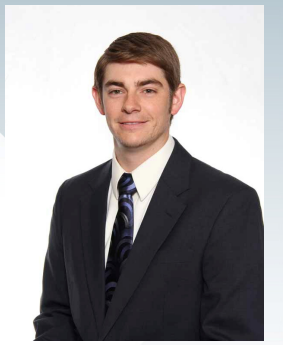
The Changing Landscape of Income Apportionment for Multistate Taxation



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There was once a time when businesses primarily provided tangible goods for local customers or services for customers in the same state. With the advancement of the internet and an increased reliance upon technology, this is no longer the case. As the business world continues to evolve, state taxing authorities are struggling to keep up with this changing environment in a cohesive manner. There have been changes in sales taxes as well as income taxes - specifically for income taxes, states are trying to capture as much income in their state as possible. One method that is gaining momentum is moving from a cost-of-performance apportionment methodology to a market-based one.

To be clear, this movement is a direct result of state efforts to collect tax on income from services which may be performed by a business in one state and where the benefit of the services are received by a customer in a different state. A cost-of-performance methodology is one that requires a taxpayer to source receipts from the sales of services to the state in which the taxpayer incurred the most costs to produce the income, whereas a market-based methodology sources gross receipts from the sales of services to the state in which those services were received, or where the customer is located. One glaring issue with this apportionment dichotomy is the potential for sales to be sourced to two states, producing an apportionment factor greater than 100%. For instance, if an engineering firm is located in Virginia (which uses a cost-of-performance approach) and provides consulting services regarding site plans for a new building in Minnesota via email to a customer headquartered in Minnesota (which uses a market-based approach) there is the possibility that Virginia could source the income from this consulting engagement to Virginia under the premise that the cost to produce this income was incurred in Virginia. Minnesota would source the very same income to Minnesota, since that is where the services were received.

A matter further complicating this issue is that those states that have adopted a market-based approach have not adopted uniform methodologies in applying their laws. For example, Michigan and Minnesota both use a market-based approach, but Michigan sources receipts from the performance of services based on where the benefit of the services are received, whereas Minnesota sources these same receipts based on where the services are received. If, in the above example, the new building happened to be located in Michigan, Michigan could claim to be receiving the benefit of the services, while Minnesota could claim to be receiving the services, since that is where their company is headquartered.

This increased burden on the taxpayer, who is now required to navigate the layered complexities of state taxation, can be ameliorated by following the steps outlined below:

Step 1: Determine whether the source of revenue is from tangible property, intangible property, or a service. It could be from two or more types.

Step 2: Determine in which states the taxpayer has income or franchise tax nexus and where (if applicable) the services are performed.

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Step 3: Determine whether the states that customers are located in utilize a cost-of-performance or market-based apportionment methodology. States currently using the market-based approach or some variation thereof include: Alabama, Arizona, California, Georgia, Iowa, Illinois, Louisiana, Maryland, Maine, Michigan, Minnesota, Nebraska, North Carolina, New Jersey, Oklahoma, Pennsylvania, Utah and Wisconsin.

Step 4: Determine the exposure by reviewing the state's specific rule for apportionment. Prepare tax returns to minimize exposure.

Step 5: Contact a tax advisor for assistance.

In this changing environment of taxation and technology used in businesses, state tax planning can be a challenge. If not monitored and a reactive approach is taken, state tax exposure could become a big issue to the bottom line.

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