



This Week in State Tax (TWIST)

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New Jersey: Market-Based Sourcing Applies for Pre-Market Sourcing Tax Years

New Jersey adopted market-based sourcing effective for tax years ending on or after July 31, 2019. Prior to that time, corporate taxpayers used cost of performance (COP) sourcing to source their service receipts. Specifically, under a New Jersey regulation, if a service was performed both within and outside New Jersey, the numerator of the receipts fraction included receipts from services based upon the cost of performance or amount of time spent in the performance of such services or by some other reasonable method that should reflect the trade or business practice and economic realities underlying the generation of the compensation for services. In a recently released unpublished opinion, the New Jersey Tax Court held that a service provider was entitled to a refund of Corporation Business Tax (CBT) because market-based sourcing better reflected the economic realities of the taxpayer's business for the 2011 and 2012 tax years. The taxpayer provided services to various government entity customers in multiple states. The taxpayer's services included serving as the third-party administrator for its government customers for two government subsidy programs (Lifeline and E-Rate) and included such activities as application intake, evaluation, eligibility determination, as well as various financial accounting. It relied heavily on web-based programs it developed for this purpose, and the various applications were housed largely on servers in New Jersey. While most of the taxpayer's infrastructure and 90 percent of its payroll was in New Jersey, the facts indicated that most of the employees performed services outside of the state for the taxpayer's customers, who were also primarily located outside New Jersey. Based on the New Jersey payroll factor, the Division rejected the taxpayer's use of market-based sourcing on amended returns. In the Division's view, the COP method was the appropriate method for sourcing the taxpayer's service receipts, and market-based sourcing was allowed only if the taxpayer requested an alternative apportionment method. The taxpayer had not affirmatively requested to use market-based sourcing.

The tax court was "unpersuaded" that market-based sourcing was forbidden prior to 2019. Although the law required receipts from sales of services performed in the state to be included in the sales factor numerator, in the court's view, "Taxation's preference for the COP method does not foreclose consideration of the alternative methods permitted under the regulation." Notably, the regulation addressing the COP method specifically allowed for use of some other reasonable method to reflect the "economic realities underlying the generation of the compensation for services." As such, if market-based sourcing reflected the economic realities underlying the generation of the income, then it was permissible. The tax court also noted that New Jersey and other state courts had applied market-based sourcing in the past to treat sales of intangible property and services the same as sales of tangible personal property when appropriate. The fact that the law was changed to mandate market sourcing after 2018 was simply clarifying that market sourcing should be the required method. The tax court also rejected the Division's argument that the taxpayer should have requested to use an alternative apportionment method. If this were the case, the court noted, then any appeal in which Taxation disagreed with the taxpayer on an apportionment issue would be futile because the taxpayer's only option would be to request relief. Further, in the court's view, the taxpayer did request an alternative method when it filed the amended returns. "It is also not credible for Taxation to contend that market-based sourcing is unavailable by law yet would be available under Section 8." The court concluded that the taxpayer was entitled to the refunds requested on the amended CBT returns at issue and noted that "for tax years prior to 2019, there is no hard-and-fast rule as to the use of COP method." Please contact [Jim Venere](#) with questions on *Solix Inc. v. Director, Division of Taxation*.

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