

DRAFT Property Analytics Firm Hybrid Sales Factor Guidelines

Introduction

During the 2022 Session, the Virginia General Assembly enacted House Bill 453 (2022 Acts of Assembly, Chapter 256) and Senate Bill 346 (2022 Acts of Assembly, Chapter 257), which allow property information and analytics firms that meet certain criteria and choose to enter into a memorandum of understanding (“MOU”) with the Virginia Economic Development Partnership Authority (“the Authority”) to source sales of services to Virginia using market-based sourcing.

These guidelines are published by the Department of Taxation (“the Department”) to provide guidance to taxpayers regarding the sourcing of sales for certain property information and analytic firms, as required by the second enactment clause of both House Bill 453 and Senate Bill 346. These guidelines are not rules or regulations subject to the provisions of the Administrative Process Act (*Va. Code* § 2.2-4000 et seq.) and are being published in accordance with the Tax Commissioner’s general authority to supervise the administration of the tax laws of the Commonwealth pursuant to *Va. Code* § 58.1-202. As necessary, additional information will be published and posted on the Department’s website, www.tax.virginia.gov. These guidelines complement the Department’s existing Corporation Income Tax Regulations (23 *Virginia Administrative Code* (“VAC”) 10-120-10, et seq.). To the extent that there is a conflict between the Department’s existing regulations and *Va. Code* §§ 58.1-416 and 58.1-422.3, the provisions of those sections of the *Code of Virginia*, as interpreted by these guidelines, supersede the existing regulations.

These guidelines represent the Department’s interpretation of the relevant laws. They do not constitute formal rulemaking and hence do not have the force and effect of law or regulation. In the event that the final determination of any court holds that any provision of these guidelines is contrary to law, taxpayers who follow these guidelines will be treated as relying on erroneous written advice for purposes of waiving penalty and interest under *Va. Code* §§ 58.1-105, 58.1-1835, and 58.1-1845. To the extent there is a question regarding the application of these guidelines, taxpayers are encouraged to write to the Department and seek a written response to their question.

These guidelines address how to compute the hybrid sales factor for a property information and analytics firm that has already qualified and entered into an MOU with the Authority for a particular taxable year (“qualified firm” or “Firm”). These guidelines do not address how to qualify under this legislation. Please consult the Authority for more information on how to qualify and the criteria that must be met.

Sales Factor Calculation

For apportionment purposes, the sales factor consists of a fraction, the numerator of which is the total sales of the corporation in Virginia during the taxable year, and the denominator of which is the total sales of the corporation everywhere during the taxable year. To be included in the sales factor, the sales must be used to produce Virginia taxable income and be effectively connected with the conduct of a trade or business within

DRAFT Property Analytics Firm Hybrid Sales Factor Guidelines

the United States, where the income from such conduct is includable in federal taxable income.

According to *Va. Code* § 58.1-416(A), sales of tangible personal property are generally deemed in Virginia and must be included in the sales factor numerator if the tangible personal property is delivered to a location in Virginia. In contrast, *Va. Code* § 58.1-416(B)(1) provides that sales other than sales of tangible personal property are generally deemed in Virginia and must be included in the sales factor numerator if:

- The income-producing activity is performed in Virginia; or
- The income-producing activity is performed both in and outside of Virginia and a greater proportion of the income-producing activity is performed in Virginia than in any other state, based on costs of performance.

Qualified firms are allowed a limited exception to these rules by being able to source sales of services using market-based sourcing. Pursuant to *Va. Code* § 58.1-416(B)(2), sales of services will be deemed in Virginia and will be required to be included in the sales factor numerator if the benefit of the service is received in Virginia.

Market-based sourcing under this legislation is limited to sales of services only. As a result, a qualified firm must compute its sales factor using standard rules, except that the sale of services would be sourced to Virginia if the benefit of such services was received in Virginia. Sales of intangible property and real estate continue to be sourced to Virginia based on the location of the greater portion of costs of performance, and sales of tangible personal property continue to be sourced to Virginia based upon whether property is received in Virginia by the purchaser.

Definitions

As used in these guidelines, unless the context requires otherwise:

“Benefit of a service is received” means the location where the taxpayer's customer has either directly or indirectly received value from delivery of that service.

“Cannot be determined” means that the taxpayer's records or the records of the taxpayer's customer which are available to the taxpayer do not indicate the location where the benefit of the service was received.

“Reasonable approximation” means considering all sources of information other than the terms of the contract and the Firm's books and records kept in the normal course of business, the location of the market for the benefit of the services is determined in a manner that is consistent with the activities of the customer to the extent such information is available to the taxpayer. Reasonable approximation shall be limited to the jurisdictions or geographic areas where the customer or purchaser, at the time of purchase, will receive the benefit of the services to the extent such information is available to the

DRAFT Property Analytics Firm Hybrid Sales Factor Guidelines

taxpayer. If population is a reasonable approximation, the population used shall be the U.S. population as determined by the most recent U.S. census data. If it can be shown by the taxpayer that the benefit of the service is being substantially received outside the U.S., then the populations of those other countries where the benefit of the service is being substantially received shall be added to the U.S. population. Information that is specific in nature is preferred over information that is general in nature.

“Service” means activities engaged in by a person for another person for consideration. The term “service” does not include activities performed by a person who is not in a regular trade or business offering its services to the public, and does not include services rendered to an entity “affiliated,” as defined in *Va. Code* § 58.1-302, with the taxpayer.

“To the extent” means that if the customer of a service receives the benefit of a service in more than one state, the gross receipts from the performance of the service are included in the numerator of the sales factor according to the portion of the benefit of the services received in this Commonwealth.

Market-Based Sourcing Methods

In determining whether sales of services are in Virginia under *Va. Code* § 58.1-416(B)(2), various sourcing methods are provided below that apply sequentially in a hierarchy. For each sale of services, a qualified firm must make a reasonable effort to apply the preceding sourcing method before seeking to apply the next sourcing method in the hierarchy. For example, the primary sourcing method for corporations and other business entities requires a Firm to determine the location where the benefit of the service is received, and if a Firm cannot do so, the secondary method requires a Firm to reasonably approximate the location of assignment. In this case, the Firm must attempt to assign the sales of serviced to the location where the benefit of the service is received (e.g., apply the primary method in the hierarchy) in good faith and with reasonable effort before it may reasonably approximate the location.

Individual Customers

In the case where an individual is the Firm's customer, receipt of the benefit of the service shall be determined as follows:

Primary Sourcing Method. The location of the benefit of the service shall be presumed to be received in Virginia if the billing address of the Firm's customer, as determined at the end of the taxable year, is in the Commonwealth. If the Firm uses the customer's billing address as the method of assigning the sales to the Commonwealth, the Department will accept this method of assignment. This presumption may be overcome by the Firm by showing, based on a preponderance of the evidence, that either the contract between the Firm and the Firm's customer, or other books and records of the taxpayer kept in the normal course of business, provide the extent to which the benefit of the service is received at a location in the Commonwealth. If the Firm believes it has overcome the presumption and uses an alternative method based on either the contract

DRAFT Property Analytics Firm Hybrid Sales Factor Guidelines

between the Firm and the Firm's customer or other books and records of the taxpayer kept in the normal course of business, the Department may examine the Firm's alternative method to determine if the billing address presumption has been overcome and, if so, whether the Firm's alternate method of assignment reasonably reflects where the benefit of the service was received by the Firm's customers.

Alternative Sourcing Method. If the presumption in primary sourcing method is overcome by the Firm, and an alternative method cannot be determined by reference to the contract between the Firm and its customer or the Firm's books and records kept in the normal course of business, then the location where the benefit of the services is received by the customer shall be reasonably approximated.

Business Customers

In the case where a corporation or other business entity is the Firm's customer, receipt of the benefit of the service shall be determined as follows:

Primary Sourcing Method. If the necessary information is available to allow the Firm to determine the location where the benefit is received, it is required to assign sales of services to such location. The location of the benefit of the services shall be presumed to be received in the location where the contract between the Firm and the Firm's customer or the Firm's books and records kept in the normal course of business, notwithstanding the billing address of the Firm's customer, indicate the benefit of the service is located. This presumption may be overcome by the Firm or the Department by showing, based on a preponderance of the evidence, that the location indicated by the contract or the Firm's books and records was not the actual location where the benefit of the service was received.

Alternative Sourcing Methods. If neither the contract nor the Firm's books and records provide the location where the benefit of the service is received, or the presumption in the primary sourcing method is overcome, then the location where the benefit is received shall be reasonable approximated.

If the location where the benefit of the service is received cannot be determined under the primary sourcing method nor reasonably approximated, then the location where the benefit of the service is received shall be presumed to be in the location from which the Firm's customer placed the order for the service.

If the location where the benefit of the service is received cannot be determined pursuant to the primary sourcing method, reasonably approximated, nor by the location where the Firm's customer placed the order for the service, then the benefit of the services shall be in the location of the Firm's customer's billing address.

DRAFT Property Analytics Firm Hybrid Sales Factor Guidelines

Example 1:

Firm A sells property information and analytic services to business customers under contracts that indicate that the benefit is received in State 1. Firm A sells other property information and analytic services to other business customers under contracts that do not indicate where the benefit is received, and Firm A's records do not indicate where the benefit is received.

For those customers whose contract indicate the location where the benefit is received, Firm A must assign these sales to State 1. For those customers whose contract does not indicate where the benefit is received, nor does Firm A have records indicating where the benefit is received, Firm A must source these sales by reasonable approximation if possible. Firm A may not choose out of convenience to source these sales based on the location from which the customer ordered the services or the customer's billing address.

However, if these sales cannot be sourced by reasonable approximation, Firm A must source these sales to the location from which the customer ordered the services. In the event that Firm A also cannot determine the location from which the customer ordered the services, Firm A must then use the customer's billing address to source these sales.

Example 2:

Firm A sells property information and analytic services to a business customer under a contract which indicates that the benefit is received in State 1, where the customer's headquarters is located. However, Firm A knows that the business customer is actually receiving and using these services at a branch office in State 2. Accordingly, Firm A must assign these sales to State 2.

General Principles of Application

In order to satisfy the requirements in the "Market-Based Sourcing Methods" section, a qualified firm's assignment of sales of services must be consistent with the following principles:

Principle 1: The Firm must apply the methods set forth in the "Market-Based Sourcing Methods" section based on objective criteria and must consider all sources of information reasonably available to the Firm at the time of its tax filing. The Firm must determine the location where the benefit of the service is received as indicated by the contract or the Firm's books and records kept in the normal course of business in good faith, and apply such determinations consistently with respect to similar transactions and year to year. The Firm must retain contemporaneous records that explain the determination and application of its method of assigning sales of services, including its underlying assumptions, and must provide those records to the Department upon request.

DRAFT Property Analytics Firm Hybrid Sales Factor Guidelines

Principle 2: The “Market-Based Sourcing Methods” section provides various sourcing methods that apply sequentially in a hierarchy. For each sale to which a hierarchical method applies, the Firm must make a reasonable effort to apply the preceding method applicable to the sale before seeking to apply the next method in the hierarchy. For example, the applicable method first requires the Firm to determine the location where the benefit was received, and if the Firm cannot do so, the method requires the Firm to reasonably approximate the location. In these cases, the Firm must attempt to determine the location where the service was received (i.e., apply the primary method in the hierarchy) in good faith and with reasonable effort before it may reasonably approximate the location.

Principle 3: The Firm’s method of assigning its sales of services, including the use of a method of reasonable approximation, where applicable, must reflect an attempt to obtain the most accurate assignment of such sales consistent with the standards set forth in the “Market-Based Sourcing Methods” section, rather than an attempt to lower the Firm’s tax liability. A method of assignment that is reasonable for one Firm may not necessarily be reasonable for another Firm, depending upon the applicable facts.

Exclusion of Sales from the Sales Factor

In a case in which a Firm cannot ascertain the location to which a sale of services is to be assigned pursuant to the applicable methods set forth in the “Market-Based Sourcing Methods” section (including through the use of a method of reasonable approximation, where relevant) using a reasonable amount of effort undertaken in good faith, the Department will require that such sale be excluded from both the numerator and denominator of the Firm’s sales factor pursuant to its authority under *Va. Code* § 58.1-416(D) to adopt remedies and corrective procedures.

Treatment of Pass-through Entities

Pass-through entities (“PTEs”) are required to use corporate apportionment to determine the portion of their income that is from Virginia sources for purposes of allocating a share of that income to nonresident individuals. This will affect the amount that the nonresident individuals report on their Virginia nonresident income tax returns or that the PTE reports on behalf of its nonresident owners, and the amount for which the PTE may be required to withhold from Virginia income. See the PTE Guidelines (P.D. 15-240) for more information.

A corporate owner of a PTE may be required to include its share of the PTE’s property, payroll, and sales in the corporation’s own apportionment factors. (See P.D. 95-19, 95-263, and 99-76.) The corporate owners would include in their factors only their share of the PTE’s factors for the applicable taxable year.

DRAFT Property Analytics Firm Hybrid Sales Factor Guidelines

Inapplicability of Virginia's Administrative Extension of Public Law 86-272

A taxpayer is not subject to Virginia corporate income tax to the extent that federal or state law exempts the taxpayer from such tax. One federal law, Public Law ("P.L.") 86-272, prohibits a state from imposing a net income tax where the only contacts with the state are a narrowly defined set of activities constituting solicitation of orders for sales of tangible personal property. While P.L. 86-272 itself only relates to sales of tangible personal property, the Department has an administrative policy of generally extending this federal law to sales other than sales of tangible personal property. See P.D. 93-75. Because services are a type of sales other than sales of tangible personal property, a Firm would generally be exempt from Virginia corporate income tax to the extent that its only sales in Virginia were services protected under this administrative policy.

However, *Va. Code* § 58.1-416(C) asserts nexus over property information and analytic firms with sales of services attributable to Virginia to the maximum extent permitted under the Constitutions of Virginia and the United States and federal law. This provision of Virginia law supersedes the Department's administrative extension of P.L. 86-272. As a result, a Firm is not eligible for an exemption from taxation on the basis that its sales of service would be protected under the Department's administrative policy. Note that *Va. Code* § 58.1-416(C) only supersedes the Department's administrative policy. It does not remove any exemption from taxation afforded to taxpayers, including Firms, under P.L. 86-272 itself. To the extent that a Firm's only sales in Virginia are sales of tangible personal property protected under P.L. 86-272, the Firm will continue to be exempt from Virginia corporate income tax.

Additional Information

These guidelines are available on the Department's website, located at <http://www.tax.virginia.gov/>. For additional information, please contact the Department at (804) 367-8037.