

California FTB issues ruling on sourcing of non-marketing services receipts

Overview

The California Franchise Tax Board (FTB) recently released Chief Counsel Ruling 2015-03¹ (Ruling 2015-03) which provides guidance on the sourcing of receipts from non-marketing services under California Code of Regulations (Regulation) Section 25136-2.² The taxpayer sought a ruling that sales of non-marketing services should be assigned to the location of the taxpayer's customer and not the location of its customer's customer. The taxpayer also sought the FTB's approval to use a particular type of data derived from the taxpayer's books and records to measure the location where the benefit of the service was received. The FTB concluded that:

1. For purposes of assigning sales of non-marketing services under California Revenue and Taxation Code (CRTC) Section 25136 and Regulation Section 25136-2, the taxpayer shall assign the sales of its services to California to the extent that the taxpayer's direct customer (not its customer's customer) receives the benefit of the service in California;³
2. Central Processing Unit (CPU)⁴ data associated with the customer's use of the taxpayer's services collected in the regular course of business (and that is kept in the taxpayer's books and records) can be used as a reasonable proxy for financial data in measuring the extent of the benefit received in California.

This Tax Alert summarizes Ruling 2015-03 and provides some taxpayer considerations.

Factual background

The taxpayer is a service provider that provides integrated financial information and analytical applications to its business entity customers who in turn provide financial services to their business entity customers (the taxpayer's customer's customer). The taxpayer's direct customers are typically in the global investment community, including portfolio managers, investment bankers, and other financial professionals. The taxpayer provides its customers consolidated content from hundreds of financial databases, which its customers can then analyze and use to "manage risk, make better management decisions, and increase productivity" to serve its own customers.⁵ The taxpayer's direct customers (the users) access the financial databases and use different levels of CPU processing power based on each user's particular needs. The taxpayer assigns a User ID to each user which is then associated with the work location provided by the user when the user signs up for taxpayer's service. When users access the taxpayer's services, the taxpayer is able to track the amount of CPU processing power that is used and match that usage to the assigned geographical location. Typically, the level of CPU usage corresponds directly to the amount of fees paid to the taxpayer (e.g., higher CPU usage results in higher fees). Further, the taxpayer did not have the resources to extrapolate the necessary financial data from its books and records kept in the regular course of its business to determine the location where the taxpayer's customer receives the benefit.

Issue 1: Assignment of non-marketing services under CRTC Section 25136 and Regulation Section 25136-2

In considering the proper sourcing of receipts, generally, "[s]ales from services are in this state to the extent the purchaser of the service received the benefit of the services in this state."⁶ Regulation Section 25136-2(c) provides a set of cascading rules and associated examples used to determine the location of the benefit of the service. However, according to Ruling 2015-03, the underlying statute and regulation do not specify when a service should

¹ Ruling 2015-03 was initially issued as Ruling 2015-02, but was subsequently renumbered, available [here](#).

² Chief Counsel Rulings are taxpayer-specific rulings issued by the FTB and as such, Ruling 2015-03, p. 8., provides that "[t]he tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts [the taxpayer] ha[s] submitted."

³ As part of its ruling request, the taxpayer also sought a ruling that its services constituted non-marketing services and that the rules used to assign sales of services should be similar to the rules used to assign marketing and non-marketing intangibles. The FTB agreed and found that the taxpayer's services were non-marketing services that were analogous to the Regulation's definition of non-marketing intangibles used in the taxpayer's customer's business operations. Ruling 2015-03, p. 1.

⁴ CPU reflects the amount of processing power, and "CPU usage is a measure of computing and processing power required for [the taxpayer] to provide services to its users." Ruling 2015-03, p. 3.

⁵ Ruling 2015-03, p. 2. Although the taxpayer's customer's customer are not described in Ruling 2015-03, a reasonable inference may be drawn that these include businesses or persons requiring the financial services of portfolio managers, investment bankers and other financial professionals.

⁶ CRTC § 25136(a)(1).

be assigned to the taxpayer's customer or its customer's customer, or when both the taxpayer's customer and its customer's customer receive a benefit from the service.

In order to provide guidance on this issue, the FTB looked to analogous rules and examples in the Regulation governing the licensing of intangibles. The FTB first noted that Regulation section 25136-2(d)(2) distinguished between marketing and non-marketing intangibles. Specifically, 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 intangible in its business. The FTB found that applying this approach to sales of services would be consistent with the Web Corp examples provided under Regulation 25136-2(c)(2)(E), which were the only examples that addressed assigning the benefit of the service to the taxpayer's customer's customer.⁷

Applying this guidance, the FTB found that sales from non-marketing services should similarly be sourced to the location where the taxpayer's direct customer receives the benefit of the service through its use in its business. The FTB explained, "[a]s 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 customer."⁸

Issue 2: Use of CPU data collected in the regular course of business as a reasonable proxy for financial data

The FTB also analyzed whether the taxpayer's CPU data is a reasonable proxy to determine where the benefit of the services is received by the taxpayer's customer. The relevant cascading rule in Regulation 25136-2(c)(2)(A) states:

The location of the benefit of the service shall be presumed to be received in this state to the extent the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the regular course of business, notwithstanding the billing address of the taxpayer's customer, indicate the benefit of the service is in this state.

Regulation Section 25136-2 does not specify what type of data from a taxpayer's "books and records" can be used to determine the location where the benefit of the service was received. The taxpayer indicated that financial data from its books and records cannot be used to reasonably extrapolate the location where the benefit is received and requested that it be allowed to use an alternative metric, i.e., CPU data gathered in the regular course of its business. The CPU data shows the location of the user who accesses the services provided by the taxpayer. Additionally, the level of CPU usage directly correlates with the amount of fees received from the taxpayer's customers. For these reasons, the FTB concluded that "CPU usage stored in the taxpayer's books and records kept in the regular course of business is an acceptable proxy for financial data that cannot be reasonably extrapolated from the taxpayer's books and records kept in the regular course of business to determine the location and measure of the benefit of the service received by the taxpayer's customers in this state."⁹

Considerations

Although the current market-based sourcing regime does not explicitly distinguish between marketing and non-marketing services or provide much guidance on how these types of services should be sourced, Ruling 2015-03 sheds light into how the FTB may apply the rules that currently exist to sales of services. In the case of non-marketing services, Ruling 2015-03 appears to follow the general rule that sales from these services are sourced to the location where the taxpayer's customer receives the benefit of the service. On the other hand, for marketing services, sales appear to be sourced by looking through layers of business relationships to the taxpayer's ultimate customer. Although marketing services are not explicitly defined, services that are related to "the advertising or promoting of a product, service or other item" may fall into this category.

Neither CRTC Section 25136 nor Regulation Section 25136-2 provide a definition or examples as to the type of data in a taxpayer's books and records that should be used to determine the location where the benefit is received. However, the fact that the FTB accepted CPU usage as an acceptable proxy for financial data in Ruling 2015-03

⁷ Ruling 2015-03, p. 6, notes that Examples 4 and 5 of Regulation Section 25136-2(c)(2)(E) indicate that where a taxpayer, Web Corp, provides internet content to its viewers and receives revenue from providing advertising services to other businesses (the advertisements of which are shown on the website to Web Corp viewers and the fees collected from advertisers are based on the number of times the advertisement is viewed and/or clicked on by website viewers), the sales from the advertising services should be sourced to the location of the viewers, the ultimate customer.

⁸ Ruling 2015-03, p. 7.

⁹ Ruling 2015-03, p. 8.

may suggest that, where a taxpayer's facts indicate a direct tie between usage and fees, this type of proxy may be an acceptable alternative.

Contacts

If you have questions regarding Chief Counsel Ruling 2015-03 or other California tax matters, please contact any of the following Deloitte Tax professionals:

[Bart Baer](#)

Principal
Deloitte Tax LLP, San Francisco
+1 415 783 6090

[Jairaj Guleria](#)

Partner
Deloitte Tax LLP, San Jose
+1 408 704 4259

[Steve West](#)

Director, California Technical Lead
Deloitte Tax LLP, Los Angeles
+1 213 688 5339

[Shirley J. Wei](#)

Senior Manager, California
Technical/Controversy Lead
Deloitte Tax LLP, Los Angeles
+1 213 553 1475

[Lauren Knapp](#)

Manager
Deloitte Tax LLP, Sacramento
+1 916 288 3267

[Valerie C. Dickerson](#)

Partner, Washington National Tax
Deloitte Tax LLP, Washington DC
+1 202 220 2693

The authors of this alert would like to acknowledge the contributions of Daisy Jacinto to the drafting process. Daisy is a tax senior working in the Sacramento Multistate Tax practice of Deloitte Tax LLP.

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