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The Quagmire of Apportionment for a Multistate Service Provider

A multistate service provider, particularly one with nexus in Michigan, should pay close attention to the apportionment rules of the various states with which it has nexus.

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The trend in recent years has been for states to adopt apportionment provisions for multistate service businesses that are heavily (or exclusively) dependent on the sales factor and which source sales using a market-based methodology. However, the landscape is certainly not uniform among states, and even within some states, as exemplified in Michigan. This article analyzes Michigan's approach and makes some comparisons to provisions in other states.

Applicable Michigan Taxes and Dependence on Federal Tax Status

In Michigan, two primary taxes are applicable to a service business depending upon its federal income tax status.

A business federally taxed as a corporation. For a business that is taxed as a corporation for federal income tax purposes, the applicable Michigan tax is its Corporate Income Tax ("CIT").[1] This tax was enacted effective for tax years beginning on or after January 1, 2012. Generally, it imposes a 6% income tax on a tax base that is federal taxable income plus or minus certain Michigan adjustments.

A business federally taxed as a flow-through entity. A business that is not taxed as a corporation for federal income tax purposes, such as a partnership, a subchapter S corporation and most limited liability companies (each a "flow-through entity"), is not subject to an entity level business tax. Instead, the tax

liability flows through to the business owners who are individually taxed under the Individual Income Tax ("IIT").[2] A form of the Michigan individual income tax has been in effect since 1967. Currently, individuals are generally subject to a 4.25% income tax based upon their federal adjusted gross income plus or minus certain Michigan adjustments.[3]

Applicable Michigan Apportionment Rules

Under the CIT, a service business federally taxed as a corporation that has business activity in Michigan and other states apportions its tax base using a single factor, sales in Michigan divided by everywhere sales. Under the IIT, the income of a flow-through entity is apportioned to its owners, also based upon a single factor, sales in Michigan divided by everywhere sales. So far, things are fairly similar in the general apportionment concepts for the two tax regimes, CIT and IIT. The real distinction lies in the disparate sourcing methodologies.

Sourcing methodology distinctions

Under the CIT, sales from services are sourced based upon where the benefit of the services is received.[4] This market-based sourcing concept was introduced to Michigan in 2008 under the business tax that preceded the CIT, the former Michigan Business Tax ("MBT"). Michigan's specific application of this benefit received concept is still being refined and the latest attempt by the Michigan Department of Treasury (the "Department") at clarifying its position is contained in its Revenue Administrative Bulletin ("RAB") 2015-20 (issued October 16, 2015). That RAB will be discussed in more detail below.

In contrast, under the IIT sales from services are sourced using the costs of performance methodology. Under costs of performance, a sale is sourced to Michigan if more than 50% of the total costs of the business activity are performed in Michigan. If not, the sale is sourced outside of Michigan. Costs of performance is an all or none methodology. A sale is sourced either 100% to Michigan or 100% out of Michigan. This is in contrast to the CIT sourcing rules, where the benefit of a service may be received in more than one state and consequently the sale may be partly sourced to Michigan and partly sourced to one or more other states.

Costs of performance concepts have been present in Michigan at least as far back as the enactment of the now repealed Michigan Single Business Tax that was effective for tax years 1976 through 2007. However, the Department did not issue any formal guidance on its interpretation of the costs of

performance methodology until its Internal Policy Directive ("IPD") 2006-8 (issued September 29, 2006) related to the Single Business Tax. The Department has never issued formal costs of performance guidance under the IIT. Certain of the Department's views on the benefit received and costs of performance methodologies are addressed below.

CIT Sourcing of Sales Factor—Where the Benefit is Received

RAB 2015-20 contains the Department's interpretations of how a taxpayer should determine where the benefits of its services are received. The RAB addresses several issues, reaches legal conclusions and includes several examples illustrating the Department's application of its views to various fact situations. The RAB starts with an excerpt from the CIT Act that states the general rules for determining a taxpayer's sales in Michigan for purposes of the apportionment sales factor:

> "(2) Sales from the performance of service are in this state and attributable to this state as follows:
>
> (a) Except as otherwise provided in this section, all receipts from the performance of services are included in the numerator of the apportionment factor if the recipient of the services receives the benefit of the services in this state. If the recipient of the services receives some of the benefit of the services in this state, the receipts are included in the numerator of the apportionment factor in proportion to the extent that the recipient receives [the] benefit of the services in this state. MCL 206.665(2)."

The RAB notes that this is the general rule for sourcing sales of services, except for certain specific types of services that are separately addressed in MCL § 206.665, such as securities brokerage services and telecommunication services.

The RAB then addresses whether the *recipient* of services can be someone other than the *purchaser* of the services. It answers this affirmatively saying that the language of the statute makes this clear.

As an example, the RAB includes a scenario in which a consulting company based in State T is engaged by a Michigan company to provide training services to its sales force about improving customer service. The consultant presenter remains in State T and provides his speech via teleconference with the client's sales employees listening by phone from their regular work locations at the client's two sales offices in Michigan and State O.

The taxpayer consulting company's receipts from this service are apportioned to Michigan and to State O, and are included in the numerator of the Michigan sales factor in proportion to the extent that the benefit of the services is received in Michigan. The RAB concludes that apportioning between Michigan and State O based upon the number of telephone participants in each state may be one, but not necessarily the only, reasonable and appropriate method.

Where is the benefit received? What if only a portion is received in Michigan? Pursuant to the RAB, all the benefit of a service is received in Michigan if any of six conditions apply.

1. The service relates to *real property* that is located entirely in Michigan.
2. The service relates to *tangible personal property* that: (a) is owned or leased by the purchaser and located in Michigan when the service is received, or (b) is delivered to the purchaser or the purchaser's designee in Michigan.
3. The service is received in Michigan and provided to a purchaser who is an *individual* physically present in Michigan when the service is received.
4. The service is received in Michigan, and is in the nature of a *personal service*, such as consulting, counseling, training, speaking and providing entertainment, that are typically conducted or performed first-hand, on a direct, one-to-one or one-to-many basis.
5. The service is provided to a *purchaser that is engaged in a trade or business* in Michigan and relates only to the trade or business of the purchaser in Michigan.
6. The service relates to the *use of intangible property* such as custom computer software, licenses, designs, processes, patents, and copyrights, which is used entirely in Michigan.

The above six guidelines apply to relatively straightforward situations where there should be little ambiguity that the service is sourced to Michigan. In contrast, the next four guidelines in the RAB apply to the more difficult to assess situations where the recipient receives only a portion of the benefit in Michigan and the receipts are in the numerator of the sales factor only to the extent the benefit is received in Michigan.

7. If the service relates to *real property* that is located in Michigan and in one or more other states, the benefit of the service is received in Michigan to the extent that the real property is located in Michigan.
8. If the service relates to *tangible personal property* that (a) is owned or leased by the purchaser and located in Michigan and in one or more other states at the time that the service is received, or (b) is delivered to the purchaser or the purchaser's designee in Michigan and in one or more other states,

the benefit of the service is received in Michigan to the extent that the tangible personal property is located in Michigan, or is delivered to the purchaser's designee in Michigan.

9. If the service is provided to a *purchaser that is engaged in a trade or business* in Michigan and in one or more other states, and the service relates to the trade or business of the purchaser in Michigan and in one or more other states, the benefit of the service is received in Michigan to the extent that it relates to the trade or business of the purchaser in Michigan.

10. If the service relates to the use of *intangible property* such as custom computer software, licenses, designs, processes, patents, and copyrights, which is used in Michigan and in or more other states, the benefit of the service is received in Michigan to the extent that the intangible property is used in Michigan.

The RAB states that if a taxpayer's situation is not addressed by one of the above specific guidelines, the taxpayer should use the guideline that most closely applies to its fact pattern.

Methods of proration. In determining how to prorate the benefit received between Michigan and other states, a taxpayer may use any method that:

1. is reasonable and appropriate in light of existing facts and circumstances,
2. the taxpayer applies uniformly and consistently,
3. is used by the taxpayer to apportion services that are substantially similar, and
4. is supported by the taxpayer's business records as they existed when the service was provided or the revenue therefrom was received by the taxpayer.

What if the taxpayer cannot determine where the recipient of a service received the benefit of the service? The CIT Act provides special sourcing rules with respect to certain types of services, such as:

- securities brokerage services,
- interest from loans secured by real property,
- fees from loan servicing, and
- receipts from credit card receivables.[5]

Certain of the specific sourcing rules contain default sourcing methods. For example, for securities brokerage services, the general rule is receipts are sourced to Michigan if the securities are sold to customers within Michigan. However, if the receipts are associated with a particular customer whose address is unknown, the customer's address is presumed to be the address of the branch office that generates the customer transactions.[6]

For sourcing revenue from general types of services, i.e., not a type of service specifically addressed, if the location where the benefit is received cannot be determined, the default is presumed to be the customer's billing address. The RAB cautions that a taxpayer cannot simply source service revenues using the customer's billing address without first making a "reasonable and demonstrable effort, based on its books and records, to determine the location where the recipient of the service received the benefit of that service."

No "throw-out"rule. Service revenues cannot be excluded from the numerator and denominator of the apportionment factor if the location of the recipient's benefit cannot be determined.

Michigan case law interpretations

There has been only one decided Michigan case dealing with where the benefit of a service was received. In *Brightspark Travel*,[7] the Michigan Court of Claims dealt with services provided by a group of Michigan-based affiliated travel companies and tour operators. The taxpayer provided travel planning services to customers traveling outside of Michigan. The issue was how the taxpayer's receipts from its Michigan customers should be sourced for purpose of the MBT apportionment sales factor.

The court determined that the benefit was received both inside and outside of Michigan, so apportionment of receipts was proper. However, the taxpayer had very poor records to establish where the travel took place. Because of the taxpayer's failure to adequately prove where the benefits of the services were received, the court applied the default rule in MCL § 208.1311 and sourced the revenue from such services to the customers' billing addresses in Michigan. Interestingly, the Department's RAB 2015-20 was not mentioned.

Other states also have positions regarding revenue received by travel companies. For example, in Washington State, revenue received by a tour operator for travel both in and outside of Washington would be apportioned proportionately based on the location of the travel. [8]

IIT Sourcing—Cost of Performance Methodology

Even though Michigan's CIT Act follows the trend of other states in adopting market-based sourcing of sales, Michigan's IIT Act continues to apply costs of performance sourcing for individual owners of flow-through service providing entities. The IIT Act provides that:

"Sales, other than sales of tangible personal property, are in this state if:

(a) The income producing activity is performed in this state; or

(b) The income producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than outside this state, based on costs of performance."[9]

The IIT has, since its inception in 1967, included a sales factor in its apportionment formula and used costs of performance for sourcing sales revenue. However, until the IIT Act was amended effective for tax years beginning on or after January 1, 2012, the IIT apportionment formula also included property and payroll factors that were equally weighted with sales.

The Legislature's revision of the IIT in 2012 to a single sales factor coincided with the introduction of the CIT, which generally requires single sales factor apportionment as did the CIT's predecessor business tax, the MBT. However, interestingly the IIT's new single sales factor was not accompanied by a sourcing change from costs of performance to market sourcing as was done under the MBT and continued under the CIT.

Even though Michigan had costs of performance apportionment rules for many years, the Department issued no formal guidance on its interpretations of costs of performance until its issuance of IPD 2006-8 (issued September 29, 2006) that explicitly applied to only the now repealed Single Business Tax. Presumably, the Department's guidelines set forth in IPD 2006-8 also apply to costs of performance under the IIT.

The following are some of the key aspects of IPD 2006-8:

(1) Costs of performance includes only "direct costs" determined in a manner consistent with the taxpayer's method of accounting for federal income tax purposes:

- Indirect costs not directly related with the performance of the contracted service are excluded.
- Direct costs do not include fixed costs unrelated to the provision of services, or remotely related costs such as human resources management, accounting, advertising, or activities conducted to maintain the business but not to provide the activity in question.
- The determination of direct costs depends upon the nature of the service performed.
- Direct costs may include labor costs of employees directly related to the performance of the service in question; materials, equipment and supplies directly related to the performance of the

service; and payments to independent contractors who perform services directly related to the contractual obligations.

(2) The costs of performance analysis is not applied to the total business activity of a taxpayer, but rather to each sale separately.

(3) Service revenue from a single transaction cannot be split or apportioned between Michigan and other states based on a time or cost allocation. 100% of the revenue from a transaction is sourced to the state where more than 50% of the business activity is performed (i.e., all or none in Michigan).

(4) In a mixed transaction involving the sale of a service together with the sale of tangible personal property, the purchaser's ultimate purpose for the transaction, viewing the entire transaction as a whole, must be determined and is controlling. If the purchaser's ultimate purpose is to purchase the performance of a service, any tangible personal property transferred as a result is incidental, and the entire transaction will be sourced based on a costs of performance analysis.

Michigan's interpretations of costs of performance are similar to, but not the same as, other states. In Virginia, for example, the Department of Taxation published a regulation governing financial corporations distinguishing between direct and indirect costs, but, unlike Michigan, it excluded payments for services performed by independent contractors from the costs of performance analysis.[10] The Virginia Supreme Court ruled that the regulation was inconsistent with the statute and impermissibly excluded indirect costs.[11] The Virginia Department of Taxation subsequently issued guidance permitting corporations to elect to continue following the regulation, and no legislative or administrative changes have occurred.[12] Similar to the facts in the *General Motors Corp.* case, the Michigan statute makes no such distinction between direct and indirect costs.

Potential Conflict With Other States' Apportionment Rules

As is frequently the case with multistate taxpayers, the interaction of the different apportionment rules of each state can lead to distortions in overall taxation. An example is a Michigan based flow-through entity service provider that also has tax nexus in Ohio.

Michigan and Ohio source sales inconsistently from one another. Michigan and Ohio apportion the tax base of a flow-through entity with a heavy emphasis on sales: Michigan 100% and Ohio 60% (Ohio also includes property and payroll factors, each weighted at 20%). Ohio uses the benefits received

methodology to source sales. This is in contrast to the costs of performance sourcing methodology used by Michigan to source sales.

For example, assume a Michigan based architectural design firm organized as a Michigan partnership designs a building to be built in Ohio for a company located in Ohio. Assume the design firm's personnel working on the project incur 20% of their hours on-site in Ohio and 80% of their hours at their home office in Michigan.

Ohio will source 100% of the project revenue to Ohio because it determines that the benefit of the services is received in Ohio, where the project is built. Michigan, on the other hand, will source 100% of the project revenue to Michigan because more than 50% of the costs of performance related to the project (design labor and supplies) were incurred in Michigan. Assuming that this was the only project the design firm did in the tax year, its taxable income would be largely taxed in both Ohio and Michigan.

Note that if the design firm were to incorporate so that it would be taxed at the entity level under the Michigan CIT, both Michigan and Ohio would apportion the design firm's tax base (although the Michigan and Ohio tax bases could be different) including a sales factor with sales sourced to where the benefit is received.

Authority of Department Pronouncements

The Department's RAB 1989-34 discusses the authority of its RABs. It states that an RAB is a directive issued by the Commissioner of Revenue (note that currently there is no such position in Michigan) with the purposes of (i) promoting uniform application of the tax laws throughout Michigan by Bureau of Revenue personnel and (ii) providing guidance to taxpayers.

An RAB expresses the official position of the Department, has the status of precedent in the disposition of cases unless and until revoked or modified, and may be relied upon by taxpayers in situations where the facts, circumstances and issues presented are substantially similar to those set forth in the RAB. Based on review of a draft of a forthcoming RAB updating RAB 1989-34 on the authority of Department pronouncements (including RABs, IPDs, letter rulings, and other guidance), RABs will continue to have the same level of authority.

RAB 1989-34 further provides that a taxpayer must consider the effects of subsequent legislation, regulations, court decisions, and RABs when relying on an RAB.

The Department's IPDs (formerly Legal Policy Determination Memos) are, per the Department, prepared to provide guidance to the Department's staff to insure uniformity in tax administration. They are made available to the public on the Department's website as they are developed and issued. In the draft of the forthcoming RAB updating RAB 1989-34, the Department's position is that IPDs are not permitted to be relied upon by taxpayers.

In summary, neither the Department's RABs nor its IPDs are significant authority.[13]

Additional Comparisons to Other State's Apportionment of Services Income

Michigan's apportionment and sourcing of income from services can be further contrasted with such rules in other states.

Connecticut

For example, Connecticut recently approved legislation changing from a three-factor formula to a single receipts factor apportionment method for personal income tax purposes (in 2015, Connecticut switched from a three-factor formula to a single receipts factor method for its corporate income tax), and also adopted market sourcing provisions for both its corporate and personal income taxes. Surprisingly, Connecticut did not adopt market sourcing in 2015 for its corporate income tax when it adopted a single receipts factor for corporate income tax years beginning after December 31, 2015.

Connecticut's recent move to single receipts factor apportionment and market sourcing of receipts under both its corporate income tax and its personal income tax (which affects owners of service businesses conducted in the form of flow-through entities) has now aligned its two income tax regimes. Service income is sourced to Connecticut if the market for the services is in the state. A taxpayer's market for services is in Connecticut if and to the extent the services are used at a location in Connecticut.

Virginia

Virginia currently uses costs of performance apportionment methodology for both its corporate and personal income taxes. Virginia requires flow-through entities to separately file an entity-level return, and withhold tax on individual owners. Virginia uses a three-factor apportionment formula for both its corporate and personal income taxes. To source the sales factor, Virginia currently requires corporations

and flow-through entities to use the costs of performance methodology. Based on Virginia Department of Taxation guidance, Virginia requires that flow-through entities apportion income to Virginia using the same method as corporations.[14]

Virginia is currently studying a possible change from costs of performance to a market-based sourcing methodology. Virginia's published analysis of the change focuses only on corporations, although under Ruling 07-150, the change of methodology may also apply to individuals and flow-through entities.

Washington

While Washington State does not impose an income tax on corporations or individuals, it imposes the Business and Occupation ("B&O") Tax on gross receipts, which requires apportioning income received from services. Washington uses a single receipts factor formula. To source such receipts, a business must determine where the benefit of the services was received. Wash. Admin. Code § 458-20-19402 provides numerous examples of this methodology, including the example of the tour operator discussed above.

Conclusion

A multistate service provider, particularly one with nexus in Michigan, should pay close attention to the apportionment rules of the various states with which it has nexus, and determine whether and how such rules are inconsistent with one another. Such service providers should be aware of the significant potential differences in apportionment methodologies between operating in a flow-through entity versus an entity taxed as a corporation.

[1] Mich. Comp. Laws ("MCL") §§ 206.621 through 206.713.

[2] MCL §§ 206.1 through 206.532.

[3] MCL § 206.51(b).

[4] MCL § 206.665.

[5] *See* MCL § 206.665(2).

[6] *See* MCL § 206.665(2)(b).

[7] Docket no. 14-281-MT.

[8] Example 28 of Wash. Admin. Code § 458-20-19402.

[9] MCL § 206.123.

[10] 23 Va. Admin. Code § 10-120-250.

[11] *General Motors Corp. v. Com., Dept. of Taxation*, 268 Va. 289 (2004).

[12] Tax Bulletin 05-3 (April 18, 2005).

[13] *See Meristar Management Co., LLC v. Mich. Dep't of Treasury*, MTT 320548 (Aug. 31, 2010) ("The [Internal Policy] Directive is not authoritative or binding on taxpayers or the Tribunal.") *See generally, In re Complaint of Rovas Against SBC Michigan*, 482 Mich. 90 (2008) ("we hold that agency interpretations are entitled to respectful consideration, but they are not binding on courts, and cannot conflict with the plain meaning of the statute.") (cited by *Edward W. Sparrow Hosp. Ass'n v. Dep't of Treasury*, 2011 Mich. App. LEXIS 307, *1 (Mich. Ct. App. Feb. 15, 2011) (discussing authoritative significance of RABs)).

[14] *See* Virginia Department of Taxation, Ruling 07-150, issued September 21, 2007 ("'income from Virginia sources' means that portion of the flow-through entity's income that has been allocated and apportioned to Virginia in the same manner as corporations.")