APPORTIONMENT OF INCOME FROM SALES OF SERVICES AND INTANGIBLES

(Cost of Performance)

The Issue: Destination or Origin

When a tangible product is sold, Virginia's apportionment formula uses the sales factor to assign it to the state in which it is delivered. This destination approach means that customer location is a significant factor in the apportionment of income from the sale of tangible products. But when services and intangibles are sold, the sales factor assigns it based on an analysis of the income-producing activity and costs of performance. In many cases this assigns income to the state in which the corporation's originating offices are located, not the states in which customers may be located.

How Virginia Law Works

Under *Va. Code* § 58.1-416, sales, other than sales of tangible personal property; are in the Commonwealth if:

1. The income-producing activity is performed in the Commonwealth; or

2. The income-producing activity is performed both in and outside the Commonwealth and a greater proportion of the income-producing activity is performed in the Commonwealth than in any other state, based on costs of performance.

This approach is derived from the Uniform Division of Income for Tax Purposes Act ("UDITPA") which was promulgated in 1957. Virginia incorporated the definition of sales factor and the income-producing activity test into its apportionment formula in 1960.

Note the reference to "greater proportion." This test is an "all or nothing" approach and is applied to each item of sales revenue. This means that, when a taxpayer performs income-producing activities in connection with an item of sales revenue in more than one state, whichever state has the greater proportion of the activities, measured by costs of performance, will be assigned all of the sales revenue related to that item of income for purposes of the sales factor. Greater proportion does not require a majority of the activities or costs, merely more than any other state. This approach is consistent with model allocation and apportionment regulations promulgated by the Multistate Tax Commission ("MTC") in 1973.

In 1976 Virginia adopted a statutory special apportionment formula for financial corporations (it has been modified several times since then). The formula is a single factor based on costs of performance in Virginia over costs of performance everywhere. Note the absence of a reference to greater proportion. Even if only a fraction of a percent of a financial corporation's costs are in Virginia, that fraction will be the financial corporation's apportionment factor.

Virginia regulations define “costs of performance” for purposes of the special financial corporation factor in the same manner as the term is defined for corporations selling services and intangible property. That definition is “the cost of all activities directly performed by the taxpayer for the ultimate purpose of producing the sale to be apportioned.”[1] The definition excludes the cost of indirect expenses such as interest or activities performed by an independent contractor. Recently the Virginia Supreme Court held that indirect expenses could not be excluded from costs of performance.

General Motors Decision[2]

One of the General Motors affiliates is GMAC, a financial corporation. It contested the Department’s exclusion of costs for independent contractors from its apportionment factor. The Supreme Court held that the regulation’s reference to “direct costs” is inconsistent with the statute because the statute did not use the word “direct.” Although only the financial corporation factor was involved in the case, the similarity of the statute and regulation for the sales factor suggests that the indirect costs may not be excluded from the sales factor.

The decision generated significant concern among in the business community. If using a Virginia independent contractor will increase a financial corporation’s Virginia income tax liability, the financial corporation may prefer to use independent contractors in other states. In response to these concerns, the Department issued a tax bulletin[3] allowing financial corporations to elect to file returns prepared in accordance with the regulation’s exclusion of indirect costs pending adoption of policies in response to the *General Motors* decision. No subsequent legislative or administrative action has occurred with respect to this issue.

What Other States Do

Most states are similar to Virginia, primarily because they have adopted UDITPA and the MTC regulations, or closely conformed to them. But there are some differences. Some of the approaches are as follows:

<u>Services</u>: Receipts from the sale of services are assigned to a state:

- When the customer is located in the state. (Used in Maryland and Minnesota.)

<u>Intangibles</u>: Receipts from intangibles are assigned to a state:

[1] 23 VAC 10-120-230 (sales of other than tangible personal property) and 23 VAC 10-120-250 (financial corporations).
[2] *General Motors Corporation v. Commonwealth of Virginia*, 268 Va. 289, 602 S.E.2d 123 (2004).
[3] Tax Bulletin 05-3 (4/18/2005).

- In proportion to the use of the intangible in the state. (Used in Kentucky and Minnesota.)
- In proportion to the average of the taxpayer's property and payroll factor. (Used in Maryland.)
- When received from sources in the state. (Used in North Carolina.)

The Perceived Problems

Businesses selling services are treated differently from businesses selling tangible property. The sales factor for tangible property recognizes that the destination state contributed to the corporation's income by providing a market. However, the sales factor for services focuses on income-producing activity and costs of performance, which does not recognize the customer's location unless the corporation sent its employees to the customer's location in order to provide a service. Nevertheless, using something other than income producing activity to assign sales of services seems to be the exception, not the rule.

When a business operates in states that use different apportionment methods it is inevitable that sum of the income apportioned to each of the states will be greater or less than the business's total income. For example, consider two similar businesses that sell services to customers who are equally divided between Virginia and Maryland. Most of the income-producing activity is performed in the central office.

For the business whose central office is in Virginia:

- Virginia will tax 100% of the corporation's income because the greater portion of all income-producing activity for every sale occurs in the Virginia office.
- Maryland will tax 50% of the corporation's income because 50% of the sales revenue is derived from customers in Maryland.

For the business whose central office is in Maryland:

- Virginia will tax none of the corporation's income because the greater portion of all income-producing activity for every sale occurs in the Maryland office.
- Maryland will tax 50% of the corporation's income because 50% of the sales revenue is derived from customers in Maryland.

Thus, in one case the corporation pays tax on 150% of its income, while in the other case only 50% of its income is taxed. (The 50% of income that is not assigned to any state is often called "nowhere income.") Corporations often complain about double taxation when they have to pay tax on more than 100% of their income, but seldom acknowledge when less than 100% of their income is not taxed.

One of the objectives in tax planning is to have as much income as possible treated as nowhere income. This is usually accomplished by having as much sales as possible assigned on the basis of destination or customer location, when many of those states either do not use customer location for apportionment purposes or do not have sufficient contacts with a corporation to impose any tax. Corporations that sell services or intangibles by phone, mail and internet can often avoid having to pay sales tax or income tax to many of the states in which their customers reside.

The only way to avoid double taxation (and nowhere income) is for all states to use the same apportionment method. So, in the example above, should Maryland be expected to change to Virginia's method, or vice versa? Should it matter that in this case Virginia's method is used by more states than Maryland's method?

Conclusion

That fact that two states use different apportionment methods does not indicate that either of the states is wrong, and provides no basis for arguing which state should change its method. Since Virginia's apportionment method for sales of services and intangibles appears to be in the mainstream of state apportionment formulas, there is little justification for Virginia to change its method.

The fact that Virginia uses different apportionment methods for varying types of income requires some consideration to ensure that sufficient justification exists for the different treatment. Services and intangibles are significantly different from tangible property to justify different treatment. In particular, it is not always obvious where a service is rendered, and a lump-sum service contract may apply to several locations belonging to a single customer.

Another consideration is revenue impact. If it is desired to incorporate customer location into the apportionment of service and intangible income Virginia is likely to experience a revenue loss. Consider the two service businesses in the example above. If Virginia adopted the same apportionment method as Maryland, the Virginia tax liability of the Virginia business would be reduced, while the Virginia tax liability of the Maryland business would increase. But, if the Maryland business does not have sufficient contacts with Virginia to allow Virginia to impose any income tax on it, then there will be no revenue gain to offset the revenue loss attributable to the Virginia business.