

WHY MERGERS & ACQUISITIONS MUST CONSIDER SOURCING SERVICE REVENUE FOR STATE INCOME TAX



The sourcing of service revenue for state income tax purposes is of particular significance in the context of [mergers and acquisitions](#) (M&A). During the tax due diligence phase of M&A, it is crucial to assess the target company's tax compliance, including its sourcing methods. Identifying potential tax liabilities related to incorrect methods can impact the valuation and terms of the deal. The target company in an M&A deal may only situs revenue to their business location(s). The state income tax landscape has changed over the last 10 years, and simply filing state income tax returns where the target company has physical business operations may not be compliant. Understanding the nuances of service revenue sourcing is essential for acquiring companies, such as private equity firms, to identify any potential exposure outside the current state tax return filings.

Cost of Performance vs. Market-Base Sourcing

The states imposing an income tax have adopted the concept of apportionment to determine how much of their federal taxable income should be taxed in the state's jurisdiction. Apportionment is a ratio of property, payroll, and sales. Most

states have adopted the sales ratio, dividing the in-state sales by the total sales everywhere. Buyers need to determine whether the target company is correctly reporting in-state revenue in the numerator of the sales factor. Cost of Performance (COP) and the Market-Based Sourcing (MBS) methods are two primary ways to source service revenue for income tax purposes.

Under the COP method, service revenue is sourced based on where the services are performed. The target company may be taking the COP position and only filing state income tax returns in states with physical locations. Historically, the states have used the COP method, but there has been a shift to MBS.

The MBS method sources service revenue to the location where the customer benefits from the service. This aligns with where the customer uses the service rather than where the provider performs it. There has been a shift towards the MBS method over the last 10 years, and most states have adopted it.

Is there Nexus?

After understanding the states' rules for sourcing, the buyer should determine if the target company has nexus in the state. Physical presence in a state will meet the state's definition of doing business, but this isn't the sole consideration. Physical presence used to be the standard, but most states have adopted the economic nexus standard, which establishes a lower threshold for doing business. Using the states' market for financial or pecuniary gain or profit may create economic nexus. The requirements of market-sourcing rules can technically trigger economic nexus in a state and an income tax return filing requirement.

The presence of remote workers in states outside of where the target company has operations can also create nexus issues. In these remote states, additional consideration should be given to COP vs. MBS sourcing rules.

The complexity of market-sourcing service revenue arises from the variations of sourcing methodology in statute and guidance by the different states. This inconsistency can lead to significant reporting challenges for businesses with a multistate footprint.

A target company may operate with customers in both COP and MBS states. If a target company performs services in a COP state but has most customers in MBS states, there is the potential to apportion more than 100% of federal taxable income. Understanding the target company's nexus footprint and apportionment methods is critical for post-closing tax planning.

Case Study Example

The Texas Supreme Court's ruling in the [Sirius XM case](#) highlighted the challenges of sourcing service revenue. The court rejected the Texas Comptroller's MBS position, which sourced revenue based on the location where the service was received (i.e., where the radio signal was decrypted). Instead, the court ruled that the substance of Sirius XM's service is producing and broadcasting original content, and the decryption was performed as part of the business model. This content should be sourced to where the original content was created instead of where the customer benefits from the service.

Conclusion

The sourcing of service revenue for state income tax purposes is a complex and evolving area of tax law. For M&A transactions, understanding and addressing these complexities is essential to ensure accurate tax compliance and avoid unexpected liabilities post-closing. Tax practitioners and corporate executives must stay informed about the latest developments in state tax laws and sourcing rules to navigate these challenges effectively.

If you have any questions related to this topic, please be sure to contact a member of your [BMF team](#).