

Which States Are Market Sourcing for Service Taxes?

November 1, 2022



With the U.S. Supreme Court’s 2018 ruling in *Wayfair* essentially blessing the economic nexus concept, at least within the sales tax context, the list of states employing income tax economic nexus continues to grow steadily. In general, states are constitutionally required to have a minimal connection in order to impose their taxes upon an out-of-state taxpayer. Economic nexus laws establish this minimum link via a revenue threshold which, if exceeded, is deemed enough of a connection with a jurisdiction to create a tax obligation for the out-of-state taxpayer.

Currently, all 45 sales taxing states have mandated some level of a “factor presence” threshold for purposes of establishing sales tax nexus. Additionally, about a dozen of those states also utilize a receipts threshold test for corporate income taxes (e.g., New York), which is often based on a percentage of the company’s total gross income, and/or other tax compliance, such as partnership filings and excise taxes (e.g., California and Washington). Accordingly, determining how receipts are sourced to a state becomes critical in light of the potential for increased income tax exposure under economic nexus. This is particularly important for service providers due to the shift in state sourcing service rules from the cost of performance methodology to the increasingly popular market-based sourcing approach.

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State Sourcing of Service Revenue

The two primary models that states use to source service revenue for income tax purposes are: (1) cost of performance and (2) market-based sourcing.

Under the cost of performance approach, service revenue is sourced to the location from which the services are rendered, which is often the business's home state. More specifically, this is the place where the costs to perform the services are incurred. When services are performed in multiple jurisdictions, some states require that either the majority or greatest proportion of the services need to be performed in the state in order to source any revenue there — in essence, an all-or-nothing test. Other states divide the revenue proportionally based on the percentage of service rendered in the state compared to the overall whole of the service rendering.

For market-based sourcing, revenues are sourced to the customer location, or more specifically, the location where the benefit of the service is received. State regulations contain various criteria for determining the jurisdiction where the benefit is received, such as the customer's billing address, the service delivery location, the order from location, or even a reasonable approximation based on the particular circumstances at hand.

Market-Based Sourcing Leading to Economic Nexus

As the vast majority of states now use market-based sourcing for corporate tax purposes, with many of them using this methodology for partnership filings as well, the interplay between the market-based sourcing concept and triggering economic nexus must be understood for the potentially significant impact on one's state taxes. To illustrate, take the following example: Corporation A renders \$750,000 of services from its office in New York for a client located in California, a market-based state. Assume California has also adopted a \$500,000 income tax economic nexus threshold. Since Corporation A's service receipts are sourced to California under market-based sourcing, it will have exceeded California's economic nexus threshold, thereby requiring Corporation A to file a tax return in the state and be subject to

state tax. Had California been a cost of performance jurisdiction, Corporation A would not have a state filing requirement because no receipts would be sourced to California given that none of the services were rendered there. Thus, Corporation A would not exceed California's economic nexus threshold.

Conclusion

Each year more and more states make the switch to market-based sourcing for service revenue to better reflect, and of course tax, the ever-expanding service-based economy. By layering in an economic nexus threshold, states stand to cast a wider net, sweeping up new taxpayers. While the above example was simple, in practice service providers can be operating in dozens of states while rendering services for clients in many others. This sharply increases the complexity of applying these rules and the need to have an in-depth understanding of the revenue sourcing methodologies and how they intersect with economic nexus.

[Contact Our Team](#)

If you have any questions regarding the state sourcing of your service revenue and how economic nexus impacts your tax obligations, please contact [Alan Goldenberg](#), Principal and Leader of the [State and Local Taxation](#) and [Tax Controversy](#) groups, or your Anchin Relationship Partner.