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Still Alive and Kickin' "Cost of Performance" Sourcing for Sales Factor in State Income Taxes

Many states continue to follow the Uniform Division of Income for Tax Purposes Act ("UDITPA") provisions that establish a "cost of performance" sourcing rule for sales of non-tangible property. The cost of performance approach often results in an "all or nothing" sales factor allocation yielding both planning opportunities and unanticipated consequences. As a result, when determining the amount of sales of non-tangible property that should be included in a state's sales factor numerator, it is important to remember that these provisions are still relevant in many states.

UDITPA §17 states the following with respect to sales other than of tangible personal property:

Sales, other than sales of tangible personal property, are in this state if:

- a) the income-producing activity is performed in this state; or*
- b) 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.*

Unlike sales of tangible property, which are generally sourced based on the destination of the property, under the cost of performance method, sales of non-tangible items are sourced to the state in which the greatest proportion of costs are incurred.

While many states are enacting provisions that do away with a cost of performance approach in favor of marketplace sourcing, cost of performance is still alive and kickin' in many states. Jurisdictions that have cost of performance statutes similar to the one above include Alaska, Arizona, District of Columbia, Florida, Hawaii, Idaho, Indiana, Kansas, Kentucky, Massachusetts, Missouri, Montana, Nebraska, New Hampshire, New Mexico, North Dakota, Oregon, Pennsylvania, Tennessee, Vermont, Virginia, and West Virginia.

Because application of a cost of performance approach can result in an "all or nothing" sales factor numerator, be warned that states may aggressively interpret their existing cost of performance statutes, particularly when they find themselves on the "nothing" side. For example, in *Bellsouth Advertising*,^[1] the Tennessee Commissioner was permitted to depart from the standard statutory apportionment formula (*i.e.*, cost of performance) since that formula was found not to represent fairly Bellsouth's activities in Tennessee. As a result, even though all of Bellsouth's costs of performance occurred outside of Tennessee, revenue was derived when the product was distributed in Tennessee and thus, was forced to be reflected in Tennessee's sales numerator factor.



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Additional Considerations

Taxpayers should examine their sales sourcing methodology to determine whether an opportunity exists to take advantage of a cost of performance approach. Possible items for consideration are as follows:

- If you are a taxpayer primarily in the business of selling tangible property, are there other separate and identifiable streams of non-tangible or service revenue that might qualify for sourcing under a cost of performance methodology?
- Is it possible that the product you provide is actually a service and not the sale of tangible property?
- Have changes in technology affected your products? In other words, could your product be “less tangible” today than it was perhaps two decades ago, due to changes in technology?
- Even in states that have recently repealed and/or changed which taxpayers are eligible for using a cost of performance approach (e.g., California, Colorado, Illinois, and Utah), you may want to consider filing amended returns.
- Many of the states that offer some form of cost of performance have very unique and, sometimes, ambiguous provisions for use of same. Be sure to take care in understanding all the potential risks and rewards.

For more information concerning whether a cost of performance approach would be beneficial for your company, please contact your CBIZ Tofias & Mayer Hoffman McCann advisor, or we can be reached at TheBottomLine@cbiztofias.com and 888.761.8835.

[1] *Bellsouth Advertising & Publishing Corp. v. Chumley*, 308 S.W.3d 350 (Tenn. Ct. App. 2009).

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