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In this installment of Pennsylvania's SALT Shaker, Karpchuk examines the lack of consistency in state courts' interpretations of "cost of performance" language in state statutes, leading to unpredictable results in sourcing cases.

Over the past year, courts around the country have been interpreting various "cost of performance" (COP) language in state statutes and coming to unpredictable conclusions. Three recent cases highlight the consistency of revenue departments' frustration with — and attempts to alter the result of — "standard" COP language in their state's statutes, and the inconsistency of state courts' interpretations of similar language.

In March 2022 a taxpayer won a reversal of an appellate court's decision on the issue of sourcing under what the taxpayer argued was COP language in a Texas statute. Under the law, receipts from performing a service are apportioned to where the service is performed. If services are performed both inside and outside the state, the receipts are attributed to Texas in proportion to the fair value of the services rendered in Texas.

In *Sirius XM Radio Inc.*,[1] the taxpayer and the comptroller ultimately disagreed about where the service was being performed. Sirius argued that its headquarters, transmission equipment, and 70 percent of the radio programming were located exclusively outside Texas and that its satellite programming services were therefore being performed almost entirely outside Texas. In the comptroller's view, the taxpayer was providing the service of "unscrambling a radio signal," not the production of satellite programming, and according to the comptroller that service occurred "at the radio receiver" (that is, the customer's location).

While the appellate court sided with the comptroller, the Texas Supreme Court ultimately reversed, relying on a plain reading of the statute supported by long-standing precedent. Thus, the Texas Supreme Court adopted an origin-based test and rejected the receipt-producing, end-product act test.

Meanwhile, in November 2022 a Florida circuit court again sided with a taxpayer regarding the use of a COP method to source its receipts from services. Under Florida's sourcing rules, a receipt is sourced to Florida if (1) the income-producing activity is performed wholly within Florida or (2) the income-producing activity is performed inside and outside Florida but a greater proportion is performed in Florida, based on COP.[2]

In *Target Enterprise Inc.*,[3] the Florida Department of Revenue issued an income tax assessment to the taxpayer, a Minnesota-based subsidiary of Target Corp. (Target), wherein it

[1] *Sirius XM Radio Inc. v. Hegar*, No. 20-0462 (Tex. 2022).

[2] Fla. Stat. Ann. section 220.15 (1).

[3] *Target Enterprise Inc. v. Department of Revenue*, No. 2021-CA-002158 (Fla. Cir. Ct. Nov. 28, 2022).

sourced certain receipts that the taxpayer received from Target to Florida, even though the taxpayer had no property in Florida and less than 1 percent of its payroll was in Florida. In an attempt to circumvent the COP language, the DOR claimed that the taxpayer failed to provide sufficient documentation to support the use of the COP method under the regulations. Thus, the DOR argued that it was entitled to use its equitable authority to construct a new method for the sales factor, one in which the taxpayer was required to attribute its service receipts to Florida based on a fraction of retail square footage of stores in Florida over retail square footage of stores across the country.

In siding with the taxpayer, the court found that the COP method provided for in the law should be used and that since the greater proportion of the payroll costs to perform the taxpayer's services was performed outside Florida, none of the service revenue was apportioned to Florida.

Regarding the DOR's ability to construct its own method, the court found that the taxpayer had provided sufficient documentation to support its COP method, as provided in the regulation, and therefore, the DOR was without authority to reconstruct the taxpayer's sales factor for apportionment purposes.

Finally, the court found that even if alternative apportionment were justified, the DOR's proposed method based on square footage was without merit because the proffered method had no relevant relationship to the taxpayer's business activity in Florida since the taxpayer's compensation was not affected by Target's use of the underlying services. Also, the method used by the DOR was looking to Target's business activity in Florida, not the taxpayer's activity in Florida. The taxpayer was a separate, distinct legal entity from Target. Therefore, the court concluded that Target's business activities in Florida were not relevant for purposes of determining the taxpayer's apportionment to the state.

Conversely, in February 2023 the Pennsylvania Supreme Court decided a COP case in favor of the Pennsylvania DOR. Before 2014 the statute required services to be sourced to the location of the "income-producing activity." When the income-producing activity occurred both within and without Pennsylvania, receipts were required to be sourced to the state where the greater proportion of income-producing activities occurred, based on COP. Effective for tax years beginning in 2014, Pennsylvania adopted market-based sourcing for services — but maintained COP sourcing for sales of intangibles.

However, before the statutory change, on audit the DOR had begun asserting that the language of the pre-2014 statutory language, in reality, was meant to lead to a market-based sourcing result. Synthes was a Pennsylvania-based company that had filed based on a "standard" understanding of COP, sourcing its sales to Pennsylvania. Thereafter, it filed a petition for refund, arguing that the uniformity clause of the Pennsylvania Constitution required the DOR to apply the department's market-based sourcing interpretation of COP to it.

Losses at the board levels resulted in an ultimate appeal to commonwealth court, where the case was assigned to the office of the attorney general, which is tasked with handling such appeals. In defending against the refund claim, the attorney general's office took a position contrary to the DOR's market-based sourcing interpretation of the COP statute and consistent with the standard understanding of COP. The DOR sought to intervene, arguing that the attorney general's office was not representing its interests. The department ultimately sided with the taxpayer in claiming, based on its reading of the statute, that it was entitled to a refund.

In siding with the DOR, the Pennsylvania Supreme Court explained that it did "not view the 2013 amendments as an attempt to alter the general framework for sourcing sales, but rather as an attempt to clarify the sourcing of sales of services to the point of delivery to the customer."[4]

Open issues still exist in Pennsylvania, which maintained the COP language for intangibles through January 1, 2023, as well as similar language for purposes of personal income tax sourcing. The 2022 legislative history for the change in sourcing for intangibles seems at tension with the Pennsylvania Supreme Court's

[4] *Synthes v. Commonwealth of Pennsylvania*, 11 MAP 2021 (Feb. 22, 2023).

reasoning in *Synthes*. In accordance with the Senate Appropriations Committee's fiscal note on the intangibles legislation, the purpose of the change to the intangibles sourcing was to "align the apportionment rules governing sales of intangible property with the sales of tangible personal property, real property and services to be consistent with market sourcing (*i.e.*, where the purchaser paying for the sales or using the property is located)." This suggests that without this legislative change, intangibles would be treated *differently* from a market result — which is contrary to the clarification that the Pennsylvania Supreme Court asserted was made to the same sourcing language for services. Nonetheless, taxpayers that sourced intangibles based on COP may have an opportunity for a refund (or be at risk for assessment).

While these decisions highlight the lack of consistency across state courts in analyzing similar language, they also highlight the desire of revenue departments in COP states to achieve market, or similar, results. Taxpayers should be on the lookout for other COP jurisdictions that may closely examine the Pennsylvania Supreme Court's decision and its potential applicability in their state. ■