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# Multistate Tax Commission Hearing Officer Report – Market sourcing

November 20, 2013

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## ***In brief***

As part of the Multistate Tax Commission's ongoing efforts to revise UDITPA provisions, the Hearing Officer issued his report on October 25, 2013. This Insight summarizes the Executive Committee's proposed revisions; commentary made during the March 28, 2013, public hearing; and the Hearing Officer's recommendations regarding revisions to UDITPA's sourcing rules for sales of services and intangibles. [[\*Report of the Hearing Officer, Multistate Tax Compact Article IV \[UDITPA\] Proposed Amendments\*](#), Multistate Tax Commission (10/25/13)]

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## ***In detail***

The Multistate Tax Commission (MTC) is proposing revisions to its model Uniform Division of Income for Tax Purposes Act (UDITPA). The MTC is focusing on the following five areas: (1) sales factor numerator sourcing for sales of services and intangibles, (2) sales definition, (3) factor weighting, (4) business income definition, and (5) equitable apportionment.

In December 2012, the MTC's Executive Committee approved proposed UDITPA revisions for public hearing. These revisions were the subject of a March 28, 2013, public hearing held by the Hearing Officer, University of Connecticut Law School Professor Richard Pomp. On October 25, 2013, the Hearing Officer issued his Report, which provides a background to the amendments, a summary of the

proposals' substantive features, a review of the public testimony provided at the hearing, and the Hearing Officer's comments, recommendations, and proposals for a redrafted statute.

The following summarizes the Report's findings regarding the sales factor numerator sourcing for sales of services and intangibles, the most sweeping of all the amendments. We address the other four areas in separate Insights.

### ***Uniformity Committee recommendations – Market-based sourcing***

The Uniformity Committee's amendments to the sales of services and intangibles sourcing rules made no attempt to salvage any of the historical costs of performance approach. The market-based rules attempt

to mirror the destination principle provided for assigning receipts of tangible personal property sales.

The market-based approach provides that in the case of a sale of a service, the income is sourced to a state "if and to the extent the service is delivered to a location" in the state.

The market-based approach also provides the following rules regarding the sourcing of intangible property sales:

- intangible property rented, leased, or licensed is sourced to where the property is used, provided that intangible property used in marketing a good or service to a consumer is used in the state of the consumer

- sales of intangible property such as a contract right or a government license to conduct business in a specific geographic area are sourced to the location of that geographic area
- receipts from intangible property that are contingent on the productivity, use, or disposition of intangible property are sourced to the location where the property is used
- all other receipts from the sale of intangible property are excluded from the numerator and denominator of the sales factor.

For both sales of service and intangibles:

- if the state of assignment cannot be determined, then the sale shall be 'reasonably approximated'
- if the taxpayer is not taxable in the assigned state, or if the state cannot be determined or reasonably approximated, then the sale is excluded from the sales factor denominator.

The state's tax administrator is authorized to prescribe rules regarding the above.

### **Hearing officer comments**

Comments by Professor Pomp include:

- The recommendations substitute market-based sourcing for the costs of performance standard and relegate key definitions to model regulations, which promotes flexibility and the ability to deal with definitional issues on an industry-wide basis.
- Market-based sourcing of services and intangibles is in its gestation period, with no consensus among

states. The result is uncertainty, lack of uniformity, inconsistencies, administrative difficulties, and the possibility of taxpayer manipulation.

- So long as receipts from sales of services and intangibles rely on terms such as 'reasonable approximation,' definitional issues will remain as taxpayers have an incentive to characterize a borderline transaction in the most favorable manner.
- The relative newness of market-based sourcing, the lack of a common understanding of terms, and the number and diversity of situations impacted make it incumbent on the MTC to make model regulations its highest priority.
- The model regulations face a formidable challenge, needing to define critical terms like service, delivery, use, intangible property, sale, lease, license, utilized in marketing, and reasonable approximation. The Hearing Officer believes that the regulations should tackle definitional issues on a narrow, industry-specific, or transaction-specific basis.
- The weaknesses of the costs of performance method can be addressed by: (1) adopting a proportionate approach rather than all-or-nothing, (2) better defining 'direct costs,' (3) addressing treatment of payments to independent contractors; and (4) defining income producing activity.
- The Hearing Officer acknowledges that costs of performance may be incompatible with the state trend

towards single-sales factor apportionment because costs of performance tends to replicate property and payroll factors. He states that even if a new and improved costs of performance rule could be made workable, "its era may have passed."

- The Executive Committee has to decide whether to refine costs of performance or to adopt the above recommendations. The Hearing Officer presumes that the Committee will endorse the recommendations and proceed with a draft of model regulations.

### **Additional reading**

Click on the following links to read our summary of the Multistate Tax Commission Hearing Officer's Report regarding:

- [sales definition](#)
- [factor weighting](#)
- [equitable apportionment](#)
- [business income](#)

### **The takeaway**

The Multistate Tax Commission's effort to amend Article IV of the Multistate Tax Compact remains controversial. While the Hearing Officer's lengthy report offers many detailed recommendations, it nonetheless leaves significant unresolved issues, including important definitional standards. The Hearing Officer anticipates the promulgation of regulations to address many of these ambiguities, leading one to believe this process will continue for quite some time. Added to these uncertainties is the ongoing litigation involving the binding nature of the Article III election to apportion income using an equally weighted three factor formula. It appears,

therefore, that taxpayers and state revenue agencies eager to have certainty with regard to corporate income tax apportionment provisions may have to exercise patience while these issues work their way through the various administrative and legal processes.

### ***Let's talk***

If you have any questions regarding the MTC's proposed amendments to UDITPA's sourcing rules for sales of services and intangibles, please contact:

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