

## 5 KEY TAKEAWAYS

# State Tax Apportionment

On March 26th, Kilpatrick Townsend State and Local Tax Partner [Jeff Reed](#) presented during a Stafford webinar entitled State Tax Apportionment. The panel discussed state tax apportionment fundamentals and cutting-edge issues.

Here are five key takeaways:

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### Imprecision in Sourcing Receipts from Services and Intangibles

Most states have now replaced their cost of performance sourcing statutes with market-based sourcing statutes. Market-based sourcing may be easier to apply on the whole, but we are seeing many situations in which the taxpayer does not have the right information to apply market-based sourcing. An example is the “multiple points of use” problem in which a services receipt is statutorily required to be assigned to different states based on where users are, but the taxpayer has no way of knowing where its customers’ users are located. In such situations, taxpayers have little choice but to source using a reasonable estimate, billing address, or location of the customer contact. In some states, it is not clear which of these methodologies taxpayers are required to use, and application of the different methodologies could yield vastly different results.

### Impracticality of Examining Books and Records For Each Receipt

Some state statutes require that taxpayers undertake an examination of their books and records to determine where the benefit of the service is received before determining how to source a receipt. This is impractical for service-providers with hundreds of customers. Also, it could be the case that for some customers the benefit of the service is received at different locations for different receipts. In recognition of the practical issues with asking companies to investigate all receipts, the Multistate Tax Commission’s model apportionment regulations contain a safe harbor under which billing address sourcing can be used for taxpayers with a large volume of transactions (over 250 services transactions) with no more than 5% of receipts coming from any one customer. Most states have not adopted a comparable rule, but they should to provide clarity and comfort to taxpayers.

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### Importance of Industry-Specific Apportionment Regimes

States often require that taxpayers in certain industries (e.g., airlines, transportation companies, asset managers) apply industry-specific apportionment rules. For manufacturers in particular, many states offer not only special apportionment, but also a host of incentives that can include property tax exemptions, special credits, and sales and use tax exemptions. Under recent case law, it may be easier to fit under the manufacturing exemption classification. For example, one recent case holds that a designer of sneaker models is a manufacturer because designing the sneakers is an important step in the manufacturing process, even where a third-party manufacturer is responsible for making the sneakers. Additionally, some states take the position that software is tangible personal property, which should mean that software companies are manufacturers. Companies should consider whether it may be possible to leverage industry-specific classifications to their advantage, depending on the nature of their business.

### Impact of Wayfair and Economic Nexus

With almost all states now adopting some form of economic nexus, businesses are finding themselves subject to tax in more and more states. One benefit of this is that receipts will increasingly not have to be “thrown back” under state throw-back statutes, because businesses will find that there are fewer and fewer states in which they are not taxable. A New Jersey case holds that a state that adopts economic nexus cannot deny use of economic nexus in determining where a corporation is subject to tax for throw-out purposes. The same logic should apply in other states and in the throw-back context as well.

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### Sourcing Receipts from Holding Companies and Special Purpose Entities

State apportionment statutes and regulations were drafted with operating companies in mind. But entities are increasingly being formed that are non-operational and that serve limited, yet still very important, purposes. Because statutes and regulations were not crafted with holding companies and special purpose entities in mind, it can be difficult to determine how to source some receipts that they generate. Where the law is unclear, taxpayers should consider requesting a formal or informal ruling or if there is not time to request and receive guidance they should to the extent possible document their logic and legal basis for the sourcing methodology that they ultimately use.

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