

Take Two: Massachusetts Department of Revenue Releases Revised Market-Based Sourcing Regulation

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Late last week, the Massachusetts Department of Revenue (the Department) released a revised [draft regulation](#) on Massachusetts's new market-based sourcing law. The changes made by the Department to purportedly address practitioner and taxpayer concerns were relatively modest. The rules remain lengthy, complex and cumbersome. There are still various assignment rules that apply to each of the following types of transactions: (1) in-person services, (2) professional services, and (3) services delivered to the customer, or through or on behalf of the customer (described in the new regulation as services delivered to the customer, on behalf of the customer, or delivered electronically through the customer, hereinafter "sales delivered to, by, or through a customer"). For a more detailed discussion of these rules see our *State Tax Notes* [article on market-based sourcing](#).

The most noteworthy changes from the initial draft relate to the taxpayer's ability to use a "reasonable approximation" method. The initial draft regulation provided taxpayer's with the ability to use a "reasonable approximation" when "the state or states of assignment" could not be determined. The new regulation clarifies that a taxpayer must, in good faith, make a reasonable effort to apply the primary rule applicable to the sale (e.g., the specific assignment rules for in-person services, professional services, or sales to, by, or through a customer) before it may

reasonably approximate. Additionally, the regulation explicitly states that a method of reasonable approximation “must reflect an attempt to obtain the most accurate assignment of sales consistent with the regulatory standards set forth in [the regulation], rather than an attempt to lower the taxpayer’s tax liability.” There is no guidance as to how a taxpayer would demonstrate that its reasonable approximation attempt was made to “obtain the most accurate assignment of sales.” This raises a number of questions—for example, if a taxpayer determines that there are two equally reasonable methods by which it can reasonably approximate its Massachusetts sales, can it use the method that results in less tax? Additionally, there does not seem to be any converse requirement that the Department make a similar demonstration (*i.e.*, that any modifications to a taxpayer’s sourcing methodology not be an attempt to *increase* a taxpayer’s liability) when exercising its authority to adjust a taxpayer’s return (as discussed below).

In an attempt to make the regulation more even-handed, the Department’s revisions provide that neither a taxpayer nor the Department may adjust a “proper” method of assignment, including a method of reasonable approximation, unless it is to correct factual or calculation errors. However, the revision isn’t all that meaningful because there are still a broad number of scenarios in which the Department can make changes, one of which is when a taxpayer uses a method of approximation and the Commissioner determines that the method of approximation employed by the taxpayer is not “reasonable.” Additionally, when a taxpayer excludes a sale from both the numerator and denominator of its sales factor because it has determined that the assignment of the sale cannot be reasonably approximated, the revised regulation provides the Commissioner with seemingly unfettered discretion to determine that the sales exclusion was inappropriate and “instead substitute a method of approximation that the Commissioner determines is appropriate.”

While the revised regulation attempts to address taxpayer concerns regarding the ability to change a sourcing method and continues to provide taxpayer’s with the ability to make prospective changes to a method of assignment (which must be properly disclosed), unlike the Department’s broad powers described above, the revised regulation restricts taxpayers to making such changes only “for purposes of improving the accuracy of assigning it sales.” This includes changes made to address changes in available information.

Importantly, the revised regulation also provides new safe harbors in an attempt to address concerns related to the difficulty of compliance and record-keeping requirements, particularly in the context of services provided to business customers by electronic means. Many providers of electronically delivered services do not track, and do not have the means to track, where their service is ultimately delivered to or received by its customers (particularly in the case of large business customers). Under the safe harbor for electronically delivered services (which applies only to services delivered to a business customer), a taxpayer may assign its sales to a particular customer based on the customer’s billing address in any year in which the taxpayer engages in substantially similar transactions with more than a 1,000 customers (whether business or individual) and does not derive more than 5 percent of its sales from that customer. A similar safe harbor was also created for professional services delivered to business customers.

A public hearing on the revised draft regulation is set for December 4th and the Department urges taxpayers to send written comments in advance of the hearing to the Rulings and Regulations Bureau at RulesandRegs@dor.state.ma.us or faxed to (617) 626-3290. Given that there has been some talk that this draft regulation may serve as the model regulation for other states and the Multistate Tax Commission, we encourage taxpayers to comment on the draft and can submit comments on behalf of taxpayers who wish to remain anonymous.

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