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Reforming the State Corporate Income Tax: A Market State Approach to the Sourcing of Service Receipts

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**REFORMING THE STATE CORPORATE INCOME TAX:
A MARKET STATE APPROACH TO THE SOURCING OF SERVICE
RECEIPTS**

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April 25, 2008

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Abstract

The state corporate income tax is about to undergo its most serious re-examination in over 50 years. The National Conference of Commissioners on Uniform State Laws has initiated a review of the Uniform Division of Income for Tax Purposes Act (UDITPA), which either has been adopted by most states or has been used as a model for similar statutes. UDITPA employs a three-factor formula to apportion the income of multistate businesses. The property and payroll factors reflect the contribution of the production states, while the sales factor is intended to reflect the contribution of the market states. A weakness of UDITPA is its treatment of services. In computing the numerator of the sales factor, UDITPA attributes service receipts to the state in which the services are performed, regardless of where they are consumed. In the past, place of performance may have been a reasonable proxy for market location, but this is no longer the case. Globalization and advances in computer and communications technology now allow many services to be provided remotely. The Article demonstrates that the UDITPA service receipts attribution rule does not effectively implement the policy of reflecting the contribution of the market states. It also shows that a market-based rule both better effectuates that policy and is administratively feasible. The Article proposes guidelines that should govern revision of the service receipts rule. Finally, the Article considers several additional issues, concluding tentatively that the sourcing of receipts from intangibles should follow a similar approach, commenting on the nexus and throwback rule consequences of a market-based rule, and cautioning that institutional reforms may be necessary in order to ensure that uniformity is achieved and maintained under a new UDITPA.

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JOHN A. SWAIN[†]

INTRODUCTION

The state corporate income tax is about to undergo its most serious re-examination in over 50 years.¹ The National Conference of Commissioners on Uniform State Laws has initiated a review of the Uniform Division of Income for Tax Purposes Act (UDITPA),² which either has been adopted by most states or has been used as a model for closely analogous statutes.³ As its name suggests, UDITPA is designed to provide a uniform solution to the thorny problem of allocating and apportioning the income of a multistate business to the various states in which it conducts economic activity. UDITPA was adopted in 1957, and it has not been amended since that time. A product of its day, UDITPA was written against the backdrop of an economy dominated by mercantile and manufacturing enterprises. The original framers of UDITPA generally did not regard the apportionment provisions of the Act as suitable to other types of

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¹ National Commission on Uniform Laws, *National Law Group Revising Important State Tax Law: ULC Revising the Uniform Division of Income of State Tax Purpose Act* (Feb. 13, 2008) (press release), available at <http://www.nccusl.org/Update>.

² UNIF. DIV. INCOME TAX PURPOSES §§ 1-18, 7A U.L.A. 147 (2002) (hereinafter cited as “UDITPA”).

³ JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, 1 STATE TAXATION ¶ 9.01 (3d ed. rev. 2007).

businesses.⁴ The U.S. economy, however, has changed dramatically since that time. Production has shifted steadily from goods to services and intangibles, and the forces of globalization, spurred by the revolution in communications technology, now allow many more goods and services to be supplied remotely. This puts tremendous pressure on division of income rules that were developed in another era.

UDITPA's solution to the problem of dividing the business income of a multi-state enterprise is formula apportionment. Rather than undertaking the often hopeless task of determining on a separate accounting basis how much income a multistate business "earned" in particular state, UDITPA apportions business income by multiplying a business's total income by an apportionment ratio.⁵ The apportionment ratio, in turn, is calculated by averaging three factors—the property factor, the payroll factor, and the sales factor. In simple terms, the property factor is the ratio of the taxpayer's in-state property to its property everywhere.⁶ The payroll factor is the taxpayer's ratio of in-state payroll to payroll everywhere.⁷ The sales factor is the taxpayer's ratio of in-state sales to sales everywhere.⁸ The property and payroll factors are intended to give weight to the states in which production occurs ("origin" states), while the sales

⁴ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 10.01.

⁵ UDITPA § 9.

⁶ UDITPA § 10. The rules for computing the property, payroll and sales factors are laced with substantially more complexity. States invariably, for example, adopt a "water's edge" approach to apportionment, which means that they generally do not include the attributes of foreign subsidiaries in the computation of the apportionment ratio. RICHARD D. POMP & OLIVER OLDMAN, 2 STATE & LOCAL TAXATION 10-35 to 10-37 (4th ed. 2001). Additionally, some states require "separate reporting" by each entity while others require all members of a commonly-controlled group of business entities conducting a "unitary business" to file a "combined return." *Id.* at 10-30 to 10-35.

⁷ UDITPA § 13.

⁸ UDITPA § 15.

factor is intended to give weight to the states that provides the market for the taxpayers products (“market” states or “destination” states).⁹

A glaring weakness in UDITPA is its treatment of receipts from services. Appropriately, service receipts are included in the sales factor.¹⁰ In computing the numerator of the sales factor, however, UDITPA attributes service receipts to the state in which the services are *performed*, regardless of where they are *consumed*.¹¹ In other words, service receipts are attributed to the state of production, rather than to the state that provides the market for the services. Many services are consumed where they are provided: a haircut, for instance. In these cases it makes no difference whether services are attributed to the destination state or the origin state. They are one and the same. Many other services, however, can be consumed remotely: a lawyer in Pennsylvania can give advice to a client in Illinois; a bank in New York can lend money to a borrower in Texas; or a technician in California can fix software installed on a computer in Massachusetts. In these cases, assigning service receipts to the numerator of the state of origin, rather than to the numerator of the destination state, is contrary to the very purpose of the sales factor, which is to reflect the contribution of the market state. Moreover, including service receipts in the numerator of the sales factor of the state of origin is essentially duplicative of the payroll and property factors, which already reflect the weight of the taxpayer’s income-producing activities in the origin state.¹²

⁹ See *infra* Part II.A.

¹⁰ UDITPA § 17 (attribution rule for receipts from sales other than sales of tangible personal property).

¹¹ *Id.*

¹² The duplication occurs because almost invariably the costs of production are incurred where the taxpayer’s assets and employees are located. Recent amendments to model regulations promulgated by the Multistate Tax Commission have somewhat attenuated this correspondence because production costs may now include costs incurred in connection with independent contractors who contribute to production. Independent contractor costs

The problem of remotely consumed services may have seemed esoteric 50 years ago. Today it is pressing. The service sector of the economy has increased dramatically in the intervening years.¹³ Additionally, personal computers, the Internet, advances in telecommunications technology, and even the simple expedient of overnight mail, have enabled a growing proportion of this expanding service sector to provide its services remotely. Place of performance is no longer a reliable proxy for identifying the marketplace for many services.

Concomitantly, the sales factor has taken a central role in the apportionment of corporate income. Under the original (and still current) version of UDITPA, the weight of the sales factor is one-third. Subsequent to a Supreme Court decision upholding the constitutionality of single sales factor apportionment,¹⁴ however, states have rushed to increase the weight of the sales factor in their apportionment ratio computation. The rate of tinkering has been so frantic that it is difficult to keep pace.¹⁵ The driving force behind this infatuation with the sales factor is inter-jurisdictional tax competition. By eliminating or reducing the weight of the property and payroll factors, a state reduces the tax impact of locating property or employees within its borders. Labor and capital are generally mobile. Markets are less so. In a modern economy, factors of production often can be geographically separated from the market. Accordingly, capital will seek out tax havens, such as states that assign little or no weight to in-state factors of production

may be distributed in locations and proportions that differ from the taxpayer's distribution of its own property and payroll. MULTISTATE TAX COMMISSION, MODEL REG. IV.17(4)(C) (2007) (hereinafter "MTC REG.").

¹³ In 1960, 42 percent of U.S. wages and salaries were earned in the goods-producing sector. By 2000, the share had fallen to 24 percent. The portion of personal consumption dollars spent on services during that same time period rose from 41 percent to 58 percent. Robert Tannenwald, *Are State and Local Revenue Systems Becoming Obsolete?* 24 ST. TAX NOTES 143, 146 (2002).

¹⁴ *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

¹⁵ Seventeen states currently use or are scheduled to implement a 100 percent sales factor apportionment formula for all or selected broad industries. There are now only 11 states that use an equally weighted, three-factor apportionment formula. The remaining states use double-weighted (or higher) sales factor apportionment formulas. Thomas S. Neubig & Robert Cline, *Future State Business Tax Reforms: Defend or Replace the Tax Base*, 47 ST. TAX NOTES 179 (2008).

when apportioning taxable income.¹⁶ For the same reason, capital will flee high tax (on capital) jurisdictions, such as jurisdictions committed to toeing the UDITPA line. The wages of virtue, it seems, are poverty.

Many observers have decried this trend.¹⁷ The cooperative impulse has yielded to that of competition, and the ensuing race to the bottom is as disheartening to some as it is predictable to others. Other observers have focused on the inevitability of the trend, arguing states have little choice in an open economy that lacks an effectively functioning coordinating mechanism. They argue that for a state to have an effective corporate income tax—one that imposes a charge for state benefits received while not repelling local investment—super-weighting of the sales factor is a near necessity.¹⁸ This Article does not to address the sales factor weighting controversy.¹⁹ The purpose of noting it here is to emphasize the increasing importance of the sales factor in the division of business income, highlighting the need to “get it right.”

This Article has three major objectives. The first is to demonstrate that the current UDITPA service receipts attribution rule does not effectively implement the policy underlying the UDITPA sales factor of reflecting the contribution of the market state to the taxpayer’s income. The second is to show that a market-based receipts attribution rule both better

¹⁶ See William F. Fox, LeAnn Luna, and Matthew N. Murray, *How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?*, 58 NAT’L TAX J. 139, 148 (2005) (describing factor mobility at the subnational level).

¹⁷ Normative questions aside, it can be observed that super-weighting of the sales factor is causing the corporate income tax to “morph” into a sales tax. At a time when the apportionment factors were generally equally weighted, economist Charles McLure demonstrated that the UDITPA factors acted as three distinct (and imperfect) taxes: a tax on capital, a tax on payroll, and a tax on sales. Sales factor super-weighting, of course, emphasizes the sales tax characteristics of the apportionment scheme. See Charles E. McLure, Jr., *The State Corporate Income Tax: Lambs in Wolves’ Clothing*, in *THE ECONOMICS OF TAXATION 372-46* (Henry J. Aaron and Michael J. Boskin, eds. 1980).

¹⁸ See Fox, Luna, and Murray, *supra* note 16, at 148-50 (describing economic forces underlying increased reliance on the sales factor).

¹⁹ Sales factor super-weighting is briefly revisited in Part VI, but no attempt is made to resolve the issue.

effectuates that policy and is administratively feasible. The third is to propose a set of guidelines that should govern the revision of the service receipts attribution rules. Part I explains UDITPA mechanics, particularly those of the sales factor. Part II demonstrates the weakness of the current origin-based approach to calculating the sales factor numerator. Part III explores the relative feasibility of the origin-based and destination-based approaches. Part IV identifies and examines existing models of destination-based receipts attribution. Part V proposes a set of guidelines for drafting destination-based service receipts attribution rules. Part VI considers several additional issues, including the sourcing of receipts from intangibles, nexus and throwback rules, and sales factor super-weighting. Part VII concludes the Article with a comment on institutionalizing UDITPA reform.

I. UDITPA OVERVIEW

Of the 45 states that impose a corporate income tax, most have adopted UDITPA or a closely analogous statute.²⁰ The fundamental purpose of UDITPA is to provide a uniform and equitable method for allocating and apportioning the income of a multistate business to the states in which it conducts economic activity. The general approach of UDITPA is to separately allocate each item of “non-business income” and to apportion by mathematical formula all “business income.” The distinction between allocable non-business income and apportionable business income is compelled by the constitutional constraint of the “unitary-business principle,” which the Supreme Court has held is the “linchpin of apportionability.”²¹ Very generally, this

²⁰ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 9.01.

²¹ Mobil Oil Corp. v. Vermont, 445 U.S. 425, 439 (1980).

means that in order for a state to include income in the tax base to which the apportionment formula is applied, the out-of-state activities that generated that income must have some synergy, interdependence, or functional integration with the business's in-state activities. Thus, income from a business's day-to-day operations is generally apportionable, while income from certain passive or unusual transactions might require specific allocation on an item- by-item basis.²² The focus of this Article is on the apportionment of business income.

As briefly described above, UDITPA apportions business income by multiplying it by an apportionment ratio.²³ The apportionment ratio is determined by an equally weighted average of three factors: the property factor, the payroll factor, and the sales factor. The property factor is the ratio of the taxpayer's in-state property to its property everywhere; the payroll factor is the ratio of the taxpayer's in-state payroll to its payroll everywhere; and the sales factor is the ratio of the taxpayer's in-state sales to its sales everywhere.²⁴

The following example illustrates the application of the UDITPA apportionment formula:

1. XYZ Co. has \$120 of State A property and \$400 of property everywhere. Thus, its State A property factor is .3 (\$120/\$400).

²² To explain further, non-business income is income that does not arise "in the regular course of the taxpayer's trade or business." UDITPA § 1(a),(e). This income is separately allocated because the rationale for the formula apportionment of a taxpayer's income only pertains when the income is part of a "unitary business." When, however, income stands apart from the taxpayer's unitary business, it is considered to be overreaching, in both a tax policy and constitutional sense, for all states in which the taxpayer is doing business to include that income in the apportionable tax base. To do so would be to claim, in effect, that the taxpayer's payroll, property, or sales in that state is contributing to the production of that income. That claim can only be made when income arises from the unitary business of which that payroll, property, and income are a part. As one might imagine, the interpretive questions that arise in discerning the contours of the unitary business principle are numerous, outnumbered only by the litigated controversies. See HELLERSTEIN & HELLERSTEIN, *supra* note 1, ¶ 9.05 (explaining the distinction between business and non-business income).

²³ See *supra* notes 5-8 and accompanying text.

²⁴ *Supra* notes 5-8.

2. XYZ Co. has \$200 of State A payroll and \$500 of payroll everywhere. Thus, its State A payroll factor is .4 (\$200/\$500).
3. XYZ Co. has \$900 of State A sales and \$3,000 of sales everywhere. Thus, its State A sale factor is .3 (\$900/\$3,000).
4. Averaging the three factors [(0.3 property factor + 0.4 payroll factor + 0.3 sales factor) ÷ 3], results in a State A apportionment factor of .33.
5. If XYZ Co. has \$300 of total business income then \$100 (\$300 x .33) of that income will be apportioned to State A. If the tax rate is 5 percent, then XYZ Co. will owe a State A tax of \$5 on that income.

The UDITPA apportionment formula is not based on the rigorous application of any particular accounting standard or economic theory. Indeed, determining the geographic source of income is a question to which “[t]here seems to be no definitive economic answer.”²⁵ Still, the formula is grounded in the reasonable notion that business income is generated in, or at least fairly apportionable to, states in which production occurs (as reflected in the property and payroll factors) or in which the market for the business’s products is located (as reflected in the sales factor). As a legal matter, “fair apportionment” is constitutionally required, and the Supreme Court has described the three-factor formula as “something of a benchmark against which other apportionment formulas are judged.”²⁶ Nevertheless, the Court has given states “wide latitude” in adopting apportionment formulas, blessing, for example, both single property factor apportionment²⁷ and single sales factor apportionment.²⁸

²⁵ Peggy B. Musgrave, *Principles for Dividing the State Corporate Tax Base*, in *THE STATE CORPORATE INCOME TAX* 234 (Charles E. McLure, Jr., ed. 1984).

²⁶ *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 170 (1983).

²⁷ *Underwood Typewriter Company v. Chamberlain*, 254 U.S. 113 (1920).

II. THE CONTROVERSIAL ROLE OF THE SALES FACTOR IN THE APPORTIONMENT OF INCOME FOR STATE TAX PURPOSES

The sales factor “has been the center of the major controversies that have arisen over the implementation of the apportionment factors.”²⁹ These controversies have been of three major types. First, and most fundamentally, the normative underpinnings for including the sales factor in the UDITPA formula have been challenged throughout the years, most notably by a Congressional Commission that was convened in the mid-1960s to review the impact of state taxation on interstate commerce.³⁰ Second, having won the role as the market state representative in the three-factor apportionment formula, the sales factor has been given a script that is not entirely consistent with that role. Third, the sales factor has undoubtedly generated the most litigation of any of the apportionment factors. Of particular importance to our analysis are the difficulties in interpreting and implementing the sales factor rules for attributing receipts from services. Each of these three sources of controversy is addressed separately below.

A. *The Sales Factor Rationale*

The concept of a sales factor was by no means the brainchild of the UDITPA draftspersons. The three-factor apportionment formula—the so-called Massachusetts formula—was in widespread use at the time UDITPA was promulgated by the National Conference of

²⁸ *Moorman Mfg.*, 437 U.S. 267, 275 (1978).

²⁹ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 9.18.

³⁰ *See infra* note 36 and accompanying text.

Commissioners on Uniform State Laws and approved by the House of Delegates of the American Bar Association in 1957.³¹ Nevertheless, there were “an amazing variety” of apportionment formulas, which varied “not only in respect of the basic factors used, but also in respect to the specific details of each factor.”³² Indeed, the need for uniformity had been felt as early as 1928, when the National Tax Association proposed a uniform law on this subject.³³

The UDITPA version of the sales factor was unquestionably intended to acknowledge the contribution of market states to the production of income. The principal draftsman, University of Michigan Law Professor William Pierce, commented:

Manufacturing states probably would prefer a system attributing sales to the place from which the goods are shipped in every case. However, the National Conference [of Commissioners on Uniform State Laws] was of the opinion that such a system would merely duplicate the property and payroll factors which emphasize the activity of the manufacturing state, so that there would tend to be a duplication by such a sales factor. Moreover, it is believed that the contribution of the consumer state toward the production of the income should be recognized by attributing the sales to those states.³⁴

Similarly, the California representative at the conference, John Warren, recalls:

Pre-UDITPA, there were three approaches to the sales factor: origin, destination, and solicitation. The origin approach was quickly dismissed as duplicative of the

³¹ William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 750 (1957).

³² Pierce, *supra* note 31, at 748.

³³ See Arthur D. Lynn, Jr., *The Uniform Division of Income for State Tax Purposes Act*, 19 OHIO ST. L.J. 41, 42 (1958); PROC. NAT’L TAX ASS’N 428 et seq. (1928).

³⁴ Pierce, *supra* note 31, at 780.

property and payroll factors and inattentive to the contribution of markets to the production of income. The destination approach answered those questions nicely, but it created the problem of the possible nontaxability in the destination state. The solicitation approach answered that problem, for there would be taxable nexus in the state where salespeople were present and acting, but it could be difficult to determine just what employee activity was responsible for the sale. The solution was to adopt the destination theory and supplement it with a throwback [to the origin state] rule to fill the gap where the taxpayer does not have taxable nexus with the state.³⁵

Despite the generally recognized need for uniformity, UDITPA was not an overnight sensation. Only a handful of states had adopted it when in 1964 the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary (the “Willis Committee”) “evoked a storm of virtually unanimous protest” from state taxing authorities by recommending abandonment of the sales factor in favor of a federally-mandated two-factor property-payroll formula.³⁶ At that time 24 states employed destination-based sales factors in their apportionment formulas, and many other states used sales factors of other varieties.³⁷ The states reacted quickly to stave off federal intervention by creating the Multistate Tax Compact, which went effective in 1967. The Compact incorporates UDITPA, and full compact members are required to adopt the Compact, including UDITPA. Twenty-one states (including the District

³⁵ John S. Warren, *UDITPA—A Historical Perspective*, 38 ST. TAX NOTES 133 (2005). Two other methods for attributing sales were used at that time: (1) sales activity and (2) place of acceptance. SPECIAL SUBCOMM. ON STATE TAXATION OF INTERSTATE COMMERCE OF THE HOUSE COMM. ON THE JUDICIARY, STATE TAXATION OF INTERSTATE COMMERCE, HR Rep. No. 1480, 88th Cong., 2d Sess. (1964); HR Reps. Nos. 565 and 952, 89th Cong. (1965).

³⁶ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶8.06.

³⁷ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶9.18[1].

of Columbia) are currently full members, while twenty-six other states have memberships of lesser status.³⁸

The Willis Committee's recommendation to abandon the sales factor was based largely on considerations of administrative convenience and costs of compliance. Additionally, several economists testified before the committee that market states do not have a legitimate claim to tax the income of businesses merely selling, but not producing products within their borders.³⁹ The opposing point of view, which also has been expressed by public finance experts, is that demand is as necessary as supply in the creation of income, and that governments in market states are entitled to extract a tax from sellers in the marketplace that they foster.⁴⁰ Peggy Musgrave perhaps takes the most candid approach:

There seems to be no definitive economic answer to the question of source [of income] definition. Either of two approaches can be taken...The first is a supply approach which says that income has its source where the factor services which generate that income operate, a concept of value added at origin. The second is a supply-demand approach which holds that market value is created through the interplay of supply and demand, by both blades of the Marshallian

³⁸ Among the goals of the Compact is to ensure the "equitable apportionment" of the tax base and "promote uniformity." Its executive body is the Multistate Tax Commission ("MTC"). In practice, member states have deviated from UDITPA, for example, in their weighting of the sales factor. See HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶¶ 8.06, 9.01 (discussing history of UDITPA, the Multistate Tax Compact, and current state membership configuration).

³⁹ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 8.06. See, e.g., Arthur D. Lynn, Jr., *The Uniform Division of Income for Tax Purposes Act Re-Examined*, 46 VA. L. REV. 1257, 1265-68 (1960) (arguing for an origin-only approach to apportionment); Paul Studenski, *The Need for Federal Curbs on State Taxes on Interstate Commerce: An Economist's Viewpoint*, 46 VA. L. REV. 1121 (1960) (criticizing the role of the sales factor in the apportionment of income).

⁴⁰ To examine the more contemporary strands of this debate see, for example, Fox, Luna, and Murray, *supra* note 16, at 141-42 (focusing on the benefits-received rationale for taxation); James Francis & Brian McGavin, *Market Versus Production States: An Economic Analysis of Apportionment Principles*, in STATE TAXATION OF BUSINESS: ISSUES AND POLICY OPTIONS, 61-68 (1992) (applying a valuation approach).

scissors...There seems to be no straightforward economic basis for choosing between the two or for assigning respective weights under the supply-demand approach.⁴¹

As a matter of practical politics, however, it is a rare (probably non-existent) state or nation that would refrain from asserting that it is entitled to tax persons selling products in its marketplace, at least to the extent that there is a practical mechanism for enforcing such a tax.⁴² The legitimacy of this political impulse has been recognized by the U.S. Supreme Court: “The three-factor formula...has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated.”⁴³ It has further observed: “The standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation’s sources of income or the social costs which it generates.”⁴⁴

The contemporary debate over the sales factor focuses less on the qualitative question of the legitimacy of its role of acknowledging the contribution of (or, at minimum, the claim of

⁴¹ Musgrave, *supra* note 25, at 234. “Marshallian scissors” refers to “the classic statement of Alfred Marshall when he addressed the question of whether ‘cost’ or ‘utility’ (i.e., supply or demand) govern value: “We might as reasonably dispute whether it is the upper or the lower blade of a pair of scissors that cuts a piece of paper...” James Francis & Brian McGavin, *supra* note 40 at 62-63.

⁴² Public finance experts have articulated this impulse under both “benefits-received” and “entitlement” theories of taxation. *See, e.g.*, Musgrave, *supra* note 25, at 230-32; William F. Fox, Luna, and Murray, *supra* note 16, at 140-42. States (and nations) usually will not seek to tax income over which they have no legal jurisdiction, yet the limits of legal jurisdiction are sometimes little more than expressions of the limits of the state’s practical power to enforce the tax. *See generally* Walter Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 GA. L. REV. 1 (2003). The is not to say that nations and states do not curb this impulse. In the international context, for example, nations frequently negotiate tax treaties under which they agree to refrain from asserting jurisdiction over treaty partner residents and/or their income in exchange for similar concessions. In the American subnational context, Congress sometimes will restrain the states by exercising its power under the Commerce Clause to regulate interstate commerce, and the Supreme Court will sometimes do the same by invoking its so-called negative or dormant Commerce Clause enforcement powers.

⁴³ *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

⁴⁴ *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 561 (1983).

entitlement of) the market state and more on the quantitative question of the weight of that role. Under the lash of tax competition, states have begun to super-weight the sales factor, in some cases relying solely on the sales factor to apportion corporate income. This Article briefly returns to the question of sales factor super-weighting in Part VI, addressing the trend and its implications.

B. The Shortcomings of the UDITPA Sales Factor's Implementation of the Destination Principle

The provisions of UDITPA implementing the sales factor are not entirely consistent with the sales factor's intended purpose of causing a share of business income to be apportioned to the market state. On the one hand, UDITPA adopts a place of delivery approach for sales of tangible personal property. This, of course, has the general effect of attributing sales to the market state.⁴⁵ On the other hand, UDITPA adopts a place of performance rule for receipts from all other types of transactions, including receipts from the performance of services. Accordingly, when the state of performance is not the market state, the policy of attributing receipts to the

⁴⁵ Section 16 of UDITPA provides that receipts from the sale of tangible personal property are includible in the numerator of the sales factor "if ... the property is delivered or shipped to a purchaser...within this state..." Thus, under the ordinarily safe assumption that the property will be used by the purchaser in the state of shipment or delivery, the UDITPA rule is consistent with the destination principle. As with any rule, interpretative issues arise. The most notable issue that arises in connection with the destination principle regards "dock sales." These are transactions in which a buyer picks up the goods at the seller's location and then distributes them to a location (or locations) out-of-state. Many states, either by statute, regulation, or court decision, have required that the seller determine the ultimate destination of the goods rather than treat the state of delivery to the buyer as the state in which the sale occurred. HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 9.18[1][a]. Indeed, the "overwhelming majority" of courts that have considered the "dock sale" issue have held that Section 16 of UDITPA "should be construed as embodying an ultimate-destination rule." *Id.*

As will be discussed shortly, services pose a problem analogous to "dock sales"—the delivery of a service to a corporate home office, for example, that may be used companywide. In anticipation of that discussion, it is interesting to note here that the problem already has been addressed in context of tangible personal property and that the destination principle generally has prevailed over the undoubtedly more administratively convenient solution of attributing the sale to the "dock" state.

market state is defeated. A more detailed discussion of these rules and their consequences follows.

Section 17 of UDITPA applies to receipts from sales other than sales of tangible personal property, including receipts from services. It provides:

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 the greater proportion of the income-producing activity is performed in this state than in any other state, based on the costs of performance.⁴⁶

Accordingly, if the customer is located in the same state in which the “income-producing activity” occurs, then this rule generally serves to effectuate the destination principle. If the customer is located in a state other than the state in which the income-producing activity occurs, however, then the receipts are assigned to the state in which the income-producing activity occurred, rather than to the market state. Similar inconsistencies with the destination principle arise when the income-producing activities take place in more than one state. In those situations, UDITPA assigns *all* of the services receipts to the state in which the greatest proportion of income-producing activities occur, measured by the “costs of performance.”⁴⁷ For example, if 40 percent of the costs of performing a service arise in State A, 35 percent in State B, and 25 percent in State C, then all of the receipts from that service will be assigned to the numerator of the State A sales factor. In this example, Section 17 operates consistently with the destination principle only when the customer receives 100 percent of the services in State A. Otherwise, all

⁴⁶ UDITPA § 17.

⁴⁷ UDITPA § 17(b).

of the receipts from the services will be attributed to State A even though the destination of some or all of the services is another state or states.⁴⁸

Additionally, the internal logic of the costs of performance rule is distinctly circular. If we truly know how to identify where income-producing activity is occurring, then why bother with formula apportionment? The whole point of apportionment is that there is a certain futility (and tremendous expense) involved in separately accounting for income on a geographic basis.⁴⁹ Moreover, the use of “costs of performance” to measure income-producing activity is a decidedly supply-oriented approach. Siting service receipts based on costs of performance ignores the demand side of the income-producing equation, while very purpose of the sales factor is to give weight to that demand. As a result, Section 17 has the effect of merely duplicating the property and payroll factors because the states in which property and payroll are located are the states in which the costs of performing income-producing activity are generally incurred. One consequence of this duplication is that when a service can be provided remotely the taxpayer’s incentive to (inefficiently) locate its business operations in tax haven jurisdictions is increased.⁵⁰ This is because all income is sourced to the states of production under a place of performance rule.

⁴⁸ As Walter Hellerstein observes:

A ... fundamental objection to UDITPA’s cost-of-performance rule for attributing receipts from services [is that] the rule often fails to serve the purpose of the sales factor to reflect the contribution of the market state to the taxpayer’s income. While services may often be performed in the same state in which they are consumed, this is not always the case, especially with regard to services such as advertising, consulting and other professional services.

HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 8.06.

⁴⁹ Further, the use of the term “income-producing” activity is a bit imprecise in the context of a factor that seeks to measure gross receipts, not net income.

⁵⁰ See Fox, Luna, and Murray, *supra* note 16, at 149 (discussing factor mobility). See also Charles E. McLure, Jr., *Implementing State Corporate Income Taxes in the Digital Age*, 53 NAT’L TAX J. 1287, 1300-01 (criticizing the current sales factor attribution rules and advocating a destination-based approach).

Further, applying different rules for the attribution of receipts from the sale of tangible personal property (destination) than are applied for the attribution of service receipts (origin) is not supported by any recognizable theory of public finance:

This treatment raises the question of why the framers [of UDITPA] distinguished between sales of tangible personal property and sales of “other than tangible personal property”. . . . Services are also “made” and sold. While the product at issue may not be tangible, it is nonetheless a product (1) in which capital and labor was employed, (2) which is marketed or sold to customers, and (3) which may be delivered, in completed form, to consumers in states other than the state in which it was made.⁵¹

The most candid response to these criticisms is that Section 17 simply was not that well thought out.⁵² UDITPA was designed for manufacturing and mercantile businesses, excluding by its original terms financial organizations, public utilities, and “the rendering of purely personal services.”⁵³ Additionally, when UDITPA was first promulgated in 1957, it was much more reasonable to assume that customer location would correlate with the place of the performance. Thus, place of performance may have been an acceptable proxy for the market state. This is no longer the case.

⁵¹ Kendall L. Houghton, Sylvia Dennen, and Joanne Borucki, *Apportionment Opportunities and Problems Involving the Sales Factor*, 12 J. OF MULTISTATE TAX’N AND INCENTIVES 1,4 (2002).

⁵² As one of the original participants has written:
Section 17 ... is the weakest part of the act. Why did the drafters give such short shrift to the subject in section 17? My impression is that they thought they had written a good act for manufacturing and mercantile businesses and that most of the non-manufacturing and non-mercantile businesses were not intended to be covered by the act.
Warren, *supra* note 35, at 135.

⁵³ UDITPA § 2.

Moreover, the framers of UDITPA expected that the equitable apportionment provisions of Section 18 would provide ample authority for the development of alternative apportionment methods for service businesses.⁵⁴ Indeed, many states have developed different methodologies for financial services, transportation, telecommunications companies, and other discrete service businesses. As we explore in greater detail in Part IV, most of these alternative approaches have the effect of implementing the destination principle.⁵⁵ These alternative methodologies, however, neither cover the expansive waterfront of service businesses nor have they been adopted (uniformly or otherwise) by all states.

Two possible rationales for the place-of-performance rule merit brief discussion. First, when UDITPA was drafted, there was concern that the sales factor would attribute sales, and thus apportion income, to states with which a business has no nexus, i.e., states that have no jurisdiction to enforce a tax against the business. This would create “nowhere” income. For sales of tangible personal property, this concern was addressed by a “throwback” rule. Under UDITPA’s throw-back provisions, sales to states in which a business is not taxable are assigned (“thrown-back”) to the numerator of the sales factor of the state from which the goods were shipped.⁵⁶ In these cases, the destination principle is trumped by the “single tax”⁵⁷ or “full

⁵⁴ See Pierce, *supra* note 31, at 780 (noting that “there are many unusual fact situations connected with this type of income and probably the general provisions of Section 18 should be utilized for this in these cases,” and suggesting, for example, that the advertising income of a magazine publisher might be apportioned on the same basis as subscription income).

⁵⁵ See *infra* Part IV.A.2.

⁵⁶ UDITPA § 16(b).

⁵⁷ See Reuven Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507, 517 (1997) (expressing the “single tax” principle in the context of international taxation).

accountability”⁵⁸ principle: multi-state businesses should not escape taxation on some portion of their income while, in comparison, a competing local business pays a tax on all of its income.⁵⁹

There is no throwback rule for service receipts. Throwback is not necessary under the existing place of performance rule because it is relatively safe to assume that there will be taxable nexus in the state in which services are performed. Thus, the place of performance rules acts as a crude throwback rule whenever the state of performance is different from the market state, sourcing service receipts to the state of origin.⁶⁰ Proceeding on the assumption that destination-based sourcing is the preferred rule, the obvious fix is simply to adopt a throwback rule for services. The cure is not to perpetuate a flawed attribution rule.

Additionally, a growing number of courts are holding that a physical presence is not required for income tax nexus. Thus, in many states, merely having in-state customers gives rise to nexus for most service businesses, obviating the need to “throwback” the service receipts to the state in which they are performed. Nevertheless, a comprehensive proposal to adopt a market-based approach to service receipts attribution needs to address the nexus and throwback ramifications of the proposed rule.⁶¹

⁵⁸ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 9.18[1][b][i] (expressing “full accountability or “full apportionment” principle in context of the UDITPA throwback provisions).

⁵⁹ The principle only speaks to the taxability of the base, and not the effective tax rate. Multistate businesses enjoy, or suffer from, the various tax rates that apply in the states in which they are taxable. For this purpose, they are taxable in a jurisdiction even if the state has not adopted a corporate income tax.

⁶⁰ If one further assumes that a service provider will have no nexus with the market state whenever the market state is not also the state of performance, then the service rule operates very similarly to the tangible personal property throwback rule. This, however, is often not the case. A service provider, for example, often will have (nexus-creating) payroll or property in the market state even though a greater proportion of the costs of providing services to customers in the market state are incurred elsewhere.

⁶¹ These are addressed in Part VI.B.

A second possible justification for the existing place of performance rule is that it counterbalances the current trend of super-weighting the sales factor.⁶² For those who oppose this trend, the place of performance rule acts as a stealth origin rule for businesses that provide services from a distance. Obviously, this is not much of a justification for the existing rule. Even if one accepts the notion that super-weighting of the sales factor is misguided, the place of performance rule does little to fix the overall problem and distinguishes without justification between remote service providers and other businesses.⁶³ Moreover, tax rules and their effects should be transparent so that policymakers can make clear choices. Rules with unintended consequences do not further this end.⁶⁴

In summary, the UDITPA sales factor has failed to live up to its billing as market state representative. While its rules for attributing receipts from the sales of tangible personal property are market state based, its rule for attributing service receipts are not. On this ground alone, the sales factor is sorely in need of revision.

C. Compliance with Section 17: Confusion and Controversy

One possible justification for the distinction that UDITPA makes between the attribution of receipts from tangible personal property and other receipts is administrability. Perhaps the

⁶² See *supra* notes 14-18 and accompanying text (discussing sales factor super-weighting trend).

⁶³ For example, it distinguishes between remote sellers of good, whose sales are sourced to the destination, and remote sellers of services. See *supra* note 51 and accompanying text.

⁶⁴ As previously noted, the place of performance rule has the unintended consequence of attributing service receipts to their origin rather than destination. See *supra* note 11 and accompanying text. The framers of UDITPA intended the place of performance rule to be a reasonable proxy for service destination, which again, in the electronic age, is no longer the case. See Pierce, *supra* note 31, at 780 (“it is believed that the contribution of the consumer states toward the production of the income should be recognized by attributing sales to those states”).

Section 17 attribution rules ease the burdens of compliance and enforcement. In practice, however, the opposite is the case. Walter Hellerstein observes:

Although the market state rule for sales of tangible personal property has spawned some confusion and controversy in the implementation of its finer details, for the most part it provides a workable, definite standard for manufacturers to use in structuring their affairs and avoiding state tax controversies. *On the other hand, the UDITPA standard for service providers is a confusing and indefinite standard. Even state taxing authorities have reported difficulties in applying the UDITPA sourcing standard to the sale of services.*⁶⁵

Indeed, there has been a chorus of criticism addressed to the difficulties of interpreting and complying with UDITPA's attribution rules for service providers, and the voices from both the tax paying and tax collecting communities are in near (and rare) unison.⁶⁶

The first major criticism is that the rules force a threshold question which is often difficult to answer: is a receipt from the sale of tangible personal property or from providing a service or licensing or selling an intangible? If the receipt is from the sale tangible personal

⁶⁵ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 10.02[a] (emphasis added).

⁶⁶ See, e.g., Jack R. Kramer, John Wertz, and Megan Wickham, *Should Traditional State Income Tax Rules Apply to Internet Advertising?*, 38 ST. TAX NOTES 523, 524-27 (2005); Benjamin F. Miller, *Current Problems with UDITPA and Possible Solutions*, 38 ST. TAX NOTES 125, 126 (2005); William H. Weissman, *An Argument for Sourcing Sales of Software as Tangible Personal Property for California Franchise and Income Tax Purposes*, 32 ST. TAX NOTES 429, 436 (2004); Francina A. Dlouhy & Scott B. Novak, *Sourcing Receipts Using the "Income-Producing Activity" Test*, 32 ST. TAX NOTES 55, 56 (2004); William H. Weissman, *Are You Using the Same Ruler? Measuring Direct Costs in Real Dollars*, 25 ST. TAX NOTES 805, 807-11 (June 2, 2003); Kathleen K. Wright, *California's Sales Factor Needs Repair*, 25 ST. TAX NOTES 143, 145-46 (Jan. 13, 2003); David Hardesty, *Online Services and the Sales Factor*, 24 ST. TAX NOTES 911, 912-15 (Dec. 30, 2002); R. Bruce Johnson, *The Greatest Challenge Facing Our State and Local Tax Systems*, 23 ST. TAX NOTES 949, 951 (June 3, 2002); Houghton, Dennen, and Borucki, *supra* note 51, at 4; John P. Carbone, *Sourcing Receipts in Sales-Factor Apportionment for Service Companies*, 10 J. OF MULTISTATE TAX'N 12, 14 (2000); Michael Herbert, Benjamin Miller, & Jordan Weiss, *Sales Factor And Intangibles: What's Up and What's Down*, 7 ST. TAX NOTES 778 (1993). Cf. Kendall L. Houghton, Jeffrey A. Friedman, and Eric Tesh, *Cable Service Providers' Comments on the MTC Proposed Uniform Regulation for Apportionment of Income from the Sale of Telecommunications and Similar Services*, 37 ST. TAX NOTES 535, 544 (2005) (industry representatives supporting costs of performance approach in context of a proposal to apply market approach to a limited subset of service industries, including the represented industry).

property, then it will be attributed to the market state; but if it is from a service or intangible, then it will be attributed to the state of performance (which often will be the state of origin rather than the market state). Accordingly, significant tax consequences can turn on characterization. Distinguishing among tangible personal property, services, and intangibles has proven to be a nearly intractable problem in the administration of tax law, particular when these items are bundled in seamless product.⁶⁷ The case law and other legal authorities are hopelessly confused and contradictory.⁶⁸ Moreover, with the advent of digital products that are the functional equivalents of tangible personal property, such as digital books, magazines, music, and movies, there remains no sensible rationale for making this distinction. What is most sensible from the standpoint of both efficient tax administration and the policies underlying the sales factor would be to have a single, destination-based, receipts attribution principle applicable to all receipts regardless of character.⁶⁹

The second major criticism of Section 17 is that the all-or-nothing feature of the costs of performance rule can lead to “capricious and inequitable” results.⁷⁰ Recall that *all* receipts from an income-producing activity are assigned to the state in which the “greater proportion of income-producing activity is performed.” Under this rule, for example, it is possible for all the services receipts of a taxpayer to be assigned to a state in which only 10 percent of the income-

⁶⁷ See REUVEN S. AVI-YONAH, *INTERNATIONAL TAX AS INTERNATIONAL LAW* 42-47 (2007) (discussing the role of characterization in the context of the sourcing of income for international tax purposes). See also *infra* note 130-131 and accompanying text (providing example of characterization issue associated with software development).

⁶⁸ *Id.* See also HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 12.08[1] (exploring the characterization issues that plague the American retail sales tax).

⁶⁹ This broad statement of principle would have to subject to a number of exceptions and specific implementing rules. As discussed in Parts IV and V, transaction or industry specific rules are sometimes required, and Part VI acknowledges that intangibles may present some special cases and deserve a separate analysis that is beyond the scope of this Article. The point here is that the destination principle should guide the specific rulemaking as much as possible.

⁷⁰ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 9.18[3][a].

producing activity occurs if the remaining 90 percent of the activity is divided evenly among the remaining 10 states in which the taxpayer has operations.⁷¹

The all-or-nothing costs of performance rule also increases the stakes when making the sourcing determination. For example, if the taxing authorities in two or three states in which roughly the same income-producing activity occurs all successfully contend that the greater proportion of such activity occurred in their state, then the result would be to effectively assign the taxpayer with a nationwide sales factor of 200 or 300 percent.

It might be suggested that the costs of performance rule should be modified to provide for the assignment of service receipts on proportionate basis.⁷² Then the overreaching described above would either not occur or would not be magnified by the all-or-nothing approach. Because of the inherent ambiguities in identifying and measuring an “income-producing activity” and a “cost of performance,” however, the gross number of disputes probably would rise under a proportionate scheme. This is because each incremental change in the assignment of a cost of performance to a state would have a tax impact.⁷³ Nevertheless, the Multistate Tax Commission has sought to mitigate the harshness of the all-or-nothing rule by adopting a model regulation that essentially substitutes a rule of proportionality when a “personal service” is provided.⁷⁴ This introduces, however, a new characterization issue: what is a “personal service” and what is not? Further, because there is no principled reason to distinguish between “personal”

⁷¹ Textual example suggested in Miller, *supra* note 66, at 126. Miller notes that there are instances, for example, of telecommunications companies taking the position that the numerator of their sales factor in California should be zero, *even with respect to calls that originate and terminate within the state*, because the greater proportion of income-producing activity occurs in another state.

⁷² A number of states have in fact adopted such a rule. *See infra* Part IV.B.3.

⁷³ *See infra* notes 75-88 and accompanying text (discussing ambiguities and interpretative problems associated with Section 17).

⁷⁴ MTC REG. § 17(4)(B)(c) (2007).

and other services for this purpose, a new inequity is introduced. A much broader remedy is in order.

A third major criticism of Section 17 involves the inherent ambiguities in the terms “income-producing activity” and “costs of performance.” Recall that all receipts with respect to a service are assigned to the numerator of the state in which the greatest proportion of income-producing activity occurs, and that the level of income-producing activity is measured by the costs of performance. This has led to frequent litigation⁷⁵ and conflicting court decisions addressing, for example, whether a taxpayer is engaging in one, or multiple, income-producing activities (e.g., operating a single National Hockey League franchise or conducting multiple professional hockey games),⁷⁶ and what is a “cost of performance” (e.g., a cost incurred by independent contractors, sales and marketing, research and experimentation, database management, or billing activities).⁷⁷ Additionally, once the relevant income-producing activity and its associated direct costs (which are typically varied and numerous) are determined, each direct cost must be geographically sourced. This too has led to disputes and administrative difficulties.⁷⁸ The administrative and compliance problems of the place of performance rule have been the subject of extensive commentary and will not be fully rehearsed here. Most relevant to this discussion of administrability is that the commentators have found the rules to be

⁷⁵ “The frequent litigation of this question underscores the potential for disagreement over exactly what ‘transactions and activities’ constitute the IPA—or multiple IPAs—that generate gross receipts.” Houghton, Dennen, and Borucki, *supra* note 51, at 3.

⁷⁶ *Boston Professional Hockey Association v. Commissioner of Revenue*, 443 Mass. 276, 820 NE2d 792, 800 (2005).

⁷⁷ See generally Kramer, Wertz, and Wickham, *supra* note 66; Hardesty, *supra* note 66 (thoughtful reviews and analyses of the practical and accounting problems associated with costs of performance approach to service receipts attribution).

⁷⁸ *Id.* See also *supra* note 66.

“confusing and indefinite,”⁷⁹ plagued by “vagueness,”⁸⁰ “ambiguity,”⁸¹ “substantial debate,”⁸² “lack of clear guidance,”⁸³ “whipsaw[ing],”⁸⁴ “tremendous flexibility, and hence [tax planning] opportunity,”⁸⁵ “frequent litigation,”⁸⁶ “inconsistency,”⁸⁷ and “confusion for taxpayers and taxing authorities alike.”⁸⁸

D. Conclusion

Reform of UDITPA’s service receipts attribution rules is long overdue. In a modern economy, the place of performance standard is no longer a reliable proxy for identifying the state that provides a market for the taxpayer’s services. In addition, the conflict between the place of performance standard applied to services and the destination principle applied to tangible personal property puts too much pressure on the characterization of mixed (services/goods) transactions. Significantly different tax consequences can flow from this often arbitrary and finely-spun distinction. Moreover, the current all-or-nothing approach to place of performance can result in arbitrary and distortive apportionment results. Finally, the place of performance

⁷⁹ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 10.02[2][a].

⁸⁰ Kramer, Wertz, and Wickham, *supra* note 66, at 529.

⁸¹ Dlouhy and Novak, *supra* note 66, at 55.

⁸² Kramer, Wertz, and Wickham, *supra* note 66, at 526.

⁸³ Weissman, *supra* note 66, at 810-11.

⁸⁴ Houghton, Dennen, and Borucki, *supra* note 51, at 2.

⁸⁵ Houghton, Dennen, and Borucki, *supra* note 51, at 2.

⁸⁶ Houghton, Dennen, and Borucki, *supra* note 51, at 4.

⁸⁷ Weissman, *supra* note 66, at 807.

⁸⁸ Dlouhy and Novak, *supra* note 66, at 56.

standard is plagued with other administrative and compliance complications, such as those arising from the difficulty of identifying and geographically sourcing income-producing activities and costs of performance.

III. A COMPARATIVE LOOK THE ADMINISTRATIVE VIRTUES OF ORIGIN AND DESTINATION SALES FACTOR SOURCING

It is incumbent upon those advocating abandonment of an old rule to suggest a new one. We must look before we leap. As convinced as one might be of the theoretical superiority of a destination-based service receipts attribution rule, the nagging question of administrability still remains. The quickest retort is that the place of performance rule has administrative and compliance frailties of its own, but this does not fully allay the concern. In this Part we address this concern by comparatively exploring the administrative and compliance issues that arise from destination-based and origin-based attribution rules for service receipts. In particular, we evaluate these rules in light of four factors that influence the complexity and burden of service receipts attribution: (1) multiple points of use and production; (2) transaction type (B2C or B2B); (3) tax return volume complexity; and (4) accounting and interpretive complexity.

A. Multiple Points of Use and Production

The administration of a receipts attribution rule, whether destination-based or origin-based, is usually less troublesome when the relevant activity occurs in a single jurisdiction.⁸⁹ If

we use an origin-based approach and know that all production occurs in one state, then the origin approach presents little problem.⁹⁰ Similarly, if we use a destination-based approach and the services are received in a single state, then we also usually avoid complexity.⁹¹ Problems typically only arise when the relevant activities straddle more than one jurisdiction. In this situation, the taxpayer is faced with the additional burden of parsing a single transaction and its associated costs or receipts. Interpretive complexity will also often enter into the equation.⁹² Table 1 explores this basic point by comparing the relative administrability of origin-based and destination-based attribution rules based solely on the variable of whether the rule implicates single or multiple jurisdictions. The entries in each cell describe the relative compliance burden (low/high) of the sourcing methodology (origin/destination).

⁸⁹ What is meant by relevant activity occurring in one state is the activity that drives the attribution determination. The transaction could still be multistate, but, because of the applicable attribution rule, the number of destinations or places of production would not be relevant.

⁹⁰ There are exceptions to this generalization, and at times it is difficult to determine where an activity occurs, or even what constitutes a single activity. *See supra* note 76 and accompanying text.

⁹¹ Problems can still arise, particularly in a B2B transaction, where receipt of, for example, an accounting service could nominally be received in a single state but arguably is provided company-wide. *See infra* Part V (Guideline 4) for a discussion of and suggested approach to this problem.

⁹² For example, if a company in State A manages the direct mail activities of a company in State B, and the mailings are sent to States C and D, the interpretive question arises as to whether the service is received in a single State (State B), States C and D, or, possibly, States B, C, and D. These interpretive issues are examined in Part V and Part VI.C, and examples of rules addressing this scenario are discussed in Part IV.B.3.

Table 1

	Single Destination State	Multiple Destination States
Single Production State	Origin (low) destination (low)	Origin (low) Destination (high)
Multiple Production States	Origin (high) Destination (low)	Origin (high) Destination (high)

*

When the production and delivery of a service each occurs in a single state,⁹³ the compliance burden of attributing the receipts from the transaction, in relative terms, is low under either a destination or origin rule. Similarly, when both production and delivery of a service occur in multiple states, then the relative burden of attributing the receipts from the transaction under each rule is generally higher. Where all production occurs in a single state but the service has a multiple destinations, then an origin-based rule would be more administrable (all else being equal), while where production is multistate but there is a single destination state then a destination-based rule would be more administrable, under this simple measure.⁹⁴

⁹³ This includes both where all activity occurs in a single state and where production occurs solely in State A and delivery occurs solely in State B.

⁹⁴ It should be emphasized that this discussion focuses on the burden of attributing receipts from *each separate* service transaction. As discussed in Part III.C *infra*, a service provider often will have many more attributions determinations to make because of the multiplicity of customers, while the attribution of the costs of production of each transaction may often be made by reference to the same set of costs. This is because the service provider will frequently be providing services to customers A, B, C, D and so on from the same location or locations, and therefore it can rely on the same costs of production determination when attributing receipts from multiple customers.

To be sure, Table 1 is based on several simplifying assumptions. Most importantly, it assumes that the variable single/multiple jurisdictions is the only variable relevant to complexity. This is of course an oversimplification. For example, there might be something more difficult about identifying the destination of a transaction than identifying its source, even if that destination is a single jurisdiction.⁹⁵ Additionally, remembering that the task under the existing costs of performance rule (origin rule) is to identify the state in which the greatest amount of income-producing activity occurs—and not to allocate receipts to every state in which there is income-producing activity—the task of assigning receipts may not be particularly challenging when the preponderance of production in a multistate scenario clearly occurs in a single state.⁹⁶ Further, even if the single/multiple jurisdictions variable were the only relevant factor, it could be the case as an empirical matter that there are far more transactions involving multi-jurisdictional destinations than multi-jurisdictional production.⁹⁷

The purpose of Table 1, however, is not to point to any hard conclusions about the relative administrability of these two basic approaches to service receipts attribution. It is presented, rather, to: (1) frame the multi-jurisdictional inquiry issue, demonstrating that it arises in the context of both attribution rules; (2) illustrate that there are “easy” (single jurisdiction) cases under the theoretically preferable destination-based approach.

⁹⁵ I argue later that the opposite is the case: it is typically easier to source a single output of an economic activity than to trace all its inputs. *See infra* Part III.D (discussing accounting and interpretive complexity).

⁹⁶ *See supra* notes 70-71 and accompanying text (discussing all-or-nothing approach to costs of performance analysis).

⁹⁷ *See infra* Part III.B for an approach to answering that question.

B. B2B and B2C Transactions⁹⁸

The premise that service receipts attribution is generally most complex when the question involves multiple jurisdictions leads naturally to the inquiry whether origin or destination sourcing is more likely to involve multi-jurisdictional issues.⁹⁹ Table 1 does not speak to that question. While it presents the logically possible fact patterns under the single/multi-jurisdiction dichotomy, it does nothing to address the frequency of their occurrence. One approach to answering this question is to examine another dichotomy: B2B versus B2C transactions.

Table 2 illustrates the simple point that under an origin-based rule, origin will *always* be associated with a business entity; while under a destination-based rule, the customer will *sometimes* be an individual consumer rather than a business.¹⁰⁰ Accordingly, by switching to a destination-based receipts attribution rule, we immediately obtain some simplification based on the reasonable and empirically verifiable assumption¹⁰¹ that individuals usually consume a service in a single jurisdiction (their state of residence), while business entities are often far-flung, both nationally and internationally.¹⁰²

⁹⁸ This means business-to-business and business-to-consumer transactions. This jargon has no doubt permeated the academic, professional, and popular vernacular to the extent that it requires no explanation, but I nevertheless err on side of caution.

⁹⁹ Again, by multi-jurisdictional I mean a situation in which a destination-based rule is applied to a transaction that has multiple destinations, or in which an origin-based rule is applied to a transaction that involves production in multiple jurisdictions. I do not mean a transaction in which a service produced entirely in State A is sold to a customer who receives and uses the service solely in State B.

¹⁰⁰ A business will always be the seller (one can imagine trivial exceptions), while the purchaser can be either an individual consumer or another business.

¹⁰¹ Consumers are typically only present in a single jurisdiction when consumption occurs. There are of course exceptions and tough cases, for example, a consumer's purchase of interstate transportation services or tax return preparation services covering state income tax returns for several states. Reasonable proxies can resolve most of these questions. See Part V.

Table 2

B2C	B2B
Destination approach (C) Origin approach (B)	Destination approach (B) Origin approach (B)

One should not press this analysis too far. For example, many service businesses may have a single, unambiguous place of performance, but have a nationwide customer base. For these taxpayers, switching to a destination rule could increase compliance complexity. This observation introduces the next factor to be considered—tax return volume complexity.

C. Tax Return Volume Complexity

One undeniable consequence of a destination-based rule is that service businesses, in the aggregate, will be asked to file more state tax returns. This is because the customers of a remote service business generally are more far flung than the business’s production location(s). There are many service businesses that are located in one state (or a handful of states) but that have customers in every state, and perhaps most continents.¹⁰³ Under the current income-producing activity approach to service receipts attribution, however, the sales factor generally attributes

¹⁰² Here we are speaking of the compliance burden of attributing receipts from a single transaction with multiple destinations. Later we address complexity arising from the burden of filing a greater number of state tax returns.

¹⁰³ With a destination approach, the apportionment ratio in states to which services are sourced will be greater than zero because the numerator of the sales factor will be greater than zero.

income only to states in which taxpayers have property and payroll.¹⁰⁴ As a result, many service businesses currently are not required to report income in many of their market states. This genre of complexity should be distinguished from the complexity that has been heretofore discussed—the difficulty, on a transaction by transaction basis, of attributing service receipts when a single service is delivered to (or produced in) several jurisdictions.¹⁰⁵

By way of comparison, sales of tangible personal property are already subject to a destination-based attribution rule, and so one might think that remote sellers of tangible products have traditionally borne and tolerated this same burden.¹⁰⁶ A long-standing federal statute, however, commonly known as P.L. 86-272, has protected sellers of tangible personal property (but not service businesses) from incurring a state income tax obligation as long as the seller’s in-state activities are limited to mere solicitation.¹⁰⁷ Though P.L. 86-272 has its supporters,¹⁰⁸ it has long been the subject of academic criticism,¹⁰⁹ and it has not restrained state courts from

¹⁰⁴ This generalization has been softened recently because the income-producing activities of independent contractors are now considered under model MTC regulations, and these activities can occur in states in which the taxpayer has neither property nor payroll. *See supra* note 12 and accompanying text.

¹⁰⁵ Put differently, this Article addresses the complexity of making service attribution determinations when preparing any particular tax return, and not the question of how many returns would need to be filed. As discussed in Part VI.C, however, the number of returns filed can increase the possibility of double taxation or under taxation when state laws and their interpretations are not uniform. Achieving and institutionalizing uniformity should be a major objective of the UDITPA reform process.

¹⁰⁶ UDITPA § 16.

¹⁰⁷ 15 U.S.C. § 381 (2007). This statute is customarily referred to by its Public Law number, 86-272, and this Article adheres to this custom.

¹⁰⁸ *See* Doug Sheppard et al., *Shining a Blue Light on Nexus: Katz and Rosen Debate the Kmart Decision*, 23 ST. TAX NOTES 847 (2002) (a lively debate between a tax administrator and high-profile tax attorney over P.L. 86-272 and related jurisdiction to tax issues).

¹⁰⁹ *See, e.g.*, John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 393-94 (2003) (the “safe harbors” of P.L. 86-272 “have no place in a modern economy”); Charles E. McLure, Jr., *A Comprehensive and Sensible UDITPA*, 37 ST. TAX NOTES 929, 931 (2005) (“the nexus standard of P.L. 86-272 is one of the nuttiest features of the state corporate income tax ‘system’”); Fox, Luna, and Murray, *supra* note 16, at 144 (“repealing the statute would lessen economic distortions and help curb tax planning”); Walter Hellerstein and Charles E. McLure, Jr., *Congressional Intervention in State Taxation: A*

holding that service businesses are subject to a state's income tax jurisdiction even though they have no physical presence in the state.¹¹⁰

I have argued elsewhere that a more sensible approach to protecting business taxpayers from the burden of tax volume complexity would be to adopt a clear *de minimis* nexus standard.¹¹¹ Under such a rule, service (and other) businesses whose sales (on a destination basis), property and payroll fall below certain thresholds would not be required to file returns. If one puts to one side the P.L. 86-272 debate, which is beyond the scope of this Article, the tax return volume complexity issue is at bottom a nexus concern, and it should be addressed by nexus rules.¹¹² It should not be addressed indirectly through the perpetuation of a flawed (origin-based) receipts attribution rule applicable to all services providers regardless of the extent of their exploitation of the destination market.

D. Accounting and Interpretive Complexity

Up until this point the discussion has nibbled around the edges of the problem, treating as the only variable the frequency with which multi-jurisdictional questions arise under the competing origin-based and destination-based approaches. A full consideration of administrability, however, requires the weighing of other factors. We earlier discussed a number

Normative Analysis of Three Proposals, 27 ST. TAX NOTES 721, 734 (2004)(criticizing proposals to extend defects of P.L. 86-272, such as revenue loss and tax planning opportunities, to other types of activities and taxes).

¹¹⁰ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 6.11 (“clear trend” of the case law is the acceptance of an economic presence standard for income tax nexus purposes).

¹¹¹ John A. Swain, *supra* note 109, at 389-93.

¹¹² See John A. Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343 (2003); Swain, *supra* note 109, at 348-59 (extensive discussions of nexus policy issues).

of criticisms of the origin-based rule, including the interpretive problems of (a) distinguishing between services and sales of tangible personal property and (b) delimiting the scope of “income-producing activity” and “costs of performance.”¹¹³ Interpretive questions also arise under a destination-based rule. For example, how do we source a transportation service that crosses state lines or an accounting service rendered to a multinational corporation? Still, it is not too speculative to suggest that these interpretive questions are generally easier to resolve than the problem of identifying which of the *many inputs* (costs of performance) count, which do not, how to measure them, and how to geographically attribute them, for the purpose of calculating costs of performance of a *single output*.¹¹⁴

Even when there are no interpretive issues, the accounting challenge of measuring and sourcing costs of performance is generally more challenging than identifying the destination of a service. Reasoning by analogy for a moment, suppose that receipts from sales of tangible personal property were attributed to the sales factor numerator based on costs of performance. Tracing the costs of producing an automobile, for example, would be a mind-numbing task compared to determining the location of the purchaser. Now consider telecommunications services. It is of course usually easier to identify the state in which a caller is located than it is to trace all the inputs to providing the call.¹¹⁵ Indeed, a call placed one moment may be routed through equipment in States A, B, and C, while the same call the next moment might be routed

¹¹³ *Supra* Part II.C.

¹¹⁴ Part V proposes guidelines for implementing the destination principle and suggests that workable proxies for place of use and enjoyment of a service, such a residence or business location, can resolve most issues.

¹¹⁵ Even in the age of mobile telephones, it is a safe assumption that most calls are made in the state of residence or billing address. THE MOBILE TELECOMMUNICATIONS SOURCING ACT 114 STAT. 626 (July 28, 2000), codified at 4 USC § 116, imposes a uniform method of sourcing these services nationwide for excise tax purposes, relying largely on the proxy, “place of primary use,” to source all calls placed by a single customer. In turn, the proxy for “place of primary use” is usually a billing address.

through equipment in States D, E and F. Benjamin Miller, California Franchise Tax Board counsel, relates: “Recently, some members of the telecommunications industry have asserted claims that the numerator of the sales factor in California should be zero, *even to the exclusion of intrastate calls*, because the greatest cost of performance is located in another state.”¹¹⁶

An additional drawback of using *costs* to situs *receipts* is that some of the costs of performing a service rendered in the current tax year often were incurred in past accounting periods, some quite ancient. Where, for example, were the costs of loading cases onto the Westlaw or Lexis legal research databases incurred during the 1980’s?¹¹⁷ In contrast, delivery of the service associated with a service receipt almost always occurs during the current tax year, eliminating the problem of identifying the location at which historical costs were incurred.¹¹⁸

E. Conclusion

Along with being the better rule from a substantive tax policy perspective, there are also good reasons to believe that a destination-based receipts attribution rule is administrable. First, there is a large class of service transactions—B2C transactions—for which, generally speaking, the task of attributing receipts will be relatively easy. Second, a destination-based rule is not plagued with the interpretative and accounting complexities that afflict the origin-based rule, in particular, identifying, measuring, and geographically sourcing “costs of performance” and

¹¹⁶ Miller, *supra* note 66, at 126 (emphasis added).

¹¹⁷ This information may be known to the company or found in its records, but supporting information is difficult to find for audit purposes. It is important to distinguish between identifying the geographical location at which a cost was incurred and the cost itself. For financial accounting, tax, and regulatory reasons, taxpayers usually have captured historical cost information, for example, to calculate cost basis and depreciation.

¹¹⁸ There are of course various minor exceptions related to prepayments, delinquent payments, and so on, although accrual accounting resolves many of these potential disconnections between year of payment and year in which a service is performed.

“income-producing activities.” Third, a destination-based receipts attribution rule is consistent with the method applied to attribute receipts from the sale of tangible personal property. Thus, it avoids the compliance and enforcement costs associated with having very different tax consequences pivot on whether a transaction is characterized as a service or a sale of tangible personal property.

To be sure, many service providers will have to file tax returns in more jurisdictions than they do currently. Customers can be far flung. However, this is not to say that the specific task that this Article addresses—the computation of the numerator of the sales factor—will be difficult for these taxpayers. Often, the destination of the service will be readily identifiable. The issue of the burden of filing in remote jurisdictions is best addressed by jurisdictional rules that exclude from compliance obligations taxpayers whose in-state presence or activities fall below a certain threshold. The nexus issue should not be addressed by contorting the substantive sourcing rules.

The greatest challenge for a destination-based service receipts attribution rule is the attribution of receipts for service transactions with multiple or ambiguous points of use. In Part IV, we explore some models for addressing this challenge. For the moment, however, it should be emphasized that the administrative challenges of a destination-based rule are no reason for turning back to an origin-based approach. This approach, it has been demonstrated, has problems of its own.

IV. DESTINATION-BASED SOURCING MODELS

A. Introduction: Principles, Proxies and Existing Models

This Article has made the substantive tax policy case for destination sourcing of receipts for sales factor purposes. It has also argued that a destination-based rule is administrable. Thus far no attempt has been made to develop the rule beyond the mere statement of the destination principle. There is no shame in this. Many a tax statute does the same. For example, UDITPA sources “non-business” patent and copyright income to a state “if and to the extent that the patent or copyright is utilized by the payer in this state.”¹¹⁹ Indeed, rules based on principles can be elaborated in great detail by reference to other principles and concepts. A fully elaborated destination rule, for example, would explore what we mean by “market” or “destination,” perhaps relying on concepts such as “use and enjoyment” or “receipt of benefit” of the service.

At some point in tax administration, however, we usually encounter interpretive and metric challenges if our only guide is a rule articulated as a principle. In such circumstances, more administrable proxies for the principle-based rule are used.¹²⁰ Consider, for example, a magazine publisher that has substantial advertising income. How should its advertising receipts be attributed under the destination principle? Perhaps they should be attributed to the business headquarters of the advertisers since they are the magazine’s advertising customers. Alternatively, since the advertisers arguably receive the benefit of the advertising where the readers are located, perhaps the receipts should be attributed to the states in which the magazine

¹¹⁹ UDITPA § 8.

¹²⁰ See Walter Hellerstein, *Consumption Taxation of Cross-Border Trade In Services in an Age of Globalization 2* (2008) (forthcoming) (discussing role of proxies for making sourcing determinations).

is sold. If this latter approach is considered to be the most accurate (or administratively convenient) application of the general principle, how would this attribution be accomplished? One approach would be to use magazine circulation or subscription revenue by state as a proxy for the general principle.¹²¹

This is all to say that the National Conference of Commissioners on Uniform State Laws faces important drafting challenges and choices. Once a principle for attributing services is identified, it must be articulated and explained. Perhaps some proxies of global application could be developed, such as “location to which the service is provided,” but it would be too great a task to draft a statute that fully addresses every industry or scenario. Ultimately, as with other tax statutes, interpretative questions will have to be left to regulations, other administrative guidance, and—regardless of how well the rules are articulated—judicial interpretation.

Fortunately, this will not be the first time that tax policymakers have sought to apply the destination principle to receipts from services (or intangibles). Income tax models can be found in states that already have adopted the destination approach, in model regulations promulgated by the Multistate Tax Commission that apply the destination principle to discrete service businesses, and in the existing version of UDITPA (non-business royalties and sales of tangible personal property).¹²² Consumption tax models can be found in the Streamlined Sales and Use Tax Agreement and various Organization of Economic Cooperation and Development (OECD) and European Union (EU) value-added tax (VAT) initiatives.¹²³ What follows is a brief exploration of these models.

¹²¹ This example was given when UDITPA was originally drafted. *See infra* note 54.

¹²² *See* Part IV.B (discussing income tax models).

¹²³ *See* Part IV.C (discussing consumption tax models).

B. Income Tax Models

1. The UDITPA Receipts Attribution Rule for Tangible Personal Property

A natural area of initial inquiry is UDITPA's destination-based rule for attributing receipts from the sale of tangible personal property. It provides that sales are within a state if "the property is delivered or shipped to a purchaser ... within this state regardless of the f.o.b. point or other conditions of the sale."¹²⁴ The comments to this provision advise that "shipped to or delivered" in this state includes shipments made directly to a person in the state at the direction of the purchaser (i.e., drop shipments).¹²⁵ The Multistate Tax Commission regulations further reinforce the place of delivery rule by providing that shipments delivered to a retailer who subsequently ships the goods to customers or branch stores out-of-state are still attributed to the in-state retailer.¹²⁶ The rules also address the other side of the coin: If a central purchasing office places an order for items that the seller ships directly to out-of-state branch offices or stores, then those sales are attributed to the state in which the branches or stores are located and not to the state in which the purchasing office is located.

Note that the place to which a product is shipped or delivered is used as a proxy for the market. Purchasers might, of course, take delivery in State A but use the property in State B. In these cases a strong argument can be made that State B is the market state. Sensibly, the rules do not attempt to capture the State B market and are based on the underlying assumption that for

¹²⁴ UDITPA § 16.

¹²⁵ UDITPA § 16, comment.

¹²⁶ MTC REG. § IV.16.(a)(3).

most transactions the state of delivery will also be the state in which consumption occurs.¹²⁷ The initial drafting point here is that UDITPA already employs proxies and there is no reason to avoid them if they are the most sensible and administratively feasible means to implement the destination principle.

More directly relevant to what has been identified as the biggest problem area—multi-jurisdictional service transactions—are the rules addressing drop shipments, wholesale transactions, and central purchasing. In a concession to administrative realities, the tangible personal property rules follow the physical flow of delivery. As noted, drop shipments are sourced to the actual recipient, and business purchases are sourced to the office to which the product is delivered even if the purchaser subsequently delivers the property to other stores or branches. When products are delivered directly to a branch, however, the sales are sourced to the state in which the branch is located. Similar issues will arise when attributing service receipts on a destination basis. These issues frequently will be harder to resolve, however, because of the intangible nature of many services. There is often no discretely traceable physical flow as there is with tangible personal property. Additionally, some services can be delivered and redelivered electronically at little cost. Thus, the service receipts attribution rules may need to be more sensitive to the possibility that taxpayers may use intermediaries situated in tax-haven jurisdictions to facilitate tax avoidance transactions.¹²⁸

A final reason to cast an eye on the tangible personal property rules is that these rules must be in sync with the service receipts attribution rules in order to avoid the problem identified

¹²⁷ MTC REG. § IV.16.(a)(2).

¹²⁸ Part V provides guidelines for resolving these questions.

earlier of having substantial tax consequences turn on nuanced characterizations.¹²⁹ It is useful here to consider an example. Assume that S delivers semi-custom payroll management software to B at its branch office in State X, a low tax jurisdiction.¹³⁰ After installation, the software is immediately accessible electronically by the customer's offices in states Y and Z. The office in State Z is the office that is actually responsible for payroll management. If characterized as the sale of tangible personal property, then the sale would be attributed to State X, the state of delivery. If characterized as a service, then to avoid a characterization dispute, the service receipts should also be attributed to State X. Taxing authorities might argue, however, that the receipts should be apportioned among the branch offices, or attributed to the payroll management office, in order to avoid the tax planning opportunity of delivering the product to a low tax jurisdiction.¹³¹

Tax planning opportunities aside, it is fair to suggest that delivery location is a less accurate proxy for the market when the product can be delivered electronically. To ask taxpayers to ferret out where a customer uses its products, however, would be an administrative

¹²⁹ See *supra* notes 67-69 and accompanying text.

¹³⁰ Developing and licensing custom software is generally viewed as a service or intangible, while licensing canned software is generally viewed as the sale of tangible personal property, at least if delivered via a tangible medium. See HELLERSTEIN & HELLERSTEIN *supra* note 3, ¶ 9.18[4][d] (discussing software and related characterization issues). See also Weissman, *supra* note 66, at 429 (proposing that software be treated as tangible personal property for sales factor purposes).

¹³¹ Tax planning in these cases will be limited by business realities. Remembering that we are considering the tax liability of the seller and not the buyer, an unrelated third-party buyer will have little interest in contorting its purchases to accommodate the seller's income tax planning objective. If, for example, the tax were a consumption tax (such as a sales tax) that the buyer was legally or contractually liable to pay, then the buyer would have a greater incentive to join in the tax planning. See *infra* Part IV.C.1 (discussing distinctions between consumption taxes and income taxes, including differences in where the tax planning incentives lie). Coase theory and its variants would suggest that a negotiation might ensue, and sometimes it does, but as noted, the income tax benefits tend not to be as great as the consumption tax benefits, so transaction costs envelop the income tax planning opportunities much more quickly. For the purpose of this discussion, it is assumed that combined reporting is required. If affiliated companies can separately report their income, then the opportunity for tax planning increases considerably. See Fox, Luna, and Murray, *supra* note 16, at 144-48 (discussing advantages of combined reporting and tax planning opportunities created by separate entity reporting). See *infra* note 223 (for additional discussion of the tax planning differences between state income taxes and sales tax).

nightmare for many taxpayers, unless other administrable proxies could be identified. I offer no answer to this dilemma for the purpose of this immediate discussion,¹³² except to note (a) that essentially the same characterization issue already arises under the existing rules and (b) the tangible personal property rules could also be adjusted during the UDITPA rewrite in order to facilitate synchronization.

In summary, the current UDITPA tangible personal property rules illustrate the use of an administratively feasible proxy to implement the destination principle. The rules also model approaches to the problem of multiple points of delivery. Finally, it will be important to keep these rules in view during the UDITPA re-write process so that they are coordinated, when possible, with the attribution rules for non-tangible personal property transactions.

2. The Multistate Tax Commission's Industry Specific Model Apportionment Regulations

The original framers of UDITPA fully acknowledged that one size would not fit all, and that deviations from the standard three-factor formula should be accommodated and even encouraged for certain industries and transaction types. As we have noted, this was particularly true with respect to transactions other than sales of personal property. The framers acknowledged that “there are many unusual fact situations connected with this type of income and probably the general provisions of Section 18 [authorizing the adoption of alternative apportionment methods] should be utilized for this purpose.”¹³³

¹³² See *infra* Part V for guidelines for implementing the destination approach in this and other circumstances.

¹³³ Pierce, *supra* note 31, at 780. Even at that time it was suggested, for example, that it might be “difficult, if not impossible, to ascertain the state of [income-producing] activity for the advertising revenue received by a magazine publisher. Accordingly, a better approach might be to apportion advertising income on the same basis as circulation income” (to which the tangible personal property destination-based rules would apply). *Id.* at 781.

In the ensuing years, state legislatures and tax administrators have adopted numerous industry-specific alternative apportionment methods by statute or regulation. Additionally, the Multistate Tax Commission (MTC) has adopted model apportionment regulations for a number of industries.¹³⁴ Focusing on the MTC's model regulations, perhaps the most pertinent observation is that they all embrace a destination-based approach to receipts attribution: airlines (departure ratio);¹³⁵ construction contractors (construction costs of in-state project);¹³⁶ financial institutions (borrower or real property collateral location);¹³⁷ railroads (mileage ratio);¹³⁸ trucking companies (mileage ratio);¹³⁹ broadcasters (audience ratio);¹⁴⁰ and publishers (circulation factor).¹⁴¹ Although we cannot leap to any hard conclusions, if “the devil is in the details,” then the destination approach appears to be the salvation when the details are in focus.

Industry specific regulations, however, cannot be viewed as a comprehensive solution to the service receipts attribution problem. Putting out tax fires is not enough, and guiding

¹³⁴ It is also currently working on model apportionment regulations for the telecommunications industry. *See* MULTISTATE TAX COMMISSION, PROPOSED UNIFORM REGULATION FOR APPORTIONMENT OF INCOME FROM THE TELECOMMUNICATIONS AND SIMILAR INDUSTRIES, *available at* <http://www.mtc.gov/Uniformity.aspx?id=1820>.

¹³⁵ MTC REG. 18.(e) (airlines).

¹³⁶ MTC REG. 18.(d) (construction contractors).

¹³⁷ MULTISTATE TAX COMMISSION, RECOMMENDED FORMULA FOR THE ALLOCATION AND APPORTIONMENT OF NET INCOME FROM FINANCIAL INSTITUTIONS (1994). More specifically, interest earned on loans not secured by real property is attributed to the state in which the borrower is located. Interest earned on loans secured by real property is attributed to the location of the real property. There are also special rules applicable to other types of services and products. Income from services not directly addressed in the regulations, however, is sourced based on costs of performance. The rules do not provide a direct answer to interest attribution when the borrower is multistate business, other than that the receipts are sourced to the state where the “borrower is located.” *See* HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 10.06[4][a][iii] (discussing the trade-off between substantive tax policy and tax administration in attributing interest received in connection with loans to multistate businesses).

¹³⁸ MTC REG. 18.(f) (railroads).

¹³⁹ MTC REG. 18.(g) (trucking companies).

¹⁴⁰ MTC REG. 18.(h) (broadcasters).

¹⁴¹ MTC REG. 18.(j) (publishers).

principles and/or proxies must be provided for the unaddressed cases. Further, depending on one's perspective, it could be argued that Section 18 authority has been excruciatingly hard to develop, and so not only are special rules not the answer, but a new UDITPA should avoid over reliance on them. To this I offer both an observation and a suggestion.

First, it is important to recognize that to date the model regulations have been developed against a backdrop that does not embrace the destination approach to services. Despite this obstacle, however, policymakers have been able to shift the focus of the receipts factor from origin to destination in developing these rules. Accordingly, if a new UDITPA embraces the destination approach *ab initio*, then it should be easier to bring interested parties to the table to implement the destination approach in an industry-specific manner. Put differently, taxpayers and taxing authorities will be faced in any event with the challenge of implementing the destination approach under the general rule, and so they will have a much greater incentive to enhance certainty and predictability by adopting industry specific rules than they have had to embrace special rules with substantively different outcomes and tax consequences. Thus, there is reason to be optimistic that industry specific rules can play an important and useful role under a new UDITPA regime.

Second, because certainty and predictability are important to taxpayers, and rightfully so, drafters of the new UDITPA might consider rules that encourage or require taxing authorities (or perhaps an organization of taxing authorities) to give binding, advance guidance to taxpayers on apportionment issues in the absence of formal, state-by-state rulemaking.¹⁴² The Streamlined Sales and Use Tax Agreement (SSUTA), for example, provides a relatively user friendly and timely procedure for obtaining essentially binding interpretations of sales tax questions in

¹⁴² See also *infra* Part VII (suggesting that institutional reforms are necessary to maintain uniformity under a new UDITPA).

member states.¹⁴³ Though beyond this scope of this Article, a revised UDITPA might be well-served by adopting some of the governance mechanisms that have been embraced by SSUTA.¹⁴⁴ If past is prologue, it will only be through such a cooperative effort or mandatory federal legislation that a new UDITPA will make substantial strides towards achieving *and maintaining* uniformity.¹⁴⁵

3. Rules in Destination Approach States

Eight states have already adopted a market state approach to service receipts attribution.¹⁴⁶ Many of these rules are relatively new and yet to be battle-tested, but they do provide drafting models and suggest approaches to attributing receipts from service transactions implicating multiple jurisdictions. These statutes (or regulations) articulate the general destination principle in various ways. Illinois, Maine, and Minnesota specify that receipts are attributed to “where the services are received.”¹⁴⁷ Maryland attributes receipts in-state if “derived from customers within the state.”¹⁴⁸ Wisconsin attributes receipts to where “the

¹⁴³ See generally WALTER HELLERSTEIN & JOHN A. SWAIN, *STREAMLINED SALES AND USE TAX* (4th ed. 2007-08).

¹⁴⁴ See John A. Swain and Walter Hellerstein, *The Political Economy of the Streamlined Sales and Use Tax*, 58 NAT’L TAX J. 605 (2005) (discussing political aspects of the streamlining coalition).

¹⁴⁵ See *infra* Part VII (discussing institutional challenge of maintaining uniformity).

¹⁴⁶ Georgia, Illinois, Iowa, Maine, Maryland, Minnesota, Ohio, and Wisconsin. Ohio is in the process of phasing out its corporate franchise (income) tax and replacing it with a “commercial activity tax” (CAT). The Ohio CAT siting rules are discussed separately *infra*, Part IV.B.4.

¹⁴⁷ 35 ILCS § 5/304(a)(3)(C5)(iv)(2008); 36 ME. REV. STAT. ANN. § 5221(16-A) (2008); MINN. STAT. § 290.191(5)(j) (2008).

¹⁴⁸ MD. REGS. CODE 03.04.03.08(C)(3)(c) (2008).

purchaser of the service received the benefit of the service,”¹⁴⁹ while Iowa attributes receipts to where “the *recipient* of the service receives the benefit of the service.”¹⁵⁰ Georgia has adopted the most expansive language, attributing receipts to the state if either “derived from customers within this state *or* if the receipts are otherwise attributable to this state’s marketplace.”¹⁵¹

The rules are fleshed out in varying levels of detail, and sometimes adopt proxies such as customer domicile, principal place of business, the location from which the order was placed, and billing address. For the purposes of this discussion, we will highlight some of the more interesting and/or viable models.

The Minnesota and Illinois statutes track each other closely. Services provided to a “corporation, partnership, or trust” may be attributed to the state only if the entity has an in-state “fixed place of [doing]¹⁵² business.”¹⁵³ If either the business customer does not have a fixed place of doing business or if the state where the services are received “is not readily determinable,” then the services are deemed to be received “at the location of the office of the customer from which the services were ordered in the regular course of business.”¹⁵⁴ If the

¹⁴⁹ 71 WIS. STAT. § 71.25(9)(dh)(1) (2008) (emphasis added).

¹⁵⁰ 701 IOWA ADMIN. CODE 54.6(422)(1) (2008)(emphasis added).

¹⁵¹ 48 GA. CODE ANN. § 48-7-31(d)(2)(A)(i) (2007). This statute is arguably unconstitutional because it is “internally inconsistent.” See HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 4.15[1](explicating “internal consistency” test); see also Walter Hellerstein, *Is “Internal Consistency” Dead?: Reflections on an Evolving Commerce Clause Restraint on State Taxation*, 61 TAX L. REV. 1 (2007). In other words, if all jurisdictions adopted this rule then many taxpayers would be subject to multiple taxation, because receipts could be derived from “customers within” State A but be “otherwise attributable to [State B’s] marketplace.”

¹⁵² MINN. STAT. § 290.191(5)(j) (2008).

¹⁵³ 35 ILCS § 5/304(a)(3)(C5)(iv) (2008). Additionally, the Illinois statute requests the Illinois Department of Revenue to develop regulations for the broadcast, cable, advertising, publishing, utility services, and other industries. 35 ILCS § 5/304(a)(3)(C5)(iv) (2008).

¹⁵⁴ 35 ILCS § 5/304(a)(3)(C5)(iv) (2008); MINN. STAT. § 290.191(5)(j) (2008).

ordering office “cannot be determined,” the services are then sourced to the billing address.¹⁵⁵

Setting aside for a moment the challenge of construing the phrases “readily determinable” and “cannot be determined,” it can be observed generally that the Minnesota and Illinois statutes acknowledge that there will be hard cases and provide administrable default rules in that event.¹⁵⁶

The Maryland market-approach rules are embodied in regulations that attribute to the state service receipts “derived from customers within this state.”¹⁵⁷ The regulations then consider individual customers and business enterprise customers separately. A service provided to an individual is attributed to the individual’s domicile. The regulations provide two examples: (1) legal services rendered by an out-of-state law firm to an in-state domiciliary (attributed in-state), and (2) accounting services render by an in-state firm to a non-resident (attributed out-of-state).¹⁵⁸

Services provided to business enterprises are also attributed according to domicile, but domicile is given a peculiar meaning in the context of these regulations. The domicile of a service customer “is the state in which is located the office or place of business that provided the *principal impetus* for the sale.”¹⁵⁹ Thus, a customer could be a domiciliary with respect to one

¹⁵⁵ *Id.* Note that this rule essentially throws back services provided to customers without a fixed place of business in a state to the state in which the customer has a fixed place of business. Without uniformity, this statute presents a risk of multiple taxation. For example, if a service is provided in Maine to a business that has no fixed place of business in Maine, Maine would attribute the receipts to Maine while Illinois would throw back the receipts to the customer’s fixed place of business in, say, Champaign-Urbana, Illinois. *See infra* note 156(discussing Maine rule).

¹⁵⁶ The Maine rules are similar to the Illinois and Minnesota rules, except, importantly, there is no requirement that a business customer have an in-state fixed place of business in order for receipts provided to that customer to be attributed to the state. 36 ME. REV. STAT. ANN. § 5221(16-A) (2008).

¹⁵⁷ MD. REGS. CODE 03.04.03.08(C)(3)(c) (2008).

¹⁵⁸ MD. REGS. CODE 03.04.03.08(D) (2008).

¹⁵⁹ MD. REGS. CODE 03.04.03.08(D)(2)(b) (2008).

service transaction but not another. Although somewhat peculiar in form, this rule simply provides that services provided to a business are attributed to the business location that provided the “principal impetus for the sale.” If an office or place of business “cannot be identified as providing the principal impetus for the sale, then the domicile shall be the state in which the headquarters or principal place of business management of the customer is located.”¹⁶⁰

Two examples are given to illustrate the operation of the “principal impetus” rule. In the first example, a service provider redesigns the software for a customer’s central billing operations.¹⁶¹ If the central billing computers are located in Maryland, then the receipts from those services are attributable to Maryland. In the second example, similar services are rendered to redesign all of the operating software of a customer’s multistate computer network, and “no particular office or place of business can be identified as the principal impetus for this contract.”¹⁶² Accordingly, the receipts are attributable to the state in which the customer’s headquarters or principal place of business management is located.

While the principal impetus rule has some appeal, unless it is more fully worked out, it may not satisfactorily address cases in which a principal impetus emanates from several locations of the customer.¹⁶³ For example, if the billing computers had been located in two states in the first example provided in the regulations, would we then turn to the default rule and

¹⁶⁰ *Id.*

¹⁶¹ MD. REGS. CODE 03.04.03.08(D)(2)(b)(2008)(example 3).

¹⁶² MD. REGS. CODE 03.04.03.08(D)(2)(b)(2008)(example 4).

¹⁶³ One might also quibble with only assigning to headquarters receipts from services that are clearly being performed companywide, arguing that these receipts call for a broader allocation than attribution only to the business headquarters. Here, as is so often the case in tax administration, principle must be balanced against administrative realities. A customer will very often not have the kind of detailed information to make such an allocation unless the service is being directly provided to each branch office or operation. *See* Part V (guideline 6) for a discussion of approaches to this issue.

attribute the sales to the customer's headquarters, or would we find two places of impetus and prorate the receipts?¹⁶⁴

One of the examples in the Maryland regulations addresses the troublesome question of identifying the “customer” when a service provider contracts to provide services directly to the customers of the party with whom it contracts.¹⁶⁵ The example given is that of a Maryland subsidiary that administers medical plans on behalf of its out-of-state parent corporation. Some of the plan participants are individuals domiciled in Maryland. The regulation provides: “The fees paid for these administration services are included in the numerator of the subsidiary’s sales factor.”¹⁶⁶ The regulation explains: “This example illustrates that the ultimate customer is determined by the domicile of the individual/business enterprise actually receiving the service.”¹⁶⁷ In other words, Maryland requires services businesses to “look through” to the final consumer if the service business is directly providing services to those consumers on behalf of its immediate customer.

Georgia and Iowa arguably have adopted the most expansive general rules. Service receipts are attributed to Iowa if “the recipient of the service receives the benefit of the service,”

¹⁶⁴ Taken at face value, it appears that the Maryland regulations attempt to avoid prorations by falling back on the headquarters rule, but it is not entirely clear.

¹⁶⁵ MD. REGS. CODE 03.04.03.08(D)(2)(a)(2008) (example 2-1). As was explored when discussing the attribution of sales of tangible personal property under UDITPA, “drop shipments” are sourced to the location of the ultimate customers, while traditional wholesale transactions are generally attributed to the location at which the retailer receives the property. *See supra* notes 125-131 and accompanying text.

¹⁶⁶ MD. REGS. CODE 03.04.03.08(D)(2)(a)(2008) (example 2-1).

¹⁶⁷ *Id.* It might have been helpful if the example did not involve an in-state subsidiary but rather involved an out-of-state party dealing at arm's length, but it does not appear that affiliation or service provider location are relevant to the general rule expressed in the example. This Article generally is written with the assumption that states have adopted combined reporting, and so transactions with affiliates such as the one described in the Maryland regulations would be netted against each other and have no tax impact. Maryland is not, however, a combined reporting state.

in the state.¹⁶⁸ Georgia attributes service receipts to the state if either the customer is within the state or if “the receipts are otherwise attributable to this state’s marketplace.”¹⁶⁹ The Georgia service receipts regulations are borrowed almost verbatim from the Iowa regulations.¹⁷⁰ Both sets of regulations require an allocation/apportionment if services are received in more than one state, and several examples are provided to illustrate this rule.¹⁷¹ Two of the examples address a direct mail service¹⁷² and provide that the “benefit of the service” is in the state to the extent that the direct mail recipients are in the state.¹⁷³ The business location of the entity actually contracting for the direct mail services is not relevant for receipts attribution purposes.

Another example addresses a pest control contract with a real estate company that owns 100 in-state units and 400 out-of-state units. In this case, 20 percent (100/500) of the receipts from this contract would be attributed in-state “in the absence of more accurate records.”¹⁷⁴

Interestingly, the Georgia regulations speak to the effort that a taxpayer must make to comply with the market state approach:

¹⁶⁸ 701 IOWA ADMIN CODE 54.6(422)(1) (2008). As noted earlier, Wisconsin has a similar rule but refers to the “purchaser” of the services rather than the “recipient.” Arguably, this distinction gives Iowa a greater ability to look to the ultimate consumer of the service rather than only to the party who actually purchases the services from the taxpayer, although a similar result might also be reached under a broad reading of the word “purchaser.”

¹⁶⁹ 48 GA. CODE ANN. § 48-7-31(d)(2)(A)(i) (2008).

¹⁷⁰ Compare GA. COMP. RUL. & REGS. 560-7-7-.03(5)(c) with 701 IOWA ADMIN. CODE 54.6(422)(1) (2008).

¹⁷¹ *Id.*

¹⁷² A direct mail service company is a company that distributes direct mail on behalf of advertisers.

¹⁷³ GA. COMP. RUL. & REGS. 560-7-7-.03(5)(c)(6)(ii)(V), (VI); 701 IOWA ADMIN. CODE 54.6(422)(1)(d),(e) (2008).

¹⁷⁴ GA. COMP. RUL. & REGS. 560-7-7-.03(5)(c)(6)(ii)(VII); 701 IOWA ADMIN. CODE 54.6(422)(1)(f) (2008). Wisconsin and Maryland address more directly services provided to real estate located in the state by providing that receipts from services rendered to in-state real property are attributed to the state. MD. REGS. CODE 03.04.03.08(D)(3)(2008); 71 WIS. STAT. § 71.25(9)(dh)(2)(a) (2008). The Georgia and Iowa rules are interesting in that they demonstrate a reasonable approach to apportioning receipts from a national service contract.

The taxpayer must expend a reasonable amount of effort to obtain the information to determine the amount that is attributable to this state’s marketplace. If the information is not available, the taxpayer may use other reasonable methods to determine the amount attributable to this state’s marketplace. Such other methods are subject to review, adjustment, or change by the Commissioner.

Neither the Georgia nor the Iowa regulations address the question of who is the customer in “drop shipment” or “wholesale” service transactions.¹⁷⁵ The direct mail regulations, however, suggest that these states would look to the location of the ultimate customer if the service were provided directly to that customer (“drop-shipped”). Also suggesting an ultimate customer approach are the Georgia regulations (similar to those adopted by a number of other states) for attributing the receipts from certain services provided to mutual fund companies.¹⁷⁶ The regulations attribute these services to the location of the mutual fund company’s customers and not to the location of the mutual fund company.¹⁷⁷

The Wisconsin statute is interesting in that it provides a set of discrete proxies for applying the general rule that receipts are attributed to the state if the purchaser received the benefit of the service in the state:¹⁷⁸

The benefit of a service is received in this state if any of the following applies:

- a. The service relates to real property that is located in this state.

¹⁷⁵ Although this is awkward terminology, it is used in this Article because of the analogy with tangible personal property sales and the rules governing their attribution.

¹⁷⁶ GA. COMP. RUL. & REGS. 560-7-7-.03(5)(c)(6)(v). See HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 10.07 (discussing the trend toward adopting special rules for mutual fund company service receipts).

¹⁷⁷ GA. COMP. RUL. & REGS. 560-7-7-.03(5)(c)(6)(v).

¹⁷⁸ 71 WIS. STAT. § 71.25(9)(dh)(2) (2008)

- b. The service relates to tangible personal property that is located in this state at the time the service is received or tangible personal property that is delivered directly or indirectly to customers in this state.¹⁷⁹
- c. The service is provided to an individual who is physically present in this state at the time that the service is received.
- d. The service is provided to a person engaged in a trade or business in this state and relates to that person's business in this state.

Proxies (a) and (b) relate to services rendered to property in the state and, as discussed later, mirror similar EU value-added place of taxation rules, and well as a Maryland proxy for services rendered in connection with real property.¹⁸⁰ Proxy (c) captures services rendered to individuals physically present in the state when the service is received. Although a sensible and generally administrable rule, proxy (c) presents challenges when the customer is a person temporarily in the state using a remote service, because usually the service provider will only have the customer's home or billing address. Unlike some of the other market-approach statutes,¹⁸¹ Wisconsin does not provide alternative domicile, customer address, or billing address proxies. Because the statute was only recently adopted, however, regulations may be forthcoming that address this concern.¹⁸² Proxy (d) is quite broad and indefinite, attributing to

¹⁷⁹ The use of a disjunctive gives rise to internal consistency problems, because property could be in State A at the time the services are rendered but the property could be for delivery for a person in State B. Thus, the same receipt could find its way into the numerator of the sales factor in two states, resulting in a risk of multiple taxation. *See supra* note 151 (discussing the "internal consistency" test).

¹⁸⁰ *See infra* Part IV.C.4 (EU directive); MD. REGS. CODE 03.04.03.08(D)(3)(2008).

¹⁸¹ *See, e.g.*, 35 ILCS § 5/304(a)(3)(C5)(iv)(2008); 36 ME. REV. STAT. ANN. § 5221(16-A) (2008); MINN. STAT. § 290.191(5)(j) (2008).

the state receipts that “relate[] to” an in-state trade or business. This does little to clarify the main rule or facilitate its administration. Wisconsin addresses the problem of multistate services by providing that if services are received in multiple states then they are included in the numerator of the Wisconsin sales factor “according to the portion of the service received in this state.”¹⁸³

In summary, the rules in states that have already adopted the market-based approach provide both raw materials and clues for drafting a workable service receipts attribution rule. First, these states provide several models for a market-based general rule. Second, many states provide proxies and default rules for determining where the benefit of a service is received and for situations in which the actual location at which the customer received the service is not readily ascertainable. Third, there is some recognition of the interpretive and accounting problems associated with the multistate attribution of a single service transaction, though the solutions vary. The Maryland regulations, for example, reflect an underlying view that there are many situations in which a “primary impetus” or “headquarters” approach would be superior to a more complex allocation or apportionment, while the Georgia and Iowa regulations suggest greater reliance on apportionment methodologies. Fourth, while the Maryland regulations provide an example in which the ultimate consumer is treated as the recipient of the service for receipts attribution purposes, the states have yet to rigorously or systematically address the problem of “drop shipment” or “wholesale” service transactions.¹⁸⁴

¹⁸² The Wisconsin statute is ambiguous in that it can be read to mean that proxies (a) through (d) either are, or are not, the exclusive circumstances under which the benefit of a service is received in the state.

¹⁸³ 71 WIS. STAT. § 71.25(9)(dh)(3) (2008).

¹⁸⁴ It should be remembered that these rules are often supplemented by industry specific receipts attribution rules which address many of the hard questions, although only for specific industries. *See supra* Part IV.B.2.

4. *The Ohio Commercial Activity Tax “Situs” Rules*¹⁸⁵

Beginning January 1, 2006, Ohio began a five-year phase-out of its corporate income tax, which is being replaced with a “commercial activity tax” (CAT) on the gross receipts from most business activities.¹⁸⁶ Services subject to the CAT are generally sourced (“situated”) to Ohio under a destination-based approach. The situsing statute provides:

Gross receipts from the sale of ... services ... shall be situated to this state in the proportion that the purchaser’s benefit in this state with respect to what was purchased bears to the purchaser’s benefit everywhere with respect to what was purchased. The physical location where the purchaser ultimately uses or receives the benefit of what was purchased shall be paramount in determining the proportion of the benefit in this state to the benefit everywhere.¹⁸⁷

If the records of a taxpayer are not sufficient to allow the taxpayer to determine the location where a service is used or enjoyed, then “[T]he taxpayer may use an alternative method to situs gross receipts ... if the alternative method is reasonable, is consistently and uniformly applied, and is supported by the taxpayer’s records.”¹⁸⁸

One reason the Ohio situsing rules are worthy of special attention is the heroic effort that the Ohio taxing authorities made from the outset to provide specific guidance to a vast array of services providers. The Ohio regulations address 54 distinct categories of services providers,

¹⁸⁵ The CAT tax uses the term “situs” in essentially the same way as this Article uses “attribute” for sales factor computation purposes.

¹⁸⁶ 57 OHIO REV. CODE ANN. § 5751.01 *et seq.* (2008).

¹⁸⁷ 57 OHIO REV. CODE ANN. § 5751.033(I) (2008).

¹⁸⁸ *Id.*

ranging from accountants to entertainers to testing laboratories.¹⁸⁹ Of particular interest are the regulations pertaining to services that can be provided remotely. Although the regulations separately address each category of services that can be provided remotely, they adopt a consistent pattern which can be illustrated by an examination of the rules for accounting services:

1. If the accounting service is provided to a client who is only located in Ohio, then all of the services are situated to Ohio.¹⁹⁰

2. If the accounting service is provided to a client with multistate operations, then receipts are situated to Ohio “if the services performed are of benefit to specific operations in Ohio.” An example is given of a national retailer who hires an accounting firm to address an Ohio inventory problem. All of those receipts would be situated to Ohio.¹⁹¹

3. If the accounting service relates to client locations both within and without Ohio, then the taxpayer may use “any reasonable, consistent, and uniform method of apportionment” that is supported by business records.¹⁹²

4. Additionally, at the option of the service provider, and as long as “applied in a reasonable, consistent, and uniform manner,” accounting services may be situated to the

¹⁸⁹ OHIO ADMIN. CODE § 5703-29-17(C) (2008).

¹⁹⁰ OHIO ADMIN. CODE § 5703-29-17(C)(1)(a) (2008).

¹⁹¹ OHIO ADMIN. CODE § 5703-29-17(C)(1)(b) (2008).

¹⁹² OHIO ADMIN. CODE § 5703-29-17(C)(1)(d) (2008).

client’s “principal place of business.”¹⁹³ The principal place of business is the location where “the business unit *being provided the service* primarily maintains its operations.”¹⁹⁴ The accounting firm must follow a hierarchy of choices in identifying the principal place of business:

a. If identifiable, the principal place of business is the “branch, division, or other unit where the client primarily receives the benefit of the service.”¹⁹⁵

b. If such a location is not identifiable, for example, where a service is rendered for the benefit of multiple branches, divisions, or units, but the management of those units is identifiable to one location, then the principal place of business is “the primary location of the management operations of the purchaser’s business unit.”¹⁹⁶

c. Finally, if a single locus of management related to the service rendered cannot be identified, then the billing address of the customer is “acceptable if provided in good faith.”

It should be noted Ohio sources some services that can be provide remotely differently from the accounting firm model, particularly if the service is easily traceable to the state. For

¹⁹³ OHIO ADMIN. CODE § 5703-29-17(C)(1)(c) (2008).

¹⁹⁴ *Id.* (emphasis supplied).

¹⁹⁵ OHIO ADMIN. CODE § 5703-29-17(C)(1)(c)(i) (2008).

¹⁹⁶ OHIO ADMIN. CODE § 5703-29-17(C)(1)(c)(ii) (2008).

example, appraisal and architectural services are situated to where the underlying property is located, and payroll services are situated to where the employees are located.¹⁹⁷

In summary, the Ohio CAT situsing rules pull together several now familiar strands. First, the basic sourcing principle is expressed in terms of the location where the purchaser receives the “benefit” of the service. Second, it recognizes the problem of services provided to multiple locations and gives the service provider broad latitude in developing and adopting an apportionment methodology. Third, in many instances the Ohio rules allow service providers to opt to situs receipts to a single purchaser location. This is often a more administrable and less risky approach to compliance than apportionment. Fourth, extensive industry specific guidance is given. .

5. The UDITPA Allocation Rule for Non-business Patent and Copyright Royalty Income

This article addresses the problem of attributing receipts to a factor employed in *apportioning* “business” income. As noted earlier, UDITPA provides also for the *allocation* of “non-business” income,¹⁹⁸ including non-business patent and copyright royalties.¹⁹⁹ UDITPA generally allocates those royalties to a state “if and to the extent that the patent or copyright is utilized by the payer in this state.”²⁰⁰ In other words, UDITPA employs a market-based approach. The framers of UDITPA recognized that this rule “generally followed the prevailing

¹⁹⁷ This is similar to the Wisconsin attribution rule for services rendered to personalty. *See supra* note 180 and accompanying text.

¹⁹⁸ *See supra* note 22 for an explanation of the distinction between business and non-business income.

¹⁹⁹ UDITPA § 8.

²⁰⁰ UDITPA § 8(a)(1).

rules ... applied by the several states” at that time.²⁰¹ Indeed, the federal income tax rule for sourcing patent and royalty income was (and still is) market-based.²⁰²

In what can only be described as an anomaly, however, UDITPA attributes *business* patent and copyright royalty receipts by using the same origin-based approach that is used for services.²⁰³ It is difficult to find a logical rationale for this disparate treatment of royalty income. The best explanation, as noted earlier, is that the sales factor rules for sales other than sales of tangible personal property were simply not thoroughly worked out.²⁰⁴

Another interesting aspect of UDITPA’s royalty allocation rule is that it both acknowledges that there will be compliance difficulties and provides a solution: “If the basis of receipts from patent [or copyright] royalties does not permit allocation to states or if the accounting procedures do not reflect the states of utilization, the patent [or copyright] is utilized in the state in which the taxpayer’s commercial domicile is located.”²⁰⁵ Again we see the familiar pattern of a general rule being supported by a default proxy in case it is impossible or infeasible to apply the general rule. Here, however, the rule defaults immediately to an origin-based proxy (taxpayer location) rather than, as we have seen in earlier examples, to alternative destination-based proxies, such as customer business address.

In summary, the patent and copyright allocation rule is pertinent to the development of a market-based service receipts attribution rule because it demonstrates that (a) UDITPA already

²⁰¹ Pierce, *supra* note 31, at 749.

²⁰² I.R.C. § 861(a)(4).

²⁰³ UDITPA § 17. The MTC has adopted some royalty specific regulations. *See infra* note 295 (describing MTC intangibles regulations).

²⁰⁴ *Supra* notes 52-54 and accompanying text.

²⁰⁵ UDITPA § 8(b),(c).

includes a market-based rule for some intangibles, and (b) UDITPA has made concessions to administrative realities when items have proved difficult to source geographically.²⁰⁶

C. Consumption Tax Models

1. Introduction: The Relevance of Consumption Tax Models

Consumption tax policymakers have been facing many of the same service sourcing issues as have income tax policymakers. Because consumption taxes—such as the American retail sales tax (RST) and the value-added tax (VAT) operative in much of the rest of the world—are intended to tax consumption by the ultimate consumer, they adopt the destination approach to sourcing.²⁰⁷ For tangible goods, this generally has not been a difficult principle to apply in practice, and place of delivery has proved to be a reliable proxy for place of consumption.²⁰⁸ With regard to services, however, the general rule in many jurisdictions has been to source the service to the jurisdiction in which the service is performed.²⁰⁹ As we already have described in the context of state corporate income taxes, this may have been a good proxy

²⁰⁶ There are other instances in which UDITPA shows this administrative flexibility. *See, e.g.*, UDITPA § 5(c) (accommodating difficulties in tracking leased property and defaulting to location where lessee obtained possession, for non-business rental income allocation purposes).

²⁰⁷ HELLERSTEIN & SWAIN, *supra* note 143, ¶ 6.01, 6.02 (discussing consumption taxes and the destination principle); OECD: INTERNATIONAL VAT/GST GUIDELINES 8 (Feb. 2006), *available at* <http://www.oecd.org/dataoecd/16/36/36177871.pdf>.

²⁰⁸ *Id.* at ¶ 6.02[1][a].

²⁰⁹ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 18.05[1] (discussing the place of performance standard as well as contrasting the relatively consistent application of the destination principle with respect to the sales taxation of tangible personal property with the less consistent assortment of rules that are applied to services). OECD: INTERNATIONAL VAT/GST GUIDELINES, *supra* note 207, at 1 (VAT treatments of place of supply of services and intangibles are “inconsistent”).

for the destination of a service transaction in the past, but in recent years it has become an increasingly less reliable proxy for identifying the jurisdiction in which a service is consumed.²¹⁰

As a result, there are a number of consumption tax reform projects underway that parallel the UDITPA project of the National Conference of Commissioners on Uniform State Laws and include in their agendas modernizing the rules for the sourcing of services. Most prominent among these are the Streamlined Sales and Use Tax Project (SSTP) of the American states and various projects undertaken by the OECD and the EU.²¹¹ These projects are the focus of our examination of consumption tax models.

Before beginning the exploration of these models, however, it is important to identify some of the relevant distinctions between income taxes and consumption taxes. These distinctions should inform any attempt to apply consumption tax models to the income tax context. First, it should be remember that, as a technical matter, the problem of “sourcing” service receipts for state corporate income tax purposes is the problem of attributing those receipts to the numerator of the sales factor for the purpose of computing a taxpayer’s apportionment ratio. Receipts attribution is not, as it is with a consumption tax, a decision to directly tax that receipt (or the income derived from that receipt), although attributing a receipt to a state will, as a general and practical matter, increase the taxpayer’s income tax liability to that state.²¹²

²¹⁰ See *supra* Part II.B.

²¹¹ See HELLERSTEIN & SWAIN, *supra* note 143, ¶¶ 1.01-3.03 (overview and historical background of Streamlined Sales and Use Tax Agreement and Streamlined Sales Tax Project); OECD: INTERNATIONAL VAT/GST GUIDELINES, *supra* note 207, at 1-2, 6-8; COUNCIL OF THE EUROPEAN UNION, NO. 16220/07 (5 DECEMBER 2007) (AMENDED PROPOSAL FOR A COUNCIL DIRECTIVE 200X/XXX/EC AMENDING DIRECTIVE 2006/112/EC AS REGARDS THE PLACE OF SUPPLY OF SERVICES), 4[hereinafter cited as “EU DRAFT VAT PACKAGE”].

²¹² This is why this Article has been careful to apply the term “attribute” when discussing placement of service receipts in the numerator of the sales factor. “Sourcing” has been reserved for the purpose of allocating a specific

Second, consumption taxes are in theory designed only to impose a (net) tax liability on the final consumer, while income taxes generally are imposed on all participants in the supply chain. Thus, one might expect that consumption tax rules do not address B2B transactions and therefore offer little guidance in that area. As a matter of practice, however, the American RST is imposed on many business inputs. In fact, it has been estimated that 40% of the American RST is attributable to businesses purchases.²¹³ Additionally, VATs are typically structured so that tax is collected at all levels in the supply chain, while credits are taken for those taxes when a supplier sells its products. Thus, at the end of the day, only the final consumer has a net tax liability, because suppliers receive credits for all of the taxes paid on their inputs. Thus, even though the VAT is designed to impose a net tax on the final consumer only, it still must address sourcing issues throughout the supply chain.²¹⁴

Third, the American RST is generally only imposed on the sale of tangible personal property, not services, although there are important exceptions.²¹⁵ Thus, the American RST rules for the sourcing of most services are not fully developed. In this regard VATs provide a better model because VATs are typically imposed on most private economic activity.²¹⁶

Fourth, our goal for attributing receipts for state income tax purposes is to recognize the contribution of the market state, while the aim of consumption tax sourcing is to identify where

item of income to a jurisdiction for the purpose of taxing it. Though not completely germane to this discussion, the tax law sometimes sources items of income for reasons other than directly imposing a tax, such as for the purpose of determining available foreign tax credits for federal income tax purposes.

²¹³ See Raymond J. Ring, Jr., *Consumers' Share and Producers' Share of the General Sales Tax*, 52 NAT'L TAX J. 79 (1999) (estimating business inputs as a share of the sales tax base as averaging about 40 percent).

²¹⁴ See ALAN SCHENK & OLIVER OLDMAN, *VALUE ADDED TAX: A COMPARATIVE APPROACH* 1-27 (2007) (discussing history of and basic approaches to value added taxation).

²¹⁵ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 12.05 (describing and exploring historical background of limited application of sales taxes to services and intangibles).

²¹⁶ See SCHENK AND OLDMAN, *supra* note 214, at 1-27.

consumption occurs. There is generally little practical difference between these two principles, but subtle rule differences may be required. For example, if everyone shops at the market in State A, but goes home to state B to consume their purchases, State A has a greater claim to tax the merchant's income than it does to tax the purchasers' consumption. Consumption tax regimes have adopted various solutions to this problem, such as exempting exports from tax and imposing a self-reporting obligation on the purchaser.²¹⁷ Setting aside the subtleties of these mechanisms, the main point here is simply to highlight that when considering a consumption tax sourcing rule as a model for income tax receipts attribution purposes, one should keep in mind the income tax objective of identifying the contribution of the market state.

Fifth, enforcement concerns often inform the various approaches to sourcing and explain differences between income and consumption tax rules. In the case of both consumption and income taxes, we generally look to the seller (or income recipient) to collect the tax. Although it is sometimes administratively feasible to ask business purchasers to either self-report (consumption taxes) or withhold (income taxes), this is generally not feasible when the purchaser is an individual consumer.²¹⁸ Thus, when we destination source B2C transactions, concerns arise about whether the destination jurisdiction has enforcement jurisdiction over the seller. In this regard, it is usually easier for a state to assert income tax jurisdiction over non-resident service providers than it is for either a state to assert RST jurisdiction or for a foreign government to assert VAT jurisdiction.²¹⁹ Internationally it is more difficult because of the legal

²¹⁷ See SCHENK AND OLDMAN, *supra* note 214, at 50-51 (zero rating exports for VAT purposes); HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 16.01[2] (historical overview of use taxation).

²¹⁸ See SCHENK AND OLDMAN, *supra* note 214, at 93-98 (reverse charge and other mechanisms for VAT collection); HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 16.01[2] (historical overview of use taxation); John A. Swain, *supra* note 112, at 343, 350 (2003) (discussing impracticality of collecting use tax from individual consumers).

and practical difficulties of asserting jurisdiction across national boundaries.²²⁰ Domestically it is more difficult because the Supreme Court has held that a seller must have a physical presence in order for a state to impose an RST collection obligation, while it appears that physical presence is not required for a state to assert income tax jurisdiction, although this is still a contentious question.²²¹ This is all to say that we may find that consumption tax sourcing rule models are more cautious about the manner in which the destination principle is applied to cross-border transactions than is necessary for state corporate income tax purposes.

Sixth, as either a legal or contractual matter, buyers usually bear the burden of consumption taxes while sellers (income recipients) usually²²² bear the burden of a tax imposed on their income.²²³ Accordingly, buyers usually are more aware of the consumption tax burden of a transaction than they are of the income tax consequence to the seller. Additionally, it is fair to say that the economic impact of consumption taxes generally is higher than the economic impact of state corporate income taxes. RST tax rates generally range between 5 to 10% of gross

²¹⁹ At least this is the case theoretically and constitutionally. In the American sub-national context, P.L. 86-272 thwarts the income tax jurisdiction of the states in connection with the income of sellers of tangible personal property whose in-state activities are limited to “mere” solicitation. *See supra* notes 107-110 and accompanying text.

²²⁰ *See generally* Walter Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 GA. L. REV. 1 (2003) (a comprehensive treatment of these issues). *Cf.* JOSEPH ISENBERGH, *INTERNATIONAL TAXATION* 93-101 (2d ed. 2005) (discussing legal threshold for conducting a U.S. “trade or business”).

²²¹ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). *See Swain, supra* note 109, at 329-43, 362-72 (2003)(arguing that the *Quill* physical presence test does not extend to state corporate income taxes); HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 6.11 (“clear trend” of the case law is to limit *Quill* to sales and use tax collection and to adopt an economic presence standard for tax income tax nexus purposes).

²²² Sometimes withholding tax obligations are imposed on other parties.

²²³ Retail sales taxes and VATs are usually added to the invoice or sales receipt as a separately-stated charge on a transaction by transaction basis. Income taxes are usually not imposed on a transaction by transaction basis, although withholding taxes are an important exception. As a result, buyers usually are more acutely aware of the consumption tax consequences of a transaction than they are of the income tax consequence to the seller. Sometimes consumption taxes become matters of negotiation, and, as a matter of economic theory, the burden of consumption taxes is borne by both buyer and seller when the supply and demand curves have some elasticity. Similarly, the economic burden of an income tax affects prices. *See* John L. Mikesell, *FISCAL ADMINISTRATION* ___ (7th ed. 2007) (describing economic tax incidence theory). *See also supra* note 131 (for additional discussion of the economics of tax planning in this context).

receipts, while state corporate income tax rates fall in about the same range, but only apply to *net* income.²²⁴ VAT rates are often even higher.²²⁵ As a consequence, the parties²²⁶ to a service transaction will generally be more motivated to structure it to avoid consumption taxes than to structure it to avoid state corporate income taxes. Additionally, the purchaser will generally be more cooperative and proactive when the goal is to avoid consumption taxes. Accordingly, it may be the case that consumption tax sourcing rules reflect and require more vigilance than state corporate income tax receipts attribution rules.²²⁷

Despite these qualifications, the consumption tax reform projects that are currently underway are essentially wrestling with the same fundamental problem of implementing the destination principle in the context of services (and intangibles). Accordingly, the following sections explore some of the proposals that are beginning to emerge from these projects.

2. *The Streamlined Sales and Use Tax Agreement*

In early 2000, under the auspices of the Streamlined Sales and Use Tax Project (SSTP), the American states undertook the unprecedented task of simplifying, unifying, and modernized the American RST.²²⁸ The primary task of the SSTP was to draft the Streamlined Sales and Use Tax Agreement (SSUTA), which is the foundational document for the streamlined system and

²²⁴ See HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 12.02 (Table 12.1, sales tax rates) and ¶ 7.08 (typical range of state corporate income tax rates).

²²⁵ See SCHENK AND OLDMAN, *supra* note 214, at 16, 23 (describing range of typical VAT rates).

²²⁶ Assuming they are unrelated and dealing at arms-length.

²²⁷ Again, this assumes combined reporting. See *supra* note 131 (discussing combined reporting, separate reporting, and the opportunities for tax planning created by separate reporting). See also Fox, Luna, and Murray, *supra* note 16, at 144-48 (discussing advantages of combined reporting).

²²⁸ The following discussion draws freely from HELLERSTEIN & SWAIN, *supra* note 143, at iii.

which became effective on October 1, 2005.²²⁹ As of early 2008, 19 states have fully conformed their sales taxes to SSUTA and become members of its Governing Board. It is expected that other states will soon follow suit, and pending federal legislation could aid in this process.²³⁰

Promulgating uniform and administrable sourcing rules was a major focus of the SSTP, and subsequently the Governing Board, although the goals of streamlining are myriad and beyond this scope of this discussion.²³¹ In broad overview, the SSUTA sourcing rules embrace the destination principle and apply equally to all taxable transactions, whether they involve tangible personal property, services, or digital products.²³² The destination principle is implemented by a series of hierarchical rules, most of which serve as back-up proxies in case the seller, in good faith, does not have the information necessary to source the transaction pursuant to the preceding rule.²³³ In broad and somewhat oversimplified terms, these rules are as follows:

1. When a purchaser receives a good, digital product, or service (collectively, “product”) at the seller’s business location, the sale is sourced to that business location.²³⁴ Receipt of services is defined to mean “making first use of services.”²³⁵

²²⁹ HELLERSTEIN & SWAIN, *supra* note 143, at iii.

²³⁰ *Id.*

²³¹ *See id.* at ¶ 3.01 (describing the purpose and scope of SSUTA).

²³² *Id.* at ¶ 6.01.

²³³ SSUTA § 310.

²³⁴ SSUTA § 310(A)(1).

²³⁵ SSUTA § 311(B).

2. When (1) does not apply, then the sale is sourced to the location where the purchaser receives the product—typically the purchaser’s shipping or delivery address.²³⁶

3. When (1) and (2) do not apply, for example, when the seller does not know the shipping location (which may occur in particular when delivery is electronic), the sale is sourced to the purchaser’s address as it appears in the seller’s general business records.²³⁷

4. When (1), (2) and (3) do not apply, for example, when there is no address in the seller’s business records, the sale is sourced to the address obtained during the consummation of the sale, for example, from credit card billing information.²³⁸

5. When none of the foregoing rules apply, the sale is sourced to its origin, i.e., the point from which the product is shipped or electronically transmitted, or where the services were provided.²³⁹

In a pattern that is now familiar, SSUTA includes a few individualized sourcing rules for specific industries or classes of transactions. These include direct mail, leasing, and

²³⁶ SSUTA § 310(A)(2).

²³⁷ SSUTA § 310(A)(3).

²³⁸ SSUTA § 310(A)(4).

²³⁹ SSUTA § 310(A)(1). This last default reverts to origin-based sourcing.

telecommunications.²⁴⁰ Additionally, the initial version of SSUTA included a somewhat novel rule for sourcing digital products and services²⁴¹ that would be available for concurrent use at multiple business locations of the purchaser.²⁴² This was known as the multiple points of use (MPU) rule. The basic concern that the MPU rule tried to address was that consumption in MPU situations would occur in locations other than the place of delivery. Further, because many digital products and services can be easily and cheaply transmitted from one location to another, purchasers might attempt to avoid tax by taking delivery in a low tax jurisdiction and then redirecting the product or service to, or accessing it from, the jurisdiction(s) of actual use.

In these MPU situations, an obligation was imposed on purchasers to provide the seller with a reasonable allocation of the purchase price to each of the points of use. In making this allocation, the business purchaser could use “any reasonable, but consistent and uniform, method of apportionment that is supported by the purchaser’s books and records that are kept in connection with the sale.”²⁴³ Sellers were then relieved of any further obligation if the sellers reported tax based on the allocation, but taxing authorities could audit the purchaser and adjust the purchaser’s tax liability if the allocation were not reasonable.²⁴⁴ Finally, if the information necessary to allocate was not forthcoming from a purchaser, then the seller could default to the

²⁴⁰ SSUTA §§ 310(B) (leasing) 313 (direct mail); 314-315 (telecommunications).

²⁴¹ Software was included within the scope of the MPU provisions in a later version of SSUTA. See HELLERSTEIN & SWAIN, *supra* note 143, ¶ 6.03 (describing history of multiple points of use provisions).

²⁴² SSUTA § 312 (repealed effective Dec. 14, 2006). See HELLERSTEIN & SWAIN, *supra* note 143, ¶ 6.03 (describing history of multiple points of use provisions).

²⁴³ SSUTA § 312(A)(2)(repealed effective Dec. 14, 2006).

²⁴⁴ SSUTA § 312(B)(repealed effective Dec. 14, 2006).

general sourcing rules, which generally would source the transaction to the location where the product was delivered.²⁴⁵

The MPU provisions were eventually repealed, however, and these transactions are now sourced pursuant to the general sourcing rules, although special rules have been developed for computer software that require an allocation to multiple points of use under limited circumstances. The heart of the problem was the lack of any apportionment guidance, interpretative problems in identifying an MPU transaction, and most importantly, taxpayer concern that the rules would conflict with rules in non-member states, resulting in double taxation. For example, a non-member state might enforce a tax on 100 percent of the sales price in the state of delivery, while a member state from which the product was accessed might claim a tax based on an apportioned amount.²⁴⁶

The SSUTA sourcing rules are an important model for both practical and substantive reasons. As a practical matter, they are supported by a broad consensus of state tax policymakers and business representatives, and they are currently in effect in at least 19 states. Additionally, if it were the case that most service providers were already in fact required to source their transactions pursuant to the SSUTA sourcing rules, then administrative convenience would weigh heavily in favor of applying the same rules for sales factor receipts attribution purposes.

²⁴⁵ See HELLERSTEIN & SWAIN, *supra* note 143, ¶ 6.03 (alternative rules not specified, “but clearly the general sourcing rules would apply”). See also *supra* notes 233-239 and accompanying text for a description of the general sourcing rules.

²⁴⁶ See HELLERSTEIN & SWAIN, *supra* note 143, ¶ 6.03 (describing rise and fall of the MPU provision). This foreshadows a concern that will be expressed during the UDITPA reform process. If not all states adopt the changes, then taxpayers providing remote services from an “old UDITPA” state to a “new UDITPA” state will be asked to attribute their receipts to both states. This is already a problem because, as we have noted, a number of states have already adopted destination-based rules. See *infra* Parts VI.C and VII (emphasizing the need for uniformity among the states).

Both of these considerations, however, are attenuated by other factors. First, business community support for SSUTA came largely from retailers, telecommunications companies, and others businesses that are required to collect and remit sales tax.²⁴⁷ These businesses were for the most part looking for clear, uniform, and easy to administer rules for collecting a tax from their customers. In the case of state corporate income tax reform, however, these taxpayers—as well as taxpayers who are not deeply involved in sales tax reporting, such as service businesses and non-retailers—will be contemplating their own substantive income tax liability. Accordingly, one might expect the business community to cast a more critical and cautious eye on UDITPA reform. For many businesses, there is simply more at stake.

Second, although applying one set of sourcing rules for both income and sales tax purposes has substantial appeal for taxpayers whose have obligations to report both types of taxes, there is a broad class of taxpayers who are not sales taxpayers, particularly service providers. Although there is a modest trend towards including services providers within the scope of the sales tax, it is probably fanciful to think that the preponderance of services will soon, if ever, being subject to sales tax in most states.²⁴⁸ Therefore, while it certainly appealing from an administrative standpoint to have a single set of rules, policymakers should not make too many substantive sacrifices when the peculiarities of the income tax suggest a different rule. There may not be so much to be gained from this brand of uniformity.²⁴⁹

²⁴⁷ See Swain and Hellerstein, *supra* note 144, at 612-15 (describing political coalition that formed around the streamlining movement).

²⁴⁸ An important exception and trend is the move toward broad based gross receipts taxes, such as the Ohio CAT described in Part IV.B.4. See also Laura Wheeler and Edward Sennoga, *Alternative State Business Tax Systems: A Comparison of State Income and Gross Receipts Taxes*, 45 ST. TAX NOTES 487 (2007) (examining the trend toward replacing the state corporate income tax with a gross receipts tax).

²⁴⁹ Even if most service providers are not required to make SSUTA sourcing determinations because their receipts are not subject to RST, the SSUTA rules still might be a useful model because of the interpretive guidance that may

As for the substance of the SSUTA rules, we find a number of familiar patterns. SSUTA embraces sensible delivery location proxies for destination, plus a series of well-developed default rules acknowledging that sellers cannot always reasonably be expected to capture the information required by a more precise rule. The rules also reflect a recognition of the need for industry specific guidance.

The failed (to date) MPU experience is at least a yellow flag for the drafters of a reformed UDITPA. Still, the MPU rules are an important model in that they (1) acknowledge the MPU issue and its importance, (2) recognize that often the relevant purchaser information will not be available to sellers, (3) experiment with placing certain information providing requirements on purchasers, and (4) provide a default rule when the information necessary for making an apportionment is not reasonably forthcoming. In fairness, it should be noted that allocating or apportioning receipts for sales tax purposes is a more novel concept than allocation and apportionment for net income tax purposes.²⁵⁰ Thus, failure to build a consensus around the MPU rules should not be read as a signal that similar efforts in the income tax arena are destined to failure.

Despite these cautionary notes, the SSUTA rules provide a good foundation for a pragmatic sourcing regime, and they have the further benefit of enjoying broad political support, at least in the sales tax context. They have yet to offer, however, a discrete solution to the problem of products delivered or enjoyed simultaneously in multiple jurisdictions.

build around them. A more general criticism of the SSUTA rules, as least to the extent they are offered as a model for service receipts attribution, is that they were obviously written with the retail sale of tangible personal property foremost in mind. This is understandable, given that this is the type of transaction that most concerns the American RST in its current form. Still, caution should be exercised when borrowing from these rules to ensure that the shoe fits in the service industry and B2B contexts.

²⁵⁰ Sales and use taxes are seldom apportioned. Rather, a system of credits for taxes paid to other jurisdictions is relied upon to avoid multiple taxation. HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 18.08 (describing the credit system for sales and use taxes and the underlying constitutional considerations).

3. The OECD E-Commerce Initiatives and International VAT/GST Guidelines

The Organization for Economic Cooperation and Development (OECD) has been active in developing sourcing guidelines for consumption taxes imposed on international trade in services.²⁵¹ As of this writing, these efforts are still ongoing, although some basic principles and proxies have emerged. As a threshold matter, the OECD has embraced the destination principle for the sourcing of consumption taxes: “Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place.”²⁵² For B2C transactions, the basic proxy for determining place of consumption for the cross-border supply of services and intangibles is the jurisdiction in which the customer has its “usual residence.”²⁵³ For B2B transactions, the basic proxy is where the customer has located its “business presence.”²⁵⁴ For this purpose, business presence is, “in principle, the establishment (for example, headquarters, registered office, or a branch of the business) *to which the supply is made.*”²⁵⁵ Countries may, however, “use a different criterion to determine the actual place of consumption,” when the residence or business presence proxies “would lead to a distortion of competition or avoidance of tax.”²⁵⁶

²⁵¹ See OECD: INTERNATIONAL VAT/GST GUIDELINES, *supra* note 207, at 1-2 (describing the history of the reform process). See also Hellerstein, *supra* note 120 (detailed analysis of the OECD proposed reforms of place of supply rules for services).

²⁵² OECD, TAXATION AND ELECTRONIC COMMERCE: IMPLEMENTING THE OTTAWA TAXATION FRAMEWORK CONDITIONS 5 (2001).

²⁵³ OECD: INTERNATIONAL VAT/GST GUIDELINES, *supra* note 207, at III.C.A.5

²⁵⁴ *Id.*, at III.C.A.3.

²⁵⁵ *Id.*, at III.C.A.3, n.4 (emphasis supplied).

²⁵⁶ *Id.*, at III.C.A.4.

These rules obviously require further refinement. For example, “the location of a recipient’s establishment to which a global supply of services is made is hardly self-defining.”²⁵⁷ In a more recent development, the OECD released a consultation paper exploring general reliance on “the relevant business agreement” for identifying the jurisdiction to which the supply is made.²⁵⁸ The consultation paper, however, does not yet explore in detail the many difficult cases in which a business customer has establishments in multiple jurisdictions. Thus, for the moment, the OECD guidelines remain very much a work in progress.

4. *The EU VAT Package*

Recognizing that “globalization, deregulation, and technological change have all combined to create enormous shifts in the volume and pattern of trade in services,” and that “it is increasingly possible for a number of services to be supplied at a distance,” the European Union (EU) has spent the better part of the last 6 years developing a “VAT Package” designed to tax services “on the basis of the destination principle.”²⁵⁹ Political agreement was reached on the VAT Package in late 2007.²⁶⁰

²⁵⁷ Walter Hellerstein, *supra* note 120, at 10.

²⁵⁸ OECD, APPLYING VAT/GST TO CROSS-BORDER TRADE IN SERVICES AND INTANGIBLES: EMERGING CONCEPTS FOR DEFINING PLACE OF TAXATION par. 8 (Feb. 2008).

²⁵⁹ COMMISSION OF THE EUROPEAN COMMUNITIES, PROPOSAL FOR A COUNCIL DIRECTIVE AMENDING DIRECTIVE 77/388/EC AS REGARDS THE PLACE OF SUPPLY OF SERVICES, EXPLANATORY MEMORANDUM 2 COM(2003) 822 Final (Dec. 23, 2003).

²⁶⁰ EU DRAFT VAT PACKAGE, *supra* note 211. *See* Walter Hellerstein, *supra* note 120, at 14-17 (providing detailed discussion of the VAT Package).

The principles informing the VAT Package are similar to those embraced by the parallel OECD effort.²⁶¹ The preamble to the draft directive declares that “[f]or all supplies of services, the place of taxation should, in principle, be the place where actual consumption takes place.”²⁶² The directive then sets forth two basic proxies for implementing this underlying principle. The proxy for B2B transactions tracks in substance the OECD rule, although it is articulated more awkwardly. The place of supply is where the business purchaser is “established.”²⁶³ However, if services are provided to a “fixed establishment” of the [business] in a place other than where the business is “established,” then “the place of supply is where that fixed establishment is located.”²⁶⁴ In other words, services are sourced to the business location to which they are provided. Otherwise—for example, if they are supplied elsewhere or, presumably, if a place of supply cannot be reasonably identified—then they are sourced to the place where the customer has established its business generally.

The general B2C proxy, however, deviates from the OECD guidelines.²⁶⁵ For B2C transactions, the main proxy is supplier location.²⁶⁶ Though obviously a deviation from the normative principle articulated in the preamble to the draft directive, this rule was, in the end, necessitated by the difficulties of collecting a VAT at the destination of a cross-border transaction when the customer is an individual consumer.²⁶⁷ This concern is not operative in the

²⁶¹ See *supra* Part IV.C.2 for a discussion of OECD place of service supply reform proposals.

²⁶² EU DRAFT VAT PACKAGE, *supra* note 211, at 3.

²⁶³ *Id.* at 7 (draft ch. 3, art. 44)

²⁶⁴ *Id.*

²⁶⁵ *Id.* (draft ch. 3, art. 45).

²⁶⁶ *Id.*

²⁶⁷ See Hellerstein, *supra* note 120, at 16 (discussing the rationale for this approach to B2C transactions).

state corporate income tax context. Indeed, as demonstrated earlier, B2C transactions are generally easier to source to the place of consumption than are B2B transactions because individuals are generally identifiable to a single residence or domicile. Additionally, it should be noted that there are a number of qualifications and exceptions to the EU B2C rule. Most importantly, B2C supplies of electronic services—perhaps the most significant category of cross-border service transactions—are sourced to the customer (destination) when either (a) the supply is from inside the EU to a customer outside the EU or (b) from a supplier outside the EU to a customer inside the EU.²⁶⁸

Two additional aspects of the VAT Package are important to identify. First, in addition to the two main proxies, there are a number of transaction and industry specific rules. For example, “services supplied in connection with immovable property” are sourced to the location of the immovable property, and “valuation of and work on movable tangible personal property” are sourced to the place where the services “are physically carried out.”²⁶⁹ Second, “in order to prevent double taxation, non-taxation or distortion of competition,” the draft directive allows member states, in many circumstances, to consider the place of supply to be “where the effective use and enjoyment of the services takes place” rather than the place that would be specified under the main proxies and other rules.²⁷⁰ Under this exception, for example, an EU member might be entitled to source a transaction to the marketplace of a business customer rather than to where the business customer is “established.”²⁷¹

²⁶⁸ *Id.* (describing the exceptions in greater detail).

²⁶⁹ EU DRAFT VAT PACKAGE, *supra* note 211, at 8 (ch. 3, arts. 47,54). These proxies are similar to the Wisconsin proxies for services provided to real estate and tangible personal property, and to the Maryland proxy for services provided to real estate. *Supra* Part IV.B.3.

²⁷⁰ *Id.* at 14 (ch. 3, art. 59a).

²⁷¹ EU DRAFT VAT PACKAGE, *supra* note 211, at 7 (ch. 3, art. 44).

The EU VAT Package is significant for several reasons. First, it deserves serious consideration if for no other reason than European consumption tax policymakers have significantly more experience than American consumption tax policymakers with the problem of sourcing services. Second, the destination principle is adopted, along with proxies based largely on the location of either the customer (B2B) or supplier (B2C). Third, other proxies are sometimes adopted when they more closely reflect the destination principle and/or provide clearer guidance.

In evaluating these rules, however, it should be remembered that the consumption tax sourcing rules will sometimes be influenced by policies and administrative concerns that differ from those implicated by the state corporate income tax. The EU's B2C rule, for example, is predicated on a concern (collecting VAT from individual consumers) that is a *non sequitur* in the state corporate income tax context.²⁷² It is also important to recognize that because the EU rules apply on a national rather than sub-national level, there may be a lower level of concern about the administrability of the destination principle when supply is made to multi-jurisdictional businesses.²⁷³ In other words, businesses may more frequently straddle American states than they do European countries. In any event, the EU rules do not yet address, beyond the main proxies, whether or how to allocate or apportion services provided to multinational businesses.²⁷⁴

²⁷² See *supra* note 265 and accompanying text. It could also be suggested that the EU may be less concerned about B2B sourcing because, in theory, businesses do not bear the economic burden of the tax because of the credit mechanism. In practice, sourcing B2B transactions is important for a variety of reasons.

²⁷³ It is fair to say that the concern is still high. See OECD, APPLYING VAT/GST TO CROSS-BORDER TRADE IN SERVICES AND INTANGIBLES: EMERGING CONCEPTS FOR DEFINING PLACE OF TAXATION, *supra* note 258, at 5 (Feb. 2008)(acknowledging need to examine “situations involving businesses with establishments in different countries”).

²⁷⁴ *Id.*

D. Conclusion

Though diverse in detail, the existing destination-based sourcing models share many common features and highlight some universal areas of tension.

1. The destination or market for a service is sometimes expressed as a broad “use and enjoyment” principle, such as where “the recipient of the service receives the benefit of the service,” and at other times as a proxy (albeit broadly cast), such as where the service is “received,” “supplied,” “provided,” or “first used.” By way of comparison, for sales of tangible personal property, UDITPA currently expresses the destination principle as a proxy: the place to which the product is “shipped or delivered.”

2. Many of the rules reflect a common recognition that B2B and B2C services require different rules or approaches.

3. There is a tension in the rules between using a customer address proxy to attribute receipts and trying to identify the actual place at which the service (or the benefit of the service) is received. The EU VAT rules, for example, are predicated on business location proxies.²⁷⁵ So too, in broad strokes, are the Illinois and Minnesota rules. Similarly, the Maryland rules assume that the main problem for B2B transactions is identifying the correct business office of the customer. SSUTA, by contrast, first looks to the place of actual delivery before defaulting to various customer address rules. Similarly, the Georgia and Iowa rules strain to apply the “place the benefit is received” or “the market which is exploited” principle. Additionally, when a service is received in more than one state (whether or not at a business location), some rules endorse reasonable apportionment as a means to attribute receipts to multiple locations of actual receipt of a service or its benefit.

²⁷⁵ Customer establishment for B2B supplies, supplier establishment for B2C supplies.

4. The tension expressed in (3) is sometimes relieved by the adoption of proxies based on criteria other than customer address. These may get closer to faithfully implementing the destination principle than customer location while being more administrable than a direct quest for the place of use and enjoyment. For example, Wisconsin and the EU have adopted proxies to attribute services provided to real estate and movables, and specific EU proxies extend to many more service categories as well. Similarly, the model MTC regulations, the extensive Ohio CAT regulations, and the SSUTA leasing and telecommunications rules all reflect an acknowledgement of the value of administrable proxies tailored to specific industries and transaction types.

5. When a service is rendered to a business that has operations in more than one jurisdiction, the sourcing problem is sometimes treated as the problem of identifying the specific customer business location to which the services should be allocated. The common approach is variously formulated as identifying the office that is supplied the service, that benefits from the service, or that provides the principle impetus for the service contract. When no such location is identifiable, then a principal business office is usually the default situs. Rather than specifically allocate service receipts to a particular business location or locations, some jurisdictions instead either allow or require a reasonable apportionment to the various business locations.

6. The existing models offer scant guidance on the attribution of receipts from “drop shipment” or “wholesale” service transactions. The basic issue in these situations is whether or not to “look through” to the ultimate consumer. The EU does address a narrow class of intermediary transactions and sources them to the ultimate customer,²⁷⁶ and the Maryland, Georgia and Iowa regulations intimate a similar approach, more broadly cast. Additionally,

²⁷⁶ EU DRAFT VAT PACKAGE, *supra* note 211, at 8 (ch. 3, art. 46).

some of the specific Ohio CAT, Wisconsin, and EU proxies reach that result (sourcing to the ultimate consumer) for the transactions to which they apply.²⁷⁷

V. GUIDELINES FOR IMPLEMENTING A MARKET STATE APPROACH TO SERVICES²⁷⁸

As emphasized throughout this paper, the framers of a reformed UDITPA will need to balance the normative benefits of destination-based service receipts attribution against the administrative and compliance costs of that approach. Although the case for reform is bolstered by the fact that the current origin-based standard is “confusing and indefinite,”²⁷⁹ one should aspire to more than modest improvements in administration. What follows are specific suggestions for developing a new, workable rule. It would be more distracting than illuminating to propose specific language this early in the reform process. Instead, general guidelines are presented and discussed.

Guideline 1: The service receipts attribution rule should embody the destination principle.

The primary aim of this Article has been to make the normative case for this guideline. The guideline could be expressed as principle, such as “where the benefit of the service is

²⁷⁷ Proxies that source based on the location of the real property for which a service is rendered, for example, will source the service to an ultimate consumer whenever a service “drop-shipper” contracts with a third-party to render a service to the ultimate consumer’s property.

²⁷⁸ In the interest of brevity and simplicity, this Article does not in this Part cross-reference each reference to the rule models that were explored in Part IV unless there is a particular need for further explanation.

²⁷⁹ *Supra* note 65 and accompanying text.

received,” or “where the service is used and enjoyed.”²⁸⁰ It could also be expressed as a proxy, such as “the location to which the service is provided.” The proxy-based approach is used in several of the states that have adopted the market state approach, the EU for VAT purposes, and the current version UDITPA for purposes of attributing receipts from the sale of tangible personal property. In my view it would be advisable to adopt a proxy-driven approach because of the ambiguity inherent in identifying where the benefit of a product is received.²⁸¹ It may not be too important which approach is taken, because proxies will be necessary to flesh-out the general rule in any event.²⁸²

*Guideline 2: B2C service receipts should be sourced under rules similar to the general sourcing rules of the Streamlined Sales and Use Tax Agreement (SSUTA).*²⁸³

It is telling that many states and the EU have found it helpful to distinguish between B2C and B2B transactions. The SSUTA rules, which apply to retail sales, were clearly written with

²⁸⁰ See supra note 278.

²⁸¹ As Richard Ainsworth comments with respect to consumption taxes: Mature consumption tax systems, like the EU VAT, determine the place of taxation indirectly, through proxies rather than directly, through express use and enjoyment rules. Proxy rules have proven to work best. This is the clear conclusion from four-decades of EU experimentation. Borrowing from this experience, the Japanese [consumption tax] relies exclusively on proxies when determining the place of taxation for services and intangibles.

Richard Ainsworth, *Taxing Services Under the EU VAT and Japanese Consumption Tax: A Comparative Assessment of the New EU Place of Taxation Rules for Services and Intangibles*, BOSTON UNIVERSITY SCHOOL OF LAW WORKING PAPER SERIES, LAW AND ECONOMICS WORKING PAPER NO. 06-30, at 26 available at <http://www.bu.edu/law/faculty/scholarship/papers.html> .

²⁸² *Id.*

²⁸³ SSUTA § 310(A). For a full explication of these rules, see supra Part IV.C.2.

the consumer in mind and provide a good model for consumer transactions. A parallel income tax rule would attribute B2C services received at the business location of the service provider to the provider's location, and would attribute other B2C services to the location where they are received. Very simply, B2C service receipts would be attributed to where received. If place of receipt information is not reasonably available, then various purchaser address default rules would be provided. If place of receipt and purchaser address reasonably remain a mystery, then the place of performance rule would apply.²⁸⁴

Guideline 3: B2B service receipts should be sourced under rules similar to the general sourcing rules of the Streamlined Sales and Use Tax Agreement (SSUTA), except that additional guidance is needed for identifying where a service is received by a business.

SSUTA-like attribution rules easily can be applied to many B2B service receipts, for example, when the customer's activities are confined to one state or when the service contract clearly confines the service to a single business location of a multistate business. It must be recognized, however, that there are a myriad of circumstances in which the place of delivery (or place where the benefit is received) is less certain. Guidelines 4 through 7 address these situations.

²⁸⁴ B2C "Drop shipments," usually gift transactions, would be attributed based on the general rule. This rule, in turn, mirrors the rule for tangible personal property. *See supra* note 125 and accompanying text. Thus, "drop shipped" consumer services should also be attributed to the location of the actual recipient of the service. For example, if a parent in State A retains an accounting firm in State B to prepare the federal income tax return of a child in State C, then the service should be attributed to State C. "Drop shipments" of services are discussed in greater detail in the context of B2B transactions. *See infra* Guideline 7.

*Guideline 4: When the attribution question has resolved itself into the problem of identifying the business location to which the receipts should be attributed, the receipts should be attributed to the business location(s) for which the service is primarily rendered. If no such location(s) are identifiable, then the customer's principal place of business management should generally serve as a default.*²⁸⁵

This a familiar and sensible pattern, identified in many of the models examined. It is not meant to be an extreme deviation from the basic SSUTA sourcing rules that are recommend generally for B2B transactions in Guideline 3. The SSUTA general sourcing rules, however, do not speak with much precision or sophistication to the provision of services to multistate businesses, and more guidance and structure is needed for this category of transaction. The Ohio CAT and Maryland rules are the most developed models for this approach.

Guideline 5: The rules should address situations in which a B2B service is received by a business customer at a location other than a business location of the customer. Administrable proxies should be the mechanism of choice.

Services are often received in locations other than at a fixed business location of a customer. For example, a business with fixed locations in States A and B might receive services in, or directed to, State C related to (a) a trade show; (b) a products liability suit; (c) developing

²⁸⁵ These rules will require some refinements, particularly when the service business is dealing with a large multinational corporation, possibly headquartered overseas. The Ohio CAT rules suggest an approach of finding the office generally responsible for managing the relevant operations, or simply using a billing address as a default. *See supra* Part IV.B.4. Service providers will have varying levels of information about the business offices and corporate structure of their customers, and the rules should accommodate this practical reality when asking service providers to attribute receipts to one of those offices.

the State C marketplace in the future; (d) finding new raw materials, (e) managing the quality control of suppliers; (f) collecting bills; (g) providing benefits to retired employees; and (h) employee training.

One approach to this problem is simply to do the best one can to apply a place of delivery or benefits-received rule, tracing geographically the physical, electronic, and conceptual flows as much as possible, guided by the underlying business agreement and records. In many cases, however, this exercise will quickly become esoteric, and subject to conflicting analyses. When this occurs, a default proxy or proxies should be made available. Often, the default proxy will be similar to that found in many of the rules we have examined, which rely on the location of the business unit that is primarily being provided the service, or if that fails, the business's management headquarters.

A second approach to the problem of attributing receipts from B2B services that are received at a location other than a business location of the customer is suggested by the EU, which uses the business location to which "supply is made" as the main proxy, deviating only when another more specific proxy is applicable. This approach abandons any initial attempt to ascertain an actual place of delivery or benefits-received.²⁸⁶ Although it may be awkward to think of identifying a business location to which supply is made when the services being considered are presupposed have been supplied elsewhere, this proxy may not be so difficult to administer in practice. Both the Maryland rule (office that provided "principal impetus") and the Ohio rule (location where business unit being provided the service maintains its operations) merit consideration as clarifying proxies.

²⁸⁶ The EU does allow member states to adopt other rules based on place of use and enjoyment in order to prevent "double taxation, non-taxation or distortion of competition." EU DRAFT VAT PACKAGE, *supra* note 211, at 14 (ch. 3, art. 59a). Additionally, numerous other proxies based on locations other than business establishment are provided. *See supra* Part IV.C.4.

Additionally, more narrowly tailored proxies are needed. If decades of experience show anything, it is that one size does not fit all, at least from the perspective of efficient tax administration.²⁸⁷ The EU, for example, provides specific rules for a number of different categories of services. Also illustrative is the recently enacted Ohio CAT (addressing 54 distinct service industries), the Wisconsin statute, as well as the MTC model regulations for specific industries.

Whichever approach is adopted, the main objective of this guideline is to advise that it will often be necessary to rely on business location or other discrete proxies and abandon the theoretical quest to identify the place at which a service, or its benefit, is received. Additionally, the rules should show flexibility and avoid penalizing taxpayers when identifying the place at which a service is received or enjoyed becomes a speculative endeavor.

Guideline 6: The rules generally should allow taxpayers to use reasonable apportionment methods to attribute receipts from services rendered in multiple jurisdictions. For both administrative and policy reasons, however, it may be more appropriate in many circumstances to allocate receipts to a specific customer location or locations, as provided in Guidelines 4 and 5.

There will be many instances when, under the applicable rule, a service is attributable to more than one jurisdiction. Borrowing, from the Iowa and Georgia regulations, for example, a service company may have a national pest control contract with a real estate company managing

²⁸⁷ See Ainsworth, *supra* note 281, at 26 (extolling the virtues of proxies in the consumption tax context).

properties in 20 states.²⁸⁸ A general rule might govern this situation, such as a rule that attributes receipts to the location at which the service is received. Alternatively, a more specific proxy may be applicable, such the location of the real property for which the service is rendered. In either case, the taxpayer will be faced with the problem of attributing its receipts under a single contract to many states. If possible, specific allocations should be made if supported by the underlying business agreement and records and not unreasonably burdensome. If specific allocations cannot be made, then taxpayers generally should be allowed to use “any reasonable, consistent, and uniform method of apportionment that is supported by the underlying business agreement and records.”²⁸⁹

Apportionment is most suitable when services are rendered directly in multiple jurisdictions, and care should be taken not to resort to apportionment when an allocation to one or more customer locations (or other location designated by a proxy) is more appropriate. For example, if a management consulting service is rendered to a multistate business, one might argue that the benefit is received companywide, and so it is appropriate to apportion the consulting receipts to each state in which the customer has operations (or even simply makes sales). Apportionment in this situation, however, butts up again Due Process and Commerce Clause sensibilities, because receipts would be attributed to states with which they probably do not have a Due Process or Commerce Clause connection.²⁹⁰ While one might resolve this

²⁸⁸ See *supra* note 174 and accompanying text.

²⁸⁹ *Supra* note 188 and accompanying text (Ohio CAT statute). The Ohio rules reflect a certain vacillation between the apportionment approach and the goal of finding a single business unit to which to attribute a service receipt. Taxpayers are essentially given the option to use either approach.

²⁹⁰ It is difficult to argue in these situations that the taxpayer “purposefully avails” itself of the states in which its customer happens to be doing business. See HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 6.01 (discussing the Due Process and Commerce restraints on state taxation of income). See also *Quill Corp. v. North Dakota*, 504 U.S. 298, 307-08 (1992)(articulating Due Process standard for state taxation).

problem with rules that throwback the apportioned receipts to other states, it is probably best to recognize that services rendered to a business customer that “indirectly” benefit branch offices and operations should be allocated to the headquarters or other office which is the primary recipient of the service. Additionally, when a service only generally or indirectly benefits multiple business locations, it is less likely, as a practical matter, that the service business will have the information necessary to make a multi-jurisdictional allocation.

Guideline 7: The problem of “drop shipped” or “wholesale” services should be resolved in a manner that parallels the attribution of receipts from sales of tangible personal property, except when industry or transaction specific guidance is given, or when different treatment is required to thwart a tax avoidance transaction.

The touchstones in these circumstances should be certainty and administrability. When a service company in State A is engaged by a business in State B to provide services directly to customers in State C, then the State A service company’s receipts generally should be attributed to State C. This mirrors the tangible personal property drop shipment rules and should be administrable in most situations.²⁹¹ In cases in which the service business cannot reasonably know the location of the persons that it is directly services, then attribution should default to the location of its immediate customer, the State B business.

²⁹¹ UDITPA § 16, comment (discussed *supra* Part IV.B.1).

By the same token, when a service is provided to a wholesaler who then redelivers the service to its customers, the service should be sourced to the wholesaler's location.²⁹² Under this same logic, services provided as inputs to a service business's production of services clearly should be attributed to where the service business receives the services, and no attempt should be made to look through to the location of its ultimate customers.

“Drop shipped” and “wholesale” service transactions raise legitimate tax avoidance concerns, because electronic services can be delivered and redelivered by wholesalers and intermediaries requiring very little capital investment and who can easily locate in tax haven jurisdictions. Thus, this guideline should be subject to tax avoidance exceptions or special rules for industries or transaction types that are particularly susceptible to this type of tax planning.²⁹³ Additionally, it may be desirable to adopt special rules for certain industries if identifying the location of the ultimate consumer is administratively feasible and would better reflect the jurisdiction in which the use and enjoyment of the service occurs. Absent workable rules, however, taxpayers should not be left to guess about who is the customer for the purpose of making the service receipts attribution determination.

²⁹² For example, assume A contracts with B to develop custom software so that A can fulfill its contract to develop that custom software for C. B develops the software and delivers it to A, who then delivers it to C. B's receipts should be attributed to the location of its direct customer, A.

²⁹³ See *supra* Part IV.B.2 (discussing industry and transaction specific rules).

VI. ADDITIONAL CONSIDERATIONS

This Part examines several additional considerations relevant to service receipts attribution reform: intangibles, throwback, nexus, and super-weighting of the sales factor. The Article then concludes with a brief comment on institutionalizing UDITPA reform.

A. *Intangibles*

This Article focuses on receipts from services. The discussion of receipts from the sale or licensing of intangibles has been left for another day.²⁹⁴ An analysis of the attribution rules for intangibles, however, would proceed down essentially the same path. The attribution of receipts from intangibles is subject to the same flawed costs of performance rules as are services.²⁹⁵ Those rules, as we have shown, are difficult to administer,²⁹⁶ duplicative of the payroll and property factors, and fail to adequately reflect the contribution of the market states.²⁹⁷ As with services, the sensible solution is to adopt a destination-based approach for

²⁹⁴ As discussed, Section 17 applies to “sales other than the sales of tangible personal property.” This includes receipts from services, intangibles, and real property. The MTC has adopted special regulations to address real estate and personal property rentals. MTC REG. IV.17(4). Applying the destination principle to real estate obviously does not present the same challenges as destination sourcing services and intangibles.

²⁹⁵ As a general matter, Section 17 applies to receipts from intangibles, although the Multistate Tax Commission has developed model regulations that specifically address intangibles. MTC REG. IV.18.(c). Very generally, Section 17 is followed if the income-producing activity can be readily identified. If not, then the receipts are not included in either the numerator or the denominator of the sales factor.

²⁹⁶ One area of particular concern is tracking geographically the historical costs of developing an intangible such as a copyright. Perhaps it is a safe bet that the costs associated with creating the animated film *Snow White* were incurred in California, but the geographic location of the costs of creating other intangibles are much more difficult to ascertain or verify on audit. (Example suggested by Carl Joseph, Tax Counsel to the California Franchise Tax Board, at the Mid-Year Meeting of the Tax Section of the American Bar Association, 2007).

²⁹⁷ See *supra* Part II.B and C.

intangibles.. Additionally, harmonizing the attribution rules for tangible personal property, services, and intangibles would obviate the disputes that currently arise because substantive tax consequences turn on whether a transaction is characterized as involving personalty, services, or intangibles.

In some respects, destination sourcing of intangibles is a more well-worn path, because patent, copyright, and similar royalties are sourced based on the destination approach for both federal income tax and UDITPA non-business income allocation purposes.²⁹⁸ That said, there are nagging questions about the administrative feasibility of a destination-based intangibles attribution rule. For example, although one might take comfort in the fact that the existing federal rule is destination-based, it should be remembered that the federal rule is applied on the national rather than sub-national level. Needless to say, it is easier for many taxpayers to determine to what extent a licensee is employing a patent in the United States or some foreign country than it is to make this same determination as between Michigan and Indiana.²⁹⁹ Additionally, pursuant to tax treaties to which most of the major trading partners of the U.S. are signatories, many royalties are sourced for federal income tax purposes on the basis of the residency of the owner of the intangible, rather than on a destination basis, when they are not attributable to a permanent established associated with owner's business in the country.³⁰⁰ This also weakens reliance on the analogy with the federal rule. Further, because intangibles often can be sublicensed, they present difficult tracking problems.³⁰¹ Finally, the term "intangibles"

²⁹⁸ See *supra* Part IV.B.5.

²⁹⁹ See *supra* Part II.B.

³⁰⁰ See ISENBERGH, *supra* note 220, at 260; UNITED STATES MODEL INCOME TAX CONVENTION, art. 12.

³⁰¹ The existing version of UDITPA resolves the analogous problem presented by the leasing of tangible personal property by using the location of the property when the lessee took possession as a proxy for place of use when

covers a broad waterfront: copyrights, patents, trade secrets and other intellectual property, as well as debt and equity instruments, contract rights, and so on. This is all to say that although the argument for destination sourcing of intangibles is strong and appealing, intangibles merit a thorough and separate treatment.

B. Nexus and Throwback

As noted earlier, the current version of UDITPA throws back to the state of origin receipts from tangible personal property sales when the destination state does not have jurisdiction to impose a tax on the seller under either federal constitutional law or federal statute.³⁰² There is no throwback rule for services because services are currently attributed to the place of performance—where the taxpayer almost invariably will be subject to tax. It follows that if service receipts are attributed under a destination-based approach, then a services throwback rule would also be required, assuming that a revised UDITPA retains the throwback rule for tangible personal property.

Much ink has been spilt over the question of whether throwback is normatively supportable.³⁰³ On the one hand, throwback theoretically ensures that a business engaged in interstate commerce is taxed as fully as a purely domestic (in-state) enterprise that does not have the opportunity to enjoy “nowhere income.”³⁰⁴ On the other hand, throwback hardly models a

better records are not available. UDITPA § 5(c) (for non-business rent allocation purposes). So-called “sandwich licenses” of intangibles have stirred up sourcing controversies on the federal level.

³⁰² See *supra* notes 56-61 and accompanying text.

³⁰³ For an excellent review of the economic arguments pro and con, see Fox, Luna, and Murray, *supra* note 16, at 153-55. See also Sylvia Dennen and Christopher Whitney, *The Hidden Apportionment Factor*, 37 ST. TAX NOTES 797 (2005) (a critique of the throwback rule, particularly when applied in a non-uniform environment).

consistent theory of income apportionment.³⁰⁵ This Article remains agnostic, but as expressed earlier, takes the view that the horns of this dilemma would be substantially avoided by nexus rules based on the concept of *de minimis*. If only *de minimis* amounts of nowhere income could be created, rather than the broad swath cut by P.L. 86-272, then the substantive consequences of throwback would be greatly reduced.

C. Super-Weighting of the Sales Factor

As noted in the introduction to this Article, states have been driven by competitive pressures to either super-weight their sales factors or adopt sales factor-only apportionment.³⁰⁶ The effect is to reduce the income tax cost of making in-state capital investments while increasing the tax cost of exploiting the state's marketplace. It is assumed that because capital is more mobile than the marketplace, the net effect from the perspective of each individual state will be salutary. Once all states have raced to the bottom, however, any one state's competitive advantages will have been erased.³⁰⁷

Again, there is fierce debate over sales factor super-weighting, and it is not the intent here to resolve the controversy.³⁰⁸ What is noteworthy for the purposes of this Article is that super-

³⁰⁴ HELLERSTEIN & HELLERSTEIN, *supra* note 3, ¶ 9.18[1][b][i] (weighing throwback rule policy considerations).

³⁰⁵ *Id.*

³⁰⁶ See *supra* notes 15-18 and accompanying text.

³⁰⁷ Without a cooperative mechanism in place, however, states are forced to move in this direction simply to maintain competitiveness (equal footing), even if they retain no competitive advantage after the race to the bottom is finished.

³⁰⁸ See, e.g., Silvia Dennen and Christopher Whitney, *Single Factor—Multiple Questions*, 32 ST. TAX NOTES 327 (2005); Jean Ross, *Should California Adopt a Single Sales Factor to Determine How Much Income to Tax*, 24 ST. TAX NOTES 1053 (2002); Michael Mazerov, *The Single-Sales-Factor Formula: A Boon to Economic Development Or a Costly Giveaway?* 22 St. Tax Notes 1775 (2001). Michael J. McIntyre, *Thoughts on the Future of the State*

weighting puts a tremendous amount of pressure on the sales factor. If a taxpayer's income tax liability hinges solely on in-state receipts, then there will be a great temptation for taxing authorities to find, for example, that the benefit of a service is received in the state (if that is the attribution rule). The ingenuity of taxpayers and their advisors may be similarly energized. In contrast, when applying the destination principle to sales of tangible personal property, the opportunities for creative theorizing are much more limited.

The Georgia and Iowa regulations foreshadow this concern. One of the examples given in the regulations, somewhat simplified, is a mail order service company in State A sending mailings to State C on behalf of a business customer in State B.³⁰⁹ The Georgia and Iowa regulations would attribute the receipts to State C—the market that is being targeted—but it is not beyond the pale to suspect that a tax administrator in State B would take the view that the receipts are attributable to State B, where the business customer is located. Indeed, one can contrast the Georgia and Iowa rule with the approach of the latest OECD consultation paper, which takes the position that the receipts of a consultant in Country A conducting market research in Country C on behalf of a client in Country B should be sourced to Country B because that is where the client is established.³¹⁰

The response to this concern is threefold. First, we can try to reassure ourselves that there is nothing new under the sun, and that the fox and the chicken³¹¹ have been playing this

Corporate Income Tax, 24 ST. TAX NOTES 931,946 (2002) (suggesting that a double-weighted sales factor would be a fair compromise between production and market states, giving 50 percent weight to each).

³⁰⁹ See *supra* note 174 and accompanying text.

³¹⁰ See OECD, APPLYING VAT/GST TO CROSS-BORDER TRADE IN SERVICES AND INTANGIBLES: EMERGING CONCEPTS FOR DEFINING PLACE OF TAXATION, *supra* note 258, at par. 4. The example given in the consultancy paper actually involves market research in State A. The result is the same, and Country C was used in the text above to maintain parallel structure with the Georgia and Iowa regulations.

³¹¹ Which is which?

game ever since the first tax was imposed, and forever will. Whipsawed foxes and chickens, however, are understandably not so philosophical. Second, this concern can be viewed as a reminder and encouragement to give clear guidance on these questions, relying extensively on workable proxies, and perhaps erring on the side of formalism to create a user-friendly apportionment regime. Third, if sales are the only basis on which income tax liabilities are determined, then the lack of uniformity in the rules (and their enforcement) may be subject to greater judicial and Congressional scrutiny than when these “idiosyncrasies” were smoothed over by averaging the sales factor with the property and payroll factors. This leads to the Article’s conclusion.

VII. CONCLUSION: THE INSTITUTIONAL CHALLENGE OF UNIFORMITY

The primary purpose of this Article has been to assist the framers of a new UDIPTA with one of their chief drafting challenges: the sourcing of service receipts. The political challenges of a new UDITPA, however, dwarf the drafting ones. Charles McLure has famously described the current lack of uniformity as “nutty,” and the centrifugal forces seem as irrepressible as ever.³¹² Even if—despite the obstacles—the immediate political challenge is met and a consensus forms around a uniform act that enjoys widespread adoption, the greater challenge will be to establish an institutional structure that *maintains* uniformity.³¹³ In all likelihood this will require federal legislation, although the framers of a new UDITPA will want to look to the

³¹² Charles E. McLure, Jr., *The Nuttiness of State and Local Taxes—and the Nuttiness of Responses Thereto*, 24 ST. TAX NOTES 841, 849 (2002).

³¹³ William F. Fox and John A. Swain, *The Federal Role In State Taxation: A Normative Approach*, 60 NAT’L TAX J. 611, 627-28 (2007)(suggesting that federal intervention in UDITPA reform may be necessary to maintain uniformity because of the inherent tendency of cartels to break down over time, among other reasons).

surprisingly resilient streamlined sales tax movement as a model for institutionalizing UDITPA reform.³¹⁴ Just as the current lack of uniformity has been driven by the states' instinct for self-preservation, perhaps a future uniform regime will be impelled by that same impulse.

³¹⁴ HELLERSTEIN & SWAIN, *supra* note 143, ch. 9 (describing SSUTA governance mechanisms).