

# **Massachusetts releases working draft regulations outlining market-based sourcing rules**

*April 14, 2014*

**UPDATE:** The comment period deadline has been extended from May 1 to May 19, 2014.

## ***In brief***

The Massachusetts Department of Revenue (Department) recently released a working draft regulation that would revise its apportionment regulation ([830 CMR 63.38.1](#)) to provide specific market-based rules with respect to apportioning receipts from services and transactions involving intangible property. Tax practitioners have eagerly awaited the Department's interpretive guidance since Massachusetts enacted market-based sourcing last summer, effective for tax years beginning on or after January 1, 2014. Prior to the statutory change, Massachusetts apportioned these receipts under a 'cost of performance' methodology.

A wide array of taxpayers will be subject to this change, including corporations, S corporations, and partnerships (as well as their nonresident owners). The rules set forth in the working draft are certainly complex and will likely create challenges for many taxpayers, both in interpretation and in collecting the necessary information to comply properly. The Department has requested that comments to the draft be submitted by May 1, 2014.

## ***In detail – General proposals***

In calculating the Massachusetts sales factor, Massachusetts law now sources sales other than sales of tangible personal property to the Commonwealth if the taxpayer's '**market for the sale**' is in Massachusetts, which is considered to be as follows:

- in the case of the sale, rental, lease, or license of real property, if and to the extent

the property is located in Massachusetts

- in the case of the rental, lease, or license of tangible personal property, if and to the extent the property is located in Massachusetts
- in the case of the sale of a service, if and to the extent the **service is delivered** to a location in Massachusetts
- in the case of the lease or license of intangible property, including a sale or

exchange of such property where the receipts from the sale or exchange derive from payments that are contingent on the productivity, use or disposition of the property, if and to the extent the intangible property is used in Massachusetts

- in the case of the sale of intangible property, where the property sold is a contract right, government license or similar intangible

property that authorizes the holder to conduct a business activity in a specific geographic area, if and to the extent that the intangible property is used in or

- otherwise associated with Massachusetts.

#### **Reasonable approximation**

Under the working draft regulations, if the state or states of assignment cannot be determined for purposes of assigning a sale, the taxpayer is allowed to use a method of **reasonable approximation** in determining the state or states of assignment. The method of reasonable approximation chosen must be applied in good faith on a consistent basis from year to year using all sources of information available. If the taxpayer reasonably believes that the geographic distribution of its non-assigned sales generally tracks that of the assigned sales, the taxpayer should include these other sales in its sales factor in the same proportion as its assigned sales.

**Observation:** If a taxpayer applies a method of reasonable approximation to assign sales on an original return, such method cannot be modified through an amended return and can only be modified in subsequent years if disclosed to the Department. Consequently, care must be taken in the preparation of 2014 returns to ensure that an appropriate method is selected.

#### **Throw-out rule**

Sales are excluded from both the numerator and denominator of the sales factor in the following circumstances: (1) a taxpayer is unable to determine or reasonably approximate the state or states to which a sale is assigned, (2) the taxpayer is not taxable in the state to

which the sale is assigned, and (3) the taxpayer sells certain intangibles.

- **Taxability standard in general** - In determining whether a taxpayer is taxable in a state for throw-out purposes, Massachusetts appears to follow the same standard that applies for purposes of determining whether sales of tangible personal property should be thrown back to Massachusetts.
- **Taxability standard with combined returns** - For purposes of determining whether a taxpayer is taxable in a state when such taxpayer is a member of a combined group, Massachusetts will apply a Finnigan approach. Thus, if any combined group member is taxable in the state to which a sale is assigned (assuming the sale is derived from the combined group's unitary business), such sale will not be thrown out.
- **Taxability standard in foreign jurisdictions** - Unlike the throwback rule, which automatically considers a taxpayer (otherwise entitled to apportion) as taxable in a foreign jurisdiction if it makes sales to purchasers in such foreign jurisdiction, the throw-out rule does not treat taxpayers in a similar manner. In other words, if a taxpayer provides services to a purchaser in a foreign jurisdiction and such taxpayer is not taxable in that foreign jurisdiction (as such term is defined under Massachusetts rules), then the foreign sales are excluded from both the numerator and denominator of the sales factor.

#### **Interconnection with other separate industry apportionment regulations**

The market-based sourcing rules do not supersede regulatory sourcing rules applied to separate industries, including financial institutions and mutual fund service corporations. However, if a financial institution provides services that should be sourced pursuant to the market-based sourcing rules, such as the provision of financial custodial services, such services are considered to be professional services and receipts from those services are assigned accordingly.

#### **In detail - Sale of services**

The sale of a service is in Massachusetts if and to the extent that the **service is delivered** to a location in Massachusetts. Generally, the term 'delivered' is construed to refer to the location of the taxpayer's market for the service provided.

#### **In-person services**

In-person services are services that are physically provided 'in person' by the taxpayer, where the customer or the customer's real or tangible property upon which the services are performed are in the same location as the service provider at the time the services are performed. In-person services include situations where services are provided on behalf of the taxpayer by a third-party contractor. The delivery of such services is considered to be the location where the service is received. Examples of in-person services include warranty and repair services; cleaning services; plumbing services; pest control; landscape services; medical and dental services, including medical testing and x-rays and mental health care and treatment; child care; hair cutting and salon services; live entertainment and athletic

performances; and in-person training or lessons.

- **Special rule for transportation services** – Transportation services involve a taxpayer physically transporting a customer from one destination to another. The sale of transportation services is assigned to the location of the transportation destination. In the case of a round trip ticket, the taxpayer may elect to assign one-half of the sale to the state of destination and one-half to the state of departure (assuming this methodology is consistently applied with respect to all round trip ticket sales).
- **Special rule for moving services** – Moving services are where a taxpayer physically transports a customer's tangible personal property from one destination to another. The sale of moving services is assigned to the state of the moving destination.

### **Professional services**

Professional services are services that require specialized knowledge and in some cases require a professional certification, license, or degree. Examples of professional services include management services, bank and financial services, financial custodial services, investment and brokerage services, fiduciary services, tax preparation, payroll and accounting services, lending and credit card services, legal services, consulting services, video production services, graphic and other design services, engineering services, and architectural services.

- **Individual customers** - Sales to an individual customer are generally assigned to the state of the customer's primary residence. But, if the state of primary residence

cannot be reasonably identified, the sale is assigned to the state of the customer's billing address.

- **Business customers** - Sales to a business customer are generally assigned to the state where the contract of sale is principally managed by the customer.<sup>1</sup> If such place is not readily determinable, the sale is assigned to the state in which the customer placed the order.<sup>2</sup>

**Observation:** If the taxpayer derives more than 5% of its sales of services from an individual customer, the taxpayer has an affirmative duty to identify the customer's state of primary residence and must assign the receipts from the service or services provided to that customer to that state. Likewise, if the taxpayer derives more than 5% of its sales of services from a business customer, the taxpayer has an affirmative duty to identify the state in which the contract of sale is principally managed by the customer.

- **Legal services & financial custodial services** - Based on the examples provided, the general sourcing rules listed above are followed with respect to legal services regardless of 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. Similarly, the general rules are followed for purposes of sourcing of financial custodial fees even if the custodial work (including the safekeeping of the customer's financial assets) takes place in another state.

- **Relevance of ultimate beneficiary?**
  - An example in the working draft regulation suggests that the ultimate beneficiary of a service may not be relevant when determining where a service is delivered. Specifically, Bank Corp provided financial consulting services to Investment Co in connection with investment accounts that Investment Co managed for individual clients located in numerous states. The example requires Bank Corp to source the receipts to Massachusetts (where the contract was principally managed by Investment Co) and makes clear that it was not relevant that the ultimate beneficiaries of Bank Corp.'s services were Investment Co's clients.

- **Special rule for architectural and engineering services** - The sale of an architectural or engineering service is received in Massachusetts if and to the extent that the services are with respect to real or tangible property located in Massachusetts. This rule applies whether or not the customer is an individual or business customer.

### **Other services**

Services that are not categorized as in-person services or professional services fall within this catch-all category. These services can be delivered directly to the customer or delivered to a third-party on the customer's behalf and the method of delivery can be by both physical and electronic means.

#### **Other services – Delivered by physical means**

Examples of services falling into this category include product delivery services where property is delivered to the customer or to a third party on

behalf of the customer; the delivery of brochures, fliers or other direct mail services; and the delivery of advertising or advertising-related services to the customer's intended audience in the form of a physical medium. Where the taxpayer is able to determine the state or states where these services are delivered, the sale should be assigned to such state or states or where reasonably approximated. These rules apply whether the taxpayer's customer is an individual customer or a business customer.

#### **Other services – Delivered by electronic means**

These services include those that are transmitted through the means of wire, lines, cable, fiber optics, electronic signals, satellite transmission, audio or radio waves, or other similar means, whether or not the service provider owns, leases, or otherwise controls the transmission equipment. Industries affected include Cable TV and Web-based service providers. In addition, a special rule in the working draft regulation states that the assignment rules applicable to catch-all services apply to sales of digital goods or services, including, among other things, the sale of various video, audio, and software products or similar transactions.

- **Individual Customers** - Sales to an individual customer are generally assigned to the state or states where the customer receives the service or to the state or states where the taxpayer can reasonably approximate where the service is received. Otherwise, the sale should be assigned to the customer's billing address.
- **Business customers** - Sales to a business customer are generally assigned to the state or states where the customer receives the

service or to the state or states where the taxpayer can reasonably approximate where the service is received. Otherwise, the sale should be assigned based on the rules for sales of professional services to business customers discussed above.

- **Through or on behalf of an individual or business customer** - Sales are assigned to the state or states where the services are delivered to the third party recipient or recipients on behalf of the customer. For example, in the case of advertising-related services where the delivery is to the customer's intended audience through electronic means, the taxpayer should assign the sale of the service to Massachusetts to the extent that the audience for such advertising is in Massachusetts.

#### **In detail - Receipts from the licensing of intangible property**

Massachusetts had previously adopted a market-based approach for the sourcing of receipts from the licensing of intangible property, so the recent legislation did not alter the general approach in this area. However, the working draft regulation provides further guidance and certain differences do exist. In general, the receipts from the license or lease of intangible property (hereafter, a 'license') are in Massachusetts if and to the extent the intangible is used in Massachusetts. The term 'use' refers to the location of the taxpayer's market for the license. However, as discussed below, the rules that apply to determine the location of the use of intangible property varies by the type of licensing transaction.

**Observation:** In some cases, the license of intangible property will resemble a sale of an

electronically delivered good or service and will not involve the license of an intangible. The receipts from these transactions will be assigned as if the transactions were a service delivered to an individual or business customer as described in the previous section. Examples of such transactions include the license of database access, the license of access to information, and the license of digital goods.

#### **License of a marketing intangible**

Where a license is granted for the right to use intangible property in connection with the sale, lease, license, or other marketing of goods, services, or other items (i.e., a marketing intangible), the royalties or other licensing fees paid by the licensee for such right generally are attributable to Massachusetts to the extent that the fees are attributable to the sale or other provision of goods, services, or other items purchased or otherwise acquired by customers in Massachusetts. Examples of a license of a marketing intangible include the license of a service mark, trademark, or trade name; certain copyrights; the license of a film, television or multimedia production or event for commercial distribution; and a franchise agreement.

#### **License of a production intangible**

Where a license is granted for the right to use intangible property in a production capacity (i.e., a production intangible), the licensing fees paid by the licensee for such right are attributable to Massachusetts to the extent that the use for which the fees are paid takes place in Massachusetts. Examples of production intangibles include the license of a patent, a copyright, or trade secrets to be used in a manufacturing process, where the value of the intangible lies predominately in its use in such process.

### **License of a mixed intangible**

Where a license of intangible property includes both a license of a marketing intangible and a license of a production intangible (i.e., a 'mixed intangible') and the fees to be paid in each instance are separately and reasonably stated in the licensing contract, the Commissioner will accept such separate statement if it is reasonable. Where such amounts are not separately and reasonably stated, it will be presumed that the licensing fees are paid entirely for the license of the marketing intangible except to the extent that the taxpayer or the Commissioner can reasonably establish otherwise.

### **Overview of the treatment of software licenses**

Pursuant to the rules discussed in the working draft regulation, receipts from the sale or license of software might be sourced in one of seven different ways, including as: (1) the sale of tangible personal property, (2) the sale of custom software, (3) the license of a marketing intangible, (4) the license of a production intangible, (5) the sale of intangible property, (6) the license of intangible property where the substance of the transaction resembles the sale of a good or service; or (7) the sale of digital goods and services.

### **In detail - Sale of intangible property**

The assignment of a sale or exchange of intangible property depends upon the nature of the intangible property sold.

#### **Certain intangibles related to a specific geographic area**

Where the intangible property sold is a contract right, government license, or similar intangible property that authorizes the holder to conduct a

business activity in a specific geographic area, the sale is sourced to Massachusetts if and to the extent that the intangible property is used in or otherwise associated with Massachusetts. For these purposes, a sale of intangible property includes a license of such property where the transaction is treated for tax purposes as a 'sale' of all substantial rights in the intangible and receipts from the transaction are not contingent on the productivity, use, or disposition of the intangible property.

#### **Covenant not to compete**

In the case of an agreement or a covenant not to compete, the receipts are sourced to Massachusetts if and to the extent that the US geographic area governed by the contract is in Massachusetts.

#### **Excluded sales**

Under the working draft regulations, the sale of intangible property not referenced above (and not re-characterized as a license) is generally excluded from the numerator and denominator of the taxpayer's sales factor. This is a bit different than the current apportionment regulations that generally source sales of intangibles to the location of the taxpayer's commercial domicile unless a specific rule requires otherwise. Examples of excluded receipts per the working draft regulation are as follows:

- The receipts derived from the sale of a security and the sale of business 'goodwill' or similar intangible value are both excluded from the numerator and denominator of a taxpayer's sales factor. Note that the phrase 'similar intangible value,' includes, without limitation, 'going concern value' and 'workforce in place.'

This rule is similar to what is currently in Massachusetts law.

- The sale of a partnership interest. The current version of the apportionment regulation generally includes receipts from the sale of partnership interests in the sales factor and such amount may be included in the numerator to the extent that the sum of the Massachusetts property and payroll factors exceeds such amount in any other one state.
- Receipts attributable to the protection or enforcement of legal rights of a taxpayer through litigation, arbitration, or settlement of legal disputes or claims, including the filing and pursuit of claims under insurance contracts. The current version of the apportionment regulation generally includes these receipts in the sales factor.

## **Let's talk**

If you have questions regarding the draft regulations, please contact:

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- <sup>1</sup> Under the working draft, the “state where a contract of sale is principally managed by the customer” means the primary location at which an employee or other representative of a customer serves as the contact person for the taxpayer with respect to the implementation and day-to-day execution of a service contract entered into by the taxpayer with the customer.
- <sup>2</sup> The term ‘place an order’ is defined to mean the physical location from which a customer places an order for services from a taxpayer, resulting in a contract for services with the taxpayer. If either of these places is not readily determinable, then the sale is assigned to the customer’s billing address.