SOURCING OF SALES APPORTIONMENT FACTOR OF THE NH BUSINESS PROFITS TAX

Income from Services and Intangibles

New Hampshire Department of Revenue Administration
Presentation to the House Ways & Means Committee
January 14, 2014
New Hampshire Apportionment

Business Profits Tax RSA 77-A:3

A business organization which derives gross business profits from business activity both within and without this state, and which is subject to a net income tax, a franchise tax measured by net income, or a capital stock tax in another state or is subject to the jurisdiction of another state to impose a net income tax or capital stock tax upon it, whether or not such tax is actually imposed, shall apportion its gross business profits so as to allocate to this state a fair and equitable proportion of such business profits.
New Hampshire uses apportionment to determine the portion of the profit of a company that is taxable to New Hampshire.

<table>
<thead>
<tr>
<th>Numerator</th>
<th>Denominator</th>
<th>Double Weight</th>
<th>Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>NH Sales</td>
<td>Everywhere Sales</td>
<td>X2</td>
<td>Sales Factor</td>
</tr>
<tr>
<td>NH Payroll</td>
<td>Everywhere Payroll</td>
<td>=</td>
<td>Payroll Factor</td>
</tr>
<tr>
<td>NH Property</td>
<td>Everywhere Property</td>
<td>=</td>
<td>Property Factor</td>
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<tr>
<td></td>
<td></td>
<td>+</td>
<td>All Factors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>/4</td>
<td>NH Apportionment</td>
</tr>
</tbody>
</table>
Sales Factor

New Hampshire – Cost of Performance method of sourcing of service and intangible sales

• Tangible sales are not sourced using Cost of Performance, they are sourced based on delivery
• Tangible items can be touched or have a physical presence, intangible products or services cannot
• The remainder of this presentation pertains only to the sales factor and the sourcing of service and intangible sales
Sales Factor Sourcing for NH

Cost of Performance Method (COP)

- Sourced based on the state with the plurality of income producing activity
- Frequently referred to as “all or nothing”
- Rev 304.04(g) allows for deviation from “all or nothing” based on specific facts in the case of personal services
- Twenty-eight (28) states use COP, nine (9) of those states use Proportionate Share COP instead of “all or nothing”
Sales Factor Sourcing for NH

- COP sourced on Income-producing activity (Rev 301.16)
  - Income-producing activity: The activities performed by the organization to obtain gain or profit
  - May not be the same location as the customer location
    - 40% of the income-producing activity may be in NH, but 80% of sales may be to out of state customers
    - Methodology: If the work is being done in NH, then it should be in the NH sales factor

- For all examples the following facts are used:

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<th>Income Producing Activity in State</th>
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<tr>
<td>A</td>
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</tr>
<tr>
<td>B</td>
<td>30%</td>
<td>40%</td>
</tr>
<tr>
<td>C</td>
<td>30%</td>
<td>40%</td>
</tr>
</tbody>
</table>
Cost of Performance Example

- Service Company has nexus in States A, B, and C
- States A, B, and C source sales of services in accordance with the COP approach
  - 40% of the company’s income producing activity occurs in State A,
  - 30% in State B, and
  - 30% in State C
- Under a COP approach all sales are sourced to State A, because a greater proportion of the income producing activity occurs there than in any other state
- Under this scenario, 100% of sales factor would be apportioned for corporate taxes
- This was the situation among the New England states until Maine (2007), and now Massachusetts (2014), went to Market Based Sourcing
Sales Factor Sourcing for Other States

• Recent Moves Towards Market Based Sourcing
  • Only affects the sales factor for services and intangibles
  • 19 states have adopted a form of Market Based Sourcing
  • Maine in 2007 and Massachusetts in 2014
  • Basic concept: The sales are sourced to where the customer is, rather than where the work is performed
Market Based Sourcing

• Regulations and rules are not universal
  • Examples include the location of the ultimate customer, location of initial customer, the state where the service or intangible is used, state where benefit is received, etc.

• Typically requires more detailed regulations than COP
  • Can be difficult to determine customer location, where the benefit is received, or have visibility to determine the ultimate customer
  • In business-to-business transactions who is the customer?
    • The receiving business?
    • Or the ultimate customers of the receiving business?
Market Based Sourcing Example

• Service Company has nexus (does business) in States A, B, and C

• States A, B, and C source sales of services using a Market Based approach
  • 20% of company’s sales are to customers in State A,
  • 40% of sales are to customers in State B,
  • 40% are to customers in State C

• Under a Market Based approach the respective sales into each state (A, B, and C) are attributable to each state for apportionment purposes

• Under this scenario, 100% of the sales factor would be apportioned for corporate taxes
COP and Market Based Sourcing Meet

How does it affect NH and NH Businesses?

• The changes in other states should not affect NH state revenues or the application of NH law

• The impact will be realized by NH businesses that do business in Market Based States
  • It will not affect businesses that sell tangible products
  • It will affect businesses that have service and intangible sales and have nexus in Market Based Sourcing States (like ME and MA)

• The change does not affect their NH liability, but does affect their total tax liability

• The Commerce Clause requires that the income be fairly apportioned
  • If a states statute is applied in all states the taxpayer would not be taxed on more than 100% of its income
COP and Market Based Sourcing Meet

Example (Competing COP and Market Based States):

• Service Company has nexus in States A, B, and C
• State A sources sales of services in accordance with the COP approach, States B and C source sales of services using a Market Based approach
  • 40% of the company’s income producing activity occurs in State A, 30% in State B, and 30% in State C
  • 20% of sales are made to customers in State A, while 40% of sales are made to customers in State B and 40% of sales are made to customers in State C
• Under competing sourcing rules, each state applies its respective apportionment formula
  • State A claims 100% of sales based on cost of performance,
  • State B claims 40% of sales based on its Market Based approach, and
  • State C claims 40% of sales based on its Market Based approach
• The company is now subject to state taxes based on 180% of its intangible sales factor
  • Because not all Market Based states have the same statute, causing variations in apportionment
  • Differences in double or single weighting of the sales factor may also cause variations
Alternatives for New Hampshire

• No Action
  • The changes in other states statutes should not affect NH revenues or the application of NH law, but may affect NH businesses
  • The impact will be realized by NH businesses doing business in Market Based States
  • It will not affect businesses that sell tangible products
  • It will affect businesses that sell intangibles and services and have nexus in a Market Based Sourcing State
  • The change in MA statute affects a businesses MA tax liability not the NH liability, but may affect overall total tax liability

• Legislative Action
  • Legislative Study
  • Statutory change to become Market Based Sourcing State
  • Statutory change to Proportionate Share Cost of Performance
  • A credit for taxes paid
Alternatives for New Hampshire (Cont.)

Legislative Study

• House Bill 1209 (2012), establishing a committee to study administration of the Business Profits Tax and the Business Enterprise Tax

  • House and Senate Study Committee
    • 3 House members and 3 Senate members
    • Included a review of “the apportionment of business profits taxation based on costs of performance.”

  • Passed in the House (OTP)
  • Passed in the Senate (OTP/A)
    • Senate removed the 3 Senate members
  • The House non-concurred with the Senate amendment
    • Bill did not pass

• This effort could be resurrected as it related to apportionment
Alternatives for New Hampshire (Cont.)

Statutory Change to Become a Market Based state

• Biggest risk: Unknown fiscal impact to state revenues
  • Would the out-of-state companies’ sales to NH be greater than the NH companies with sales elsewhere?
• This should be researched extensively
• This type of statutory change may require other changes, such as a throw-out rule (if the company does not have nexus in a state, it does not include those sales in the denominator)
• COP can penalize in-state companies investing resources in the state – Market Based Sourcing would not
  • If the company locates in NH, then its greatest amount of income producing activity may be in NH
Alternatives for New Hampshire (Cont.)

Statutory Change to Proportionate Share COP

- Nine (9) states currently use this methodology
- Biggest risk: Unknown fiscal impact to state revenues
- This should be researched extensively
- This type of statutory change would require other changes, such as more specialized apportionment rules
- Would decrease the penalty on companies investing resources within New Hampshire
- Would not be the same as Market Based Sourcing, as the sales factor would still be based on the location of the income producing activity
  - May or may not be the same as the customer location

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A Credit for Taxes Paid

- Has been suggested publicly by business representatives
- What would the credit be?
  - The change to Market Based Sourcing is a change to the sales factor only. It is possible that the taxpayer already had payroll and property apportionment to a Market Based state, and had previously paid tax to that state.
  - The credit would have to be for any state that has Market Based Sourcing (19 States)
  - There would be no reciprocal benefit; only a loss of revenue
  - Would give tax relief to NH businesses
Additional Information about Market Based Sourcing and Cost of Performance

• Multistate Tax Commission, Report of the Hearing Officer, Proposed Amendments to Multistate Tax Compact Article IV, October 25, 2013, pages 54 – 96
  • [http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Proposed%20Final%20Final3.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Proposed%20Final%20Final3.pdf)

• AICPA, The Tax Advisor, November 1, 2012
QUESTIONS?

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