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Cost of Performance vs. Market Approach to Sourcing Revenue

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Calculating how to source gross receipts is a key element in determining a staffing company's state income tax liability. Staffing companies operating in multiple states should be aware of the growing trend in which states are migrating from a cost of performance based sourcing method toward a market-based approach when determining where to properly source gross receipts derived from sales of services.

Under cost of performance (COP), receipts earned from performance of services are apportioned to the state based on the location where the taxpayer incurs expenses associated with providing those services. For example, assume Company ABC has all its property and employees in State A. State A uses the cost of performance for sourcing receipts from services. Company ABC clients are located in states B and C. Since State A had adopted the cost of performance rules, all of ABC Company's revenue would be sourced to State A as the COP is incurred entirely in State A.

However, if state A had opted market-based sourcing rules, Company ABC could potentially be sourced to State B and C. Under the market-based approach, the taxpayer assigns sales of services to the state in which the services is received or where the benefit of the services is received. The market approach attempts to better match the receipts to the source of the corresponding revenue stream. The market approach also collects more tax from out of state businesses with significant economic activity, but have little in the way of payroll or property.

States differ in applying the market-based sourcing rules. In general, market can be defined in the following ways:

- Where the benefit is received
- Where the service is received
- Where the service is delivered
- Where the customer is located

Most states using market-based sourcing use a single factor sales apportionment instead of a traditional three-factor apportionment (this involves using a percentage based on property, payroll, and sales located in a state). It is possible for a taxpayer to pay no tax on a portion of their service revenue in states that have a single sales factor apportionment. For example, Company ABC has offices and employees located in State A. ABC Company has clients that are located in State D. The clients receive the benefits of ABC Services in State D. State D uses a COP based receipts for sourcing revenue whereas state A uses a market approach to sourcing revenue.

Both State A and D use a single factor sales apportionment. Under State D's COP based rule, the revenue would not be sourced to State D because the expenses associated with providing the services are incurred in State A. Therefore, in this example, income is not allocated to either State A or D.

It is also possible for taxpayers to have "double taxation". If in the above example, State D utilized a market approach and State A utilized a COP based sourcing, State A would allocate all of ABC's revenue to State A (where the services are performed, and the cost of services are incurred) and State D would allocate the revenue to State D (where the benefits of the services are received). In this example, the same revenue would be attributed to both states and subject to tax in both states.

Staffing companies need to review their current operations to identify and if possible to reduce the risk of double taxation. Tax planning should be examined to avoid under or over allocating income to states.