence"

- California: $50,000 of property; $50,000 of payroll; $500,000 of sales
- Colorado: $50,000 of property; $50,000 of payroll; $500,000 of sales
- Ohio: $50,000 of property; $50,000 of payroll; $500,000 of sales
- New York: $1 million of New York sales
- Washington: $53,000 of property; $53,000 of payroll; $267,000 of sales

These may Work if the “Trigger” Created a *Rebuttable Presumption* of Nexus

- But having an economic presence “bright line” test seems problematic.

Public Law 86-272

- P.L. 86-272 is a federal-law exemption to income taxation even when nexus is present.
- A business is not subject to income tax in those states in which its physical contacts are limited to the solicitation of orders for the sale of tangible goods if those orders are sent outside of the state for acceptance and fulfilment.
- The universe in which P.L. 86-272 applies is pretty limited.

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Sales Tax Nexus

- Until recently, *Quill's* physical presence substantial nexus bright line test has been respected-*ish*.
- Attributional nexus law attacks (so-called "affiliate nexus" and "Amazon" "click-through nexus" laws) have nibbled at the edges of the physical presence standard.
- 20-25 states now have click-through nexus laws or departmental policies.

Sales Tax Affiliate Nexus

- Activities conducted in a taxing state by a “person” on behalf of a remote seller could cause the remote seller to qualify as a sales tax vendor when the two parties are affiliated (i.e., ownership interest). There is a broad range of activities in addition to solicitation that can create nexus:
  - Engaging in activities that benefit the remote seller in its development or maintenance of a market for its goods or services;
  - Facilitating the in-state delivery of products;
  - Performing repair or maintenance services;
  - Selling a similar line of products under the same name or a similar business name;
  - Using the same or similar trademark, service mark or trade name.
- Over 40 states have affiliate nexus laws or departmental policies.

Another Way to Skin the Cat

- ***Marketplace Providers*** that "maintain a place of business in the state" (i.e., have nexus) are required to collect sales & use tax on all facilitated sales for the out-of-state retailer and remit the tax to the state.
- Marketplace Provider
  - A business that facilitates sales for retailers by:
    - 1. Listing or advertising goods and services for sale by the retailer in any forum, and
    - 2. Either directly or indirectly, through agreements or arrangements with third parties, collects payments from customers and transmits those payments to the retailer, regardless of whether they receive compensation or consideration in exchange for their services.

Another Way to Skin the Cat (continued)

- The concept of requiring some taxpayer other than the vendor is in New York's "co-vendor" regulation, and has been used to require trade show promoters to collect and remit for the displayers.
- The Governor proposed a statutory change to accomplish this in New York, but it was edited out of the final version of the 2017-18 Budget.

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DMA v. Brohl

- In February, 2010 Colorado passes a law requiring non-nexus sellers to report information on Colorado purchases to Colorado. Remote sellers are required to:
  - Provide a transactional notice to the purchaser regarding their obligation to self-report and pay use tax on the transaction;
  - Provide an annual purchase summary to purchasers with over $500 or more in calendar-year purchases regarding their obligation to self-report and pay use tax on the transactions;
  - Provide an annual customer information report to the DOR listing their customers, their purchases, and their total amount of purchases during the year.

DMA v. Brohl (continued)

- The Direct Marketing Association sues in federal court.
- Lawyer games ensue.
- Eventually the case gets to the Supreme Court, which rules that the Tax Anti-injunction Act does not prohibit the case from being brought in federal court, and remands the case for a decision on the merits.

And then Justice Kennedy Throws Down

- In his concurring opinion Justice Kennedy states:

"Given these changes in technology and consumer sophistication, **it is unwise to delay any longer a reconsideration of the Court's holding in *Quill*.** A case questionable even when decided, *Quill* now harms States to a degree far greater than could have been anticipated earlier. See *Pearson v. Callahan*, 555 U.S. 223 (2009) (*stare decisis* weakened where "experience has pointed up the precedent's shortcomings"). It should be left in place only if a powerful showing can be made that its rationale is still correct.

The instant case does not raise this issue in a manner appropriate for the Court to address it. It does provide, however, the means to note the importance of reconsidering doubtful authority. **The legal system should find an appropriate case for this Court to reexamine *Quill* and *Bellas Hess.*"**

(Cue image of flood gates opening)

Kill *Quill* Vols. 1 - ?

- Starting with the A's
- Alabama Admin. Code 810-6-2-.90.03, Requirements for Certain Out-of-State Sellers Making Significant Sales into Alabama (effective Jan. 1, 2016).
- Out-of-state sellers who lack an Alabama physical presence but who are making retail sales of tangible personal property into the state have a substantial economic presence in Alabama for sales and use tax purposes and are required to register for a license with the Department and to collect and remit tax, when Seller's retail sales of tangible personal property sold into the state exceed $250,000 per year based on the previous calendar year's sales.

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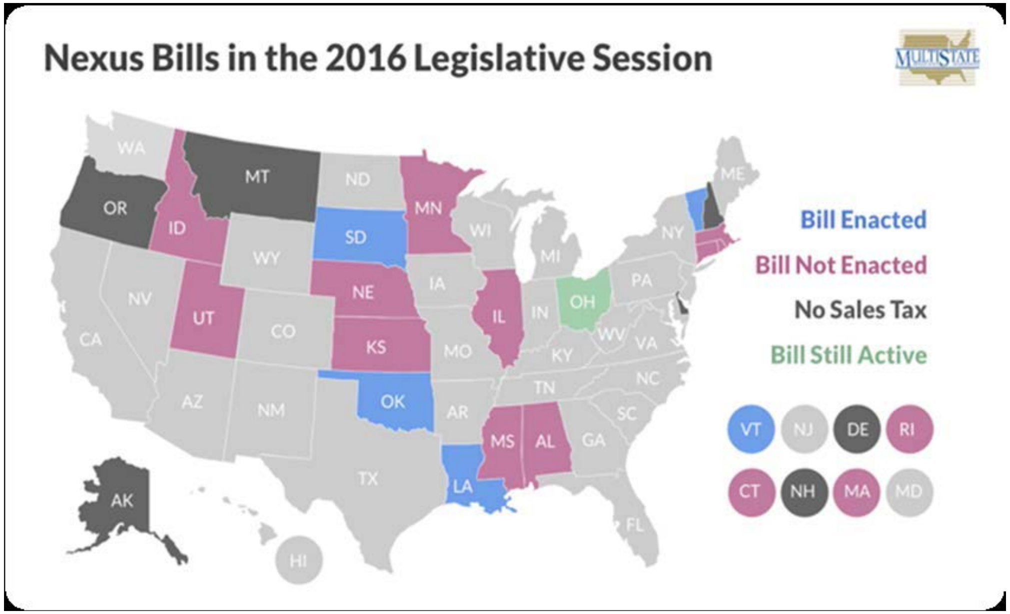
Kill *Quill* Vols. 1 - ?

2016 State legislative efforts to challenge *Quill.*

Legislation addressing sales tax nexus has been a major trend across the country this year as states pursue strategies to overturn *Quill.*

42 bills were introduced in 16 states with 4 bills ultimately enacted in Louisiana, Oklahoma, South Dakota, and Vermont.



Graphic from *Multistate Associates Inc.*

Kill *Quill* Vols. 1 - ?

- South Dakota (SB 106 – effective May 1, 2016).

- A seller has nexus for sales & use tax purposes, provided that the seller meets *either* of the following in the previous calendar or the current calendar year:
  - 1. The seller's gross revenue from delivery of products or services into South Dakota exceeded $100,000; or
  - 2. The seller sold such goods for delivery into South Dakota in 200 or more separate transactions.
- Includes provisions that direct the courts to act as expeditiously as possible to resolve taxpayer challenges regarding the constitutionality of this law.
- Coming to a courtroom near you:
- *State of South Dakota v. Wayfair Inc., Systemax, Inc., Overstock.com, Inc. and Newegg Inc.*
- *ACMA & NetChoice v. Gerlach*

Kill *Quill* Vols. 1 - ?

- Vermont (HB 873 – contingent upon future developments)
  - Same provisions as South Dakota law

- Tennessee Rule 1320-05-01-.129 Out-of-State Dealers
  - Out-of-state dealers who engage in the regular and systematic solicitation of consumers in this state through any means and make sales that exceed $500,000 to consumers in this state during the previous twelve-month period also have substantial nexus in this state.
  - Register by March 1, 2017 and affirmatively acknowledge that they will begin to collect and remit tax beginning July 1, 2017 unless a later date is established by the Department by notice.

And in Light of the Clear Need for Sound Guidance

- Here comes the U.S. House of Representatives.
- The “No Regulation without Representation Act of 2017” was introduced on June 12, 2017.
- It would codify *Quill’s* physical presence standard for both taxation and regulation, and would explicitly expand the standard to income taxes.
- The bill is as likely to become a law as…

MARKET SOURCING 101

So you have nexus, now what?

Apportionment Factors

➢ **THAT WAS THEN:**

- Traditionally states used the UDITPA Formula, which was an equally weighted, three-factor formula including sales, property, and payroll
- Payroll and Sales Factors are the most troublesome, especially in the services context

➢ **THIS IS NOW:**

- Many states have modified the traditional formula by adding weight to (or exclusively using) the **Sales Factor**

UDITPA Three Factor Formula

$$\frac{\dfrac{\text{In-State Property}}{\text{Total Property}} + \dfrac{\text{In-State Payroll}}{\text{Total Payroll}} + \dfrac{\text{In-State Sales}}{\text{Total Sales}}}{3} \times \text{Apportionable (Business) Income} = \text{Income taxable by the State}$$

Sales Factor

- The sales factor is a fraction, the numerator of which is the taxpayer's sales in a state divided by the denominator, which is its total sales everywhere

$$\frac{\text{In-state Sales}}{\text{Everywhere Sales}}$$

- Sales of TPP and real property are generally sourced by destination *(i.e.*, the purchaser's or real property's location)
- **ISSUE:** What about services and intangibles?

Sales Factor –
Cost of Performance

- **THAT WAS THEN:**
- Cost of performance (UDITPA)
  - Source receipts where income-producing activities take place
    - **ISSUE:** All-or-nothing or proportional?
    - **ISSUE:** What are the "income-producing activities"? Where do they take place?

Sales Factor – *Market-Based Sourcing*

- **THIS IS NOW:**
- Many states still use cost of performance, but trend is toward market-based sourcing = location of the taxpayer’s market for the sale
- Market-Based Sourcing: UDITPA Rule
  - Looks to “if and to what extent” the service is delivered to a location in a state
  - If delivery cannot be determined, sourcing location should be “reasonably approximated”
  - Includes a “throw-out” provision when taxpayer is not taxable in state to which sale is assigned (or if state of assignment cannot be determined)

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Sales Factor – *Market-Based Sourcing (continued)*

- States which require (or allow) market-based sourcing
  - Alabama, Arizona, California, Connecticut, District of Columbia, Georgia, Illinois, Iowa, Maine, Maryland, Massachusetts, Michigan, Minnesota, Nebraska, **New York**, Ohio, Oklahoma, Pennsylvania, Rhode Island, Tennessee, Utah, and Wisconsin
- **ISSUE**: How to define the "market"? Where is the service delivered? Where is the "benefit" received?
- **ISSUE:** Why are states moving toward market-based sourcing?

SOURCING RECEIPTS IN NEW YORK STATE & NEW YORK CITY

Market-Based Sourcing in New York State

- New York State's market-based sourcing rules took effect in 2015 (Corporate Tax Reform)
- Single-factor, receipts-only apportionment
  - Compare with LLC/Partnership Rules
- Complex apportionment form on the CT-3 and CT-3S (Part 6) requires separate apportionment of various categories of receipts
- **NOTE:** NYS is issuing bills for additional tax due, computed using a 100% BAP, if the apportionment form is not properly filled out

Market-Based Sourcing in New York State

Part 6 – Computation of business apportionment factor *(see instructions)*

Mark an *X* in this box only if you have **no receipts** required to be included in the denominator of the apportionment factor *(see instr.)* .. ● ☐

		A – New York State	B – Everywhere
Section 210-A.2			
1 Sales of tangible personal property ●	1		
2 Sales of electricity ●	2		
3 Net gains from sales of real property ●	3		
Section 210-A.3			
4 Rentals of real and tangible personal property ●	4		
5 Royalties from patents, copyrights, trademarks, and similar intangible personal property ●	5		
6 Sales of rights for certain closed-circuit and cable TV transmissions of an event ●	6		
Section 210-A.4			
7 Sale, licensing, or granting access to digital products ●	7		

Section 210-A.5(a)(1) – Fixed percentage method for qualified financial instruments (QFIs)

8 To make this irrevocable election, mark an *X* in the box *(see instructions)* ● 8 ☐

Section 210-A.5(a)(2) – Mark an ***X*** in each box that is applicable *(see line 8 instructions)*

		A – New York State	B – Everywhere
Section 210-A.5(a)(2)(A)			
9 Interest from loans secured by real property ●	9		
10 Net gains from sales of loans secured by real property ●	10		
11 Interest from loans **not** secured by real property (QFI ● ☐) ●	11		
12 Net gains from sales of loans **not** secured by real property (QFI ● ☐) ●	12		
Section 210-A.5(a)(2)(B) (QFI ● ☐)			
13 Interest from federal debt ●	13		
14			
15 Interest from NYS and its political subdivisions debt ●	15		
16 Net gains from federal, NYS, and NYS political subdivisions debt ●	16		
17 Interest from other states and their political subdivisions debt ●	17		
18 Net gains from other states and their political subdivisions debt ●	18		
Section 210-A.5(a)(2)(C) (QFI ● ☐)			
19 Interest from asset-backed securities and other government agency debt ●	19		
20 Net gains from government agency debt or asset-backed securities sold through an exchange ●	20		
21 Net gains from all other asset-backed securities ●	21		
Section 210-A.5(a)(2)(D) (QFI ● ☐)			
22 Interest from corporate bonds ●	22		
23 Net gains from corporate bonds sold through broker/dealer or licensed exchange ●	23		
24 Net gains from other corporate bonds ●	24		
Section 210-A.5(a)(2)(E)			
25 Net interest from reverse repurchase and securities borrowing agreements ●	25		
Section 210-A.5(a)(2)(F)			
26 Net interest from federal funds ●	26		
Section 210-A.5(a)(2)(I) (QFI ● ☐)			
27 Net income from sales of physical commodities ●	27		
Section 210-A.5(a)(2)(J) (QFI ● ☐)			
28 Marked to market net gains ●	28		
Section 210-A.5(a)(2)(H) (QFI ● ☐) 210-A.5(a)(2)(G) (QFI ● ☐)			
29 Interest from other financial instruments ●	29		
30 Net gains and other income from other financial instruments ●	30		

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Part 6 – Computation of business apportionment factor *(continued)*

		A – New York State	B – Everywhere
Section 210-A.5(b)			
31 Brokerage commissions ●	31		
32 Margin interest earned on behalf of brokerage accounts ●	32		
33 Fees for advisory services for underwriting or management of underwriting ●	33		
34 Receipts from primary spread of selling concessions ●	34		
35 Receipts from account maintenance fees ●	35		
36 Fees for management or advisory services ●	36		
37 Interest from an affiliated corporation ●	37		
Section 210-A.5(c)			
38 Interest, fees, and penalties from credit cards ●	38		
39 Service charges and fees from credit cards ●	39		
40 Receipts from merchant discounts ●	40		
41 Receipts from credit card authorizations and settlement processing ●	41		
42 Other credit card processing receipts ●	42		
Section 210-A.5(d)			
43 Receipts from certain services to investment companies ●	43		
Section 210-A.6			
44 Receipts from railroad and trucking business ●	44		
Section 210-A.6-a			
45 Receipts from the operation of vessels ●	45		
Section 210-A.7			
46 Receipts from air freight forwarding ●	46		
47 Receipts from other aviation services ●	47		
Section 210-A.8			
48 Advertising in newspapers or periodicals ●	48		
49 Advertising on television or radio ●	49		
50 Advertising via other means ●	50		
Section 210-A.9			
51 Transportation or transmission of gas through pipes ●	51		
Section 210-A.10			
52 Receipts from other services/activities not specified ●	52		
Section 210-A.11			
53 Discretionary adjustments ●	53		
Total receipts			
54 Add lines 1 through 53 in columns A and B ●	54		

Calculation of business apportionment factor

55 New York State business apportionment factor *(divide line 54, column A by line 54, column B and enter the result here; round to the fourth decimal place; if 100% in New York State, enter as* **1.0000***)* ● 55

Enter line 55 on Part 3, *Computation of tax on business income base*, line 14; and on Part 4, *Computation of tax on capital base*, line 12.

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New York State Taxation of Partners/LLC Members

- Three-Factor Apportionment
  - Property Factor
  - Payroll Factor
  - Gross income
    - Origin-based <u>NOT</u> market-based:

      “all sales negotiated or consummated, and charges for services performed, by an employee… or independent contractor chiefly situated at, connected by contract… or sent out from offices, branches of the business or other agencies, situated within NYS.”

- COMPARE WITH **PERSONAL INCOME TAX** RULES (PLACE OF PERFORMANCE)

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Market-based Sourcing in New York City

- NYC taxes flow-through entities at the entity level
- Currently 3 separate regimes
  - New Corporation Business Tax for C corporations (follows new Article 9-A) = Market-based sourcing
  - Old General Corporation Tax for federal S corporations (like old Article 9-A) = Cost of performance sourcing
  - Unincorporated Business Tax for partnerships/LLCs = Cost of performance sourcing
- Three-factor formula completely phased out by 2018. Receipts only going forward

NEW YORK APPORTIONMENT – OUT WITH THE OLD, IN WITH THE NEW

Pre-2015	2015 Reform

• **<u>New York State</u>**
  • Article 9-A taxpayers
    • Single sales factor
    • Sourcing of Services = Cost of Performance Rule
  • Article 32 taxpayers (banking corporations)
    • Double-weighted three factor formula
    • Sourcing = To the extent deposits are maintained by the taxpayer at a branch location
 	
• **<u>New York City (C Corps)</u>**
  • Three-factor formula (single sales factor phase-in by January 1, 2018)
  • Sourcing of Services = Cost of Performance Rule
	• **<u>New York State</u>**
	  • Article 9-A taxpayers
	    • Single sales factor
	    • Sourcing of Services/Digital Products = Market-Based Rule (sourcing hierarchies)
	    • Sourcing of QFIs = Customer-based or Fixed Percentage Method
	
	• **<u>New York City (C Corps)</u>**
	  • Maintains three-factor formula (single sales factor phase-in by January 1, 2018)
	    • Taxpayer with < $50 million of receipts allocated to NYC may make a one-time election to determine BAP based on a three-factor formula: 93% sales, 3.5% property, and 3.5% payroll
	  • Sourcing of Services = Market-Based Rule
	  • **NOTE:** <u>S Corps</u> use pre-2015 rules = Cost of Performance Rule

CATEGORIES OF RECEIPTS

NEW YORK STATE DRAFT REGULATIONS – CATEGORIES OF RECEIPTS

- NYS has issued <u>draft</u> regulations on nexus, apportionment, combined reporting, and discretionary adjustments
- Creates complex rules for apportioning 15 different categories of receipts, along with different rules and definitions for business vs. individual customers
- Creates high burden of "due diligence" for taxpayers to obtain information to properly source income and receipts, including corporate partners of partnerships
- Current draft of regulation permits Tax Department to use its discretionary authority if the statutory apportionment fraction does not "reach a fair result."

Nine Major Categories of Receipts

1. Sales of tangible personal property, electricity and real property;
   - Destination test and location of real property (same as prior law)
2. Rentals and royalties;
   - Location of property or location of use (same as prior law)
3. Digital products;
   - Hierarchical sourcing method (see later slides)
4. Financial transactions;
   - Fixed percentage election method or customer-based sourcing (see later slides)
5. Receipts from railroad and trucking business;
   - Amount of receipts multiplied by fraction of miles travelled within NYS/NYC divided by miles everywhere

Nine Major Categories of Receipts (continued)

6. Receipts from aviation services;
   - Air freight: 100% if both pick-up and delivery done in NYS/NYC; 50% if either pick-up or delivery
   - Other: Receipts multiplied by avg. of following three percentages:
     - NYS/NYC arrivals and departures;
     - Percentage of revenue tons; and
     - Percentage of NYS/NYC originating revenue
7. Receipts from sales of advertising
   - Newspapers & Periodicals: Receipts multiplied by number of newspapers/periodicals delivered in NYS/NYC divided by number all newspapers/periodicals delivered
   - Other: Receipts multiplied by number of NYS/NYC viewers/listeners divided by number of all viewers/listeners
8. Receipts from transportation or transmission of gas through pipes;
   - Receipts multiplied by taxpayer's "transportation units" within NYS/NYC divided by total "transportation units"
9. Receipts from other services and business receipts
   - Hierarchical sourcing method (see later slides)

WHAT TYPE OF RECEIPTS?

- Is the sale a service? A good?
- I**SSUE:** What about bundled transactions?

Sourcing Service Receipts

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

Sourcing Service Receipts (continued)

- The benefit of in-person services (for example, medical or repair services, but not legal, accounting, or financial services) are received where customers receive the service
- Taxpayers must exercise “due diligence” under each method in the hierarchy before rejecting it and proceeding to the next method, and must base its determinations on information known to the taxpayer or that would be known through reasonable inquiries
- **ISSUE:** What is in the “books and records”?
- **ISSUE:** How to make “reasonable inquiries” to customers?
- **ISSUE:** What are “reasonable approximations”? Population theory?

Sourcing Digital Product Receipts (NEW YORK)

- **Digital products** are defined as: "Any property or service, or combination thereof, of whatever nature delivered to the purchaser through the use of wire, cable, fiber-optic, laser, microwave, radio wave, satellite or similar successor media, or any combination thereof."
  - Includes: audio work, audiovisual work, visual work, book or literary work, graphic work, game, information or entertainment service, storage of digital products and computer software by whatever means delivered, furnished, provided to, or accessed by the taxpayer
  - Does not include: legal, medical, accounting, architectural, research, analytical, engineering or consulting services provided by the taxpayer
- The sourcing of digital products is based on the hierarchy of sourcing, as follows:

1. Customer's primary use location;
2. Where digital product is received/accessed;
3. Apportionment fraction of prior year for such digital product; or
4. Apportionment fraction in current taxable year for receipts that can be sourced using (1) and (2) above

Sourcing Digital Product Receipts (OTHER STATES)

- **Pennsylvania**
  - Sourced to location of customer
  - Taxpayers may determine location based on customers' electronic address such as email, FTP account, or IP address
  - If customer is located in multiple states, taxpayers use a "reasonable and proportionate" methodology, considering factors such as:
    - Usage of service in each state
    - Number of recipients in each state
    - Value of service consumed in each state
  - Receipts from data delivery services to a server or the cloud are sourced to user's location

Sourcing Digital Product Receipts (OTHER STATES)

➢ Massachusetts

- Sourcing depends on whether recipient is a (1) business customer or (2) an individual
- – General Rule = Source to location where customer receives the service
- – BUT – Different rules apply when location of receipt cannot be determined
  - – Business customer
    - (1) Where the customer principally manages the contract of sale (required to use this method if more than 5% of sales are to one business customer)
    - (2) Customer's place of order
    - (3) Customer's billing address
  - – Individual
    - (1) Reasonable approximation
    - (2) Customer's billing address
    - BUT – If more than 5% of sales are from an individual customer, taxpayer must identify and assign receipts to "customer's state of primary residence"

➢ **ISSUE:** Lack of uniformity?

Sourcing Financial Transaction Receipts

- Four primary categories of financial transactions
  1. Qualified Financial Instruments (QFIs)
  2. Broker/dealer activities
  3. Receipts from credit cards
  4. Services to investment companies/regulated investment companies

Qualified Financial Instruments

- “Qualified Financial Instruments” (QFIs) are marked to market under IRC §475 or §1256, and are either:
  - A loan;
  - Federal, state or municipal debt;
  - Asset-backed securities and other government agency debt;
  - Corporate bonds;
  - Dividends and net gains from sale of stock or partnership interests;
  - Other financial instruments as defined under NY Tax Law §210-A.5(a)(2)(H); or
  - Physical commodities

- QFIs exclude loans secured by real property and stocks that are investment capital

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200
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Qualified Financial Instruments (continued)

- Fixed Percentage Election
  - 8% of net income from all QFIs is included in the apportionment factor numerator
  - Election is irrevocable and must be made on an annual basis on the taxpayer's original timely filed return
  - Election applies to all members of a combined group

OR

- Customer Sourcing Method
  - Applied if fixed percentage election is not made
  - Individuals: based on billing address
  - Business Entities: based on commercial domicile hierarchy:
    1. Location of management and control; or
    2. Billing address of business entity

Qualified Financial Instruments (continued)

- **Interest and net gains on loans:**
  - If secured by real property - location of real property
  - If not secured by real property – location of borrower/purchaser

- **Federal, state or municipal debt:**
  - Excluded from numerator and not sourced to NY
  - If issuer is US or NY – 100% of interest/net gain in denominator
  - If issuer is not US or NY – 50% of interest/gain in denominator

- **Asset-backed securities:**
  - 8% of interest income from asset-backed securities and 8% of net gains from sales of asset-backed securities

- **Corporate bonds:**
  - Interest: Issuing corporation's commercial domicile
  - Net gain: 8% of net gain if sold by broker-dealer or licensed exchange; otherwise, multiply net gains by proceeds from sales to NYS/NYC purchasers divided by proceeds from all such purchasers

Qualified Financial Instruments (continued)

- **Reverse repurchase agreements, securities borrowing agreements, federal funds:**
  - 8% of net interest income
- **Dividends and net gains from sales of stock or partnership interests:**
  - Excluded from numerator and denominator unless the commissioner determines inclusion is necessary to properly reflect the business income or capital of the taxpayer
- **Other financial instruments:**
  - Interest: location of payor
  - Net gain: 8% of receipts if sold through broker-dealer or licensed exchange; otherwise, location of payor
- **Physical commodities:**
  - Delivery location of commodity or location of purchaser

Broker-Dealer Transactions

- The following activities constitute “other receipts” (not included within sourcing of financial instruments) and are sourced based upon customer’s mailing address:
  1. Brokerage commissions
  2. Margin interest
  3. Fees for advisory services/managing underwriting
  4. Primary spread of selling concession from underwritten securities
  5. Account maintenance fees
  6. Fees for management/advisory services

- If mailing address cannot be determined, 8% of receipts are included in numerator

- Interest earned on loans and advances made to an affiliated corporation which the taxpayer may not file a combined return with is sourced based upon affiliated corporation’s principal place of business

Credit Card Activities

- Credit Cards:
  - Interest, fees, penalties or service charges = mailing address of card holder
  - Merchant discounts = location of merchant
  - Authorization, processing and clearing = location where credit card processor’s customer accesses the processor’s network
  - Other receipts = Multiply by average of 8% and percentage of NYS/NYC access points

OTHER HOT TOPICS

OTHER HOT TOPICS

- Look-through sourcing (intermediary purchasers)
- Throw-out rules

$$\frac{\text{In-state Sales}}{\text{Everywhere (?) Sales}}$$

- Safe harbors
  - Billing addresses as proxies (not in New York!)
- Intersection between economic nexus and market-based sourcing
  - **ISSUE:** What does it all mean for non-New York service providers?

EXAMPLES

EXAMPLE #1

Office Interiors Corp. contracts with 75 business customers to provide workspace design services. Newco hires Office Interiors Corp. to design workspaces for its main office in NYS and a satellite office in another state. The contract provides for a flat fee for designing the 2 locations.

Where does the customer receive the value of Office Interiors Corp.'s services?

Per the draft regs., Office Interiors Corp. should make reasonable inquiries of the customer to determine where the value is received. Square footage of each office can be used to reasonably approximate to benefit received by Newco at each location.

EXAMPLE #2

Teaching Corp provides in-person seminars in NYS to customers. The seminar materials are prepared outside of NYS and many of the teachers and attendees are from outside NYS.

Where do the customers receive the benefit of Teaching Corp's services?

Per the draft regs., since the customers are in the same location as Teaching Corp when the service is provided, it is deemed an in-person service and thus, the entire benefit is received in NYS.

EXAMPLE #3

Law Corp is located outside of NYS. A client hires Law Corp to handle a major litigation matter regarding the sale of its plant in NYS. The client has plants in several states and the litigation occurs outside of NYS.

Where does the client receive the benefit of Law Corp's services?

Per the draft regs., since Law Corp's services are only related to the plant in NYS, the benefit of the service (and therefore 100% of the receipts) are NYS.

EXAMPLE #4

Production Corp enters into a contract with Cable Network Corp, located in NYS, to produce a made-for-tv movie. Cable Network owns the copyright to the movie and will air it to its subscribers.

Where does Cable Network receive the benefit of Production Corp's services?

Per the draft regs., this is not an intermediary transaction (which would be sourced to the location of the subscribers) because Production Corp produces the movie and delivers it to Cable Network, not the subscribers. Therefore, the benefit is received at the location of Cable Network Corp in NYS.

EXAMPLE #5

Book Corp sells books on its website in physical or electronic form. Customers may purchase the book in either form or for one price, in both forms. E-books are available for immediate download after purchase.

How does Book Corp source its receipts from its sale of books on its website?

- Physical books are sourced based on the ship-to address
- E-books are sourced based on the billing address of the customer
- Bundled physical and e-book sales are treated as a comingled receipt and are sourced as TPP (i.e. ship-to address for physical book).

EXAMPLE #6

Software Corp enters into a contract with Customer Corp, with physical locations in NYS and elsewhere, to develop software to be licensed to Customer Corp. Software Corp will deliver the software electronically to Customer Corp.

How does Software Corp source its receipts from the contract?

Software Corp must ask Customer Corp to provide the total number of licenses to use the software and the location of the employees utilizing the licenses. The receipts from the contract will be apportioned based on number of licenses used in NYS over licenses used everywhere.

EXAMPLE #7

Online Game Corp., located outside NYS, develops a web-based game. Customers pay a fee to access the game on a variety of devices, including mobile devices.

How does Online Game Corp. source its fees?

Online Game Corp. can use the billing address of its customers to determine the percentage of receipts to apportion to NYS.

EXAMPLE #8

App Design Corp, located outside NYS, designs a mobile phone app to its customer, Bank Corp, located in 50 states. Bank Corp contracts with App Design Corp to design a free app for the bank's account holders. The app will be updated periodically under the contract.

How does App Design Corp source its receipts from the contract with Bank Corp?

This constitutes an intermediary transaction because the app is passed on to the bank's customers and App Design Corp continues to update the app once it is downloaded by account holders. App Design Corp must make reasonable inquiries of Bank Corp for the location of account holders who download the app in NY vs. other states (or can reasonably approximate based on total account holders in NY vs. other states). If this information isn't provided, App Design Corp can reasonable approximate based on publicly available information such as number of bank branches of Bank Corp in NYS vs. everywhere.

Shameless Plug

- Read our new blog (on Fridays).
- **Taxes in New York (TiNY)** is a blog by the Hodgson Russ LLP State and Local Tax Practice Group. The weekly reports are intended to go out within 24 hours of the Division of Tax Appeals' (DTA) publication of new ALJ Determinations and Tribunal Decisions. In addition to the weekly reports, TiNY may provide commentary on other developments in the world of New York tax law. But while TiNY intends to briefly (and we mean really-really briefly) summarize <u>all</u> published DTA cases, it will be choosy about the other developments on which it reports.
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THANK YOU

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