



MULTISTATE INCOME/FRANCHISE TAX

California Franchise Tax Board issues guidance on sourcing gross receipts from sales of services to business entities Tax Alert

Overview

On March 25, 2022, the California Franchise Tax Board (“FTB”) issued [Legal Ruling 2022-01](#), which provides guidance on how to source gross receipts derived from sales of services by one business to another business for purposes of calculating the California sales factor.

This Tax Alert summarizes Legal Ruling 2022-01, and unless otherwise noted, quotations in this Alert are from the ruling.

Legal Ruling 2022-01

Background law

For taxable years beginning on or after January 1, 2013, Cal. Rev. & Tax Code (“CRTC”) § 25136(a)(1) provides that “[s]ales from services are in [California] to the extent the purchaser of the service **received the benefit of the services in [California]**”. (Emphasis added).

Cal. Code Regs. tit. 18, (“Regulation”) § 25136-2(b)(1) provides that the “[b]enefit of a service is received” means the location where the taxpayer’s customer has either directly or indirectly **received value from delivery of that service**.” (Emphasis added).

Regulation § 25136-2(c)(2)(A) through (D) further provides a specific set of cascading rules to determine where the benefit of a service is received when the taxpayer’s customer is a corporation or other business entity (“cascading rules”).

Analysis for sourcing receipts from sales of services to business entities

In Legal Ruling 2022-01, the FTB stated that to properly assign gross receipts from sales of services to business entities under the cascading rules, the following four questions must be addressed as described below.

- **Who is the customer:** For purposes of sourcing receipts, it is the value to the taxpayer's customer that is analyzed, even if a third party (e.g., the customer's customer) may also benefit.
- **What is the service provided:** Generally, the contract will identify the service. If the contract does not identify the service, the taxpayer must identify the service activity that it is engaged in exchange for consideration.
- **What is the benefit being received:** Legal Ruling 2022-01 asserts that, usually, the value of the service is the direct effect of the function or action being performed (citing to the Web Corp Example 4 in Regulation § 25136-2(c)(2)(E) as an illustration). The ruling's equation of "value" with "direct effect of the function or action being performed" is new—this definitional construct does not appear in CRTC § 25136 or Regulation § 25136-2.
- **Where is the benefit of the service received:**
 - When the value of the service is the direct effect of the action or function being performed, the location where the benefit is received will be the location where the direct effect impacts the taxpayer's direct customer (citing to the Web Corp Example 4 in Regulation § 25136-2(c)(2)(E) as an illustration). Beyond referencing Example 4—which focuses on the location where viewers click or view advertising, as opposed to where the advertisement is uploaded or where clicks or views result in sales—the ruling does not address how to determine precisely which impact of a service is relevant to the sourcing analysis.
 - When the service provided by the taxpayer is directed at the customer of the taxpayer's customer, the benefit received by the taxpayer's customer is likely located at the location of the customer of the taxpayer's customer. This is most common when the taxpayer's services directly engage or principally concern the customer of the taxpayer's customer.
 - In particular, subcontracting arrangements by a business entity with a corporate subcontractor may involve the location of the contractor's customer, because the service provided by the subcontractor is directed towards persons or things other than the subcontractor's customer.

Application of the FTB's sourcing analysis to hypothetical situations

Legal Ruling 2022-01 provides that, after the four issues discussed above have been determined, the cascading rules in Regulation § 25136-2(c)(2) provide guidance on measuring the location where the benefit of a service was received. The ruling then applies these cascading rules to three hypothetical scenarios as set forth below.

- **Situation One**

- Planner Corp., the taxpayer, enters into a contract with a customer, Box Corp (located in State X), to provide event planning services for an event that will occur in State Y. However, Planner Corp performs most of the services remotely in its office in State Z.
- The benefit of the service—the planned and coordinated event—is received in State Y, the location of the event.
- Applying the cascading rules, due to the nature of the work, the FTB anticipates such location will be available in Planner Corp’s books and records.

- **Situation Two**

- Pharmacy Benefit Manager (“PBM”), the taxpayer, contracts with Health Company, the customer, to provide services which primarily consisted of processing member claims and fulfilling pharmaceutical deliveries to Health Company’s members, who receive pharmaceuticals directly at home or pick them up at pharmacies.
- The direct effect and benefit of the service to Health Company is that its customers (i.e., members) are able to obtain pharmaceuticals, which improves Health Company’s service performance to its members.
- The service provided by PBM directly engages Health Company’s customers and thus, the location of the benefit to Health Company is the location where the pharmaceuticals are delivered to the members. This is the location where the benefit impacts Health Company.
- Applying the cascading rules, due to the nature of the work, the FTB anticipates PBM will have information relating to the pharmaceutical delivery location in its books and records. However, if a member retrieves the pharmaceuticals at a pharmacy, and the pharmacy location is the only data that PBM has, it is reasonable to presume that the pharmacy is located in the same jurisdiction as the members.

- **Situation Three**

- Tracker Corp (located in State X) contracted with Manufacturing Corp to provide consulting services relating to efficient management of power consumption for its manufacturing plant in State Y. Tracker Corp subcontracts a portion of these services to Niche Corp (located in State Z). In this scenario, Niche Corp is the taxpayer, and Tracker Corp is the customer.
- The direct effect and benefit of the service provided to Tracker Corp is that its own customer, Manufacturing Corp, receives consulting services. This improves Tracker Corp’s performance of its services to Manufacturing Corp.
- The service provided by Niche Corp directly engages Manufacturing Corp. Manufacturing Corp uses Niche Corp’s services at its plant location and thus, this location is where the benefit impacts Tracker Corp.

- Applying the cascading rules, due to the nature of the work, the FTB anticipates Niche Corp will have information relating to the location of Manufacturing Corp’s plant in its books and records.

Considerations

The FTB is in the process of considering possible amendments to Regulation § 25136-2 (“Draft Regulations”) (the most recent version of the Draft Regulations is available [here](#)). As currently drafted, the proposed amendments set forth in the Draft Regulations would apply to taxable years beginning on or after January 1, 2023.

The FTB’s approach in Legal Ruling 2022-01 for identifying the benefit received and determining its location does not appear to be reflected in the current Regulation nor in the Draft Regulation. In operation, however, the approach may arguably yield results that are consistent with the result obtained by applying the Draft Regulations. For example, in the Draft Regulations, the location where the benefit of the service is received is presumed to be a specific location depending on whether the service predominantly relates to real property, tangible personal property, intangible property, or individuals. Once the presumption is applied, the location is then substantiated through, for example, the taxpayer’s contracts or books and records. Although Situations Two and Three, described above, seem to follow two of the four presumptions in the Draft Regulations – namely, services that predominantly relate to tangible personal property and real property, respectively – it is uncertain which presumption would apply to Situation One, as it does not appear to fall squarely within one of the four presumptions.

Although Legal Ruling 2022-01 appears to provide guidance on the manner in which to determine, for example, the location where the benefit of the service is received, it is important to note that Legal Ruling 2022-01 makes no reference to the fact that both Regulation section 25136-2 and the Draft Regulations merely provide a rebuttable presumption as to where the benefit of the service is received. That presumption may be rebutted by the taxpayer or the FTB based on a preponderance of the evidence that such location is actually elsewhere.

Based on the FTB’s guidance in Legal Ruling 2022-01, taxpayers that provide services to customers may be required to look beyond the location of their customers to the location of their customer’s customers for sales factor sourcing purposes. This is because, in the FTB’s view, the benefit of a service is usually the direct effect of the action or function being performed, and the location of that benefit is where it impacts the taxpayer’s customer. Taxpayers should consult their tax advisers to discuss the impact that Legal Ruling 2022- may have on their California tax liabilities.

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