

Do Go Chasing Waterfalls

Description

C corporation taxpayers have their work cut out for them. [New rules](#) provide a fifty-two page guide on how to compute Rhode Island apportionment (or the slice of total income Rhode Island is able to tax), and require familiarity with several different “waterfall” methodologies.

Apportionment is now entirely based on sales, and the rules have significantly changed for sourcing services and receipts from transactions dealing with intangibles. The good news is that the new guidance is very comprehensive. The bad news is that you may have to work a lot harder to figure out your Rhode Island sales.

Generally, the new rules require you to source sales here if a customer receives the “benefit” of the transaction in Rhode Island. Like many states, Rhode Island has adopted a so-called “waterfall” methodology to deal with situations where it is less than clear which state has the “benefit.”

The new rules have distinct “waterfalls” for different types of sales activities, such as those earned from providing electronically-delivered services or selling intangible property. If the taxpayer lacks the information to reliably source a sale in a given step, it progresses to the next. For example, the “waterfall” for sourcing electronically-delivered services to business customers looks like this:

1. Source the sale to the location where the customer’s employees will use the services;
2. If number 1 is unknown, source to the state which *reasonably approximates* where the benefits are received;
3. If numbers 1 and 2 are both unknown, source to the state identified in customer contracts (location where the contract is principally managed, the place of the customer’s order, or finally the customer’s billing address).

While the “waterfall” approach to implementing market-based sourcing is popular, states differ on the order in which steps are applied. Rhode Island’s new sourcing rules are generally similar to [Massachusetts](#). But [California](#), for example, starts its “waterfall” analysis by first looking at data not used until the very last step in Rhode Island’s “waterfall”; the customer’s billing address. The difference in ordering could prove to be a trap for the unwary on audit for businesses operating in both states.

A Rhode Island C corporation operating in multiple states should review the new rules, and develop a reasoned and well-documented market-based sourcing methodology that can be applied across all jurisdictions. As is the case with most state and local tax issues, one of the best defenses in the event of an audit is usually the taxpayer’s own consistency in reporting its activities among the states.

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