A simpler method for sourcing revenues for professional service firms is on the way?

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The Multistate Tax Compact passed amendments to the Model General Allocation and Apportionment Regulations on Feb. 24, 2017. One of the primary purposes of the compact is to promote uniformity or compatibility in the various state tax systems. While the compact has no actual ability to require states to conform or adopt any of its regulations, the model regulations are provided as a recommendation to the states to encourage them to adopt similar rules. Currently 47 states and the District of Columbia are members.

The model regulations made changes to the definition of apportionable income and receipts (sales) and removed the recommendation for use of three-factor apportionment, however, the major change that will be discussed here is the change to the regulations adopting "market-based sourcing" of receipts.

Within the regulations, Reg. IV.17(d)(2) discusses the rules for in-person services. Reg. IV.17(d)(3) covers services delivered to the customer electronically and Reg. IV.17(d)(4) explains professional services.

Professional services are defined as "services that require specialized knowledge and in some cases require a professional certification, license or degree." While there can be some overlap of in-person services and professional services, the regulations state that "professional services where the service is of an intellectual or intangible nature, such as legal, accounting, financial and consulting services, are assigned as professional services under the rules of this Reg. IV.17(d)(4), notwithstanding the fact that these services may involve some amount of in-person contact." The regulations also provide that even if the professional services include the transmission of documents or communications by mail or electronic means, the rules of Reg. IV.17(d)(4) apply and not those of Reg. IV.17(d)(3).

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The regulations acknowledge that there are multiple ways of characterizing the location of the delivery of professional services by "emphasizing different elements of the service provided, no one of which will consistently represent the market for the services. Therefore, the location of delivery in the case of professional services is not susceptible to a general rule of interpretation, and must be reasonably approximated."

Additionally, the regulations provide that a "taxpayer's customer is the person that contracts for the service, irrespective of whether another person pays for or also benefits from the taxpayer's services. In any instance in which the taxpayer is not taxable in the state to which receipts from a sale is assigned, the receipts are excluded from the denominator of the taxpayer's receipts factor." This clarifies who the client is in situations where a firm represents a client in a litigation matter, but the other party ultimately pays the firm's fees. This portion of the regulations also recommends adoption of the throw-out rule.

The regulations distinguish between individual and business customers/clients as well. Generally, the receipts from individuals shall be assigned to the individual client's state of primary residence or, if that is not reasonably identifiable, to the client's billing address.The regulations provide a safe harbor that allows the taxpayer to "assign its receipts from sales to a particular customer based on the customer's billing address in any taxable year in which the taxpayer (1) engages in substantially similar service transactions with more than 250 customers, whether individual or business, and (2) does not derive more than 5 percent of its receipts from sales of all services from that customer."

For business clients, the regulations provide that "the taxpayer shall assign the receipts from the sale as follows: first, by assigning the receipts to the state where the contract of sale is principally managed by the customer; second, if the place of customer management is not reasonably determinable, to the customer's place of order; and third, if the customer's place of order is not reasonably determinable, to the customer's billing address; provided, however, in any instance in which the taxpayer derives more than 5 percent of its receipts from sales of all services from a customer, the taxpayer is required to identify the state in which the contract of sale is principally managed by the customer."

The regulations have moved completely away from any determination of where the client receives the benefit of the service, which in many cases has been too subjective to make any reasonable determination. This means that accounting personnel at firms would no longer have to work with the attorneys to determine what type of work was being performed and try to estimate where the benefit of the service is received, based on that type of work. The jurisdiction where a litigation matter is heard would also no longer be relevant.

While these model regulations may end up causing some firms to have more favorable state tax outcomes for their partners and others to have less favorable state tax outcomes, the adoption of these regulations by the states will provide taxpayers with an approach that appears to be easier and less subjective to understand and administer, which should result in less work and more certainty for accounting personnel.

Taxpayers need to keep in mind that member states must adopt these amendments before they apply in any specific state.

About the author

Bill Apple, Partner in the tax and assurance group, has been with Baker Tilly Virchow Krause, LLP since 2007. Bill has more than 25 years of experience advising clients in their business and personal income tax matters, financial planning and various other types of business transactions.