AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT
CALIFORNIA SOURCES THE SALE OF A SERVICE PURCHASED BY A SERVICE PROVIDER TO THE CUSTOMER'S CUSTOMERS' LOCATIONS

SUMMARY

The California Franchise Tax Board recently issued Chief Counsel Ruling 2015-03 (Dec. 31, 2015), which provides guidance on where to assign the gross receipts from the sale of a service provided to a business customer who, in turn, uses that service to provide a service to their business customers for purposes of the Corporation Income Tax sales factor. In the ruling, the Chief Counsel held that a taxpayer who provides integrated financial information and analytical applications services to its customers, who in turn provide financial services to their business customers, should assign such receipts to its business customer's location rather than its customer's customer location (sometimes referred to as the "look-thru" rule).

DETAILS

Background

Under Cal Rev. & Tax Code § 25136(a)(1), for purposes of the Corporation Income Tax sales factor, California requires sourcing receipts from the sale of a service to the state to the extent the purchaser received the benefit of the service in California, effective for taxable years beginning after December 31, 2012. In Cal. Code Regs. tit. 18, § 25136-2(b)(1), the Franchise Tax Board defines "benefit of a service received" to mean "the location where the taxpayer's customer has either directly or indirectly received value from delivery of that service."

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At least until Ruling 2015-03, guidance on the application of the definition of "benefit of a service received" to business customers was limited to a few examples in the regulations pertaining to relatively straight-forward situations. These examples include illustrations of taxpayers that sell non-marketing services to customers that do not use the services to provide services to their customers (e.g., payroll services, audit services, legal services, and services to real estate). In these situations, the receipts are assigned to the state where the customer receives the service. These examples also include an illustration of a taxpayer that sells marketing services (e.g., internet advertising services). In this situation, the receipts are assigned to the state where the customer's products are sold (i.e., the "look-thru" rule). However, none of these examples provide guidance on where to assign receipts from the sale of a service used by a business customer to in turn provide services to their business customers. *See* Cal. Code Regs. tit. 18, § 25136-2(b)(1) and (c)(2). In this situation, it may be unclear whether the customer directly or indirectly received value from the delivery of the service at its location (or locations) or at its customers' locations.

Under Cal. Code Regs. tit. 18, § 25136-2(d), the regulations provide guidance on where to assign receipts from the licensing of non-marketing (or manufacturing) and marketing intangibles. With respect to the former, the receipts are assigned to California to the extent the non-marketing intangible is used by the customer in the state (e.g., used in manufacturing carried on in the state). With respect to the latter, the receipts are assigned to California to the extent the marketing intangible is used by the customer's customer in the state (e.g., based on the customer's customers' California sales or by use of the "look-thru" rule). *See* Cal. Code Regs. tit. 18, § 25136-2(d)(2)(A)(1), (B), and (D).

Ruling 2015-03

The taxpayer in Ruling 2015-03 provides integrated financial information and analytical applications to global business customers that, in turn, provide financial and other similar services and product offerings to their own business customers. The applications offer customers computer access to real-time news and quotes, company and portfolio analyses, multi-company comparisons, industry analysis, and other information and tools, which is based on content from hundreds of databases consolidated by the taxpayer. The customers purchasing these applications are typically portfolio managers, market research and performance analysts, risk managers, and other similar professionals that can each have numerous users of the service and at different usage levels.

The taxpayer assigns a user ID to each user of an application (multiple user IDs are assigned if the customer has multiple users). The taxpayer can track the amount of processing power that is used by each user ID, and match that usage to its associated geographic location. While the taxpayer can track processing power usage, the taxpayer does not have the resources to determine the location and measure of the benefit of the service received by each customer.

The taxpayer requested a ruling that: (i) the service be considered a "non-marketing service" and the receipts from the sale thereof are assigned to California based on the location of its customers; and (ii) its data related to processing power usage should be used as a proxy for determining the location and measure of the benefit received by its customers. With respect to the first issue, the Chief Counsel analogized the service provided by the taxpayer to a non-marketing intangible, characterized it as a "non-marketing service," and ruled that receipts from sales of the taxpayer's service should be assigned to California to the extent its customers receive the benefit of the service in the state (i.e., rather than look-thru to the customer's customers to ascertain where they received the benefit). With respect to the second issue, the Chief Counsel ruled that the taxpayer may assign receipts from the sales to California based on its processing power usage data.

BDO INSIGHTS

- Because each ruling represents the conclusion of the Chief Counsel regarding the application of the law at that time to the facts specified, taxpayers are cautioned against reaching the same conclusion in other cases unless the facts, circumstances, and law are the same. However, taxpayers now have some guidance as to how the Board may apply the Corporation Income Tax sales sourcing provisions where a non-marketing service provided by a taxpayer to its customer is in turn used to provide services to the customer's customers, even if the facts and circumstances are not exactly the same.
- A ruling is intended to be retroactive in effect, unless otherwise stated in the ruling. Ruling 2015-03 does not limit the retroactive application of this ruling. Thus, California taxpayers that provide services to businesses that, in turn, use the service to provide their business customers with a service, should evaluate whether they may use a different sourcing methodology on a previously filed return.