



Guidelines for Computing the Sales Factor Based on Market-Based Sourcing

INTRODUCTION AND SUMMARY

On October 1, 2015, Governor Pat McCrory signed into law House Bill 259 (S.L. 2015-268). Provisions in that legislation direct the Revenue Laws Study Committee to study the calculation of the sales factor under N.C. Gen. Stat. § 105-130.4 using market-based sourcing. To assist the Committee in determining the effect of market-based sourcing on State revenues and corporate taxpayers, every corporate taxpayer that meets certain criteria with respect to the taxable year beginning in 2014 is required to file an informational report with the Department of Revenue. Those criteria are:

1. The taxpayer had apportionable income greater than ten million dollars (\$10,000,000)
2. The taxpayer had a North Carolina apportionment percentage less than one hundred percent (100%)
3. The taxpayer was subject to apportionment of income based in whole or in part on the sales factor as determined under G.S. 105-130.4

The informational report, Form CD-400 MS, is due by April 15, 2016 and is not subject to extension.

The report for all corporations other than excluded corporations and public utilities will contain:

1. The 3-factor apportionment percentage and sales factor used with respect to the corporation's 2014 North Carolina corporate return ("Original")
2. The 3-factor apportionment percentage and sales factor as calculated under market-based sourcing guidelines with respect to the corporation's 2014 taxable year ("MBS")
3. The primary economic sector under the North American Industry Classification System ("NAICS") in which the corporation has business activities
4. The taxpayer's apportionable income
5. Income apportioned to North Carolina using the Original 3-factor apportionment percentage and income apportioned to North Carolina using the Original sales factor only
6. Income apportioned to North Carolina using the MBS 3-factor apportionment percentage and income apportioned to North Carolina using the MBS sales factor only
7. Capital stock, surplus and undivided profits before apportionment

8. Capital stock, surplus and undivided profits after apportionment using the Original 3-factor apportionment percentage and capital stock, surplus and undivided profits after apportionment using the Original sales factor only
9. Capital stock, surplus and undivided profits after apportionment using the MBS 3-factor apportionment percentage and capital stock, surplus and undivided profits after apportionment using the MBS sales factor only

The report for **excluded corporations and public utilities** will contain information based on the sales factor only.

The principal member of a group authorized by the Secretary of Revenue to file a **combined return** for tax year 2014 must complete all lines of the CD-400 MS. Other members of the group are required to file CD-400 MS and complete lines 6 through 8 only.

Failure to timely file the informational report will result in a \$5,000 civil penalty.

The legislation requires the Department of Revenue to publish guidelines for computing the sales factor based on market-based sourcing on or before February 1, 2016. The guidelines are not subject to the provisions of Chapter 150B with respect to rule making. The guidelines issued under this legislation are for the purpose of the informational report only and may not be used by the Department for any other purpose without further legislative authorization and compliance with the provisions of Chapter 150B.

The guidelines must be based on the following:

1. Market-Based Sourcing Principles:
 - a. In the case of sale, rental, lease, or license of real property, if and to the extent the property is located in this State.
 - b. In the case of rental, lease, or license of tangible personal property, if and to the extent the property is located in this State.
 - c. In the case of sale of a service, if and to the extent the service is delivered to a location in this State.
 - d. In the case of intangible property that is rented, leased, or licensed, if and to the extent the property is used in this State. Intangible property utilized in marketing a good or service to a consumer is "used in this State" if that good or service is purchased by a consumer who is in this State.

- e. In the case of intangible property that is sold, if and to the extent the property is used in this State. A contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area is "used in this State" if the geographic area includes all or part of this State. Receipts from intangible property sales that are contingent on the productivity, use, or disposition of the intangible property shall be treated as receipts from the rental, lease, or licensing of the intangible property as provided under item d. above. All other receipts from a sale of intangible property shall be excluded from the numerator and denominator of the sales factor.
2. The most recent model regulations with respect to market-based sourcing drafted by the UDITPA Section 17 Work Group convened by the Multistate Tax Commission ("MTC").
3. Any other model apportionment regulations and model statutes with respect to the allocation and apportionment of income consistent with those adopted by the MTC and that are not inconsistent with the principles outlined in the Market-Based Sourcing Principles in item 1.

The UDITPA Section 17 Work Group presented its recommended model to the MTC Uniformity Committee on December 10, 2015. The Committee approved and forwarded the recommendation to the MTC Executive Committee. Guidelines for the apportionment and allocation of receipts of financial institutions are based on model statutes as amended and adopted by the Multistate Tax Commission on July 29, 2015.

Under current North Carolina law, receipts from services are sourced to North Carolina if the income-producing activities are performed in North Carolina. Receipts from intangible property are sourced to North Carolina if the source of the receipt is in North Carolina. Both of these types of receipts are sourced differently under a market-based approach. There is no difference in the sourcing of receipts from the sale of real or tangible personal property.

The MTC rules include a throwout provision. In the case where a taxpayer is not taxable in a state to which a sale is sourced, that receipt is excluded from the denominator of the sales factor. The North Carolina guidelines **do not** include that provision. However, the MTC rules also include a throwback provision for receipts for which the taxpayer cannot determine or reasonably approximate the state where the sales should be sourced. The North Carolina guidelines **do** include that provision.

When a taxpayer cannot determine the state to which a sale should be sourced, the guidelines provide for reasonable approximation. In certain cases, the receipt from the sale of a service where the source is unknown is sourced in the same proportion as sales where the taxpayer knows the source of the

receipts from similar services. The same applies to receipts from intangible property where the sale resembles the sale of tangible property or services.

The North Carolina guidelines include numerous examples intended to assist the taxpayer in understanding the provisions of market-based sourcing, which make the document lengthy. The following tables are provided to summarize the basic principles of the guidelines for sourcing receipts from services and intangibles and to provide an easy reference tool. Please refer to the applicable sections and examples of the guidelines for further detail.

**IN-PERSON SERVICES, OTHER THAN PROFESSIONAL SERVICES
(DIRECTLY/INDIRECTLY PROVIDED BY THE TAXPAYER) Guidelines Section IV.(2)**

The receipt is from a service:	Source to North Carolina
Performed on the body of a person	If the customer is located in North Carolina
Performed in the physical presence of a customer	If the customer is located in North Carolina
Performed on real estate	If the property is located in North Carolina
Performed on non-shipped tangible personal property	If the property is located in North Carolina
Performed on shipped tangible personal property	If the property is shipped/delivered to a customer located in North Carolina

PROFESSIONAL SERVICES Guidelines Section IV.(4)

The receipt is from a service:	Source to North Carolina
General – provided to an individual customer and <5% of the taxpayer’s sales of services are from the customer	If North Carolina is the customer’s state of primary residence, or, if not identifiable, the customer’s billing address is in North Carolina
General – provided to an individual customer and >5% of the taxpayer’s sales of services are from the customer	If North Carolina is the customer’s primary state of residence
General – provided to a business customer and <5% of the taxpayer’s sales of services are from the customer	If: (i) the customer principally manages the contract in North Carolina, (ii) if not reasonably determinable, the customer placed the order in North Carolina, (iii) if not reasonably determinable, the customer’s billing address is in North Carolina
General – provided to a business customer and >5% of the taxpayer’s sales of services are from the customer	If the customer principally manages the contract in North Carolina

General provided to an individual or business customer optional safe harbor (if substantially similar service transactions with >250 customers and <5% of the taxpayer's sales of services are from the customer)	If North Carolina is the customer's billing address
Architectural services – real estate improvements	If the property is located or expected to be located in North Carolina
Architectural services – other	As required under the general professional services guidelines
Engineering services – real and tangible personal property	If the property is located or expected to be located in North Carolina
Engineering services - other	As required under the general professional services guidelines
Financial institution services – receipts not otherwise apportioned under Section VII, Special Rules	As required under the general professional services guidelines

NON-IN-PERSON AND NON-PROFESSIONAL SERVICES DELIVERED TO THE CUSTOMER ON BEHALF OF THE CUSTOMER OR DELIVERED ELECTRONICALLY THROUGH THE CUSTOMER Guidelines Section IV.(3)

The receipt is from a service:	Source to North Carolina
Delivery to or on behalf of a customer by physical means – individual or business customer	To the extent the service is actually delivered to the customer or the customer's customer is in North Carolina or, if not determinable, by reasonable approximation based upon information available regarding place of delivery
Delivery to a customer by electronic transmission – individual customer	To the extent the customer actually receives the service in North Carolina or, if not determinable, by reasonable approximation as follows (in order of priority): (i) based upon sufficient information regarding the customer's place of receipt; or (ii) if insufficient information regarding place of receipt, based upon the customer's billing address
Delivery to a customer by electronic transmission – business customer	To the extent the service is directly used by the customer's employees or designees in North Carolina or, if not reasonably determinable, reasonably approximate as follows (in order of priority): (i) if sufficient information regarding location where directly used by the customer's employees or designees, based upon the location where directly used by the customer's employees or designees; (ii) if insufficient information, as

	follows (in order of priority: a. based upon where the contract is principally managed by the customer, b. if not reasonably determinable, based upon the customer's place of order, or c., if not reasonably determinable, based upon the customer's billing address (but must use state where the customer principally managed the contract if more than 5% of sales of services are from that customer); or (iii) where engaged in substantially similar transactions with more than 250 customers, does not derive more than 5% of sales from the customer and cannot reasonably approximate under (i), may assign on the basis of the customer's billing address
Delivery through or on behalf of a customer through electronic transmission – general rule	To the extent the end-user or other third-party recipient is actually in North Carolina, or, if not determinable, by reasonable approximation based upon sufficient information regarding place of delivery.
Delivery through or on behalf of a customer through electronic transmission – advertising service	To the extent the audience for the advertising is in North Carolina, or, if insufficient information, reasonably approximate as follows (in order of priority): (i) based upon the location of the audience, or (ii), if insufficient information, based upon a percentage that reflects the ratio of the North Carolina's population in the specific geographic area in which the advertising is delivered relative to the total population in such area.
Delivery through or on behalf of a customer through electronic transmission – customer is a reseller	To the extent the end-user or other third-party recipients receive such services in North Carolina, or, if not determinable, reasonably approximate as follows (in order of priority): (i) based upon sufficient information regarding place of delivery, or (ii) if insufficient information, based upon a percentage that reflects the ratio of the North Carolina geographic area in which the customer reseller resells such services relative to the total population in such area.

LICENSE OR LEASE OF INTANGIBLE PROPERTY Guidelines Section V

The receipt is from:	Source to North Carolina
Marketing intangible with actual evidence	To the extent receipts are attributable to North Carolina
License/lease – marketing intangible without actual evidence and use relates to retail	Using the following formula: fee multiplied by a percentage that reflects the ratio of the North

customers	Carolina population in the geographic area in which the licensee makes use of the intangible property to market goods/services relative to the total population in such area
Marketing intangible without actual evidence and use relates to wholesale customers	Using the following formula: fee multiplied by a percentage that reflects the ratio of the North Carolina population in the geographic area in which the licensee's goods/services are ultimately marketed relative to the total population in such area
Production intangible initial presumption	If the customer's state of commercial domicile is North Carolina (business licensee) or North Carolina is the customer's state of primary residence (individual licensee), except to the extent the taxpayer can demonstrate the actual location of a portion of the use takes place outside North Carolina
Mixed marketing and production intangible (fees separately stated)	As required under the rule applicable to each revenue stream
Mixed marketing and production intangible (fees not separately stated)	As required under the marketing intangible rules (except to the extent the Department or the taxpayer can establish otherwise)
Resembles a sale of goods/services	As required under the rules pertaining to either: (i) the delivery to a customer by electronic transmission, or (ii) the delivery of services electronically through or on behalf of a customer

SALE OF INTANGIBLE PROPERTY Guidelines Section VI

The receipt is from:	Source to North Carolina
Contract right or government license that authorizes business activity in a specific geographic area	To the extent the intangible property is used or is authorized to be used in North Carolina, or through reasonable approximation
Sale that resembles a license	As required under the license/lease of intangible property guidelines
Sale that resembles a sale of goods/services	As required under the license/lease of an intangible that resembles a sale of goods/services guidelines
Excluded sales	Exclude the following from the numerator and denominator of the sales factor: (i) securities, (ii) business goodwill, (iii) agreement not to compete, (iv) workforce in place, (v) other similar intangible

	value.
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SPECIAL RULES Guidelines Section VII

Software transferred via tangible medium	As required under the tangible personal property sourcing rules
Software all other cases	As otherwise required under the intangible personal property sourcing rules
Financial Institutions	Special industry guidelines are in Section VII.(3) and are based on the MTC model regulations. Detailed sourcing guidelines are provided for specific streams of income specific to that industry.