

## **INTERNAL POLICY DIRECTIVE 2006-8**

September 29, 2006

### **SINGLE BUSINESS TAX SALES APPORTIONMENT - COSTS OF PERFORMANCE**

The purpose of this IPD is to provide guidance and standardize policy regarding the application of the "costs of performance" methodology as it pertains to the Single Business Tax (SBT) sales apportionment factor. This IPD applies to the provision of services; as well as in general, the sale of intangible property; the sale of real property; and the rental of property.

#### **POLICY ISSUES**

1. The apportionment of sales of tangible personal property is addressed in MCL 208.52. How are sales other than the sales of tangible personal property apportioned for SBT purposes?
2. How is the "costs of performance" methodology applied? Is business activity examined as a whole, or on a per transaction basis?
3. What are the direct costs to be used in determining the "costs of performance"?
4. Are sales revenues ever split between Michigan and other states based on a percentage of the "costs of performance"?
5. How can one distinguish between a sale of tangible property and the performance of a service?

#### **POLICY DETERMINATIONS**

1. The inclusion of sales in the numerator of the SBT sales factor is governed by MCL 208.53 for sales other than sales of tangible personal property. Pursuant to section 53, sales are attributed to this State if the business activity that gave rise to the sale is performed entirely within this State. MCL 208.53(a). Also, sales are attributed to this State if the business activity is performed both within and without this State, but the greater proportion of the business activity is performed in this State than is performed outside this State based on "costs of performance." MCL 208.53(b). This IPD does not address MCL 208.53(c).
2. Sales are attributed to this State if, with respect to a particular sale, the greater proportion of the business activity is performed in this State than is performed outside this State based on costs of performance. "Costs of performance" means direct costs that are determined in a manner consistent with a taxpayer's method of accounting for federal income tax purposes. A costs of performance analysis is not applied to the total business activity of a taxpayer, but to each sale separately.
3. "Costs of performance" means direct costs consistent with a taxpayer's method of accounting for federal income tax purposes. In other words, those costs directly related to the activity performed for the client. Indirect costs not directly related with the performance of the contracted service are not used in calculating the costs of performance.

Direct costs do not include fixed costs unrelated to the provision of property or services; or remotely related costs such as human resources management, accounting, advertising, or activities conducted to maintain the business but not to provide the business activity in question.

The determination of direct costs is dependent on an examination of the nature of the service performed. Direct costs may include labor costs of those employees directly related to the performance of the service in question; materials, equipment, and supplies directly related to the performance of the service; and payments to an independent contractor who performs services directly related to the contractual obligations.

4. No, there is no statutory provision for splitting service revenue from a single transaction between several states based on a time or cost allocation. Revenue from a transaction is sourced to the state where the majority of the business activity is performed, i.e., the greater proportion of the business activity is performed in the state than is performed outside the state based on costs of performance.
5. In order to distinguish between the sale of a service and the sale of tangible personal property, the ultimate purpose of the transaction on the part of the purchaser must be analyzed, viewing the entire transaction as a whole, rather than examining the components of the transaction separately. If the ultimate purpose of the transaction is to purchase the performance of a service, any tangible personal property transferred as a result is incidental to providing this service, and the entire transaction will be sourced based on a costs of performance analysis.

## **DISCUSSION**

The inclusion of sales in the numerator of the SBT sales factor is governed by MCL 208.52, for the sales of tangible personal property, and MCL 208.53 for sales other than sales of tangible personal property. Section 53 directs that:

Sales, other than sales of tangible personal property, are in this state if:

- (a) The business activity is performed in this state.
- (b) The business activity is performed both in and outside this state and, based on costs of performance, a greater proportion of the business activity is performed in this state than is performed outside this state. . . .

Business activity is defined by section 3(2) of the SBT Act, MCL 208.3(2):

“Business activity” means a transfer of legal or equitable title to or rental of property, whether real, personal, or mixed, tangible or intangible, or the performance of services, or a combination thereof, made or engaged in, or caused to be made or engaged in, within this state, whether in intrastate, interstate, or foreign commerce, with the object of gain, benefit, or advantage, whether direct or indirect, to the taxpayer or to others, but shall not include the services rendered by an employee to his employer, services as a director of a corporation, or a casual transaction. Although an activity of a taxpayer may be incidental to another or other of his business activities, each activity shall be considered to be business engaged in within the meaning of this act.

Sale is defined at section 7(1) of the SBT Act, MCL 208.7(1):

- (a) "Sale" or "sales" means the amounts received by the taxpayer as consideration from the following:
- (i) The transfer of title to, or possession of, property that is stock in trade or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.
  - (ii) The performance of services, which constitute business activities other than those included in subparagraph (i), or from any combination of business activities described in this subparagraph and subparagraph (i).
  - (iii) The rental, lease, licensing, or use of tangible or intangible property which constitutes business activity.

MCL 208.53 provides for the inclusion of sales in the numerator of the sales factor from transactions other than sales of tangible personal property. Pursuant to section 53, sales are attributed to Michigan if, with respect to a particular sale, the greater proportion of the business activity is performed in this State than is performed outside this State based on "costs of performance."

"Costs of performance" is not defined in the SBT Act. The Department's position is that "costs of performance" means direct costs that are determined in a manner consistent with a taxpayer's method of accounting for federal income tax purposes. Direct costs may include activities that are performed on behalf of a taxpayer to provide the contracted service, such as those conducted on behalf of a taxpayer by an independent contractor.

The Department has adopted a transactional approach if a business activity of the taxpayer is the performance of a service. For purposes of the sales factor numerator in the apportionment percentage, "costs of performance" must be considered for each sale separately. This approach is supported by the definitions of business activity (MCL 208.3(2)) and sales (MCL 208.7(1)), and is consistent with what is required by the SBT Act with respect to the sale of tangible personal property. (MCL 208.52).

As noted previously, MCL 208.53 addresses the inclusion of sales, other than sales of tangible personal property, in the sales factor numerator. If the service is performed in Michigan, the consideration for the service is allocated to Michigan. If the service is performed both within and outside of Michigan, then a taxpayer must demonstrate, using a "costs of performance" analysis on a transactional basis, where the greater proportion of the business activity is performed.

Michigan is a member of the Multistate Tax Commission and has adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA") for income tax purposes. However, the SBT is levied on business activity that is allocated or apportioned to this State and is not an income tax. See MCL 208.31. For apportionment purposes, the SBT Act uses a weighted three factor formula. These factors, property, payroll and sales, are the same factors as are used in UDITPA, but unlike UDITPA, the SBT factors are not equally weighted. The UDITPA General Allocation and Apportionment Regulations are not applicable to the SBT and deviate in some aspects from the policies detailed in this IPD.

No previous publications by the Department or promulgated rules exist concerning this issue.