California FTB issues ruling on the application of market-based sourcing rules to "non-marketing" services

Overview

The California Franchise Tax Board ("FTB") recently released Chief Counsel Ruling 2017-01[1] ("Ruling 2017-01") in which a subcontractor ("Taxpayer") to health plans sought a ruling in connection with three issues related to the proper sourcing under California Revenue & Taxation Code ("CRTC") Section 25136 and California Code of Regulations ("Regulation") Section 25136-2 of sales derived from the Taxpayer's performance of certain management and administrative services that the health plans were contractually obligated to perform for its customers. Specifically, the Taxpayer sought guidance on whether those services constituted "non-marketing" services that were properly assigned based on the location of its customer (and not the health plan's customer(s)), whether the benefit derived by the health plans from the Taxpayer's services was the discharge of the health plan's contractual obligation to provide those services to its customers, and whether the location where the health plans derived such benefit was at the location of the health plans' current base of operations. The FTB granted the Taxpayer's request for ruling, answering all three questions in the affirmative, and applied the rationale set forth under Chief Counsel Ruling 2015-03.[2]

This Tax Alert summarizes Ruling 2017-01 and provides some taxpayer considerations.

Factual Background

The Taxpayer is a service company operating primarily in the United States.[3] The Taxpayer contracts directly with managed care organizations, health insurers, third-party administrators, employers, union sponsored benefit plans, worker's compensation plans, and government health programs (collectively, "Health Plans"). Generally, a Health Plan enters into a Health Benefit Plan Services Agreement ("Health Plan Agreement") with its customers, which include commercial employers, unions, or other groups (collectively, "Plan Sponsor"), to provide health insurance services to those customers' employees or members (collectively, "Members").[4]

The Health Plans subcontract various operational and transactional aspects of their benefit services to the Taxpayer which allows them to take advantage of operational efficiencies and cost savings, which in turn allows them to reinvest these savings and focus on other core business functions. None of the services subcontracted to the Taxpayer involved marketing the Health Plans' services. The services provided by the Taxpayer to the Health Plans included addressing affordability concerns by securing discounts, providing technology and related services,

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[1] Chief Counsel Ruling 2017-01, available here.
[2] On March 25, 2016, Deloitte Tax LLP issued an External Multistate Tax Alert (available here) discussing Chief Counsel Ruling 2015-03 (available here). In Ruling 2015-03, the FTB distinguished between "marketing" and "non-marketing" services and applied a treatment to sales derived from those services that was similar to the treatment provided under Regulation Section 25136-2 for sales derived from "marketing" and "non-marketing" intangibles. A "marketing intangible" (which would be sourced to the location of the taxpayer's customer's customer) includes "the license of an intangible where the value lies predominantly in the marketing of the intangible property in connection with goods, services, or other items[,]" and "marketing" involves "the action or business or promoting and selling products or services." A "non-marketing or manufacturing intangible" (which would be sourced to the location where the taxpayer's customer's uses the intangible) includes "the license of an intangible to be used in a manufacturing or other non-marketing process, where the value of the intangible property lies predominantly in its use in such process." Chief Counsel Ruling 2015-03, p. 5 (citing California Code of Regs., tit. 18, §§ 25136-2(b)(4)(A)-(b), (d)(2); Oxford Dictionaries, Oxford University Press (April 2014)). Based on those rules, the FTB explained that "[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 [(which is where the value would lie for marketing services)], but rather the value lies in the service being used in the business operations of the taxpayer's customer." Chief Counsel Ruling 2015-03, p. 7.
[3] Chief Counsel Ruling 2017-01, p. 2.
[4] *Id.*

processing payments, managing other third-parties, providing customer service, and delivering other services. Although the Health Plans subcontract those services to the Taxpayer, the Health Plan still conducts the primary management of the Health Plan Agreement and makes all material benefit plan design choices.[5] The Health Plans usually conduct these business functions at the location of their "primary commercial and administrative base of operations, which is generally also the location at which [the Taxpayer] has contacts with the Health Plan in the course of providing its services."[6]

FTB's conclusions on the Taxpayer's request for rulings

The Taxpayer sought a ruling in connection with three issues: (1) whether the Taxpayer's sales of "non-marketing" services should be assigned to California to the extent the Health Plans (and not the Plan Sponsors or their Members) received the benefit from the Taxpayer's services in California, (2) where the Taxpayer's service is to fulfill the Health Plan's contractual obligations to the Plan Sponsors, whether the benefit that the Health Plans received from the Taxpayer's services is the discharge of its obligation to perform the business functions that the Health Plans would otherwise be required to perform under the Health Plan Agreements, and (3) whether the location where the Health Plans received the benefit from the Taxpayer's services is determined with respect to the business location at which the Health Plans would have performed those business functions that the Taxpayer now handled.[7]

On the above three issues, the FTB concluded that, for purposes of assigning sales of "non-marketing" services under CRTC Section 25136 and Regulation Section 25136-2,

1. the Taxpayer shall assign the sales of its services to California to the extent its direct customers (the Health Plans), and not its customer's customer (the Plan Sponsors or their Members), received the benefit from the Taxpayer's services in California,
2. the benefit received by the Health Plans is that of being relieved of the obligation to perform the business functions required under the Health Plan Agreements, and
3. the Taxpayer shall assign the sales of its services to California to the extent the Health Plans received the benefit of the service in California as determined under the cascading rules in Regulation Section 25136-2(c)(2).[8]

Issue 1: Should sales of "non-marketing" services be assigned to California to the extent the Health Plans (and not the Plan Sponsors or their Members) received the benefit from the Taxpayer's services in California?

CRTC Section 25136 provides that "[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."[9] Regulation Section 25136-2(b)(1) defines "benefit of a service is received" as "the location where the taxpayer's customer has either directly or indirectly received value from delivery of that service."[10] However, neither CRTC Section 25136 nor Regulation Section 25136-2 provides guidance on how to determine which party receives the benefit from "non-marketing" services where both the taxpayer's customer and its customer's customer receive the benefit from those services.[11] As a result, the FTB applied the rationale set forth in Chief Counsel Ruling 2015-03 in which the FTB distinguished between "marketing" and "non-marketing" services and applied a treatment to those services that was similar to the treatment provided in Regulation Section 25136-2 to sales from "marketing" and "non-marketing" intangibles. Accordingly, similar to "marketing" intangibles, "marketing" services should be sourced to the location where the taxpayer's customer's customer receives the

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[5] Chief Counsel Ruling 2017-01, p. 2. For example, the Health Plan will retain, among others, the following business functions: determination of the benefit plan design; benefit plan administration, including primary customer service, establishment of plans, Plan Sponsor relationship management, plan rate establishment, billing, etc.; eligibility establishment and governance, enrollment and health plan data services including maintaining the database of members and approved benefits. Chief Counsel Ruling 2017-01, p. 2-3.

[6] Chief Counsel Ruling 2017-01, p. 3. Examples of the types of contacts that the Taxpayer has with the Health Plans include "periodic meetings to discuss ongoing services, management reporting and contract compliance meetings, data and information communication, billing, problem resolution and various other interactions necessary to manage the [redacted] benefits programs." *Id.*

[7] Chief Counsel Ruling 2017-01, p. 1, 3.

[8] Chief Counsel Ruling 2017-01, p. 3-4.

[9] Cal. Rev. & Tax. Code § 25136(a)(1); *see* Chief Counsel Ruling 2017-01, p. 5.

[10] Cal. Code Regs., tit. 18, § 25136-2(b)(1); *see* Chief Counsel Ruling 2017-01, p. 5.

[11] Chief Counsel Ruling 2017-01, p. 5.

benefit from the taxpayer's services. Similar to "non-marketing" intangibles, "non-marketing" services should be sourced to the location where the taxpayer's customer receives the benefit from the taxpayer's services.[12] Applying this approach to the Taxpayer's facts, the FTB concluded that, because the sales at issue are "non-marketing" services, the location where the benefit is received should be determined based on the Health Plan's *direct* benefit, and not the *indirect* benefit received by the Plan Sponsors or their Members.[13]

Issue 2: Is the benefit received by the Health Plans from the Taxpayer's services the discharge of its obligation to perform certain business functions that the Health Plans would otherwise be required to perform under the Health Plan Agreements?

Regulation Section 25136-2(b)(1) defines "benefit of a service is received" to mean "the location where the taxpayer's customer has either directly or indirectly received value from delivery of that service."[14] The FTB noted that the Taxpayer contracts with the Health Plans to manage and administer certain benefits that the Health Plans are contractually obligated to provide under the Health Plan Agreements and that the Health Plans subcontract those functions to the Taxpayer to take advantage of certain benefits such as operational efficiencies and cost savings.[15] However, if the Health Plans terminated their contracts with the Taxpayer, they would be contractually obligated to provide those business functions themselves. Therefore, the FTB concluded that the benefit received by the Health Plans from the Taxpayer's services was "that of being relieved of the obligation to perform these business functions that they would otherwise be required to perform themselves, but for their contracts with [Taxpayer]."[16]

Issue 3: Is the location where the Health Plans received the benefit from the Taxpayer's services determined with respect to the business location at which the Health Plans would have performed those business functions that the Taxpayer now handled?

To determine the location where the Health Plans received the benefit from the Taxpayer's services under the cascading rules in Regulation Section 25136-2, the FTB stated that it was necessary to determine where the Health Plans received value from not having to perform those business functions themselves.[17] The FTB explained that, to the extent that the information is unavailable or unclear in the Taxpayer's agreement with the Health Plans or its books and records, the Taxpayer should source the sales at issue under the other cascading rules in Regulation Section 25136-2. This includes using a reasonable approximation to determine where the Health Plans would perform the subject business functions based on existing information of the account managers and other publicly available information regarding the Health Plans. However, the FTB noted that "the best reasonable approximation" was the location where the Health Plans would conduct those business functions if they cancelled their contract with the Taxpayer.[18] Because the Taxpayer currently conducted the other business functions that were not subcontracted to the Taxpayer from its primary commercial and administrative base of operations, the FTB concluded that that location seemed to be "the best indicator of where the Health Plan clients would perform the [business functions at issue] themselves, especially since [the Taxpayer] generally has information in its books and records to determine this location because of the ongoing relationship between [the Taxpayer] and the Health Plans."[19]

Considerations

California's market-based sourcing rules do not explicitly distinguish between "marketing" and "non-marketing" services or provide detailed guidance on how these types of services should be sourced. Although Regulation Section 25136-2 provides some examples on how to determine the location where the benefit of the services is received for various revenue streams, none of those examples involve subcontracted management and administrative services performed for health plans or even the health care industry in general. Therefore, Ruling 2017-01 provides some insight into how the FTB may apply the market-based sourcing provisions to taxpayers in similar businesses. However, because Chief Counsel Rulings are taxpayer-specific rulings and thus, only apply to the named taxpayer as limited by the facts as set forth in the ruling,[20] Ruling 2017-01 serves merely as guidance and may not be relied

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[12] *Id.*
[13] Chief Counsel Ruling 2017-01, p. 5-6.
[14] Cal. Code Regs., tit. 18, § 25136-2(b)(1); *see* Chief Counsel Ruling 2017-01, p. 6.
[15] Chief Counsel Ruling 2017-01, p. 6.
[16] *Id.*
[17] Chief Counsel Ruling 2017-01, p. 6.
[18] *Id.*
[19] Chief Counsel Ruling 2017-01, p. 6-7.
[20] *Id.*, p. 7.

upon by other taxpayers. Taxpayers with questions regarding the application of California's market-based sourcing provisions or Ruling 2017-01 should consult with a California tax specialist.

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