



# Market Sourcing of Sales of Services

## Impact on Corporate Net Income Tax

Amy Gill, Deputy Secretary for Tax Policy



# ▶ Market Sourcing of Sales of Services

- Prior to Act 52 – 2013
  - Sales, other than sales of tangible personal property, are in this State if:
    - The income-producing activity is performed in this State; or
    - The income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other state, based on costs of performance.

Primary area of conflict was with the definition of income producing activity. OOS taxpayers would focus on cost of performance while DOR would look to where the benefit of the income producing activity took place. The new language helps to clarify that.

# ➤ Market Sourcing of Sales of Services

- Act 52 – 2013
  - Effective for tax years **2014** and forward
  - The sale, lease, rental or other use of real property occurs at the location of the real property.
  - The rental, lease or licensing of tangible personal property occurs at the location of first possession of the property.
  - These changes were not substantial to the sourcing of real property as had been done prior to Act 52

# Market Sourcing of Sales of Services

- Act 52 – 2013
  - The significant change was to the sourcing of Sales of Services, which are more clearly aligned with market sourcing.
  - Sales of services occur at the point of delivery of the services. If the service is delivered to locations inside and outside of the state, the sales are in this state based upon the percentage of total value in this state.
  - If the state or states of assignment cannot be determined for a customer who is an individual that is not a sole proprietor, a service is deemed delivered at the customer's billing address.

# ▶ Market Sourcing of Sales of Services

- Act 52 – 2013
  - If the state or states of assignment cannot be determined for a customer (except for the prior situation), a service is deemed to be delivered at the location from which the services were ordered in the customer's regular course of operations. If that cannot be determined, a service is deemed to be delivered at the customer's billing address.
  - Income-producing activity / Cost of performance is still used for sales not covered above – primarily intangibles.

# Market Sourcing of Sales of Services

- Estimated impact of Act 52 – 2013
  - There is no direct way to estimate the impact of Market Sourcing of Sales.
  - Universe of affected entities – corporations with sales factor denominator greater than \$100M.
  - Split into groups – appeals, service companies, manufacturers, and all other
  - Appeals
    - Actual impact from appeal
    - Queried for keywords “income producing activity” or “cost of performance”
    - These figures were not significant to the overall numbers

# ▶ Market Sourcing of Sales of Services

- Estimated impact of Act 52 – 2013
  - Service companies
    - If current apportionment between 3% and 10%, no change
    - Pennsylvania is generally about 4.5% share of the U.S.
    - If current apportionment less than 3% or greater than 10%, switch to physical presence (defined as average of property and payroll factors)
    - For service companies, the assumption is that where property and payroll are, customers are nearby
    - Recalculate tax

# ▶ Market Sourcing of Sales of Services

- Estimated impact of Act 52 – 2013
  - Manufacturers
    - Determine percentage of Sales of Services that are from non-manufacturing activities.
    - To do this used 1998 data. For the Capital Stock Franchise Tax, there was a manufacturing exemption for the sales factor.
    - By comparing the sales between CNIT and CSFT, the percentage of sales by manufacturers that are due to manufacturing can be calculated.
    - The new sales numerator for apportionment is calculated as (PA sales \* non-mfg ratio \* service percentage change) + PA manufacturing sales
    - Recalculate CNIT



# ▶ Market Sourcing of Sales of Services

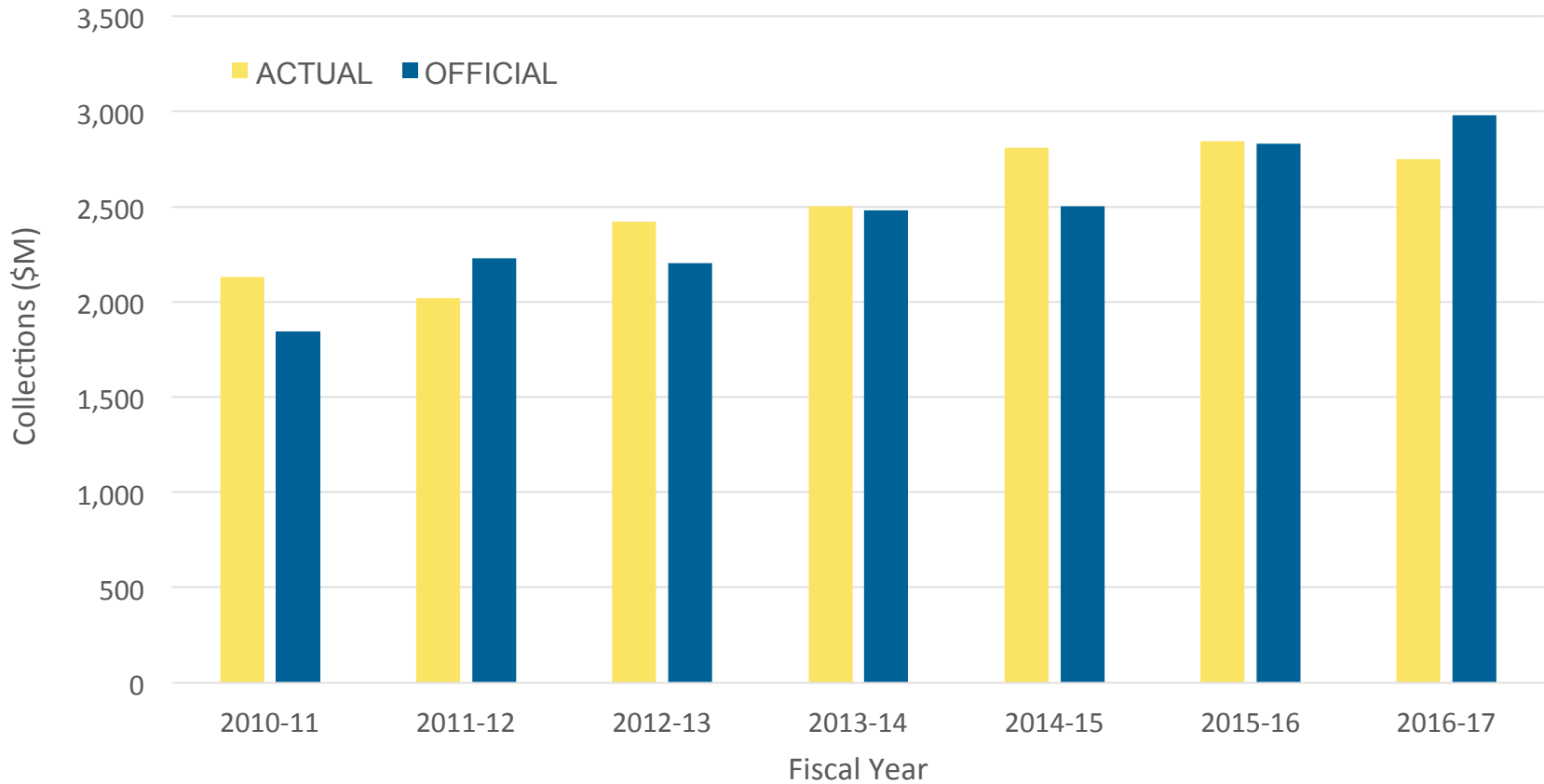
- Estimated impact of Act 52 – 2013
  - All Other
    - Use the percentage change from service companies.
  - Results
    - Once fully phased-in, Market Sourcing of Sales of Services should increase CNIT collections by around \$25M (on a base of \$2.8B).

# ➤ Market Sourcing of Sales of Services

- Actual impact of Market Sourcing
  - Can't be measured directly
  - Entire change in CNIT caused by apportionment changes is used as proxy.
  - Measure apportionment change impact on tax year 2013 as baseline.
  - Measure apportionment change impact on tax year 2014
    - the first year of the new language.
  - Difference between these two effects is assumed to be Market Sourcing of Sales of Services.

# Market Sourcing of Sales of Services

## Corporate Net Income Tax Collections



# Market Sourcing of Sales of Services

- Actual impact of Market Sourcing
  - Sample strata
    - Service companies and All Other
    - Change in payments between the two tax years
  - Sample size = 1,000
    - Driven by two factors – number of entities in a given strata and the average absolute value of the difference in payments for the strata.

Taxable Income = (Income to be apportioned)(Apportionment) – NOL

Taxable Income<sub>ALT</sub> = (Income to be apportioned)(Apportionment<sub>2013</sub>) – NOL

# ▶ Market Sourcing of Sales of Services

- Actual impact of Market Sourcing
  - Notes on methodology
    - Tax year 2012 apportionment had a sales factor weight of 90%. This has been reweighted to 100% for the 2012 to 2013 comparison so as not to skew the results.
    - Changes for entities using single factor apportionment are not included.
    - If a taxpayer used four-factor apportionment, their impacts are included.