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In this edition of Inside Deloitte, the authors discuss a recent California chief counsel ruling regarding the application of market-based sourcing rules for services provided to service providers.

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Introduction

In Chief Counsel Ruling (CCR) 2017-01,[1] the California Franchise Tax Board issued guidance interpreting its market-based sourcing rules for services, stating that where a taxpayer/service provider is performing services for another service provider (client service provider), the benefit received is the client service provider being relieved of having to perform some of its contractual obligations for its own customers. As discussed below, this generally results in the service fees being sourced to the principal location of the client service provider and not to the location of its ultimate customers. A fact pattern involving services being performed for a service provider appears to be a matter of first impression and may have significant implications for the sourcing of receipts from subcontracting and outsourcing service relationships.

The FTB also maintained its existing position on the sourcing of receipts from so-called non-marketing services first set out in CCR 2015-03,[2] which limits situations in which the benefit received from services is determined regarding the customer's customer. Finding that the services were non-marketing services, the FTB determined in CCR 2017-01 that the taxpayer should assign sales of those services to California to the extent that its direct customer, and not its customer's customer, receives the benefit of the service in the state.[3]

Finally, in concluding that the benefit received by the taxpayer's customer is that of being relieved of the obligation to perform services it was contractually obligated to fulfill, CCR 2017-01 determined that the location where that benefit is received is the location where the taxpayer's customer (that is, the client service provider) would otherwise have performed the services itself.

This article analyzes CCR 2017-01 and discusses its potential implications for similarly situated taxpayers.

[1] California Franchise Tax Board, Chief Counsel Ruling (CCR) 2017-01 (Apr. 7, 2017).

[2] FTB, CCR 2015-03 (Dec. 31, 2015).

[3] CCR 2017-01, *supra* note 1, at 3.

California Sourcing of Sales of Services

California's market sourcing rules are set out in California Revenue and Taxation Code section 25136 and California Code of Regulations, title 18, section 25136-2. Under those rules, California sources sales of services to a state to the extent the purchaser of the services receives the benefit of the services in the state.[4] When the purchaser of a service receives the benefit of that service in more than one state, the gross receipts are attributable to California based on the portion of the benefit of the services received in California.[5] Under the regulation, the location where the benefit of a service is received is the location where the customer has either directly or indirectly received value from delivery of the service.[6]

Determining where the customer has directly or indirectly received value from the delivery of the service is determined by two sets of cascading rules or information sources, depending on whether the taxpayer's customer is an individual or a business entity.[7] When the taxpayer's customer is a business, the rules begin with a presumption that the service was received in California to the extent it is indicated in the contract or the taxpayer's books and records, notwithstanding the billing address of the taxpayer's customer. That presumption may be overcome based on a preponderance of the evidence that the location indicated by the contract or the taxpayer's books and records was not the location where the benefit was actually received.[8] When neither the contract nor books and records provide the location where the benefit is received, that location is determined based on reasonable approximation.[9] If it is not possible to reasonably approximate the location where the benefit is received, the location from which the taxpayer's customer placed the order is used, and if that location cannot be determined, then the taxpayer is to use its customer's billing address.[10]

Analyzing Where the Benefit of Services Is Received

Three primary issues should be analyzed in determining where the benefit of services is received when the services are performed for a business customer:

- Whose benefit is being measured, the taxpayer's direct customer, the customer's customer, or other end user?
- What is the benefit?
- Where is that benefit received?

Although each taxpayer situation is unique, it generally is logical to analyze those three issues in the order noted.

Prior Guidance on 'Non-Marketing' Services

CCR 2015-03, issued in December 2015, addressed the sale of non-marketing services performed for a business customer and whether the sale of those services should be sourced based on the location where the taxpayer's customer or its customer's customer received the benefit of the service.[11] In determining whether to focus on the direct customer or the ultimate customer, the FTB looked to analogous rules and examples in the regulations governing the licensing of intangibles under regulation section 25136-2(d)(2), which distinguishes between marketing and non-marketing intangibles.[12] The regulation requires marketing intangibles to be sourced to the location of the ultimate customer and non-marketing intangibles to be sourced to the location where the direct customer uses the intangibles in its business.[13]

The FTB found that distinguishing between marketing and non-marketing services, similar to distinguishing between marketing and non-

[4] Cal. Rev. & Tax. Code section 25136(a)(1).

[5] Cal. Code Regs. tit. 18, section 25136-2(b)(8).

[6] Cal. Code Regs. tit. 18, section 25136-2(b)(1).

[7] Cal. Code Regs. tit. 18, section 25136-2(c)(1)-(c)(2).

[8] Cal. Code Regs. tit. 18, section 25136-2(c)(2)(A).

[9] Cal. Code Regs. tit. 18, section 25136-2(c)(2)(B).

[10] Cal. Code Regs. tit. 18, section 25136-2(c)(2)(C)-(D).

[11] CCR 2015-03, *supra* note 2, at 5.

[12] A marketing intangible includes a copyright, trademark, etc., in which the value lies predominately in the marketing of the intangible property in connection with the sale of goods, services, or other items to ultimate customers. Cal. Code Regs. tit. 18, section 25136-2(b)(4)(A).

[13] Cal. Code Regs. tit. 18, section 25136-2(d)(2)(A)-(B).

marketing intangibles, would be consistent with the regulation. The FTB reasoned that "as is true for a non-marketing intangible, the value of a non-marketing service lies not in the advertising or promoting of a product, service or other item, but rather the value lies in the service being used in the business operations of the taxpayer's customers."[14] Thus, the FTB concluded that since the taxpayer's service was analogous to a non-marketing intangible used in its customers' business operations that "similar to the assignment rules for sourcing non-marketing intangibles, [taxpayer's] sales receipts for non-marketing services should be sourced to this state to the extent its customers receive the benefit of the service in this state."[15]

While the regulation does not specifically define marketing services or non-marketing services, it sets out examples that might support the FTB's distinction between those types of services. The Web Corp example, provided in regulation section 25136-2(c)(2)(E)(4), arguably involves marketing services because the taxpayer is providing advertising services targeted to ultimate customers (that is, viewers). The example indicates that when the taxpayer, Web Corp, provides internet content to its viewers and receives revenue by showing advertisements online and collecting fees based on the number of views or clicks by website viewers, the sales from the advertising services should be sourced to the location of the viewers, that is, the ultimate customers. In contrast, the Builder Corp example, provided in regulation section 25136-2(b)(1)(B), arguably is an example of a non-marketing service. It indicates that when the recipient of the services, Builder Corp, outsources management of the construction of an in-state office building to an out-of-state, third-party, Engineering Corp (the taxpayer), the revenue from Engineering Corp's services should be sourced to the location where Builder Corp would have conducted the management function that it had outsourced.

CCR 2017-01

CCR 2017-01 addresses a request by a taxpayer seeking clarity on three issues regarding the application of the market-based sourcing rules for non-marketing services. The taxpayer is a service provider that contracts directly with a client service provider to manage and administer the services that the client service provider is contractually obligated to provide to its customers.[16] The CCR describes the direct customer (client service provider) as a health plan that provides comprehensive healthcare services to employers and other ultimate customers. The health plan then engages the taxpayer to perform a portion of those healthcare services on its behalf.

In the ruling's first conclusion, the FTB reiterated its prior guidance in CCR 2015-03, that when a taxpayer performs non-marketing services, the taxpayer should assign sales of its services to California to the extent its direct customers, and not its customers' customers, receive the benefit in California.[17] As in the prior ruling, the taxpayer's services in CCR 2017-01 were deemed not to be marketing services, in contrast to the advertising services described in the Web Corp example in the regulations.

In the ruling's second conclusion, the FTB determined that under the taxpayer's facts, the benefit received by its client service provider is that of being relieved of the obligation to perform a business function that it would otherwise be required to perform itself under its contracts with its customers.[18] In other words, the client service provider had its own service contracts with its customers, under which it took on obligations to perform services for those ultimate customers. In contracting with taxpayer to perform some of those service obligations, client service provider was relieved of the need to do those services itself and hence received a benefit.

In the ruling's third conclusion, the FTB determined that under the taxpayer's facts, the

[14] CCR 2015-03, *supra* note 2, at 7.

[15] *Id.*

[16] CCR 2017-01, *supra* note 1, at 2.

[17] *Id.* at 3.

[18] *Id.*

location where that benefit was received is where the client service provider would have performed the services itself had it not hired the taxpayer.[19] Further, if that location is not evident in the customer agreement or its books and records, then taxpayer should use the remaining cascading rules, including reasonable approximation, to determine the location of the benefit.[20] The FTB explained that it is reasonable to assume that the location where the client service provider would have performed the services, notwithstanding the contracts with the taxpayer, is the location where the taxpayer's customer conducts residual services or functions under the existing contracts with its customers.[21] The ruling states, "the current base of operations is the best indicator of where the taxpayer's customer would have otherwise been obligated" to perform its duties to the client service provider.[22] Thus, "the best reasonable approximation" of the location where the benefits are received would be the location where the client service provider would conduct the function that the taxpayer is providing, in the event that it canceled its contract with the taxpayer.[23]

CCR 2017-01: Taxpayer Implications

Taxpayers providing services to business customers should take a close look at their sourcing method with the FTB's recent guidance in mind. To the extent a taxpayer is providing services to another service provider, it should consider whether it can determine the location where its customer would provide the services if the taxpayer were not otherwise performing that service on its behalf, by either looking to the taxpayer's books and records or its customer's base of operations. Finally, if taxpayer determines that its prior market sourcing method should be modified to align more closely with the FTB's guidance in CCR 2017-01, it may need to obtain the FTB's approval. Regulation section 25136-2(g)(2)(A) provides that, to the extent that a taxpayer is using a reasonable approximation method, the taxpayer must seek permission to change to an alternative reasonable approximation method. ■

[19] *Id.* at 4.
[20] *Id.* at 6.
[21] *Id.*
[22] *Id.* at 1.
[23] *Id.* at 7.