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Florida: Taxpayer's Costs of Performance Did not Occur in Florida when Majority of Payroll Out-of-State

On November 28, 2022, a Florida circuit court ruled in a taxpayer's favor in a dispute over the proper sourcing of a taxpayer's service receipts. As background, Florida's tax statutes are silent with respect to sourcing sales of other than tangible personal property. Under Fla. Admin. Code Ann. 12C-1.0155(2)(l), "other" receipts are sourced to Florida if the income-producing activity giving rise to the receipts is performed wholly within Florida or if a greater proportion of the income-producing activity is performed in Florida, based on the costs of performance (IPA/COP rule). Despite the rule, the Department of Revenue has indicated in its guidance and rather consistently taken the position that Florida is a market-based sourcing state and has cited favorably to guidance from other states that sourced the "income-producing activity" for a particular taxpayer to where the benefit is received or where the customer or purchaser is located.

Background: The taxpayer at issue was a Minnesota-based subsidiary of a large, multistate retailer. The taxpayer earned revenue by providing merchandising, marketing, and management consulting and advisory services to the retailer and others in exchange for compensation. After an audit, the Department asserted that the taxpayer's service receipts should be attributed to Florida based on a numerator that was the retail square footage of the retail stores of the taxpayer's parent corporation in Florida and the denominator of which was the retail square footage of all the parent corporation's retail stores across the country. As support for this adjustment, the Department relied on Fla. Stat. §220.44, which permits the Department to make adjustments to a taxpayer's income—including adjustments to any factor taken into account to apportion income—to clearly reflect business activity in the state. The taxpayer protested the adjustment, noting that the Department's regulation attributed these receipts to the location of the income-producing activity engaged in by the taxpayer, which was determined based on the location that the costs to perform the services were incurred. In the taxpayer's view, the location of the costs to perform its services occurred at its Minnesota headquarters where the large majority of its employees were located. The dispute was not resolved, and matter eventually came before a circuit court.

The court's decision: The circuit court noted at the outset that the issue of how the receipts should be sourced was governed by the IPA/COP rule that looked to the location where the costs to perform the relevant services were incurred. Under this all-or-nothing rule, if the greater proportion of those costs were incurred outside Florida, the taxpayer would have no sales attributable to Florida and have a zero Florida sales factor. The Department's position at trial was that the taxpayer failed to provide sufficient documentation to support the use of the IPA/COP rule, which meant it was entitled to adjust the apportionment factor under Fla. Stat. §220.44. The court rejected this position.

The taxpayer had provided state-by-state payroll, property, and sales apportionment workpapers to the auditor. The workpapers made clear that the overwhelming proportion of the taxpayer's payroll costs were incurred outside Florida; therefore, the court concluded that none of the receipts from the sale of services should be considered Florida sales. Further, the court did not find that the Department had any reason to apply an alternative apportionment method, as the taxpayer had provided sufficient documentation to support its costs of performance approach.

The court further noted that even if the Department could apply an alternative method, the proposed method (square footage of its parent corporation's retail stores) had no relevant relationship to the taxpayer's business activity in the state of Florida. Importantly, the taxpayer was not providing these services directly to the retail locations; rather, the services were provided to the parent corporation at its Minnesota headquarters. The court concluded that the Department's proposed formula conflated the parent corporation's Florida business activity with the taxpayer's business activity and would therefore be rejected.

Next Steps and Contacts: It remains to be seen whether the state will appeal the decision. As noted above, the Department of Revenue has in the past interpreted the income-producing activity test in a manner that resulted in a customer-based or market approach for sourcing service receipts.[1] It appears (based on the written opinion) that the Department's position in this case focused primarily on whether the taxpayer's evidence was insufficient so that an alternative apportionment method was allowed, as opposed to any particular interpretation of the income-producing activity test. However, taxpayers—particularly those that have utilized a market-based method for Florida purposes—should consider potential corporate income tax refund opportunities as a result of this decision. Despite the outcome of this recent decision, we anticipate the Department may remain focused on its previous customer-based approach to identifying income-producing activities, and taxpayers should be prepared to document and defend their sourcing analysis for audit and refund negotiation purposes. Please contact Jeremy Dukes or Henry Parcinski to discuss *Target Enterprise, Inc. vs. State of Florida Dep't of Revenue*.

[1] See e.g., Technical Assistance Advisement No. 20C1-001 (Jan. 13, 2020); Technical Assistance Advisement 20C1-010 (Sept. 11, 2020).