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Massachusetts Market Sourcing – A Pocket Guide To The Labyrinth

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Introduction

Sales, other than sales of tangible personal property, are in Massachusetts if a corporation's market for the sales is in Massachusetts.[1] With these 21 words, the Massachusetts legislature abandoned the sometimes frustrating apportionment regime that sourced a service provider's sales to the state where it incurred most of the income-producing activity's direct costs. For taxable years beginning on or after January 1, 2014, the alternative "market sourcing" regime promised to benefit multistate businesses headquartered in state. Their sales factor would no longer compound the effect of high property and payroll factors. Sourcing their sales of services and their licensing of intangible property in proportion to their instate market also promised to be fairer than the "all or nothing" sourcing of sales to just one state based on costs of performance. In addition, market sourcing held the promise of greater certainty for taxpayers and tax authorities, particularly against the whipsaw risk inherent in their often conflicting analyses of "direct costs" and "income-producing activities."

On January 2, 2015, the Massachusetts Department of Revenue (the "DOR") promulgated an amended apportionment regulation to explain what market sourcing really means.[2] The comprehensive provisions pertaining to sales other than sales of tangible personal property offer an impressive level of detail. The section pertaining to the sales factor is now nearly four times its former length, boasting more than 60 new examples and its very own 32 section table of contents. Transactional categories cascade in seemingly interminable analytical tiers, which in some instances are seven subsections deep. The DOR's approach eventually comes into view as themes repeat, but not before readers wish for the equivalent of a GPS navigation device, or early retirement.

The new regulation may ultimately offer little certainty for taxpayers. What might otherwise be bright line rules depend in nearly every instance upon taxpayer determinations and approximations being "reasonable," which in practice may mean "reasonable" in the mind of line auditors who are inclined to second guess. It may not be known until the first audit cycle whether sourcing sales to a taxpayer's market is easier to figure out than sourcing based on costs of performance.[3]

Some variation of the Massachusetts rules may nevertheless be coming soon to other states, because the Multistate Tax Commission has endorsed the Massachusetts rules as a starting point for a model regulation.[4] While a truly comprehensive review is beyond the scope of this article, it provides an introduction for taxpayers and their advisors who are just getting their bearings. In addition, an outline of the Massachusetts rules and examples is available online for your reference.

Transaction-Based Approach

The sales factor apportionment provisions focus in particular on sales of services, and on licenses, leases and sales of intangible property. Sales of services generally go into the sales factor numerator if the services are "delivered" in state.

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1 *See* M.G.L. c. 63, § 38(f); 830 CMR 63.38.1(9)(d)(1)(a) ("Sales, other than sales of tangible personal property, are in Massachusetts within the meaning of this regulation if and to the extent that the corporation's market for the sales is in Massachusetts. . .").

2 *See* 830 CMR 63.38.1.

3 *Cf.* David Sawyer, "ABA Meeting: MTC Market-Sourcing Regulations to Harmonize Disparate Rules," 2015 STT 22-4 ("University of Connecticut law professor Richard Pomp questioned the entire movement to market-based sourcing.").

4 *See* Amy Hamilton, "MTC to Base Model Market-Sourcing Rules on Massachusetts Approach," 2014 STT 239-1 (Dec. 12, 2014) ("The Multistate Tax Commission's Uniformity Committee on December 11 voted to instruct the work group charged with designing market-based sourcing model regulations to use as its starting draft the package of rules proposed in Massachusetts.").

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The rules for sourcing by delivery distinguish among three principal categories of service transaction: (i) in-person services; (ii) services delivered to the customer or on behalf of the customer, or delivered electronically through the customer; and (iii) professional services. Where the rules acknowledge that subcategories may be coextensive, cross references point to a default rule, in one instance referencing yet another cross reference.[5] Whether the categories are exhaustive is by no means obvious. A table listing examples of each category of service transaction types is at the conclusion of this article.

Each category of transaction has its own "waterfall" of rules for *determining* the delivery location, or if it cannot be determined, for *reasonably approximating* it. Secondary, tertiary and quaternary "proxy" rules of reasonable approximation govern the sourcing of sales whose delivery location cannot be reasonably approximated.

For some transaction categories, the tiered proxy rules vary depending upon whether the taxpayer's customer is an individual or a business customer. The hierarchy sometimes includes a "billing address" safe harbor, which permits taxpayers to source certain "large volume" sale transactions (substantially similar service transactions to more than 250 customers) to the customer's billing address. This safe harbor is unavailable, however, for sales to any customers from which the taxpayer derives more than 5% of its sales of services (a "> 5% customer").

If following the rules enable a taxpayer to assign some but not all sales, but the taxpayer "reasonably believes" that the geographic distribution of any remaining sales "generally tracks" that of the assigned sales, then the taxpayer may assign such sales by extrapolation from its assigned sales.[6] Sales that ultimately cannot be assigned pursuant to any of the rules, despite a "reasonable amount of effort undertaken in good faith," are excluded from the taxpayer's sales factor numerator and denominator.[7]

Throwout

Following the statute, the regulation provides two "throwout" rules that may greatly increase the Massachusetts tax of an out-of-state taxpayer.[8] Under the first, if the taxpayer can neither determine nor reasonably approximate the market with respect to a sale, the sale falls out of both the numerator and the denominator of the sales factor.[9] The second rule provides that if the taxpayer is not taxable in the state to which a sale ordinarily would be assigned, the sale likewise falls out of both the numerator and the denominator.[10]

In principle, this latter throwout rule should rarely be applicable, because the threshold for taxability in a market state for a service enterprise is very low, amounting to any physical footprint in a state above a *de minimis* level, or the systematic "exploitation of the instate market" without *any* physical presence.[11] But practitioners have expressed fear that for throwout purposes, auditors will reject the idea that a taxpayer is taxable in the market state in circumstances in which they clearly would assert jurisdiction if the geographic tables were turned.

Some corporations engaged in the development and sale of prewritten software, whose manufacturing activity has qualified them for single sales factor apportionment, may previously have sourced their sales under the apportionment rules governing sales of tangible personal property and "thrown back" sales to customers in states where they are not taxable.[12] Such corporations may benefit under market sourcing, insofar as sales to states in which they are not taxable are thrown "out" (rather than "back") under one of the various market sourcing rules for software transactions.[13] On the other hand, corporations that avoided "throw back" entirely for sales of tangible personal property to purchasers in foreign countries, where the corporations were deemed to be taxable, may be worse off under the market sourcing "throwout" regime, which considers them not taxable in foreign (that is, non-US) jurisdictions that represent their market.[14]

Higher Stakes Nexus

Previously, nexus may have made little difference to out-of-statute service providers that would have sourced no sales to Massachusetts under the cost of performance rules,

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5 *See* 830 CMR 63.38.1(9)(d)6.a.v (sourcing some sales of IP under the rules for licenses of IP that resemble sales of goods and services, which are sourced under the rules for service delivered *to* a customer or electronically through a customer).

6 *See 830* CMR 63.38.1(9)(d)1.e.ii.

7 *See* 830 CMR 63.38.1(9)(d)1.f.1.

8 *See* G.L. c. 63, § 38(f); 830 CMR 63.38.1(9)(d)1.f.

9 *See* 830 CMR 63.38.1(9)(d)1.f.i.

10 *See* 830 CMR 63.38.1(9)(d)1.f.ii.

11 *See Capital One Bank v. Commissioner of Revenue*, 453 Mass. 1 (2009); *Geoffrey v. Commissioner of Revenue*, 453 Mass. 17 (2009).

12 *See* 830 CMR 63.38.1(9)(c)2.

13 *See* 830 CMR 63.38.1(9)(d)7.a.

14 *See* 830 CMR 63.38.1(5)(b)3.b. *Contrast* G.L. c. 63, § 38(f) (providing that for purposes of the "throwback" rule that applies to certain sales of TPP, the taxpayer is deemed to be taxable in destination jurisdictions outside the US); 830 CMR 63.38.1(9)(c)2.b.ii.

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if the service providers were subject to Massachusetts tax jurisdiction. Nexus determinations now carry higher stakes for service providers whose outbound service transactions with Massachusetts customers, or whose licenses of intellectual property for use in Massachusetts, generate Massachusetts sales under the market sourcing rules.

In this regard, it is worth noting that the new market sourcing rules do not apply only to C corporations. They also are incorporated by reference for purposes of the so-called "sting tax," which applies at the entity level to large S corporations doing business in Massachusetts,[15] and for purposes of determining the Massachusetts-source income of nonresident owners of S corporations, partnerships and limited liability companies.[16] In practical terms, this means that individual partners in service partnerships who reside elsewhere, for example, may for the first time be faced with a significant Massachusetts tax liability even if the partnership's physical footprint in the Commonwealth is very modest.

Arguably, the filing requirement for business entities taxed as partnerships reflects a limitation on the partnerships over which Massachusetts asserts tax jurisdiction. The statute requires "[e]very partnership having a usual place of business" in the Commonwealth to file a partnership return.[17] The regulation requiring withholding by passthrough entities, however, generally requires a passthrough entity that maintains an office "*or* engages in business in Massachusetts" to deduct and withhold Massachusetts tax from the members' pro-rata shares of Massachusetts-source income.[18] The DOR may assert that engaging in business in Massachusetts gives rise to a withholding obligation and that partnerships subject to this obligation, must compute their withholding using the market sourcing apportionment rules.[19]

In-Person Services

For "in-person" services, that is, services physically provided in person by the taxpayer, where the customer or the property on which the services are performed are *in the same location* as the service provider, the market is that location (characterized in the regulation as the place of "receipt").[20] In-person services include but are not limited to warranty and repair, cleaning, plumbing, pest control, landscaping, medical and dental, child care, hair cutting and salon services, and live entertainment and athletic performances, but not professional services within the rules described below.[21]

Transportation and delivery services are assigned to the state of departure, in the case of services provided exclusively by air, or based on departures and arrivals (or pickups and deliveries) in the case of services provided by means other than exclusively by air.[22]

For services with respect to tangible personal property, the place of receipt is generally deemed to be the place at which the property is delivered to the customer.[23]

Professional Services

For professional services (including but not limited to legal, accounting, consulting, banking, investment and brokerage, payroll, design, engineering and architectural services), sourcing generally depends on whether the client is an individual or a business.[24] If the client is an individual, the sale goes to the state of primary residence if known, or to the billing address otherwise, but if the taxpayer derives more than 5% of its sales of services from one individual, the taxpayer has an affirmative duty to identify the state of primary residence.[25]

If the client is a business, the sale goes to the state

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15 *See* G.L. c. 63, § 32D.

16 *See* G.L. c. 62, §§ 17, 17A; 830 CMR 62.5A.1; 830 CMR 62.17A.1.

17 *See* G.L. c. 62C, § 7. *See also* 830 CMR 62.5A.1(11)(b) ("In general, a partnership must maintain an office or other place of business in the state (which may include an office that is neither owned nor rented by the partnership, but is provided by another party) in order for it to have a 'usual place of business' in Massachusetts. It is not necessary that the place of business maintained in Massachusetts be the principal place of business of a partnership in order for it to be a usual place of business."); LR 855 (ruling that the test for having a "usual place of business in Massachusetts" was met where the general partners of a limited partnership, located in Boston, performed all management and support services and maintained the financial records of the partnership at their offices, and noting that "[i]n general, a partnership must maintain an office or other business quarters in the state in order for it to have a 'usual place of business' in Massachusetts.").

18 *See* 830 CMR 62B.2.2 (emphasis added). *See also* G.L. c. 62B, § 2 (providing for employer withholding).

19 *See* 830 CMR 62.5A.1(6)(a) ("To arrive at the apportioned income figure, the passthrough entity must multiply its taxable net income by the apportionment percentage determined under M.G.L. c. 63, § 38(c)-(g) and 830 CMR 63.38.1.").

20 *See* 830 CMR 63.38.1(9)(d)4.b.ii.

21 *See* 830 CMR 63.38.1(9)(d)4.b.i.

22 *See* 830 CMR 63.38.1(9)(d)4.b.iii.

23 *See* 830 CMR 63.38.1(9)(d)4.b.ii(C).

24 *See* 830 CMR 63.38.1(9)(d)4.d.iii.

25 *See* 830 CMR 63.38.1(9)(d)4.d.iii(A)1.

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where the client principally manages the contract of sale if known, otherwise to the client's place of order if known, and otherwise to the billing address. A "billing address" safe harbor permits a taxpayer to assign its sales to a customer based on the customer's billing address, if the taxpayer engages in substantially similar service transactions with more than 250 customers, provided that whenever a taxpayer derives more than 5% of its sales of services from a customer, the taxpayer has an affirmative duty to source such sales to the state where the contract is principally managed.[26]

In the case of architectural or engineering services, whether the customer is an individual or a business, the sale is attributed to the location of the property with respect to which the services are performed.[27]

The regulation points out that the scope of banking services that fall within its rules is limited, because specific rules set forth in the financial institution tax statute are unchanged by the new market sourcing rules except insofar as that statute incorporates them by reference where the specific rules are inapplicable.[28]

Services that Are Neither In-Person Services nor Professional Services

For these services, the regulation distinguishes between services that are delivered to a customer, on behalf of a customer to a third party (such as advertising services), or electronically through a customer for resale.[29] Services delivered physically that are neither in-person nor professional services, such as delivering brochures via direct mail or installing custom software on a computer, are sourced to the point of delivery.[30] If this point cannot be determined, the taxpayer may use a reasonable approximation.[31]

Services delivered electronically to an individual customer are sourced to the place of receipt if that can be determined or reasonably approximated, otherwise to the customer's billing address.[32] Services delivered electronically to a business customer are sourced in the same way, except that if the place of receipt cannot be determined or reasonably approximated, the sale is sourced to the state where the contract is principally managed, or, if not known, to the place from which the order was made, or, if that is not known, to the billing address.[33] A "billing address" safe harbor permits a taxpayer to assign its sales to a customer based on the customer's billing address, if the taxpayer engages in substantially similar service transactions with more than 250 customers, provided that whenever a taxpayer derives more than 5% of its sales of services from a customer, the taxpayer has an affirmative duty to source such sales to the state where the contract is principally managed.[34]

Services delivered electronically to a third party through or on behalf of a customer – whether an individual or a business – are sourced to the point of delivery if that can be determined or reasonably approximated.[35] For example, receipts from the placement of television advertising are sourced to the location of the viewer.[36]

Transactions With Respect to Intangible Property

Even under prior law, Massachusetts had comprehensive rules for determining how transactions involving intangible property were to be treated for sales factor purposes. For example, receipts from the licensing of intangible property have been sourced to Massachusetts to the extent that the licensee used the property in the Commonwealth.[37] Also, sales of goodwill and like property were excluded from both the numerator and denominator of the sales factor,[38] but sales of most other intangible property were included in the numerator of the state of the selling corporation's commercial domicile. It was not expected that the shift to market sourcing would change these preexisting rules materially, but in fact the new regulation makes some significant changes in certain areas, and it further fleshes out the rules in others.

As before the change in the law, the regulation provides that intangible property licensed as part of the sale or lease of tangible property is treated as the sale or lease of tangible property.[39] But the regulation now goes on to say that if in such cases the taxpayer is not taxed in the state to which the sale is assigned, it is excluded from both the numerator and the denominator of the sales factor.[40]

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26 *See* 830 CMR 63.38.1(9)(d)4.d.iii(A)2, 3.

27 *See* 830 CMR 63.38.1(9)(d)4.d.iii(B).

28 *See* G.L. c. 63, § 2A; 830 CMR 63.38.1(9)(d)4.d.iii(C).

29 *See* 830 CMR 63.38.1(9)(d)4.c.i.

30 *See* 830 CMR 63.38.1(9)(d)4.c.ii(A).

31 *See* 830 CMR 63.38.1(9)(d)4.c.ii(A)2.

32 *See* 830 CMR 63.38.1(9)(d)4.c.ii(B)1.

33 *See* 830 CMR 63.38.1(9)(d)4.c.ii(B)2.

34 *See* 830 CMR 63.38.1(9)(d)4.c.ii(B)2.c, d.

35 *See* 830 CMR 63.38.1(9)(d)4.c.ii(C).

36 *See* 830 CMR 63.38.1(9)(d)4.c.ii(C)1.

37 *See* G.L. c. 63, § 38(f).

38 *Id.*

39 *See* 830 CMR 63.38.1(9)(d)5.a.iii.

40 *See* 830 CMR 63.38.1(9)(d)5.a.iv.

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The rule excluding sales of goodwill and like assets from the factor is retained, but the regulation now states that even if such a sale "may be characterized as a license or lease of intangible property," receipts from such sales are thrown out.[41]

The regulation treats the licensing of film, television or multimedia productions or events for commercial distribution as the licensing of "marketing intangibles," the receipts from which are assigned to viewer location.[42]

Where a license in substance resembles electronic distribution of digital goods and services, it is so treated for apportionment purposes rather than falling under the licensing rules *per se*.[43]

Sales of contract rights or a government license authorizing business activity in a particular area (such as FCC broadcast licenses) are assigned to the numerator of the state representing that particular area. If the extent of Massachusetts use under this rule is not known, it may be reasonably approximated.[44]

Under prior law, sales of partnership interests generally were included in the numerator of the state where the partnership, in the year of sale, had the highest average property and payroll factors. Under the regulation, such sales generally are excluded from both numerator and denominator.[45]

Likewise, under prior law, sales of many intangibles fell under a default rule that sourced them to the numerator of the state of commercial domicile. The new default rule is to throw such sales out of the factor entirely.[46] And whereas under prior law receipts attributable to the protection or enforcement of legal rights were presumed to go into the numerator of the state of commercial domicile of the taxpayer, under the regulation they are thrown out of the sales factor entirely.[47]

The regulation references no fewer than seven categories into which software transactions may be placed for apportionment purposes "depending on the facts" – as a sale of tangible personal property, as the sale of custom software, as a license of a marketing intangible, as the licensing of a production intangible, as a sale of intangible property, as a sale of digital goods and services, or as a transaction that resembles a sale of digital goods and services.[48] Arguably, this array of possible characterizations is inconsistent with statute's suggestion that standardized computer software is tangible personal property. Specifically, for purposes of the apportionment statute, the development and sale of "standardized computer software" is "a manufacturing activity, without regard to the manner of delivery of the software to the customer."[49]

Rules of General Application

In important respects, the rules provide cold comfort for taxpayers seeking certainty and predictability. So long as a taxpayer "properly assigns its sales" on an originally filed return, the DOR will *not* modify the taxpayer's methodology for such sales for such year.[50] Yet the DOR *will* adjust the sales factor if a taxpayer "fails to properly assign a sale," uses an unreasonable method of approximation, unreasonably fails to approximate, approximates inconsistently across sales over time, fails to retain contemporaneous records, or relies on customer billing addresses for tax avoidance purposes.[51] Taxpayers have no comparable latitude to amend their returns, so in practice, adjustments to originally filed returns may nearly always benefit the DOR.[52]

Taxpayers may revise their assignment methodologies prospectively, if doing so will improve accuracy and provided that they properly disclose the fact of the change,

41 *See* 830 CMR 63.38.1(9)(d)5.a.v.

42 *See* 830 CMR 63.38.1(9)(d)5.b.

43 *See* 830 CMR 63.38.1(9)(d)5.e.

44 *See* 830 CMR 63.38.1(9)(d)6.a.i.

45 *See* 830 CMR 63.38.1(9)(d)6.a.vi.

46 *See id*.

47 *See* 830 CMR 63.38.1(9)(d)7.c.

48 *See* 830 CMR 63.38.1(9)(d)7.a, b.

49 G.L. c. 63, § 42B ("For purposes of this section and [G.L. c. 63, § 38], the development and sale of standardized computer software shall be considered a manufacturing activity, without regard to the manner of delivery of the software to the customer.").

50 *See* 830 CMR 63.38.1(9)(d)1.g.i. ("In any case in which a taxpayer files an original return for a taxable year in which it properly assigns its sales using a method of assignment, including a method of reasonable approximation, in accordance with the rules stated in 830 CMR 63.38.1(9)(d), the application of such method of assignment shall be deemed to be a correct determination by the taxpayer of the state or states of assignment to which the method is properly applied. In such cases, neither the Commissioner nor the taxpayer (through the form of an audit adjustment, amended return, abatement application or otherwise) may modify the taxpayer's methodology as applied for assigning such sales for such taxable year.").

51 *See* 830 CMR 63.38.1(9)(d)1.g.ii.

52 DOR asserts a similar prerogative with regard to federal change adjustments, which taxpayers must report, but DOR does not necessarily respect.

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the nature and extent of the change, and the reason for it.[53] Such a change may not be respected by the DOR, even if it is adequately disclosed, because the DOR asserts the right to enforce year-to-year conformity in methods of approximation.[54] Further, if it considers a method of approximation to be unreasonable, the DOR reserves the right to substitute its own "reasonable" method.[55]

The regulations specify that they do not override either the special apportionment regime for mutual fund service corporations or industry-specific regimes that the DOR has adopted by regulation.[56] The new regulations do replace the previous sales-factor sourcing regimes for motor carriers, airlines, and courier and package delivery services.[57]

Conclusion

The market sourcing regulation is daunting in its complexity. Even for large corporations with significant in-house tax resources, it will prove a challenge both to navigate and to capture the information needed to comply with its Byzantine logic tree while at the same time dealing with different sets of rules in force in all the other states where they do business. Taxpayers will need to know and track their customers in new ways, developing systems to identify which customers represent more than 5% of their market for particular services, and tracking the location where customers manage their service contracts. Taxpayers may also need to maintain census information in the geographic areas where they do business.

It remains uncertain whether the Massachusetts approach to market sourcing will fulfill its promise of greater certainty for taxpayers. The DOR's "transaction-based" guidance offers at least the appearance of a comprehensive, rule-based system for sourcing all types of sales. However difficult the transition may be, and however magnified the difficulties of complying with varying rules in different states, Massachusetts at least offers a protocol that taxpayers may follow.

Skeptics may respond that the regime is so complicated and fact-specific that in many instances, the examples do not illustrate the rules but in fact *are* the rules. This is particularly so with regard to the examples concerning the sourcing of services delivered *to*, *on behalf of* or electronically *through* a customer. In addition, there are so many "forks in the road" that taxpayers may be unable to apply the rules with any degree of certainty. Finally, the appearance of a rules-based system may be illusory, insofar as nearly every rule invokes a "reasonableness" standard. If reasonable sourcing is ultimately in the eye of the auditors, then market-based sourcing may offer no greater predictability for taxpayers.

Some examples of transaction types can be found in the chart on the following page.

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53 *See* 830 CMR 63.38.1(9)(d)1.g.iii.

54 *See* 830 CMR 63.38.1(9)(d)1.g.ii.

55 *Id.*

56 *See* 830 CMR 63.38.1(9)(d)1.h.

57 *See* 830 CMR 63.38.1(9)(d)1.h.

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SOME EXAMPLES OF TRANSACTION TYPES

Services			Licensing of Intangibles		
In-Person Services	**Delivered To or On Behalf of a Customer, or Electronically Through a Customer**	**Professional**	**Marketing**	**Production**	**Other**
Athletic Performances Camera Repair Carpentry Child Care Cleaning Construction Contractor Hair Cutting & Salon In-Person Lessons In-Person Training Landscape Live Entertainment Medical and Dental Medical Testing X-Rays Mental Health Care Pest Control Plumbing Transportation and Delivery Services Exclusively by Air By Other Means Cars, Buses, Trains Trucks Warranty and Repair	**By Physical Means** Advertising and Related Services Custom Software Delivery of Advertising to Customer's Audience via Physical Medium Delivery of Brochures or Fliers Direct Mail Services Fulfillment Services Product Delivery to 3P on behalf of Customer Product Delivery to Customer **By Electronic Transmission Through** Audio or Radio Waves Cable Electronic Signals Fiber Optics Lines Satellite Transmission Wire	Accounting Architectural Bank and Financial Consulting Credit Card Engineering Fiduciary Financial / Custodial Graphic / Design Investment and Brokerage Legal Lending Management Payroll Tax Preparation Video Production	Copyrights (some) Film Franchise Agreement Multimedia Event Service Mark Television Production Trade Name Trademark	Copyrights (some) Patent Trade Secrets	Database Access Access to Information Digital Goods Software (not TPP)