Massachusetts releases proposed regulations outlining market based sourcing rules

November 17, 2014

UPDATE: The regulation was finalized on January 2, 2015.

In brief

The Massachusetts Department of Revenue (Department) recently released a proposed regulation that would repeal and replace 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. The proposed regulation supplants the working draft regulation released this spring (click here for our summary). Although the final regulation will likely be promulgated by the end of this year, the statutory change adopting the market based sourcing approach is already in effect 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 proposed regulation are certainly complex and will likely create challenges for many taxpayers, both in interpretation and in collecting the necessary information to comply properly. The hearing for the proposed regulation is scheduled for December 4, 2014.

As drafted, the proposed regulations generally require a taxpayer seeking to change its sourcing methodology in subsequent years to disclose such change to the state. Accordingly, care should be taken in the preparation of 2014 returns to ensure that an appropriate method is selected.

In detail — General proposals

Effective for tax years beginning on or after January 1, 2014, in calculating the Massachusetts sales factor, Massachusetts law requires taxpayers to source sales other than sales of tangible personal property to the Commonwealth if the taxpayer’s ‘market for the sale’ is in

- 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 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 tangible personal property, if and to the extent the property is located in Massachusetts
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.

**General principles of application**

The proposed regulation provides various assignment rules that apply sequentially in a hierarchy. For each sale to which a hierarchical rule applies, a taxpayer must make a reasonable effort to apply the primary rule applicable to the sale before seeking to apply the next rule in the hierarchy. Accordingly, a taxpayer must first apply the applicable primary rule (or set of primary rules) in determining the state or states of assignment before choosing a method of reasonable approximation (when permitted).

**Reasonable approximation**

Under the proposed regulation, 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. However, before a taxpayer may use a method of reasonable approximation, the taxpayer must in good faith and with reasonable effort first attempt to determine the state or states of assignment.

In some cases, the reasonable approximation must be made in accordance with specific rules of approximation prescribed by the regulation (e.g., with professional services). In other cases, taxpayers are permitted to reasonably approximate the state or states of assignment using a method that reflects an effort to approximate the results that would be obtained under the applicable rules or standards for the service offering or the sale, license or lease of intangible property.

Finally, 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.

**Observation:** Whatever method, including a method of reasonable approximation, that a taxpayer applies to assign sales on an original return, such method is deemed to be a correct determination of the sales assigned, provided that the method is properly applied. When this is the case, a taxpayer cannot modify its methodology for assigning sales except to correct factual errors or calculation errors. Moreover, if a taxpayer desires to change its methodology in a subsequent year, it may only do so for the purpose of improving the accuracy of assigning sales and must disclose its change 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 sales regard 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 statutes and regulations

The market based sourcing rules do not supersede the statutory rules for sourcing certain receipts of financial institutions. But 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.

Similarly, the market based sourcing rules do not supersede the statutory and regulatory rules for sourcing the receipts of a mutual fund service corporation. Further, in the case of mutual fund sales made by a taxpayer that is not a mutual fund service corporation, such mutual fund sales shall be assigned in a manner consistent with the sourcing methodology for mutual fund service corporations, i.e., sourced to the state of domicile of the RIC shareholders. In these cases, the mutual fund sales made by the taxpayer directly or indirectly to the RIC are included in the numerator and denominator of the taxpayer’s sales factor irrespective as to whether the taxpayer is taxable in one or more of the states in which the RIC’s shareholders are domiciled.

The market based sourcing rules also do not supersede certain industry-specific alternative apportionment regulations. Specifically the regulations for pipeline companies, corporations engaged in the electricity industry, and corporations engaged in the telecommunications industry remain fully in effect, except for a special rule that pertains to taxpayers providing telecommunications services that are also engaged in the sale or license of digital goods and services.

However, the Commissioner of Revenue has determined that the sales factor sourcing rules for certain industry-specific regulations are no longer necessary. Accordingly, the Commissioner of Revenue has proposed amending the respective regulations for the apportionment of income of motor carriers, airlines, and courier and package delivery services. The proposed amendment to these three regulations indicates that the sales factor for these industries will be determined pursuant to the market based sourcing rules discussed in the proposed apportionment regulation.

Note that the property and payroll factor rules for apportioning the income of motor carriers, airlines, and courier and package delivery services will not be affected.

In detail - Sale of services

The sale of a service is in Massachusetts if and to the extent that the service is delivered at 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. However, if the state or states where a service is actually received cannot be determined, but the taxpayer has sufficient information regarding the place of receipt from which it can reasonably approximate the state or states where the service is received, the taxpayer shall reasonably approximate such state or states.

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; carpentry construction contractor 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 rules for transportation and delivery services

Transportation and delivery services involve a taxpayer physically transporting people or freight from one destination to another. The rule of assignment to be applied depends upon whether the transportation and delivery services are provided by air or by a means other than by air.

- Transportation and delivery services provided by air are assigned to the state or states of the taxpayer’s aircraft departures. The amount of flight revenue assigned to Massachusetts is determined by multiplying the taxpayer’s total flight revenue by the percentage of the taxpayer’s aircraft departures occurring in Massachusetts relative to the aircraft departures that take place everywhere (subject to a weighting rule for air craft types).

- Transportation and delivery services (other than by air) are assigned to the state or states of the taxpayer’s departures and arrivals (in the case of the transportation of people), or pickups and deliveries (in the case of the transportation of freight). The amount of sales revenue assigned to Massachusetts is
determined by multiplying the taxpayer’s total revenues from such services by the percentage of the taxpayer’s total departures (or pickups) and arrivals (or deliveries) that take place in Massachusetts relative to the taxpayer’s departures (or pickups) and arrivals (or deliveries) that take place everywhere.

**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, investment and brokerage services, fiduciary services, tax preparation, payroll and accounting 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. If such place is not readily determinable, the sale is assigned to the state in which the customer placed the order. If either of these places is not readily determinable, then the sale is assigned to the customer’s billing address.

**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.

- **Safe harbor for taxpayers with a large volume of transactions** - Notwithstanding the rules above for sourcing receipts derived from personal services, a taxpayer may assign its sales to a particular customer based on the customer’s billing address in any taxable year in which the taxpayer (1) engages in substantially similar service transactions with more than a thousand customers, whether individual or business, and (2) does not derive more than 5% of its sales of services from such 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 proposed 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 rules for certain architectural and engineering services** - The sale of an architectural service with respect to real or tangible personal property is assigned to a state or states if and to the extent that the services are with respect to real estate improvements located, or expected to be located, in such state or states. Similarly, the sale of an engineering service with respect to real or tangible personal property is assigned to a state or states if and to the extent that the services are with respect to tangible or real property located in such state or states, including real estate improvements located in, or expected to be located in, such state or states. These rules apply whether or not the customer is an...
individual or business customer. Receipts derived from architectural or engineering services not covered by these rules are assigned under the general rule for professional services.

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 be 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 actual state or states where these services are delivered, the sale must be assigned to such state or states. Where the taxpayer is unable to determine where the service is actually delivered, but has sufficient information regarding the place of delivery from which it can reasonably approximate the state or states of delivery, the taxpayer must reasonably approximate such state or states. If neither of the first two assignment rules can be met, 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. For this purposes, it is intended that the state or states where the service is received reflect the location at which the service is directly used by the employees or designees of the customer. Where the taxpayer is unable to determine where the customer actually receives the service, but has sufficient information regarding the place of receipt from which it can reasonably approximate the state or states where the service is received, the taxpayer must reasonably approximate such state or states.

If neither of the first two assignment rules can be met, then – unless the safe harbor rule can be applied (discussed below) the sale should be assigned based on the rules for sales of professional services to business customers discussed above.

• Safe harbor rule for services delivered by electronic transmission to a business customer - When applicable, a taxpayer may assign its sales to a particular customer based upon the customer’s billing address in any taxable year in which the taxpayer (1) engages in substantially similar service transactions with more than a thousand customers, whether business or individual, and (2) does not derive more than 5% of its sales of services from such customer.

Other Services – Delivered electronically through or on behalf of an individual or business customer
Indirect delivery by electronic means is of two varieties: (1) services can be delivered electronically to third-party recipients ‘on behalf of’ the customer and (2) services can be delivered electronically ‘through’ a customer to third-party recipients. ‘On behalf of’ electronically delivered services include the direct or indirect delivery of advertising on behalf of a customer to the customer’s intended audience, as may arise in the Cable TV industry. ‘Through’ electronically delivered services are delivered electronically to a customer for purposes of resale and subsequent electronic delivery in substantially identical form to end users or other third-party recipients, as may arise for certain Web-based service providers.
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.

If the taxpayer cannot determine the state or states where the services are actually delivered to the end users or other third-party recipients either through or on behalf of the customer, but has sufficient information regarding the place of delivery from which it can reasonably approximate the state or states where the services are delivered, it shall reasonably approximate such state or states.

- If neither of the first two assignment rules can be met AND the taxpayer’s service is the delivery of the service to a customer that then acts as the taxpayer’s intermediary in reselling such service to end users or other third-party recipients, then the taxpayer must approximate the extent to which the service is received in a state by using the percentage that reflects the ratio of the state’s population in the specific geographic area in which the reseller’s intermediary resells such services, relative to the total population in such area.

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- For example, in the case of advertising-related services where the audience for such advertising is Massachusetts, the taxpayer should assign the sale of the service to Massachusetts to the extent that the audience for such advertising is in Massachusetts.

If the taxpayer cannot determine the state or states where the services are actually delivered to the end users or other third-party recipients either through or on behalf of the customer, but has sufficient information regarding the place of delivery from which it can reasonably approximate the state or states where the services are delivered, it shall reasonably approximate such state or states.

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Other services – Sales or license of digital goods or services

In the case of a sale or license of digital goods or services (other than described below for telecommunication companies), including the sale of various video, audio and software products or similar transactions, the receipts from the sale or license shall be assigned by applying the same rules described above as if the transaction was a service delivered to an individual or business customer or delivered through or on behalf of a customer. 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 assigned 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 (production intangible), the licensing fees paid by the licensee for such right are assigned 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 (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 proposed 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 assigned to a state if and to the extent that the intangible property is used in or otherwise associated with the state. 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 assigned to a state based upon the percentage that reflects the state’s population in the US geographic area specified in the contract relative to the total population in such area.

**Excluded sales**
Under the proposed apportionment of income regulation, 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 proposed 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 proposed regulations, please contact:

**State and Local Tax Services**

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1 Under the proposed regulation, 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.

ii In another example, Advisor Corp provides investment advisory services to Investment Fund LP, a partnership that invests in securities. Although the partners of the partnership are the ultimate beneficiaries of the investment advisory services, receipts are assigned pursuant to the business customer rules discussed above.

iii In another example, Advisor Corp provides investment advisory services to Investment Fund LP, a partnership that invests in securities. Although the partners of the partnership are the ultimate beneficiaries of the investment advisory services, receipts are assigned pursuant to the business customer rules discussed above.