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SHOP TALK

Lessons from Two Recent Taxpayer Victories in Sales Factor Cases

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Excepting nexus and combined reporting, the sales factor is perhaps the most frequent source of state corporate income tax controversy. It is easy to understand why. With states increasingly abandoning the property and payroll factors, the sales factor has become, in many states, the sole metric used to determine how much of a taxpayer's income the state can tax.

This column first provides a short overview of the sales factor. It then discusses two recent taxpayer appeals court victories on sales factor issues and suggests some lessons that can be learned from those cases.

Introduction: Sales factor sourcing

For corporate income tax purposes, states generally source receipts from tangible personal property to the state of delivery. Sales other than sales of tangible personal property are typically sourced one of three ways: (1) cost of performance, based on where the costs associated with the income-producing activity are highest ("COP" sourcing); (2) location where the service is received sourcing ("market-based" sourcing); or (3) location where the service is performed sourcing ("location of performance" sourcing).

Of these three methods, COP sourcing has historically been the most commonly used, as the Uniform Division of Income for Tax Purposes Act (UDITPA) provides for COP sourcing and most states, at least initially, enacted UDITPA. However, many states, including larger states like California and New York, have amended their sourcing statutes to provide a market-based sourcing rule for services.

The states have a powerful weapon at their disposal when it comes to sourcing: alternative apportionment. Even if a statute ordinarily mandates one sourcing methodology, state tax administrators can always argue that application of the statute does not fairly reflect the taxpayer's income in the state and that, accordingly, a different sourcing methodology is warranted. UDITPA Section 18 grants state tax administrators this ability to deviate from statutory apportionment in select cases, and most states have enacted UDITPA Section 18 or some equivalent. Taxpayers also possess the ability to petition for alternative apportionment, although in practice such petitions are rarely granted.

Sales factor issues are particularly conducive to audits and litigation. An adjustment that changes a taxpayer's sales factor sourcing methodology from location of performance sourcing to market-based sourcing will often produce a dramatically different tax result. Sales factor disputes can often be difficult to settle because any settlement for the audit period will often leave open questions about how to apply the sales factor in future periods.

Quest (Louisiana): Quest for sales factor justice

Service providers are frequently embroiled in sales factor disputes. If a state uses COP or location of performance to source services, the result in some cases will be that no sales from in-state customers are sourced to the state, because the costs are highest out of state or the services are performed out of state. While this is how the statutes are designed to operate, tax administrators are often unsatisfied with these results and seek ways to apply market-based sourcing to the service provider.

A recent decision involving Quest Diagnostics ("Quest") illustrates the type of services sourcing disputes that service providers frequently encounter.[1]

As described by the Louisiana Court of Appeal, First Circuit, Quest earns income by performing diagnostic testing services for clients for a fee. This involves obtaining specimens from clients, testing the specimens at Quest's laboratories, interpreting the results of the tests, and then conveying test results to clients.

Historically, Quest sourced receipts from Louisiana clients to Louisiana, because it operated a laboratory in Louisiana where specimens from Louisiana clients were tested. But then Hurricane Katrina struck, destroying Quest's laboratory in Louisiana. Post-Katrina, specimens that previously were delivered to the Louisiana laboratory were instead routed to a Quest laboratory in Texas.

On its Louisiana corporate income tax returns, Quest initially continued to source all receipts from Louisiana clients to Louisiana, but then filed refund claims to source receipts relating to testing performed at the Texas laboratory out of Louisiana. In so doing, it relied on this Louisiana sourcing statute in effect for the years at issue, which applied to "service enterprises": "For the purpose of this Subsection, the gross apportionable income from Louisiana sources shall include the revenue from services performed in this state, and any other gross income derived entirely from sources within this state."[2]

Applying a straightforward reading of this statute, Quest's refund claim should have been granted. The statute plainly provides that receipts from services are sourced to Louisiana only if the services are performed in Louisiana. So why did the Louisiana Department of Revenue refuse to grant the refund claim?

The Louisiana Department of Revenue argued that the statute quoted above should not apply, because the statute defines "service enterprises" only as businesses in which property is not a substantial income producing factor in their business. Since Quest uses highly sophisticated equipment (property) in its business, the Louisiana Department of Revenue argued, and the court agreed, that the statute, on its terms, is inapplicable.

However, the statute that applies to other service providers (ones for whom property is a substantial income producing factor in their business) is vague and does not delineate the correct sourcing approach to use. In the absence of clarity, the court sensibly ruled that the same sourcing rule should apply to both types of service providers (the ones for whom property is and those for whom it is not a substantial income producing factor in their business). Since that is a location of performance sourcing rule, the court held that the receipts from diagnostic testing performed in Texas were not Louisiana receipts and hence granted the refund claim.

Cynical taxpayers may think that it is an impossible quest to find a judge who will read the statutes straightforwardly and find for the taxpayer in a sales factor sourcing case, but *Quest* shows that it is possible.

Rent-A-Center (South Carolina): When is alternative apportionment warranted?

An equally pro-taxpayer decision was recently issued in South Carolina, where the Court of Appeals refused to apply alternative apportionment. Commendably, South Carolina courts have shot down alternative apportionment assertions from the South Carolina Department of Revenue in the absence of proof that alternative apportionment is warranted.[3]

In *Rent-A-Center West, Inc. v. South Carolina Dep't of Revenue,*[4] the taxpayer (RAC West) had two relevant revenue streams: (1) sales made at retail stores it operated in western states, and (2) sales from licensing intellectual property to an affiliated company (RAC East) that operated retail stores in eastern states. The taxpayer had no retail store locations in South Carolina, so the only sales in its South Carolina numerator were from licensing intangible property to RAC East. Its sales factor denominator included all the sales from store locations in western states, resulting in a low South Carolina apportionment percentage.

The South Carolina Department of Revenue invoked alternative apportionment and proposed to remove the store sales from the denominator, thereby increasing the South Carolina apportionment percentage.

However, the court noted that a party invoking alternative apportionment must: (1) prove that the statutory formula does not fairly represent the taxpayer's business activities in the state, and (2) then show that the alternative method is reasonable. On the first issue, the court held that the South Carolina Department of Revenue had not met its burden of showing that the statutory formula does not fairly represent the taxpayer's business activities in South Carolina. To the contrary, the auditor testimony in the record "did not point to any specific evidence the standard apportionment method did not fairly represent RAC West's business activities."

The department's support for alternative apportionment was based on the testimony of an expert witness who stated that, effectively, the taxpayer had apples in its numerator (the licensing sales) but apples and oranges in its denominator (the licensing sales and the sales from retail operations). However, as the taxpayer's expert witness explained, and as the court agreed, that is how apportionment is supposed to work—the denominator captures all sales from all operations and the numerator captures only in-state sales from in-state operations—so this showed that the apportionment formula worked properly, not the opposite.

Since the department did not meet its threshold burden of showing that the apportionment formula did not fairly represent the taxpayer's income, the court ruled in favor of RAC West.

Lessons from these cases

All around the country the sales factor continues to be a hot audit issue. While taxpayers are not winning all the litigated decisions in this area, the victories discussed above illustrate that winning is possible if a case is convincingly presented. A common thread in these two cases is that the taxpayer not only showed that its construction of the statutes was reasonable, but the taxpayer also went on the offense and demonstrated the weaknesses in the state revenue department's position.

In *Quest*, this was done by pointing out that the department was effectively arguing for a different sourcing methodology for service enterprises depending on whether property is a major income producing factor in the service enterprise's business, a distinction that was difficult to defend. In *Rent-A-Center*, the taxpayer not only pointed to the lack of evidence in the record to justify alternative apportionment, but also was able to successfully use the department's expert witness's own language against the department.

Both decisions, and especially *Rent-A-Center*, contain favorable pro-taxpayer language that may be cited not only in Louisiana and South Carolina, but also in other states in which similar sales factor issues are in dispute.

[1] *Quest Diagnostics Clinical Laboratories, Inc. v. Louisiana Dep't of Revenue*, No. 2015 CA 0926 (La. Ct. App. Sept. 9, 2016).

[2] La. Rev. Stat. § 47:287.95(D).

[3] *See Carmax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Revenue*, 411 S.C. 79 (2014).

[4] *Rent-A-Center West Inc. v. South Carolina Dep't of Revenue,* No. 2012-208608 (S.C. Ct. App. Oct. 26, 2016).