

MEMORANDUM

TO: Helen Hecht, General Counsel, Multistate Tax Commission [or: Members of Drafting Group]

FROM: Bruce Fort, Counsel, Multistate Tax Commission

RE: SECTION 17 REGULATION PROJECT: SOURCING OF RECEIPTS FROM SERVICES---REAL PROPERTY

DATE: December 1, 2014

At the last meeting of the Section 17 regulatory drafting workgroup on November 25, 2014, the workgroup requested that staff prepare a memorandum outlining some approaches to sourcing receipts from services performed with respect to real property, to see if a rule could be promulgated for those types of receipts that would meet the criteria established in the drafting group's issues checklist. I believe that a proposed model regulation could be drafted to meet the checklist requirements, including: (1) providing certainty and clarity; (2) harmonizing results among statutes defining market-based sourcing based on "benefits received" and "services delivered" concepts; (3) reflecting existing regulatory and statutory treatment to the extent possible; and (4) minimizing the extent of different sourcing results in situations where a service or other activity could arguably be classified in more than one way.

I have proposed some model language for the working group's consideration, below.

It appears that five states currently specify distinct treatment for services "related to" or "connected with" real property as distinct from other types of in-person or "personal" services: Maryland, Massachusetts, Nebraska, Utah and Washington. (Two other states, California and Alabama, have adopted examples which indicate that receipts from services rendered in "connection to" real property should be sourced to the location of that property, as the location where the benefit is received and the service delivered, respectively.) One obvious policy reason for making a distinction between services "related to" real property and other types of services is certainty; the location of real property is almost always known. Additionally, the taxpayer is likely to have nexus in the state in which receipts for services affecting real property are identifiable.

A. Structure of Existing Regulations, and Recommendation to Adopt List of Specific Services:

States have adopted different approaches to distinguishing between real property services and other "in person" or "personal" services.

One approach is to state a general rule and to provide examples of that rule's application.

A second approach is to identify very limited categories of services that are always sourced to the location of the relevant real property. Massachusetts, Utah and other states have identified only architectural and engineering services; presumably many other types of services would also be sourced to the location of real property as the location of delivery or benefit.

A third approach, used by Washington, is to state a general rule for services related to real property and to provide a non-exclusive list of services subject to the rule.

I favor this approach above the others as it provides the most certainty to a broad group of taxpayers. The use of an extensive but non-exclusive list also provides an opportunity to control the scope of covered services under the legal canon of *ejusdem generis*, which "limits general terms [that] follow specific ones to matters similar to those specified," *Gooch v. United States*, 297 U.S. 124, 128 (1936). Washington, for instance, lists surveying and janitorial services, both performed at the site of real estate. But Washington's regulation also lists brokerage and appraisal services. These services may not be performed at the site of the real estate, but bear a direct relationship to real estate transactions. "Similar services" would presumably not include legal or accounting services provided to a real estate firm under the *ejusdem generis* doctrine, unless directly related to a particular real estate transaction.

B. Relationship of Service to Real Estate: "Related to", "Connected to" and Similar Phrases; And a Proposal for a Different Standard.

A common theme in all of the states which have attempted to define a separate classification for treatment of services "related to" real property is to establish how direct or substantial that relationship should be to the real property, as opposed to providing a service to the customer's business as a whole. Alabama uses the phrase (for all personal services) "substantial connection to a specific geographical location." Other states use a variation of the verb phrase "relating to" or "with respect to" real property. Other states rely on a limited number of examples to make the point that services "related to" real property are sourced to the property's location regardless of how much of the service is performed in-state.

I don't think the phrases "related to" or "connect[ed] to" are critically important in connecting the service receipts to real property, nor do I think those terms require further refinement, such as adding modifiers like "directly", "principally" or "substantially." I believe the more important distinction is whether the property locations are "identifiable." If the location of the relevant property is readily identifiable, the service is likely to have a "direct" and "substantial" (and predictable) relationship to that property. Conversely, if the location of the property is not readily identifiable, it is likely the service relates to the customer's business as a whole and should be sourced under generally-applicable rules for business to business transactions.¹

¹ Notwithstanding the oft-cited example of a lawyer providing real estate advice to an individual client concerning a non-residence property in another state, the vast majority of receipts falling into this classification will be business to business receipts; where services are provided to individuals, in the majority of situations the services would be sourced to the same state under any theory. That is, in most transactions with individuals, the location of the individual's property, residence and billing address will be the same.

Thus, in the great majority of cases a business providing architectural, engineering, property management, construction and similar services will be able to easily identify the location in which those services were used or delivered to the customer. Conversely, where a taxpayer that does not know whether the services will be used in or delivered to an identifiable location, the service should be sourced as other business to business “in person” services.

C. Subcontracted Services:

Some state examples implicitly or explicitly provide that a corporation’s receipts from reimbursement of subcontracted services performed on real estate should be sourced to the location of the real estate. Other state examples do not specify whether gross receipts sourced to the location of real estate should include reimbursement for subcontracted services performed on that real estate. I would propose an example covering subcontracted services as well as directly performed services in keeping with the current rule. (See proposed model, below.)

D. Separately-Stated or Distinct Aspects to Covered Services:

Several states have already adopted examples clarifying that the rule applies even if some aspects of a service are not directly performed on real property. Several states provide an example of engineering services being performed partially within a state and partially without a state. Those examples could be strengthened to emphasize that the entire contract amount is sourced to the state in which the real property is located, even though the service may have distinct components, e.g., construction overhead, which may occur in a different state from the real property itself. (See proposed model, below.)

E. A Note on “Reasonable Approximation.”

Any regulation under Section 17 must be cognizant of the need to establish when resort to “reasonable approximations” is appropriate when business records do not provide the level of detail necessary to allow sourcing based on location of delivery or benefits. The drafting group should be aware that California has an example of such a rule in the context of services “related to” real property in which the drafters concluded that the location where the benefit of a service was received could not be reasonably approximated.² I think the example is problematic because the degree of services provided to specific

² California’s Example:

“ Benefit of the Service - Business Entity, subsection (c)(2)(C). For a flat fee, Painting Corp contracts with Western Corp to paint Western Corp's various sized, shaped and surfaced buildings located in this state and four (4) other states. The contract does not break down the cost of the painting per building or per state. Painting Corp's books and records kept in the normal course of business indicate the location of the buildings that are to be painted but do not provide any method for determining the extent that the benefit of the service is received in this state, i.e. the size, shape, or surface of each building, or the materials used for each building to be painted. In addition, there is no method for reasonably approximating the location(s) where the benefit of the service was received. Since neither the contract nor Painting Corp's books and records indicate how much of the fee is attributable to this state and

property can usually be estimated, for instance, on a square foot or hours-expended basis. Thus, Georgia uses an example of pest control services provided to a multistate apartment complex owner that are apportioned according to the number of apartment units located in each state. Neither example is repeated in the proposed model.

F. Proposed Model Regulation Applicable to Real Property:

I propose adopting a version of Washington’s regulation which sets forth the general rule and then provides a laundry list of professional services after setting forth the basic rule. Thus,

“Receipts from services performed [in connection with] [relating to] [with respect to] identifiable real property shall be sourced to the location(s) of that real property. Such services include:

- (i) Construction;
- (ii) Architectural;
- (iii) Surveying;
- (iv) Janitorial;
- (v) Security;
- (vi) Engineering;
- (vii) Permitting and site approval;
- (viii) Appraisals;
- (ix) Selling and Brokerage;
- (x) Property Management; and
- (xi) Similar services.

Examples:

1. A corporate taxpayer from State Y wins a contract to construct an office complex in State C. The taxpayer sub-contracts with an engineering firm from State X to oversee construction of the complex in State C. The engineering firm performs some of its service in State C at the building site and also some of its service in State X. The engineering firm separately bills the taxpayer for its overhead in administering the project from State X. The entire gross receipts from the contract, including reimbursed amounts for the entire engineering service, are attributable to State C because [the recipient of the service received all of the benefit of the service in State C] [the services was delivered in state C].
2. Franchisor in State X hires Architectural Firm A to design a model interior for all of its restaurants, including furniture, color schemes, kitchen layouts and floor plans. Although the firm is aware that Franchisor does business in 20 states, the work does not relate to any identifiable properties. The receipts should be sourced to State X

there is no method of reasonably approximating the location of where the benefit of the service is received, the sale will be assigned to this state if the order for the service was placed from this state.”

[as other business-to-business personal services], despite the fact that Architectural Firm A is engaged in real estate-related design work.

3. Same facts as above, but Franchisor then hires Architectural Firm A to modify the model plan to suit a proposed location in an interior shopping mall in State Y. Architectural Firm A must source its receipts from this contract to State Y.

Appendix:

Selected Excerpts from Relevant State Regulations:

Alabama: service provided to a third party;

“substantial connection to a specific geographic location”

Maryland:

relating to construction or improvement to real property;

Massachusetts:

Architectural and Engineering Services with respect to Real or Tangible Personal Property.

Nebraska:

- (i) The service, when rendered, relates to real property located in this state;

Utah:

Engineering services are performed in connection with a property being constructed in Utah.

Washington:

“relates to real property”, with non-exclusive listing of specific services falling into that category:

- (i) Architectural;
- (ii) Surveying;
- (iii) Janitorial;
- (iv) Security;
- (v) Appraisals; and
- (vi) Real estate brokerage.