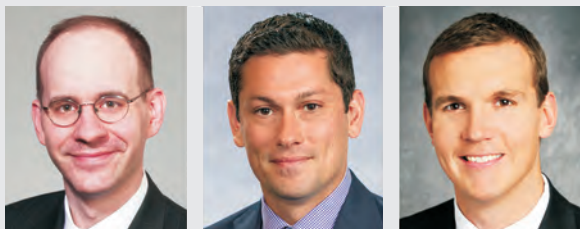


Source It Here, Source It There: The Pennsylvania Sales Factor

by Kyle O. Sollie, Jack Trachtenberg, and Paul E. Melniczak



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Until recently, Pennsylvania's sourcing statute provided a cost-of-performance rule for services. However, the Department of Revenue has often taken a position that more closely resembles market sourcing, leaving taxpayers uncertain how to address tax questions for years before 2014.

In our inaugural column, "This Is Why We Fight: A Survey of New York Tax Issues,"¹ we set forth our mission to advocate for taxpayers by challenging state revenue department actions that contravene the tenets of good tax administration and pose risks to taxpayer rights. In this installment, we turn to the Commonwealth of Pennsylvania.

As in many states, Pennsylvania taxpayers struggle to comply in good faith with Pennsylvania's rules on sourcing receipts from the sale of services. Like many of its sister states, Pennsylvania has played both sides of the fence, enforcing both cost-of-performance and market-based sourcing regimes in a manner that is seemingly designed to maximize revenue. In this article, we will explore Pennsylvania's wavering position and encourage taxpayers to follow the state's own dual interpretation of its tax code by taking whichever reporting position produces the most advantageous result.

Last summer, Pennsylvania enacted HB 465, which adopted market-based sourcing for receipts derived from services, beginning in 2014. For tax years before 2014, Pennsylvania's statute sources receipts from services under a Uniform Division of Income for Tax Purposes Act cost-of-

performance rule. However, as many out-of-state taxpayers have become acutely aware, Pennsylvania's Department of Revenue has been selectively applying market-based sourcing for several years.

The department tends to impose its market-based method primarily on out-of-state taxpayers who would otherwise source little or no receipts to Pennsylvania under the cost-of-performance rule. By contrast, the department expects taxpayers that perform services in Pennsylvania to source their receipts there. This seemingly revenue-driven inconsistency fosters a level of uncertainty regarding tax compliance obligations that inevitably wastes public and private resources and creates a distrust of government taxing authorities. It also raises uniformity issues.²

Although consistency would be a better policy, in the inconsistency there is a potential benefit for taxpayers. Because the department's policy is to apply two different methods, taxpayers also have the freedom to take whatever position produces the best results for them. Accordingly, for tax years before 2014, taxpayers may follow either the cost-of-performance method or the market-based approach.

Option 1: Source to Where the Service Was Performed

Pennsylvania's statute requires that receipts from services be sourced based on the location of the "income-producing activity."³ If the income-producing activity is in more than one state, the receipts are sourced to the state where the greater share of the activities take place, based on costs of performance. There is no Pennsylvania case law interpreting

²Article VIII, section 1 of Pennsylvania's constitution requires that "all taxes shall be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax." See also *Commonwealth v. The Budd Co.*, 108 A.2d 563 (Pa. 1954) (differentiating between taxpayers on the basis of the date their taxes were resettled violates the uniformity clause); *Amidon v. Kane*, 279 A.2d 53 (Pa. 1971) (imposing higher rates of tax on taxpayers with greater income or different personal situations violates the uniformity clause); *Commonwealth v. Molycorp, Inc.*, 392 A.2d 321 (Pa. 1978) (classifying otherwise similarly situated taxpayers into classes depending on which method a taxpayer uses to compute tentative tax violates the uniformity clause); *Tredyffrin-Easttown Sch. Dist. v. Valley Forge Music Fair, Inc.*, 627 A.2d 814 (Pa. Commw. Ct. 1993) (imposing different levels of amusement tax among amusement providers violates the uniformity clause).

³72 Pa. Code section 7401(2)2(a)(17).

¹*State Tax Notes*, Oct. 14, 2013, p. 117.

either the phrase “income-producing activity” or “costs of performance.” The department has not issued any regulations on this topic.

Under the more natural interpretation of the statute, a taxpayer that does not perform a service in Pennsylvania, but instead merely has customers in the state, does not have any income-producing activity in Pennsylvania. Thus, under this approach, receipts from Pennsylvania customers are not sourced to the state unless the taxpayer’s activities are there. And even if some activities are in Pennsylvania, the receipts are not sourced there unless more activities are in Pennsylvania than in any other state. The department has taken this approach — especially when it produces a beneficial outcome in terms of revenue.⁴ Taxpayers should also take this approach if it suits them.

Option 2: Use Market-Based Sourcing

Alternatively, taxpayers can source based on the customer’s location. Consider the following cases involving taxpayers in a broad range of industries in which the department has sourced service receipts on a market basis:

- The department audited an Internet service provider, sourcing receipts from those services based on the customers’ service address.⁵ Total subscriber and advertising revenue was multiplied by the percentage of the total U.S. population living in Pennsylvania even though almost all the costs for providing services were incurred in data centers located outside Pennsylvania.
- The department audited a financial services company and included in the sales factor numerator receipts from charge card, travel, and stored value products.⁶
- Several financial institutions engaged in the origination of mortgage loans were assessed by the department.⁷ The taxpayer’s activity in Pennsylvania was limited to advertising and using the services of independent mortgage brokers. All other activities, such as

securing funds, managing risk, investigating the credit worthiness of prospective borrowers, and the negotiation of contractual terms and conditions occurred at the taxpayer’s headquarters outside Pennsylvania.

- The department denied the refund claims of several telecommunication service providers that argued that receipts from wireless long-distance and calling card telecommunication services to individuals and businesses must be sourced outside Pennsylvania. The direct costs associated with the income-producing activity that generated interstate revenue from those services were incurred almost entirely outside Pennsylvania.⁸
- The department assessed a broadcast satellite television provider, sourcing a portion of those services to Pennsylvania based on the location of the taxpayer’s subscribers.⁹ The taxpayer asserts that the income-producing activity occurred outside Pennsylvania, where its primary satellite uplink equipment was located and where contract negotiations took place.
- The department assessed a restaurant franchiser and sourced receipts from service-fee income to Pennsylvania.¹⁰ The service fees were earned in exchange for various educational, training, consulting, and marketing services provided to franchise restaurants. These services all took place at the taxpayer’s headquarters outside Pennsylvania.

The above cases were settled by the department or are pending in court. In these cases, the department consistently focused on the customer’s location, regardless of the location of the taxpayer’s activities. Thus, this approach continues to be a valid option for taxpayers.

Taxpayers that have not used the optimal sourcing method on prior year returns should strongly consider filing refund claims taking the alternative position. Under Pennsylvania’s three-year statute of limitations, refund claims for the 2010 tax year must be filed by April 15, 2014, for most taxpayers. The same sourcing method used on any refund claims should also be used when preparing the 2013 return. ☆

⁴December 16, 2009, unpublished letter from Department of Revenue deputy chief counsel (for traders of electricity derivatives, receipts sourced to the location where the taxpayer performs its activities).

⁵*America Online, Inc. v. Commonwealth*, 963 A.2d 903 (Pa. Commw. Ct. 2008).

⁶*American Express Travel Related Services Co., Inc. v. Commonwealth*, No. 860 F.R. 2007, Penn. Commw. Ct. (Petition for Review, Dec. 14, 2007).

⁷See, e.g., *Citimortgage, Inc. v. Commonwealth*, No.52 F.R. 2011, Penn. Commw. Ct. (Stipulation for Judgment, Dec. 19, 2012).

⁸See, e.g., *GTE Wireless of Ohio, Inc. v. Commonwealth*, No. 214 F.R. 2011 (Petition for Review, Apr. 1, 2011).

⁹*Dish Network LLC v. Commonwealth*, No. 406 F.R. 2013, Penn. Commw. Ct (Petition for Review, May 22, 2013).

¹⁰*McDonald’s USA, LLC v. Commonwealth*, No. 302 F.R. 2012, Penn. Commw. Ct. (Petition for Review, Apr. 27, 2012).