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Reed Smith Teleseminar Series

Massachusetts Releases Proposed Market Sourcing and Throwout Regulations: What Does it Mean for You?

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Agenda

- Background/General Rules
- Leases and Licenses
- Services
- Intangible Property
- Throwout

Background

- Chapter 46, Acts of 2013 (HB 3535): enacts market-based sourcing
- Effective January 1, 2014
- Department's proposed regulations released March 25, 2014
- Department accepting comments on the regulations until May 1, 2014

General Rules for Sourcing

- Sales other than sales of TPP are attributed to Massachusetts if the corporation's market for the sale is in Massachusetts
- If the state to which a sale is attributed under the specified rules cannot be determined, the state of assignment should be "reasonably approximated"
 - Shall be determined in good faith based on all sources of information available to the taxpayer
 - No refunds permitted
 - Must be applied consistently from year to year

Receipts from Real Property and Rental, Lease, or License of TPP

- “If and to the extent” the property is in Massachusetts...
 - Mobile property:
 - e.g., leases of planes, automobiles, trailers, construction equipment
 - Rules follow property factor
 - Required to use special apportionment regulations, if applicable
 - Otherwise, any “reasonable” method
 - Software:
 - Pre-written software delivered on tangible medium = sale of TPP
 - Custom software or electronic delivery = sourced as service or intangible under these regulations



Sales of Services

General Rule for Services

- Sales of services are within Massachusetts if and to the extent the services are delivered at a location in Massachusetts
- “Delivered” refers to the location of the taxpayer’s market for the service

In-Person Services

- The customer or property upon which a service is performed is in the same location as the service provider at the time of service
 - Examples: Repairs, landscaping, cleaning, live entertainment, medical
- Services are delivered at the location where services are received
 - When services are performed on TPP, the sale is in Massachusetts if the TPP is shipped or delivered to a customer in Massachusetts, regardless of where the services are performed. An example would be repairs to TPP.
- Transportation/Moving Services: Destination rule
 - Conflict with special industry apportionment regulations?

Services Delivered to the Customer or Through/On Behalf of the Customer

- Sales of services that are neither in-person nor professional
 - Examples: Outsourced/support services; advertising-related; and direct mail services
 - Rules depend on whether delivered by physical means or electronic transmission
- Delivery by physical means:
 - Assigned to state where services are delivered
 - If delivery state cannot be determined—reasonable approximation

Services Delivered to the Customer or Through/On Behalf of the Customer (cont.)

- Delivery through electronic transmission (including digital goods):
 - Delivered to *individuals*: Service received
 - Taxpayer may apportion among states
 - Where unable to determine or approximate: Billing address
 - Delivered to *businesses*: Service received
 - Taxpayer may apportion among states
 - Where unable to determine or approximate: Location of contract management; then customer order location; then billing address
 - Delivered *through or on behalf of individual/business*: Location of third-party recipient

Professional & Financial Services

- Services that require specialized knowledge or certification, license, or degree
- Also – services provided by financial institutions if not covered by existing sourcing rules
- Services performed for individuals:
 - Primary residence of customer; then billing address
- Services performed for businesses:
 - Location of contract management; then customer order location; then billing address
- Affirmative duty to identify state of primary residence/state where contract is principally managed in certain instances



Intangible Property

Intangible Property—Definitions

- Broad definition
- Examples:
 - Trademarks, patents, securities, copyrights, franchise fees, etc.
 - Broadcast rights
 - Certain pre-written software
 - Database access
 - Information access

Intangible Property—What receipts are included in factor?

- Intangible receipts included in sales factor
 - All “licenses” of intangibles
 - Specified “sales” of intangibles
- All other receipts from intangibles—thrown out of factor

Intangible Property—Sales vs. License

- Sales vs. License
 - Sale: conveys “all substantial rights” in intangible property
 - License: Any other transactions involving intangibles unless intangible property licensed with sale of TPP.
 - License of intangible property w/ sale of TPP = sale of TPP

License of a Marketing Intangible

- Marketing intangible: “Intangible intended to promote consumer sales”
- License to retailer
 - Receipts from sales of related goods/services to Massachusetts customers; or
 - Percentage of population in Massachusetts compared with total U.S. population in license area
- License to wholesaler
 - Percentage of population in Massachusetts compared with total U.S. population in license area

License of a Production Intangible

- Production intangible: Predominant value of intangible is used in manufacturing process
- General Rule:
 - Sourced to state where “use for which fees are paid takes place”; typically licensee’s commercial domicile or primary residence
- If Massachusetts can show “actual use” is “in part” in Massachusetts, presumption is 100 percent sourced to Massachusetts

License of a Mixed Intangible

- License includes both marketing and production intangible
- If license agreement separately states “reasonable” fees for each type of intangible—source each fee using general rules for marketing and production intangible
- If fees are not separately stated or “reasonable,” presumption that license is 100 percent marketing intangible

License of Intangible Property Resembles a Sale of Goods or Services

- Examples:
 - Database access
 - Access to information
 - Certain pre-written software
 - Digital goods
- Sourced following rules for services delivered through electronic transmission

Sales of Intangible Property

- Limited Category – Does not include receipts from sales of securities, partnership interests or goodwill/going concern value
- Different sourcing rules for different types of intangibles
 - Contract rights or government licenses authorizing business activity in a specific geographic area
 - Agreements not to compete
 - Sales with purchase prices contingent on productivity, use or disposition
- Goodwill, going concern value and workforce in place

Throwout Rules

- Mandatory Throwout
 - Sales other than sales of TPP where the taxpayer is *not taxable* in the state to which the sale is assigned
 - Sales other than sales of TPP where the Department determines that the taxpayer's Method of Reasonable Approximation ("MRA") is unreasonable
 - Sales of intangibles like partnership interests, securities, goodwill, going concern value and workforce in place
 - Sales of patented technology
- Optional Throwout
 - Sales other than sales of TPP where *the taxpayer* cannot determine or reasonably approximate the state to which a sale should be assigned

Throwout – Taxable in Another State

- Rules for determining whether taxpayer is taxable in another state
 - Look to Constitution and Laws of United States (as interpreted by Massachusetts)
 - Not taxable if activities are protected by P.L. 86-272
 - Taxable if state elects not to extend its taxing jurisdiction to Constitutional limits
 - Application to taxpayers filing combined returns
 - Presumption that taxpayer is not taxable in a state if no return is filed

Throwout – Potential Challenges

- Constitutional distortion?
 - Exclusion of receipts from sales factor can produce a mismatch between factors and the tax base
 - Examples:
 - Corporation has \$100,000 of apportionable income (\$10,000 of operating income and \$90,000 gain from sale of partnership interest)
 - Corporation has 10 percent Massachusetts apportionment percentage with throwout of receipts from sale of partnership interest
 - None of partnership property, payroll or sales is in Massachusetts
 - Does apportionment of \$10,000 of income to Massachusetts constitute distortion under *Norfolk & Western* and *Hans Rees*?

What's Next?

- Submit questions for DOR response
- Regulation comment process
- Questions?

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About Reed Smith's Massachusetts Tax Practice

Reed Smith's Massachusetts tax practice is built on more than 15 years of experience in Massachusetts state tax planning and controversy matters, focusing on income and sales and use taxes. The Massachusetts tax team writes and speaks frequently on Massachusetts tax issues, and handles significant Massachusetts tax appeals for some of the nation's largest companies.

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