

INFORMATION NOTICE CORPORATION TAXES 2014-01

December 12, 2014

1.0 PURPOSE

For purposes of determining the appropriate net income and capital stock franchise tax apportionment factors, this notice provides taxpayers with guidance on sourcing the sales of services to this Commonwealth, as defined in Act 52 of 2013, 72 P.S. § 7401(3)2.(a)(16.1)(C). Note that sales of services are no longer subject to the income-producing activity and cost of performance rules found in subparagraph (17).

2.0 STATUTORY RULES: 72 P.S. § 7401(3)2.(a)(16.1)(C)(I, II, III)

Rule #1: Sales from the sale of a service are in this state if the service is delivered to a location in this State. If the service is delivered both to a location in and outside this State, the sale is in this State based upon the percentage of total value of the service delivered to a location in this State.

Rule #2: If the state or states of assignment under Rule #1 cannot be determined for a customer who is an individual that is not a sole proprietor, a service is deemed to be delivered at the customer's billing address.

Rule #3: If the state or states of assignment under Rule #1 cannot be determined for a customer, except for a customer under Rule #2, 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 the location from which the services were ordered in the customer's regular course of operations cannot be determined, a service is deemed to be delivered at the customer's billing address.

3.0. APPLICATION OF THE STATUTE

3.1 The Purpose of the Sales Factor

72 P.S. § 7401(3)2.(a)(16.1)(C) provides the rules for sourcing service income for purposes of Sales Factor Apportionment. The Sales Factor provides a means to apportion a taxpayer's sales to the location of the marketplace where the consumer of a product, service, or intangible receives it. In *Gilmour Manufacturing Co. v. Commonwealth*, 573 Pa. 143 (2003), the Pennsylvania Supreme Court agreed with the Commonwealth Court, noting,

The [CNI] tax is designed to measure the amount of commercial activity that an entity engages in during a given year and tax it accordingly. [...]

Statutes permitting a corporation to apportion its sales for purposes of the CNI are designed to represent the contribution of various consumers and purchasers to the entity's overall sales. Specifically, in Pennsylvania the numerator of the sales factor represents the contribution of Pennsylvania consumers and purchasers to the entity's sales, while the denominator represents the contribution of all consumers and purchasers. *Id.* at 155, citing 750 A.2d at 953.

3.2 "Delivery" and "Location"

Consistent with the Pennsylvania Supreme Court and the intention of the Pennsylvania Legislature¹ in passing Act 52, the Sales Factor identifies the state or states in which the taxpayer has a market for the services, *i.e.*, it reflects the location where the customer for the service resides or is located.

While Rule #1 requires sales of services be sourced to PA if the services are delivered to a location in this State, the statute does not define the word "delivered." Neither does the statute define the word "location." Therefore, proper interpretation of Section (16.1)(C)(I) requires analysis of how to apply the concept that "the service is delivered to a location in this State." Appropriately, the Department looked to the principles of statutory construction² and legislative intent for any guidance in defining these terms.

Because the Legislature intended to enact one-hundred percent market-based sourcing of services, any interpretation of the statute that can frequently cause receipts to be sourced to locations other than where customer is located is misguided. Therefore, the term "location" must mean the location of customer. It follows, simply, that delivery to a location not representative of where the customer for the service is located does not represent completed delivery of the service.

Unfortunately, the surrounding statutory provisions are of no value in interpreting (16.1)(C)(I) since the surrounding code does not address the same class of subject as a service. Notably, services and tangible personal property ("TPP"), as addressed in (16), are not in the same class of things: TPP can be possessed remotely and still be of value to the customer, but the value of a service depends upon direct interaction with the customer or with TPP for which the customer has an interest, and a service itself cannot be "possessed."

However, services often are performed on real or personal property, and may be performed either locally or remotely. The table below shows the delivery location of some simple and common service situations.

¹ Pa. House Bill HB 465, PN 2211, Fiscal Notes, Page 2, July 1, 2013.

² 1 Pa.C.S. § 1921, § 1922, § 1927, and § 1932.

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Business Model	Examples	Location of Delivery
Service is performed locally	<ol style="list-style-type: none"> 1. Plumber fixes pipes in customer's house. 2. Temp agency provides clerical employees to customer's main office. 	<ol style="list-style-type: none"> 1. Address of customer's house 2. Address of the customer's office where the temp employees work.
Service is performed remotely on TPP owned by customer	<ol style="list-style-type: none"> 1. Customer drops off car for repair at garage, later returns for pick-up. 2. Customer ships damaged cell phone to repair facility that repairs and returns it. 	<ol style="list-style-type: none"> 1. Address of garage. 2. Address of customer.
Service is performed remotely and delivered in the form of incidental value TPP	<ol style="list-style-type: none"> 1. Research report printed on paper. 2. Customized market research database provided on a CD. 	<ol style="list-style-type: none"> 1. Address where customer takes physical possession. 2. Address where customer takes physical possession.
Service is performed remotely and delivered electronically	<ol style="list-style-type: none"> 1. Streaming video. 2. Online access to a database. 	<ol style="list-style-type: none"> 1. Location of purchaser where service is consumed or used. 2. Location of purchaser where service is consumed or used.
Service involves moving TPP from one place to another	<ol style="list-style-type: none"> 1. Shipping company hired to move packages from one place to another. 2. Bicycle express delivery of small packages. 	<ol style="list-style-type: none"> 1. Address of the recipient of the package. 2. Address of the recipient of the package.

The remainder of this Notice deals with more complex service delivery situations.

3.3 Third Party Delivery

It is not uncommon for a service to be delivered to the location of the customer by a third party. For example, an original service provider may find it cost effective to hire a third party to complete ultimate delivery of the contracted service to the customer. In this situation, delivery of the service from the customer's perspective occurs at the location where the customer representative of the market for this service actually receives it.

Accordingly, the passage of a service from a provider to an intermediate party or agent, whether or not such party or agent is legally affiliated with the customer, is not representative of the market for the service; therefore, delivery is not completed at the location of the intermediate party or agent.

Further, Pennsylvania courts have noted, "A sham transaction is an agreement or exchange that has no independent economic benefit or purpose and is entered into solely for some illegitimate purpose." See *Pitti v. Pocono Bus. Furniture*, 859 A.2d 523, 525 (Pa. Commw. Ct. 2004) quoting Black's Law Dictionary, 1380 (7th Ed. 1999). Therefore, taxpayers should be advised that any transactions that determine a taxpayer's ability to apportion or source its sales of services to a location other than the location of the customer are subject to review under the sham transaction doctrine.

3.3.1 Example of In-Transit Delivery

PA-based Customer orders a service from Taxpayer based in Virginia. Customer's purchase office in New Jersey actually places the order on behalf of the PA Office. Taxpayer delivers the service output to Customer's New Jersey Office. Customer's New Jersey Office delivers service output to the PA Office. The service receipts are sourced to PA because the purchasing office is an intermediate transit point prior to delivery to the location of the customer.

3.4 Electronic Delivery

Apportionment of services delivered electronically to locations in PA and one or more other states may be accomplished by using IP address records or other network data where individual street addresses of customers are not available. However, network data should be used only if it corresponds reasonably well to locations where the data is delivered to actual customers.

Note that services delivered to an electronic address (e.g., an email address, FTP account or IP address) are delivered to PA if the location of delivery is the location of the customer. If the user of the electronically-delivered service is both in PA and at least one or more other states, the service should be sourced among the states in a reasonable and proportionate manner considering such factors as: (a) usage of the service in each state; (b) the number of recipients in each state; or (c) the value of the service consumed in each state.

3.5 Apportionment by Jurisdiction

If a service may be sourced both to PA and outside of PA, it may be necessary to apportion the service to each state. In the event a service is apportioned, a reasonable and consistent method must be used. For example, apportionment may be based on "expected usage" or "actual usage" or "value of the usage;" however, whichever method is selected, the taxpayer must be consistent from year-to-year by continuously using a single selected method for those receipts in all subsequent years.

4.0 GUIDELINES FOR CERTAIN TYPES OF SERVICES OR SERVICE INDUSTRIES USING RULE #1

4.1 Personal and Professional Services for Individuals

If a service is delivered in this state and is in the nature of personal services (e.g., consulting, counseling, personal advice, training, speaking, and providing entertainment) that are typically conducted or performed first-hand, on a direct, one-to-one, or one-to-many basis, the service is delivered to PA, even if the service is provided from a remote location and/or delivered via electronic means.

4.1.1 Example

Taxpayer develops and analyzes X-ray film in Kansas for delivery to a doctor in PA. All receipts are sourced to PA.

4.2 Trade or Business Services Distinguished from Employee Services

4.2.1 Trade or Business Services

The term “trade or business” as used in this document shall include the administration, management, business processes, marketing, sales, manufacturing, distribution, and all other operations that support the trade or business itself. Trade or business services do not include paid services used only by employees for reasons not related to the conduct of the trade or business. Services provided to a trade or business that are used by the trade or business are delivered to the business location(s) containing the actual customers for the service.

4.2.1.1 Trade or Business Services Example

A-Corp decides to outsource its payroll processing functions to Taxpayer, who manages all of A-Corp’s payroll processing and reporting, including the issuance of checks to A-Corp employees. This service is sourced to the location of A-Corp because the payment of compensation to employees is a normal cost of doing business that would be incurred by A-Corp whether it processed payroll itself or paid a third party to do so. Further, although A-Corp employees benefit from the receipt of their individual paychecks, there is no direct interaction between A-Corp employees and Taxpayer. Thus, the receipts received by Taxpayer are not altered because of discretionary actions of the employees.

As for apportionment of receipts to PA, suppose half of A-Corp’s employees are located in PA and half are located in New York. A-Corp’s headquarters and human resources functions are located in PA. Taxpayer sources all of the payroll services to PA because the service is designed to meet the normal operating requirements of the company, and it is the company that uses the processing service, not the employee.

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4.2.2 Employee Services

Employee services not related to the conduct of the trade or business are services for which the employee can directly affect the amount of the service provided to him or her. If a service is provided to employees of a company and the service is designed and intended for employees' personal use and benefit, rather than for directly benefitting the normal trade or business operations of the company, then the service is delivered in PA following the guidelines above for delivery of Personal and Professional Services for Individuals.

If it is not possible for the taxpayer to ascertain or provide a reasonable estimate of the value of services delivered to employees in PA, then the delivery location of the services shall be apportioned to PA based on the number of employees assigned to PA by the purchasing company.

4.2.2.1 Employee Services Example.

Taxpayer provides to PA-based A-Corp a common, uniform 401K benefit program for the employees of A-Corp. The program is intended to help employees invest their personal earnings. As a result, individual employees have discretion to alter service levels provided by Taxpayer. Employee decisions, therefore, may impact both Taxpayer's program costs and Taxpayer's receipts.

Two-thirds of A-Corp's employees reside in PA and one-third resides in Ohio and each A-Corp employee participates equally in the plan. As a result, two-thirds of Taxpayer's receipts are sourced to PA.

4.2.3 Apportionment to Multiple States.

If a service is provided to a customer engaged in a trade or business in PA and relates only to the trade or business of that customer in PA, the service is delivered to PA. If the service is provided to a customer engaged in a trade or business in PA and one or more other states, the service is delivered in PA in proportion to the value of the service received by the customer in PA compared to the value of the service received by the customer everywhere.

4.2.3.1 Apportionment to Multiple States Example.

A-Corp hires Taxpayer to provide pest-extermination services for its headquarters office as well as each of its six branch offices located in PA (3 offices) and NJ (3 offices). A-Corp pays a fixed fee of \$70,000 for an annual contract that includes once-per-year inspections of A-Corp's headquarters office and each branch office. Taxpayer sources \$40,000 of its service to PA and \$30,000 to NJ.

4.3 Franchise and Service Fees

If a taxpayer receives payment for services provided to a franchisee, then the service fee receipts are sourced to the location where the services were delivered. Any separately-stated charges for the use of intangible property such as trademarks should be sourced under the provisions of Section 401(17).

4.4 Brokerage Services

The service is delivered to PA if the home address of an individual purchasing the service is in PA. The service is delivered to PA if the principal business address of a business purchasing the service is in PA. However, if the broker deals primarily with a company location other than the principal business location, then the service is delivered to the location of the customer or office with whom the broker has dealt.

4.5 Package Delivery and Courier Services

Receipts from a delivery service are sourced to PA by a delivery service or courier when the package is delivered to an address in PA, unless the taxpayer is otherwise subject to the special apportionment rules of 72 P.S. § 7401 (3)2.(b).

4.6 Subscription Services

A subscription service is delivered to a location in PA if the subscription customer is located in PA. If the actual physical locations of customers or licensees using the subscription service is difficult to ascertain, delivery of the service should be sourced, proportionately, to each state based on the number of subscribers in each state or, as appropriate, the number of licenses received by customers located in each state.

4.7 Mutual Fund Service Providers

Because a mutual fund service provider's services are ultimately designed to meet the needs of the shareholders of the funds, and because the shareholders often are the true owners of the funds, providers' sales from administering the plan are sourced to the location of each shareholder.

4.8 Advertising

The act of creating an advertisement itself may include the creation of TPP. However, the distribution and delivery of the advertisement to a target audience is a service. Delivery of an advertisement to a target audience is complete only upon reaching its intended target audience. Delivery to a target audience may follow these guidelines:

4.8.1 To the extent that an advertisement specifically targets audiences in PA, the advertisement service is considered delivered to PA.

4.8.2 To the extent that an advertisement specifically targets audiences in another state, the advertisement service is not delivered to PA.

4.8.3 To the extent an advertisement is targeted to multiple states or the location of the target audience cannot be ascertained, then a representative portion of the advertisement service is delivered to PA based on reasonable estimates of the location of the target audience.

4.9 Data Processing, Internet Access, Data Streaming, Data Storage and Information Services

Data processing and information services, such as streaming audio or video, access to stored data, or corporate shared services are delivered to the location of the user of the services. For example, if a PA-based taxpayer provides internet access to a customer's PA-based location, all receipts from the PA locations are sourced to PA.

Delivery of data services to a server, "the cloud," or another data storage device does not constitute delivery of these types of services. Rather, the services are considered delivered to the location of the user.

If the users of stored data are third parties, such as public web site users whose physical addresses are unknown to the cloud storage company, receipts shall be sourced using IP addresses or other network data.

Receipts from providing Internet access service are sourced to PA to the extent the access service is used by a customer in PA.

4.10 Custom Computer Software

The sale of pre-written ("canned") computer software will be sourced as tangible personal property. The development of custom computer software for a purchaser is considered a service if the purchaser provides specifications that make the resulting software unique to that purchaser. Online access to custom software is sourced according to Guideline 4.9 above. However, consistent with Section 3.2 above, custom software received via a hard medium only (*e.g.*, DVD, flash drive, or other physical device) is sourced to the address where the customer takes physical possession. If the service is utilized both in PA and in another state, the software is delivered to PA to the extent it is used in this state relative to use in other states.

4.11 Construction Services, Landscaping Services

If a service relates to real property that is located entirely in this state then the service is sourced to PA. If the service relates to real property that is located in this state and in one or more other states, the service is delivered to PA to the extent that the real property is located in PA.

4.11.1 Example

If a taxpayer constructs a building in New Jersey for PA-based customer, no receipts are sourced to PA.

4.12 Retail Sales (only) of Telecommunications Services

Companies with receipts subject to the federal Mobile Telecommunications Sourcing Act (MTSA) shall source those receipts in accordance with MTSA rules, which sources the receipts to the “place of primary use,” which is typically the billing address of the customer. Telecommunications services not subject to the federal MTSA, are delivered to a location in this Commonwealth if the service address of the account is in this Commonwealth. If the service is delivered to an individual or business with service accounts in the Commonwealth and at least one other state, the service is delivered in this Commonwealth based on the proportion of service addresses in this Commonwealth compared to service addresses in other states. In the event the service provider cannot determine the ultimate customer’s actual location(s) (*i.e.*, state[s]) to which the service is delivered, but has sufficient information regarding the place of receipt from which it can reasonably approximate the state or states where the service is delivered, the service provider shall make such reasonable approximations.

4.13 Transportation

Railroads, motor carriers, bus lines, airlines, and other transportation companies shall continue to apportion income under the rules of 72 P.S. § 7401 (3)2.(b).

4.14 Pipeline or Natural Gas Companies

Pipeline or natural gas companies shall continue to apportion income under the rules of 72 P.S. § 7401 (3)2.(c).

4.15 Water Transportation Companies

Water transportation companies shall continue to apportion income under the rules of 72 P.S. § 7401 (3)2.(d).

4.16 Sale, Lease, Rental, or Other Use of Real Property

Sourcing of receipts for sale, lease, rental, or other use of real property shall be sourced under (16.1)(A).

5.0 USE OF RULES 2 AND 3

Generally, taxpayers should be able to source most services using Rule #1. In the rare instance Rule #1 cannot provide reasonably accurate apportionment, Rules #2 or #3 may be employed. The following examples illustrate application.

Rule #2

Example: Taxpayer provides worldwide traveler emergency and advice service via phone to individuals located throughout the United States. Customers may

call for assistance from any phone located in the United States. Taxpayer sources service receipts to PA for all customers with PA billing addresses.

Rule #3

Example: Taxpayer provides phone-based drug and alcohol crisis counseling services to employees of Company A, whose headquarters is in Ohio but who has 40% of its employees in Ohio and 60% in PA. Employees may request counselling by calling a crisis hotline phone number. Employees may use the service anonymously, and are not charged an individual fee to use the service. By agreement, Taxpayer keeps confidential the identities of Company A employees who use the service. Taxpayer charges Company A a fixed annual service fee by Taxpayer. None of Taxpayer's receipts are sourced to PA.

6.0 APPORTIONMENT OF RECEIPTS FROM OTHER PROPERTY (INTANGIBLES)

Computation of a taxpayer's Sales Factor requires apportionment of sales from property as well as services. Additionally, sales not addressed under the property or services categories identified above are sourced separately under Section (17). The statutory provisions providing sourcing rules for all sources of property and services sales subject to PA Corporate Taxes can be summarized as follows:

PROPERTY

Tangible Personal Property – Section 16

Real Property – Section 16.1(A)

Tangible Personal Property Renting/Leasing/Licensing – Section 16.1(B)(I)

SERVICES

All Services – Section 16.1(C)

INCOME NOT APPORTIONED UNDER (16) OR (16.1)

Remainder – Section (17)

With the exception of intangible property, the rules for sourcing services and other types of property are explicitly identified. While this Notice does not define the universe of possible services, a general rule for distinguishing "property" income from "services" income is that a receipt requiring a specific "performance" of activities by the taxpayer is a service, while a receipt in exchange for a taxpayer granting possession or a right to use any type of property (tangible, real, or intangible) to another party is income from property and should be sourced under the applicable rules related to sourcing of income from property. Additional distinctions between property and services are discussed in Section 3.2 above.

Unlike services, the statute provides different sourcing rules for different types of property. However, notably absent from Sections (16) and (16.1) are rules for sourcing receipts derived from the ownership, use, sale, exchange, or other disposition of intangible property. Intangible property means any of the following:

- Patents, copyrights, trademarks, and trade names.
- Money and instruments representing the ownership of money.
- Equity or debt securities, such as stocks and bonds, and derivatives of such securities.
- Credits such as tax credits, energy credits, and billing credits.

Receipts from intangibles include any of the following.

- Royalties for the use of intangible property.
- Interest, capital gains or dividends arising from the ownership, sale, exchange or other disposition of intangible property.

6.1 Amended Income Producing Activity Law

Effective 1/1/2014, 72 P.S. § 7401 has been amended to limit the use of “income-producing” activity apportionment of sales to receipts from property other than property that is apportioned according to Sections (16) and (16.1):

(17) Sales, other than sales under paragraphs (16) [tangible property] and (16.1) [services], 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.

6.2 Interpretation and Application

6.2.1 First Priority: What is the Income Producing Activity?

Intangibles income will continue to be apportioned to PA if the income producing activity is performed in this state, using Subparagraph (17)(a). While Pennsylvania law does not define the term “perform,” the common meaning of the term is defined in *Black's Law Dictionary* as “[t]o perform an obligation or contract is to execute, fulfill or accomplish it according to its terms.” *Black's* further defines “performance” as “[t]he fulfillment or accomplishment of a promise, contract, or other obligation according to its terms.” Accordingly, performance of the income producing activity occurs when the

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performance is accomplished or fulfilled. Correspondingly, the location where performance is fulfilled is the location of the income producing activity. The department has consistently applied this income producing activity rule focused on fulfillment of performance of the sale to the customer. Uniform application of the rule applies to both PA-based and non PA-based taxpayers.

Further, income producing activities are identified at the transaction level, rather than at the operational level. Thus, an activity for which a customer would not pay for separately is not an income producing activity because it generates no income in and of itself. For example, the operating costs to maintain and update an internet server device are not income producing activities.

6.2.2 Example

Taxpayer is a Maryland-based restaurant chain that grants franchises to individuals in specific locations throughout Maryland and Pennsylvania. In exchange for granting a franchise to an individual, Taxpayer leases its trademarks and patented food-processing techniques to its franchisees. The leases are paid annually and entitle the franchisee to use those intangibles in specific restaurants throughout Pennsylvania and Maryland. The receipts from intangibles leased to Pennsylvania-based franchisees are sourced to Pennsylvania because the income-producing activity (use of the intangible) occurs in Pennsylvania.

6.2.3 Costs of Performance

In instances where the income producing activity of a single transaction is fulfilled or completed (*i.e.*, performed) in more than one state, then it may be necessary to use the costs of performance method (17)(b) for assigning the sales activity to a particular state. In calculating the costs of performance in each state, the taxpayer may include only those costs related to income-producing activities that are directly responsible for income generation in PA. The taxpayer must specifically identify each claimed income producing activity and must justify how each income producing activity directly affects the production of income in PA.