

(5A) Income Tax Apportionment Sourcing - NC & Multistate

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With You Today

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- **Director of State and Local Tax (“SALT”)**
- ✓ CPA with >32 years SALT experience - Big 4, Fortune 500, Consulting, Mid-size accounting
- ✓ CMI’s in Sales Tax & Income Tax
- ✓ Head of *Advanced Sales Tax School* for the Institute for Professionals in Taxation (“IPT”)
- ✓ Income tax CMI designation committee member
- ✓ IPT Distinguished Service Award - 2021
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Agenda

Overview

Sourcing Tangible Property Sales/Leases

Sourcing Service Revenue

Sourcing Income from Intangibles

Sourcing Gain on Sale of Property

Wrap-Up & Questions

Overview

State Income Tax Apportionment

- Focus: Sales factor sourcing for income tax apportionment.
 - Sourcing for direct allocation of income and business/nonbusiness income determinations are beyond the scope of this discussion.
- “Apportionment” is the method used to divide total taxable income among the states where a taxpayer conducts business.
- 3 possible “factors” averaged to calculate apportionment %
 - Property
 - Payroll
 - Sales (aka “revenue” or “receipts”)

State Income Tax Apportionment

- Some states use all three factors
- Some states use only the sales factor
 - “single sales factor apportionment”
- Trend has been toward single sales factor, or super-weighting the sales factor
- North Carolina
 - Single sales factor apportionment beginning 1/1/2018
 - 2017 was quadruple-weighted sales
 - 2016 was triple-weighted sales
 - Prior to 2016 was double-weighted sales

Special Industry Apportionment

- In addition to the standard apportionment provisions applicable to most businesses, states (including North Carolina) apply special apportionment provisions for certain industries
 - e.g., banking, transportation, telecommunication
- These special apportionment rules are beyond the scope of this presentation
- Our discussion here will cover only the standard apportionment method.

Key Takeaway



- The Sales Factor typically has the greatest impact on the apportionment factor.
- How the Sales Factor is calculated can significantly impact your tax liability.

The Sales Factor

- Key elements
 - What types of revenue are included in the Sales Factor?
 - i.e. – What is the denominator of the fraction?
 - How is revenue sourced among the states?
 - i.e. – What is the numerator of the fraction?
 - Each state defines these elements differently
 - Today's focus – How is revenue sourced for the sales factor numerator?

Sales Factor Sourcing

- Sourcing rules differ by state
- Sourcing rules differ by type of revenue
 - Tangible personal property sales
 - Real property sales
 - Service revenue
 - Income from intangibles
 - Gain on sale of property
- We'll compare North Carolina's sourcing of these revenue types how other states typically source them.

Sourcing Tangible Property Sales/Leases

Tangible Personal Property (“TPP”) Sales

- Typical State Treatment

- Destination-based sourcing for interstate sales.
 - i.e., ship-to location
- Drop shipments
 - Location where the purchaser’s designee receives the item
- “Dock sales”
 - Some states source to ultimate destination,
 - Some states source to the pick-up location
- U.S. government sales
 - Many states apply origin-based sourcing

Tangible Personal Property Sales

- Typical State Treatment

- Unitary combined returns
 - Are sales of non-nexus members included in the sales factor numerator?
 - Joyce Rule – No
 - Finnigan - Yes
- Some states apply a “Throwback” rule
 - Sales to non-nexus states “thrown back” to ship-from state’s numerator
 - Joyce & Finnegan rules also impact throwback for unitary groups
- A few states apply a “Throwout” rule
 - Sales to non-nexus states are excluded from the numerator and denominator

Tangible Personal Property Sales

- North Carolina Treatment

- Destination-based sourcing for interstate sales.
- Drop shipments
 - Place where purchaser's designee receives the item
- Dock sales
 - Place at which the goods are ultimately received after all transportation has been completed
- U.S. government sales
 - Ship-to location, or location where received or accepted by the U.S. government.

Tangible Personal Property Sales

- North Carolina Treatment

- No “Throwback” rule
- No “Throwout” rule
- Combined returns
 - Typically not allowed, but Commissioner may require or taxpayer may request
 - Finnigan rule for sales sourcing

Tangible Personal Property Leases

- Typical State Treatment
 - Location-based sourcing
 - Where is the property located?
 - Necessitates tracking location over life of lease
 - A few states source based on location at inception of lease
- North Carolina Treatment
 - Location-based sourcing

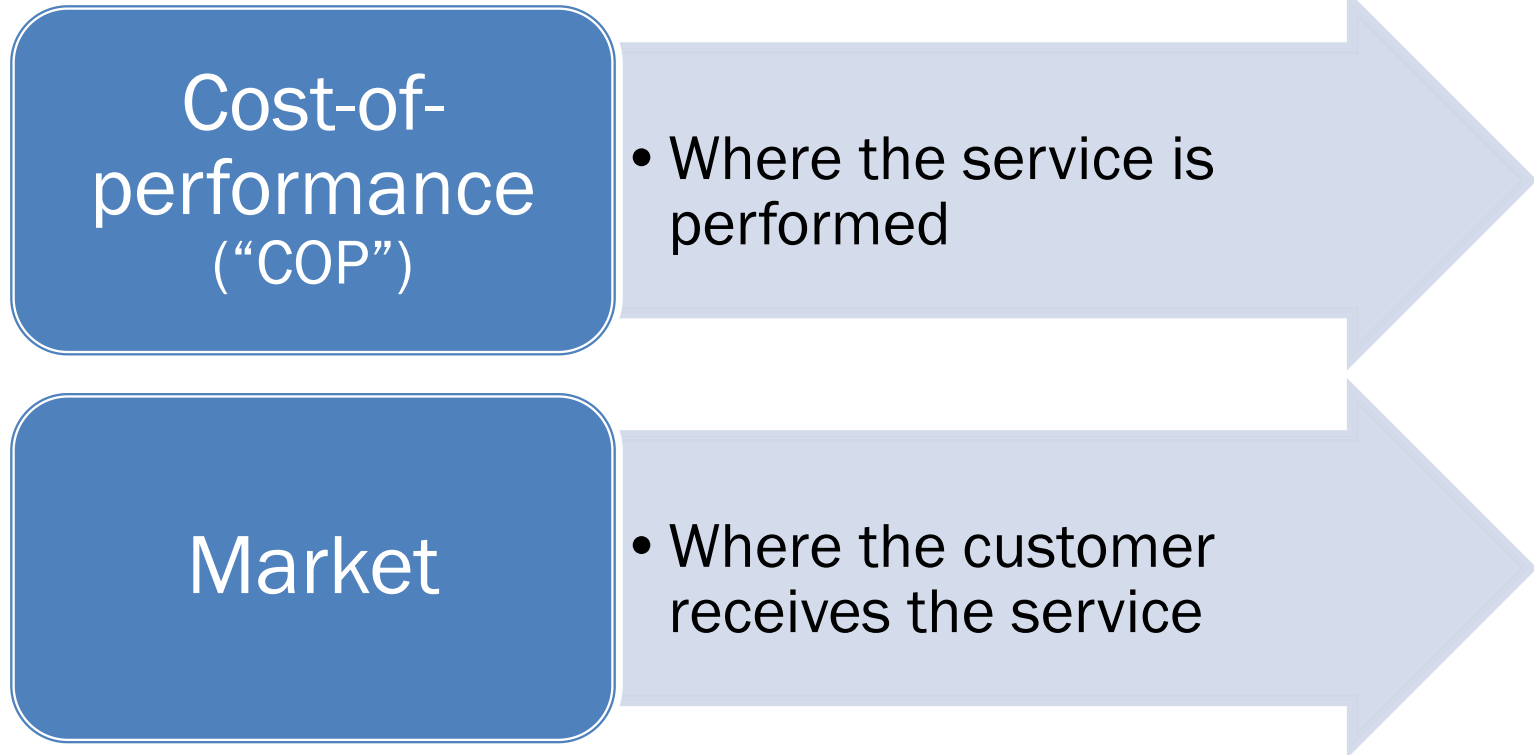
Real Property Sales/Leases

- Typical State Treatment
 - Location-based sourcing
- North Carolina Treatment
 - Location-based sourcing

Sourcing Service Revenue

Sourcing Service Revenue

Two primary sourcing methodologies



The concepts are simple, but applying them can be complex

Cost-of-Performance (“COP”) Sourcing

- 11 states apply COP sourcing method
- Where does the service provider perform the service?
- Location of the “income-producing activity” based on “costs of performance”
- Often results in sourcing sales to where property and payroll are located
- Puts service providers domiciled in the state at a disadvantage
 - Risk of double-taxation as more states move to market-based sourcing
- **North Carolina** applied COP sourcing prior to 2020

Applying the COP Sourcing Method

- Typical State Treatment

- Predominant COP
 - State where > 50% of COP occurs
- Proportionate COP
 - Each state according to the actual % of COP
- How is COP defined?
 - Income-producing activity
 - Broadcasting industry
 - Other remote, cloud-based services
- Direct costs vs. contractors
 - Cost of contractors may or may not be included in COP

Applying the COP Sourcing Method

- North Carolina Treatment (**pre-2020**)

- “Place of performance”
 - If the income-producing activity that gave rise to the receipt was performed within North Carolina.
- Proportionate COP
 - If performed both within and outside the state, the receipts are attributable to the state in proportion to the amount of time spent performing the services in state as compared to everywhere.
- Includes subcontractor costs
 - “Income producing activity” means the activities directly performed by the taxpayer or its agents for the ultimate purpose of generating the sale of the service

COP Sourcing Example

North Carolina Pre-2020



NC-domiciled service provider
\$100 service revenue from GA customer

Result:

GADOR sources \$100 to GA
NCDOR sources \$100 to NC
Double Taxation



Market-Based Sourcing

- Typical State Treatment

Where is the
“Market”?

Service delivery

Benefit of the
service

Issues

Direct vs. indirect
delivery/benefit

Remote services

Multiple points of
use

Applying the Market Sourcing Method

- Typical State Treatment

- If the benefit of the service is received at multiple locations
 - Primary benefit
 - Proportionate benefit
 - Location of the customer's customer
- If the location where the benefit of the service is received cannot be directly determined
 - Reasonable approximation method
 - Exclude from the sales factor numerator & denominator
- Specific rules often apply for personal services

Applying the Market Sourcing Method

- North Carolina Treatment

- For taxable years beginning on or after 1/1/2020
- Location of the taxpayer’s “market for the service”
- If and to the extent the service is “delivered” to a North Carolina location
- Reasonable approximation method allowed if the market for a receipt cannot be directly determined.
- Receipt is excluded from the sales factor if a reasonable approximation cannot be made.

Market Sourcing Example

North Carolina Post-2019



NC-domiciled service provider
\$100 service revenue from GA customer

Result:

Both states source \$100 to GA
\$0 sourced to NC
No more double-taxation



Applying the Market Sourcing Method

- North Carolina Treatment

- Personal Services - Customer is <5% of total revenue
 - Individual customer
 - State of primary residence, or billing address
 - Business customer
 - Location where customer principally manages the contract; or
 - If the place of contract management is not reasonably determinable, and the location where the customer placed the order; or
 - If the place of order is not reasonably determinable, the customer's billing address.
- Both customer types: If substantially similar service transactions with greater than 250 customers – source to billing address.

Applying the Market Sourcing Method - North Carolina Treatment

- Personal Services - Customer is >5% of total revenue
 - Individual customer
 - Customer's identifiable primary state of residence
 - Business customer
 - Location where customer principally manages the contract (must determine).

Applying the Market Sourcing Method

- North Carolina Treatment

- Professional Services
 - Service performed on shipped tangible personal property
 - Source to location where the property is shipped/delivered to the customer
 - The following are sourced to the customer's physical location:
 - service performed on the body of a person, in the physical presence of a customer;
 - service performed on real estate;
 - service performed on non-shipped tangible property.

Applying the Market Sourcing Method

- North Carolina Treatment

- Architectural services (real estate improvements)
 - Location of the property
- Engineering services (real and tangible personal property)
 - Where the property is located or expected to be located
- Architectural and Engineering services (other)
 - Apply the general professional services sourcing rules

Applying the Market Sourcing Method

- North Carolina Treatment

- Electronic Services
 - Individual customer
 - Customers place of receipt
 - If actual receipt location isn't determinable, use reasonable approximation based on available information.
 - Otherwise, source to billing address.

Applying the Market Sourcing Method - North Carolina Treatment

- Electronic Services
 - Business customer
 - Location where the service is directly used by the customer's employees or designees
 - if not reasonably determinable, approximate as follows (in order of priority):
 - where the contract is principally managed by the customer;
 - customer's place of order;
 - Customer's billing address.
 - However: must use state where the customer principally managed the contract if customer represents >5% of total revenue
 - Specific rules apply for related-party services

Applying the Market Sourcing Method

- North Carolina Treatment

- Electronic Services
 - Drop-shipped electronic services
 - Location where received by the end-user or other 3rd-party recipient.
 - If not known, approximate based on relative NC vs. total population in the service-delivery area
 - Electronic advertising services
 - Location of the audience
 - If unknown, approximate using (in order of priority):
 - Ratio of NC vs. total subscribers in the geographic area where the advertising is delivered;
 - Ratio of NC vs. the total population in the geographic area where the advertising is delivered.

Sourcing Income from Intangibles

Royalties for use of intangible assets

- Typical State Treatment

- Examples: patents, copyrights, trademarks, tradenames
- Generally sourced to location where the intangible asset is “used”.
 - Marketing intangibles
 - Location of sales of the subject product(s)
 - Often requires ratio approximation (e.g., sales-by-state)
 - Production intangibles
 - Location of the plant(s) where the patent or process is used

Royalties for use of intangible assets

- North Carolina Treatment

- On or after 1/1/2020
 - Sourced to location where the intangible asset is used
- 7/1/2018-12/31/2019
 - Sourced to location of use.
 - Taxpayer's market for intangible is the location of the payor
- Prior to 7/1/2018
 - Sourced to NC to the extent royalties are received or used in NC

Sales of Intangible Assets

- We'll cover this in the “property sale gains” discussion

Sourcing Gain on Sale of Property

Sourcing Gain on Sale of Property

- Typical State Treatment

- Tangible personal property - Location of the property
- Real property - Location of the property
- Many states exclude significant gains from occasional sale transactions. (Deemed distortionary)
- Some states exclude all gains from the sales factor

Sourcing Gain on Sale of Property

- North Carolina Treatment

- Tangible personal property - Location of the property
- Real property - Location of the property
- Receipts from the casual sale of property are excluded from both the sales factor.
 - Defined as the sale of any property that was not purchased, produced or acquired primarily for sale in the taxpayer's regular trade or business.

Sourcing Gains from Intangibles

- Typical State Treatment

- Depends on type of intangible and circumstances of the sale
- If excluded as occasional sale, sourcing becomes N/A
- Treasury function gains/losses often sourced to headquarters state *if* included in receipts factor
- Goodwill
 - Often excluded as occasional sale, making sourcing N/A
 - Location of the income-producing activity
 - Sourcing based on sales factor history
 - Sourcing based on property & payroll factor history

Sourcing Gains from Intangibles

- North Carolina Treatment

- Sourced based on where the intangibles are used.
- Marketing intangibles
 - The sale of an intangible that authorized the holder to conduct a business activity in a specific geographic area is “used in the state” if the geographic area includes all or part of the state.
- Production Intangibles
 - The sale of an intangible asset that is contingent on its productive use or disposition is sourced in the same manner as receipts from the rental, lease, or licensing of the intangible property.
- All other receipts from sales of intangible property are excluded from the sales factor.

Wrap-Up & Questions

Receipts Sourcing Trends

Product definition

TPP vs service vs intangible

Cloud-based products & services

Bundled products & services

Definition of “income-producing activity”

Location of service effort vs location of customer access

Broadcasting

Other distributed services

Indirect beneficiary of services

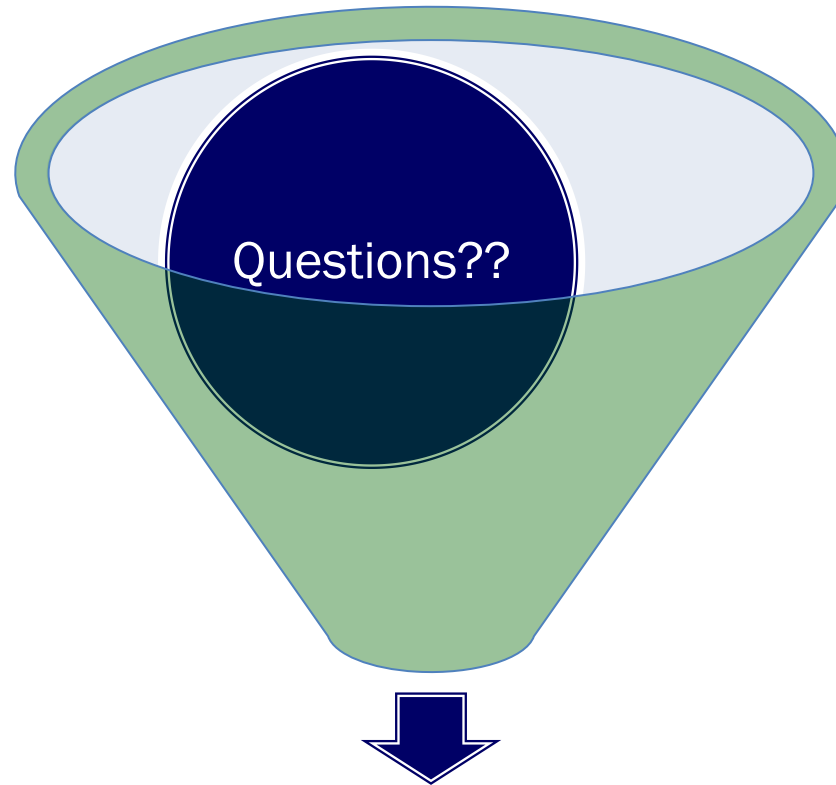
Direct customer’s customers

Where is the benefit actually received?

Key Takeaways

- Increased emphasis on the receipts factor due to super-weighting
- Technology = remote services = increased complexity
- Is the revenue item includable in the receipts factor?
- What sourcing method applies?
- Does a throwback or throwout rule apply?

Questions



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