

Legislative Changes Regarding Single-Sales Factor Apportionment and Market-Based Sourcing



Corporation Business Tax and Income Tax

Special Notice 2017(1)

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I. Summary

This Special Notice addresses apportionment changes to the Connecticut Corporation Business Tax (the Corporation Business Tax), which are applicable to income years beginning on or after January 1, 2016, and the Connecticut Income Tax (the Income Tax), which are applicable to taxable years beginning on or after January 1, 2017. The Apportionment Legislation¹ described in this Special Notice applies to those taxpayers identified in *Section II*.

The most significant aspects of the Apportionment Legislation are:

Single-Sales Factor

Prior to the Apportionment Legislation, certain taxpayers were required to apportion their income using a formula that consisted of the property, payroll, and sales factors. These taxpayers are now required to apportion their income based solely on the sales factor. The single-sales factor is discussed in *Section III*.²

Market-Based Sourcing

For purposes of calculating the sales factor, affected taxpayers are required to utilize market-based sourcing. The change to market-based sourcing generally affects transactions involving services or intangible property and sources receipts from such transactions based upon where the services or intangible property are used by the customer. Market-based sourcing is discussed in *Section V*.

Receipt Exclusion

Receipts from the sale of certain property are excluded from the sales factor (numerator and denominator) if such property is not held by taxpayers primarily for sale to customers in the ordinary course of the taxpayer's trade or business. Receipts excluded from the sales factor are discussed in *Section VI*.

Economic Nexus

In general, the sales sourcing rules for apportionment purposes are also used for determining whether a taxpayer has economic nexus. Therefore, the economic nexus rules of the Corporation Business Tax and the Income Tax are indirectly affected by the adoption of market-based sourcing.

A taxpayer that is not otherwise subject to tax has economic nexus with Connecticut if it derives income from sources within this state and has a substantial economic presence within this state. The Department of Revenue Services (DRS) has established a bright-line rule, which provides that a taxpayer will not be found to have a substantial economic presence "if the frequency, quantity, and systematic nature of the business's economic contacts with the state are such that it has receipts from business activities that are less than \$500,000 attributable to Connecticut sources during such taxable year." See **Informational Publication 2010(29.1)**, *Q&A on Economic Nexus*.

¹ For purposes of this publication, *Apportionment Legislation* refers to 2015 Conn. Pub. Acts 1, § 40 (Dec. Spec. Sess.) and 2016 Conn. Pub. Acts 3, § 199 (May. Spec. Sess.), which amended Conn. Gen. Stat. § 12-218 (Corporation Business Tax), and 2016 Conn. Pub. Acts 3, § 200 (May. Spec. Sess.), which amended Conn. Gen. Stat. § 12-711 (Income Tax).

² For purposes of this publication, *sales factor* refers to the sales factor under Conn. Gen. Stat. § 12-218(b) of the Corporation Business Tax and to the gross income percentage under Conn. Gen. Stat. § 12-711(c) of the Income Tax.

II. Who is Affected by the Apportionment Legislation?

a. Corporation Business Tax

For Corporation Business Tax purposes, the changes made by the Apportionment Legislation apply to companies that:

1. Have the right to apportion; **and**
2. Are not subject to industry-specific apportionment.

Right to Apportion

A company, other than a financial service company, must conduct business or have economic nexus both within and without Connecticut in order to have the right to apportion its net income. If the company conducts business or has economic nexus in this state and does not have the right to apportion, it is subject to tax in this state on all of its net income.

A financial service company has the right to apportion its income regardless of whether it conducts business or has economic nexus outside of this state.

Industry-Specific Apportionment

Prior to the enactment of the Apportionment Legislation, companies that engaged in certain activities were required to use industry-specific apportionment rules to apportion their net income. Companies subject to the following industry-specific apportionment rules should continue to use such industry-specific apportionment and sourcing rules:

Industry/Activity	Apportionment Statute
Air carrier	Conn. Gen. Stat. § 12-244
Broadcasting and programming production services	Conn. Gen. Stat. § 12-218(k)
Carrying of passengers or property for hire	Conn. Gen. Stat. § 12-218(c) & (d)
Credit card activities by financial service companies	Conn. Gen. Stat. § 12-218(i)
Financial service company	Conn. Gen. Stat. § 12-218b
Limited partnership interests	Conn. Gen. Stat. § 12-218(g)
Securities brokerage services	Conn. Gen. Stat. § 12-218(f)
Services to regulated investment companies	Conn. Gen. Stat. § 12-218(e)

Manufacturers: Prior to the enactment of the Apportionment Legislation, manufacturers were required to apportion their income using the single-sales factor apportionment formula. As a result of the Apportionment Legislation, manufacturers must use the market-based sourcing rules and the receipt exclusion rules to calculate the sales factor.³

Application of Apportionment Legislation to Financial Services (Corporation Business Tax): Financial service companies are required to apportion their income utilizing the rules described in Conn. Gen. Stat. § 12-218b (Financial Service Apportionment). Financial service companies are not impacted by the Apportionment Legislation.

³ Conn. Gen. Stat. § 12-218(j) provides the industry-specific apportionment rules for manufacturers. Since 2001, this subsection has required manufacturers to use the single-sales factor to apportion their income and to calculate such sales factor under the rules of Conn. Gen. Stat. § 12-218(b). The Apportionment Legislation amended Conn. Gen. Stat. § 12-218(b) to require companies to source their receipts using the new market-based sourcing and receipt exclusion rules described in this Special Notice. Because manufacturers calculate their sales factor under the rules of Conn. Gen. Stat. § 12-218(b), which was amended by the Apportionment Legislation, manufacturers are subject to such new rules.

In some circumstances, companies that provide financial services will not meet the definition of *financial service company*. Such companies generally must apportion their income under Conn. Gen. Stat. § 12-218(b) and not the Financial Service Apportionment rules. Such companies, however, should apply the Financial Service Apportionment sourcing rules for purposes of sourcing their financial service receipts if, and to the extent, the Financial Service Apportionment sourcing rules identify the market for the relevant services.

Companies that do not meet the definition of *financial service company* should apply the Financial Service Apportionment rules for purposes of sourcing financial service receipts only and not for any other purpose.

b. Income Tax

For Income Tax purposes, the Apportionment Legislation applies to those businesses, trades, professions, or occupations that are carried on or have economic nexus both within and without this state.

Application of Apportionment Legislation to Financial Services (Income Tax): Taxpayers that are subject to the Income Tax and provide financial services should, beginning with taxable year 2017, utilize the Financial Service Apportionment rules under Conn. Gen. Stat. § 12-218b(j) to source their receipts from financial services if, and to the extent, such sourcing rules identify the market for the relevant services.

Taxpayers subject to the Income Tax should apply the Financial Service Apportionment rules for purposes of sourcing financial service receipts only and not for any other purpose.

III. Single-Sales Factor

Taxpayers affected by the Apportionment Legislation are required to use the single-sales factor to apportion their income. The single-sales factor is a fraction based upon where sales are made. The numerator of the fraction includes a taxpayer's receipts that are sourced to this state. The denominator of the fraction includes all of a taxpayer's receipts, other than receipts that are excluded. *Section IV* and *Section V* of this Special Notice address sourcing rules and *Section VI* addresses which receipts are excluded from the calculation of the sales factor.

IV. Sourcing Rules - General

With the enactment of the Apportionment Legislation, there is significant, but not complete, consistency between the sourcing rules under the Corporation Business Tax and Income Tax.

The chart on Page 6 compares the general sourcing rules, as amended by the Apportionment Legislation, under the Corporation Business Tax and Income Tax with respect to the most common types of transactions.

This chart is intended to highlight the general sourcing rules, which may not apply to all situations. Taxpayers should refer to the statutes referenced to determine the application of the sourcing rules to their specific facts and circumstances.

Receipts From	Corporation Business Tax* <i>(Applicable to income years commencing on or after January 1, 2016)</i>	Income Tax including Pass-Through Entities** <i>(Applicable to taxable years commencing on or after January 1, 2017)</i>
Sale of Tangible Personal Property	Include in the numerator of the sales factor if delivery/ship to location is in Connecticut. <i>Conn. Gen. Stat. § 12-218(b)(1)</i>	Include in the numerator of the sales factor if delivery/ship to location is in Connecticut. <i>Conn. Gen. Stat. § 12-711(c)(2)(A)</i>
Rental, Lease or License of Tangible Personal Property	Include in the numerator of the sales factor if, and to the extent, the tangible personal property is located in Connecticut. <i>Conn. Gen. Stat. § 12-218(b)(3)</i>	Include in the numerator of the sales factor if, and to the extent, the tangible personal property is located in Connecticut. <i>Conn. Gen. Stat. § 12-711(c)(2)(C)</i>
Sale of Services	Include in the numerator of the sales factor if, and to the extent, the customer uses the service in Connecticut. <i>Conn. Gen. Stat. § 12-218(b)(2)</i>	Include in the numerator of the sales factor if, and to the extent, the customer uses the service in Connecticut. <i>Conn. Gen. Stat. § 12-711(c)(2)(B)</i>
Rental, Lease or License of Intangible Property	Include in the numerator of the sales factor if, and to the extent, the customer uses the intangible property in Connecticut. <i>Conn. Gen. Stat. § 12-218(b)(4)</i>	Include in the numerator of the sales factor if, and to the extent, the customer uses the intangible property in Connecticut. <i>Conn. Gen. Stat. § 12-711(c)(2)(D)</i>
Sale of Real Property	Include in the numerator of the sales factor if the real property is located in Connecticut. <i>Conn. Gen. Stat. § 12-218(b)(3)</i>	Receipts from the sale of real property are excluded from the sales factor (numerator and denominator). Net gain (or loss) on the sale of real property is allocated to Connecticut if the real property is located in Connecticut. <i>Conn. Gen. Stat. § 12-711(c)(2)(F)</i>
Rental of Real Property	Include in the numerator of the sales factor if the real property is located in Connecticut. <i>Conn. Gen. Stat. § 12-218(b)(3)</i>	Receipts from the rental of real property are excluded from the sales factor (numerator and denominator). Net income (or losses) from the rental of real property is allocated to Connecticut if the real property is located in Connecticut. <i>Conn. Gen. Stat. § 12-711(c)(2)(F)</i>

* For Corporation Business Tax purposes, receipts from the sale or other disposition of real property, tangible personal property, or intangible property are excluded from the calculation of the sales factor (numerator and denominator) if such property is not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business.
Conn. Gen. Stat. § 12-218(b)(6)

**For Income Tax purposes, receipts from the sale or other disposition of tangible personal property or intangible property are excluded from the sales factor (numerator and denominator) if such property is not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business. If receipts from the sale of tangible personal property are excluded from the sales factor, the net gain (or loss) from such sale should be allocated to the state where the property is located and is not subject to apportionment.
Conn. Gen. Stat. § 12-711(c)(2)(E)

V. Sourcing Rules – Market-Based Sourcing

Under the Apportionment Legislation, a taxpayer subject to the Corporation Business Tax or the Income Tax is required to use market-based sourcing for purposes of calculating its sales factor. The change to market-based sourcing generally affects the sale of services and the rental, lease or license of intangible property. Under market-based sourcing, receipts from these transactions are sourced to Connecticut if, and to the extent, the customer uses such services or intangible property in this state.

In general, use occurs at the location(s) where the taxpayer's customer either directly or indirectly receives value from the service or intangible property. Identifying where a customer receives value from such a service or intangible property depends upon the specific facts and circumstances of the transaction.

This section contains procedures intended to help taxpayers source their receipts under the market-based sourcing rules. These procedures allow taxpayers to systematically apply the market-based sourcing rules to their specific facts and circumstances. This Special Notice also contains examples to illustrate the application of the sourcing rules.

If, after using diligent effort to apply the guidance in this Special Notice to its specific circumstances, a taxpayer still cannot determine the proper sourcing of its receipts, such taxpayer may petition the Connecticut Commissioner of Revenue Services (the Commissioner) for permission to source its receipts on an alternative basis. Petitions are discussed in *Section VII*.

a. Sourcing of Receipts from the Sale of Services

Individual Customers

Receipts from the sale of a service to an individual customer (i.e., not a business customer) are sourced to this state if, and to the extent, the customer uses the service in this state. The location(s) where an individual customer uses a service shall be determined as follows:

Services that Relate to Real Property. A service that relates to real property is used in this state if the real property is located in this state.

Services that Relate to Tangible Personal Property. A service that relates to tangible personal property is used in this state if the tangible personal property is delivered to a customer in this state.

Services that Require the Physical Presence of the Customer. A service that requires the customer to be physically present (e.g., haircuts and physical therapy) is used in this state if the service is performed in this state.

All Other Services. With the exception of the services described above, a service shall be presumed to be used in this state if the billing address of the taxpayer's customer, as determined when the bill for the service is issued, is in this state.

If the taxpayer uses the customer's billing address as the method of sourcing the receipts to this state, DRS will accept this sourcing method, unless DRS reasonably believes that the billing address was used for tax avoidance purposes.

The presumption to use the billing address may be overcome by the taxpayer by showing that either the contract between the taxpayer and the taxpayer's customer, or other books and records of the taxpayer kept in the normal course of business, provide the extent to which the service is used at a location (or locations) in this state.

If the taxpayer believes it has overcome the presumption and uses a method based on either the contract between the taxpayer and the taxpayer's customer or other books and records of the taxpayer kept in the normal course of business, DRS may examine the taxpayer's method to determine if the billing address presumption has been overcome and, if so, whether the taxpayer's method of assignment reasonably reflects where the service was used by the taxpayer's customers.

Example 1

Services – Individual Customer – Real Property

Janitorial Company provides janitorial services at an individual customer's vacation home in Connecticut. Janitorial Company sends the bill to the customer's billing address, which is outside of Connecticut. Receipts from such services should be sourced to Connecticut because the services relate to an individual customer's real property in this state.

Example 2

Services – Individual Customer – Tangible Personal Property

Customer leaves a watch to be repaired with Jewelry Store located in Connecticut. Because of the complexity of the repairs, Jewelry Store mails the watch to its nationwide repair facility in Arizona. After the repairs are complete, Customer picks up the watch at Jewelry Store. Because the tangible personal property is delivered to Customer at Jewelry Store in Connecticut, Jewelry Store should source the receipts to Connecticut.

Example 3

Services – Individual Customer – In Person Service

Pediatrician provides medical services to her patients at her medical office in Connecticut. Receipts from such medical services should be sourced to Connecticut, regardless of the residency or billing address of the patients, because the medical services are provided to the patients in person at a location in this state.

Example 4

Services – Individual Customer – Billing Address

Educational Company provides educational services to Student over the internet. Student registers online and attends class by webinar. Student may access the class anywhere an internet connection is available. Because the services do not relate to real or tangible personal property and do not require the customer's physical presence, the receipts from the educational services provided to Student should be sourced to the location of Student's billing address. If the services are billed to someone other than Student, such as Student's parents, the services should be sourced to the billing address of such other person.

Business Customers

In general, receipts from the sale of a service to a business customer are sourced to Connecticut if, and to the extent, the customer uses the service in this state. The service is deemed to be used in this state to the extent that the service relates to the business customer's activities in this state.

In the case of intermediary transactions, receipts are sourced based on the location of the ultimate customer (i.e., the customer's customer), rather than the taxpayer's customer. An intermediary transaction is a transaction where the service is: (A) provided by the taxpayer, at the direction of its customer, directly to such ultimate customer; **or** (B) provided by the taxpayer to its customer, who then passes on the service to the ultimate customer, and the taxpayer knows the identity of the ultimate customer.

The location(s) where a business customer or, in case of an intermediary transaction, the ultimate customer, uses a service shall be determined as follows:

1. **Contract or Books and Records.** A service is used in this state to the extent the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the normal course of business properly indicate that the use of the service is in this state.
2. **Reasonable Approximation.** If neither the contract nor the taxpayer's books and records properly indicate where the service is used, then the location(s) where the service is used shall be reasonably approximated.
3. **Where the Order is Placed.** If the location(s) where the service is used cannot be determined under paragraph (1) or reasonably approximated under paragraph (2), then the location where the service is used shall be presumed to be in this state if the location from which the taxpayer's customer placed the order for the service is in this state.
4. **Billing Address.** If the location(s) where the service is used cannot be determined pursuant to paragraphs (1), (2), or (3), then the use of the service shall be in this state if the billing address of the taxpayer's customer, as determined when the bill for the service is issued, is in this state.

Example 5

Services – Business Customer – Books and Records

Janitorial Company provides janitorial services at five commercial office buildings owned by Customer. The janitorial services provided to each building are substantially similar. One of the office buildings is located in Connecticut. Janitorial Company separately bills its customer for the janitorial services provided to each building. Receipts from the services associated with the Connecticut office building should be sourced to this state because Janitorial Company's books and records indicate that the services were used in this state.

Example 6

Services – Business Customer – Reasonable Approximation

Same facts as *Example 5*, except that Janitorial Company does not separately contract, bill or account for the services provided to each building. However, Janitorial Company does know the size of each building it services. In these circumstances, Janitorial Company should reasonably approximate the extent to which its receipts are derived from services used in this state. Based upon the facts of this example, Janitorial Company can source its receipts from Customer based upon the relative square footage of Customer's Connecticut office building compared to the total square footage of all five of Customer's office buildings.

Example 7

Services – Business Customer – Intermediary Transaction/Books and Records

Engineering Firm provides engineering services to Manufacturer to assist with the design of custom tools for Customer. Through its work with Manufacturer, Engineering Firm knows the identity of Customer and that Customer plans to use the tools at its sole facility located in Connecticut. Because the engineering services are being used to develop custom tools for a specific, known customer, this is an intermediary transaction. Accordingly, Engineering Firm's receipts from the services provided to Manufacturer should be sourced to Connecticut because Engineering Firm's records indicate that the ultimate customer will use the service in this state.

Example 8

Services – Business Customer – Books and Records

Same facts as *Example 7*, except that Customer cancels its order before Manufacturer delivers the tools. Engineering Firm's receipts from the engineering services provided to Manufacturer should be sourced to Connecticut because the services were intended to be used by the ultimate customer in this state.

Example 9

Services – Business Customer – Reasonable Approximation

Same facts as *Example 7*, except that Engineering Firm does not know where Customer will use the custom designed tools, but Engineering Firm does know that Customer has multiple facilities equipped to use the custom designed tools. Through publicly available data, Engineering Firm knows the size and location of such facilities. In these circumstances, Engineering Firm should reasonably approximate the extent to which its receipts are derived from services used in this state. Based upon the facts of this example, Engineering Firm can source its receipts attributable to the engineering services based upon the relative square footage of Customer's Connecticut facilities equipped to use the tools compared to the total square footage of Customer's facilities equipped to use the tools. If the square footage of each facility is not available, Engineering Firm can source its receipts based upon the number of Customer's Connecticut facilities equipped to use the tools compared to the total number of Customer's facilities equipped to use the tools.

Example 10

Services – Business Customer – Books and Records

Sales Company earns a commission from Client for brokering the sale of Client's products to Third Party. Third Party is the ultimate consumer of Client's products. Client will ship the products to Third Party at various locations where Third Party's employees will use the products. Sales Company possesses a copy of the contract between Client and Third Party that states the locations where the products will be shipped. Because Sales Company's brokerage services are used by Client in connection with the sale of Client's products to Third Party and Sales Company knows where Third Party will use the products, Sales Company should source its receipts to this state in the same proportion that Client's products are shipped to Third Party in this state.

Example 11

Services – Business Customer – Reasonable Approximation

Same facts as *Example 10*, except that Sales Company does not know where the products will be shipped. From publicly available data, Sales Company knows that Third Party has multiple locations where the products likely will be used and knows the number of employees at each location. In these circumstances, Sales Company should reasonably approximate the extent to which its receipts are derived from services used in this state. Based upon the facts of this example, Sales Company can source its receipts from Client based upon the number of Third Party's employees at Connecticut locations where the products likely will be used compared to the total number of Third Party's employees at all locations where the products likely will be used.

Example 12

Services – Business Customer – Books and Records

Laboratory Company provides clinical trial analytical services for Pharmaceutical Company, which has its corporate headquarters in Connecticut. Such services relate to Pharmaceutical Company's research and development department, which is located in Massachusetts. Therefore, Pharmaceutical Company's research and development activities occur exclusively outside of Connecticut. Laboratory Company's receipts for the clinical trial analytical services should not be sourced to Connecticut because its records indicate that the service is used in research and development conducted outside of the state.

Example 13

Services – Business Customer – Intermediary Transaction/Books and Records

Same facts as *Example 12*, except that Laboratory Company hires Third Party to assist with the accumulation of data from the clinical trials. Because the data accumulation services are directly used by Laboratory Company in its provision of the clinical trial analytical services to Pharmaceutical Company, this is an intermediary transaction. Accordingly, the receipts Third Party receives from Laboratory Company are sourced to where the ultimate customer, Pharmaceutical Company, uses the clinical trial analytical services. Because Pharmaceutical Company's research and development activities occur exclusively outside of Connecticut, Third Party's receipts for data accumulation services should not be sourced to Connecticut.

Example 14

Services – Business Customer – Intermediary Transaction/Place of Order

Same facts as *Example 13*, except that Third Party does not know the location of Pharmaceutical Company's research and development activities and has no basis upon which to reasonably approximate where Pharmaceutical Company will use the clinical trial analytical services. However, based upon Third Party's inquiries to Laboratory Company, Third Party knows that the Pharmaceutical Company placed the order for the clinical trial analytical services from its headquarters in Connecticut. As such, Third Party should source its receipts for data accumulation services to Connecticut.

Example 15

Services – Business Customer – Not an Intermediary Transaction

Same facts as *Example 13*, except that Laboratory Company will not identify its customer to Third Party. As such, Third Party has no ability to determine where the ultimate customer will use the service. Accordingly, Third Party should not treat this as an intermediary transaction, but instead should source its receipts to where Laboratory Company uses the services, which may be at the location of the clinical trials or Laboratory Company's headquarters depending on the facts.

Example 16

Services – Business Customer – Books and Records

Customer is a business that is headquartered in Connecticut and has multistate operations. Customer's operations in California have been underperforming compared to the operations in other states. Customer's senior management team in Connecticut engages Management Consultant to perform a review of the California operations and make recommendations for improvement. Management Consultant performs the review of the operations in California and sends its report to the senior management team in Connecticut. Management Consultant also sends its invoice to Customer's headquarters in Connecticut for payment. The report and related recommendations are read by the senior management team in Connecticut who share the findings with the management team in California responsible for day-to-day operations in the state. The California management team implements several of the recommendations made by the Management Consultant.

The receipts from the services provided by Management Consultant should not be sourced to Connecticut because its records indicate that the service is used solely at the operations in California where the recommendations are implemented.

Example 17

Services – Business Customer – Reasonable Approximation

Marketing Company performs market research for Customer, which is headquartered in Connecticut. The market research pertains to developing a market throughout New England. Neither the contract nor Marketing Company's books and records indicate the extent to which such services will be used in each respective state. In these circumstances, because population data is publicly available, Marketing Company should reasonably approximate the extent to which its receipts are derived from services used in this state. Based upon the facts of this example, Marketing Company can source its receipts from Customer based upon the relative population of Connecticut to the overall population of New England.

Example 18

Services – Business Customer – Books and Records

Payroll Service Company provides payroll processing services to Client, which has offices within and without Connecticut. Payroll Service Company charges Client a fee for the payroll processing services based upon the number of Client's employees. Because of the nature of the services it provides, Payroll Service Company books and records identify the location where Client's employees work. Payroll Service Company should use this information to determine the amount of the receipts from the payroll processing services that should be sourced to this state.

Example 19

Services – Business Customer – Books and Records

Web Company provides internet content to viewers and receives revenue from Client based on the viewer's clicks of Client's advertisements that were placed by Web Company. Web Company knows the location from which the viewers view Client's advertisements. Receipts should be sourced to Connecticut based upon Web Company's records that indicate the number of clicks recorded in Connecticut.

Example 20

Services – Business Customer – Reasonable Approximation

Same facts as *Example 19*, except that Web Company does not know where the viewers view Client's advertisements. However, Web Company knows that the advertisements are targeted to an American audience. In these circumstances, because population data is publicly available, Web Company should reasonably approximate the extent to which its receipts are derived from services used in this state. Based upon the facts of this example, Web Company can source its receipts from Client based upon the relative population of Connecticut to the overall population of the United States.

b. Sourcing of Receipts from the Rental, Lease or License of Intangible Property

Individual Customers

Receipts from the rental, lease, or license of intangible property to an individual customer are sourced to Connecticut if, and to the extent, the customer uses the intangible property in this state. If the taxpayer's customer is an individual, intangible property shall be presumed to be used in this state if the billing address of the taxpayer's customer, as determined when the bill for the intangible property is issued, is in this state.

If the taxpayer uses the customer's billing address as the method of sourcing the receipts to this state, DRS will accept this sourcing method, unless DRS reasonably believes that the billing address was used for tax avoidance purposes.

The presumption to use the billing address may be overcome by the taxpayer by showing that either the contract between the taxpayer and the taxpayer's customer, or other books and records of the taxpayer kept in the normal course of business, provide the extent to which the intangible property is used at a location (or locations) in this state.

If the taxpayer believes it has overcome the presumption and uses a method based on either the contract between the taxpayer and the taxpayer's customer or other books and records of the taxpayer kept in the normal course of business, DRS may examine the taxpayer's method to determine if the billing address presumption has been overcome and, if so, whether the taxpayer's method of assignment reasonably reflects where the intangible property was used by the taxpayer's customers.

Business Customers

Receipts from the rental, lease or license of intangible property to a business customer are sourced to this state if, and to the extent, the customer uses the intangible property in this state. The location(s) where a business customer uses intangible property shall be determined as follows:

Marketing Intangibles. If a license is granted for the right to use intangible property in connection with the sale, lease, license, or other marketing of goods, services, or other items, the royalties or other licensing fees paid by the licensee for such right(s) are sourced to this state to the extent that the fees are attributable to the sale or other provision of goods, services, or other items purchased or otherwise acquired by the ultimate customers in this state. If the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the normal course of business provide a method to determine the ultimate customers in this state, the taxpayer shall utilize such contract or books and records to determine the location(s) of the use of the intangible property. If the location(s) of use cannot be determined by the contract or books and records, the location(s) of use shall be reasonably approximated. If the location(s) of use cannot be reasonably approximated, it shall be presumed that use occurs at the location where the order is placed or, if unknown, at the licensee's billing address.

Non-marketing and Manufacturing Intangibles. If a license is granted for the right to use intangible property other than in connection with the sale, lease, license, or other marketing of goods, services, or other items, the licensing fees paid by the licensee for such right(s) are attributable to this state to the extent that the use for which the fees are paid takes place in this state. If the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the normal course of business provide a method to determine the location(s) of use, the taxpayer shall utilize such contract or books and records to source the receipts. If the location(s) of use cannot be determined by the contract or books and records, the location(s) of use shall be reasonably approximated. If the location(s) of use cannot be reasonably approximated, it shall be presumed that use occurs at the location where the order is placed or, if unknown, at the licensee's billing address.

Mixed Intangibles. If a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing intangible, and the fees to be paid in each instance are separately stated in the licensing contract, then the separately stated fees should be sourced based upon the above.

If the fees to be paid in each instance are not separately stated in the contract, it shall be presumed that the licensing fees are paid entirely for the license of a marketing intangible except to the extent that the taxpayer or DRS can reasonably establish otherwise.

Example 21

Marketing Intangible – Business Customer – Books and Records

Licensor and Retailer enter into a license agreement that permits Retailer to use Licensor's trademarks in connection with Retailer's sale of certain products to retail customers. Under the contract, Retailer is required to pay a licensing fee to Licensor that is a fixed percentage of the total volume of monthly sales made by Retailer of products using the Licensor trademarks. Under the agreement, Retailer is permitted to sell the products at multiple store locations, including store locations that are both within and without this state. The licensing fees that are paid by Retailer are broken out on a per-store basis. The licensing fees paid to Licensor by Retailer represent fees from the licensing of a marketing intangible. These fees that are derived from the sales at stores in Connecticut should be sourced to Connecticut.

Example 22

Marketing Intangible – Business Customer – Reasonable Approximation

Same facts as *Example 21*, except neither the contract between Licensor and Retailer nor Licensor's books and records provide a method for the determination of the amount of sales made in Connecticut of products that use the licensed trademark. In this instance, Licensor should reasonably approximate the extent to which the trademark is used in Connecticut. Based upon the facts of this example, Licensor can source the fees from Retailer by multiplying the amount of the fee by the percentage of Retailer's stores in Connecticut over its total stores in the specified geographic region in which the retail sales are made.

Example 23

Non-marketing and Manufacturing Intangible – Business Customer – Reasonable Approximation

Patent Holder and Manufacturer enter into a license agreement that permits Manufacturer to manufacture products using Patent Holder's patent. The license agreement requires Manufacturer to pay Patent Holder a royalty for the use of the patent. At the time the contract is entered into, Patent Holder knows that Manufacturer has multiple manufacturing facilities, some of which are in Connecticut. In this instance, Patent Holder should reasonably approximate the extent to which patent is used in Connecticut. Based upon the facts of this example, Patent Holder can source the fees from Manufacturer based upon the relative number of Manufacturer's manufacturing facilities in Connecticut compared to the total number of Manufacturer's manufacturing facilities everywhere.

Example 24

Non-marketing and Manufacturing Intangible – Business Customer – Place of Order/Billing Address

Same facts as *Example 23*, except that Manufacturer is a small, privately-held manufacturing corporation that has no publicly available information as to its manufacturing locations and Patent Holder has no independent knowledge of Manufacturer's locations. Because Patent Holder does not know or have a reasonable basis to approximate where the patent will be used, it should source all of the licensing fees to Connecticut if Manufacturer placed the order for the intangible property in Connecticut or, if the place of order is not known, if Manufacturer's billing address is in Connecticut.

Example 25

Mixed Intangible – Business Customer – Separately Stated

Tech Company enters into a two-year license agreement with Widget Maker granting Widget Maker the right to produce widgets using patented technology owned by Tech Company, and also to sell such widgets by marketing the fact that the widgets were manufactured using Tech Company's technology. The widgets are manufactured outside this state, but Widget Maker is granted the right to sell the widgets in a geographic area in which Connecticut's population constitutes 25% of the total population in the geographic area during the period in question. The license agreement specifies separate fees to be paid for the right to produce the widgets and for the right to sell the widgets by marketing the fact that the widgets were manufactured using Tech Company's technology. The licensing agreement constitutes both the license of a marketing intangible and the license of a non-marketing intangible. Tech Company should: (A) source no part of the licensing fee paid for the non-marketing intangible to Connecticut because the patented technology is used outside the state; **and** (B) source 25% of the licensing fee paid for the marketing intangible to Connecticut.

Example 26

Mixed Intangible – Business Customer – Not Separately Stated

Same facts as *Example 25*, except that the licensing agreement requires an upfront licensing fee to be paid by Widget Maker to Tech Company but does not specify which percentage of the fee is derived from Widget Maker's right to use Tech Company's patented technology. Unless it can be established otherwise, it is presumed that the licensing fees are paid entirely for the license of a marketing intangible and 25% of the entire licensing fee should be sourced to Connecticut.

c. Market-Based Sourcing – Miscellaneous Issues

Reasonable Inquiry

A taxpayer must make reasonable inquiries to its business customers to determine where the use of the taxpayer's services or intangible property will occur.

Reasonable inquiries, however, are not required if the taxpayer has more than 250 business customers purchasing substantially similar services and no more than 5% of receipts from such services or intangible property are from one customer.

Reasonable Approximation

Reasonable approximation is a method used to determine the location at which a customer uses a service or intangible property when the:

- Location(s) where the service or intangible property is used cannot be determined, or obtaining the location(s) where the service or intangible property is used would require the taxpayer to expend undue effort and expense; **and**
- Taxpayer has sufficient information to estimate the location(s) where the service or intangible property is used.

In some of the examples, the receipts are sourced using a method that reasonably approximates where a service or intangible property is used. When an example states that a particular method of reasonable approximation is acceptable, it does not preclude the existence of other methods that may also be acceptable depending upon the facts and circumstances.

Good Faith and Consistent Sourcing

A taxpayer's method of sourcing its receipts should be determined in good faith, applied in good faith, and applied consistently with respect to similar transactions, similar customers and year-to-year. Such method must be based on objective criteria and should consider all sources of information reasonably available to the taxpayer. Taxpayers may, in good faith, rely on information provided by their customers.

A taxpayer must retain records that explain the determination and application of its method of sourcing its receipts used in completing the return, including its underlying assumptions, and must provide such records to the Commissioner upon request. A taxpayer must also document the steps it took before abandoning each level of the hierarchy.

Once a taxpayer has applied a sourcing method and changes such method in a subsequent year or on an amended return, the taxpayer must disclose such change and the reason for the change by attaching a statement to its return.

DRS may reject a taxpayer's use of a particular sourcing method if it reasonably believes that the taxpayer used such sourcing method for tax avoidance purposes.

VI. Exclusion of Receipts

a. Corporation Business Tax

For Corporation Business Tax purposes, receipts from the sale or other disposition of the following property are excluded from the calculation of the sales factor if such items are not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business:

- Real property;
- Tangible personal property; **and**
- Intangible property.

Gain or loss from excluded items

In general, gain (or loss) from excluded items is included in the calculation of net income and is subject to apportionment.

b. Income Tax

For Income Tax purposes, receipts from the sale or other disposition of the following property are excluded from the calculation of the sales factor if such items are not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business:

- Tangible personal property; **and**
- Intangible property.

For Income Tax purposes, the income (or loss) from the sale, rental, lease or license of real property is allocated to the state where the real property is located. As such, the receipts from such transactions are always excluded from the calculation of the sales factor.

Gain or loss from excluded items

Gain (or loss) from the sale or other disposition of tangible personal property that is excluded from the calculation of the sales factor is allocated to the state where the tangible personal property is located. Gain (or loss) from the sale or other disposition of intangible property that is excluded from the calculation of the sales factor may be subject to apportionment if such property was employed in the taxpayer's business.

Example 27

Receipt Exclusion – Corporation Business Tax

Seller, a corporation subject to the Corporation Business Tax, sells one of its divisions to Buyer. Seller receives proceeds and recognizes taxable gain from the sale of the following assets: inventory, manufacturing facility (real property), machinery and equipment, patents, and goodwill. The receipts from the sale of the manufacturing facility, machinery and equipment, patents, and goodwill are not included in Seller's sales factor pursuant to Conn. Gen. Stat. § 12-218(b)(6). The receipts from the sale of the inventory are included in Seller's sales factor and are sourced to where the inventory is held. The gain (or loss) on the entire sale, regardless of whether it relates to items included in or excluded from the sales factor, is included in the computation of Seller's net income.

Example 28

Receipt Exclusion – Income Tax

Same facts as *Example 27*, except that Seller is a pass-through entity subject to the provisions of the Income Tax. The receipts from the sale of the manufacturing facility, as real property, is not included in the sales factor pursuant to Conn. Gen. Stat. § 12-711(c)(2)(F). Gain (or loss) from the sale of the manufacturing facility is allocated to the state where the real property is located and is not subject to apportionment pursuant to Conn. Gen. Stat. § 12-711(b)(1)(A).

The receipts from the sale of the machinery and equipment, patents, and goodwill are not included in Seller's sales factor pursuant to Conn. Gen. Stat. § 12-711(c)(2)(E). Gain (or loss) from the sale of the machinery and equipment is allocated to the state where the tangible personal property is located and is not subject to apportionment pursuant to Conn. Gen. Stat. § 12-711(b)(1)(A). Because the patents and goodwill were employed in Seller's business, the gain (or loss) from the sale of such patents and goodwill (as intangible assets) is subject to apportionment. See Conn. Gen. Stat. § 12-711(b)(3).

The receipts from the sale of the inventory are included in Seller's sales factor and are sourced to where the inventory is held. The gain (or loss) for the sale of such inventory is subject to apportionment.

VII. Petition for Alternative Sourcing Basis

Certain taxpayers, despite diligent effort, may be unable to reasonably determine how to apply the sourcing rules to their specific facts and circumstances. Pursuant to Conn. Gen. Stat. §§ 12-218(b)(8) and 12-711(c)(1)(H), these taxpayers may petition the Commissioner to request permission to establish an alternative basis to source their receipts. A petition must be submitted 60 days prior to the due date, or extended due date, of the return.

Petitions are optional and are intended for those limited circumstances when the sourcing of the transactions at issue have a material impact on the taxpayer's apportionment factor. Petitions allow for DRS and the taxpayer to establish an agreed-upon sourcing methodology prior to the filing of the return.

Petitions should be sent to:

Department of Revenue Services
Legal Division
450 Columbus Blvd Ste 1
Hartford CT 06103-1837

Effect on Other Documents

DRS is in the process of identifying those documents affected by the legislative changes described herein, and will update those publications as soon as practicable.

Effect of This Document

A Special Notice announces a new policy or practice in response to changes in state or federal laws or regulations or to judicial decisions. A Special Notice indicates an informal interpretation of Connecticut tax law by the DRS.

For Further Information

Call DRS during business hours, Monday through Friday:

- **1-800-382-9463** (Connecticut calls outside the Greater Hartford calling area only); or
- **860-297-5962** (from anywhere).

TTY, TDD, and Text Telephone users only may transmit inquiries anytime by calling 860-297-4911.

Forms and Publications

Visit the DRS website at www.ct.gov/DRS to download and print Connecticut tax forms and publications.

Paperless Filing/Payment Methods (fast, easy, free, and confidential)

Business and individual taxpayers can use the **Taxpayer Service Center (TSC)** at www.ct.gov/TSC to file a variety of tax returns, update account information, and make payments online.

File Electronically

You can choose first-time filer information and filing assistance or log directly into the *TSC* to file returns and pay taxes.

Pay Electronically

You can pay taxes for tax returns that cannot be filed through the *TSC*. Log in and select the *Make Payment Only* option. Designate a payment date up to the due date of the tax and mail a paper return to complete the filing process.

DRS E-Alerts Service

Get connected to the latest news from DRS. Receive notification by email of changes to legislation, policies, and procedures.

DRS E-Alerts provide information for employer's withholding tax and News – Press Releases. Visit the DRS website at www.ct.gov/DRS and select Sign up for e-alerts under *How Do I?* on the gold navigation bar.

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Corporation Business Tax and Income Tax

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