State of California
Franchise Tax Board
Legal Division MS A260
PO Box 1720
Rancho Cordova, CA 95741-1720
tel: (916) 845-7831 fax: (916) 843-2114
ftb.ca.gov

chair John Chiang | member Jerome E. Horton | member Ana J. Matosantos

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Chief Counsel Ruling 2011-01

Subject: Chief Counsel Ruling Request for ********** and Subsidiaries

Dear **********:

By letter dated February 16, 2011, you requested on behalf of your client, ********** **********, ("Company"), CCN *******, a Chief Counsel Ruling that the billing address of Company's customers be used as reasonable proxy for the customers' "commercial domicile" for purposes of applying California Code of regulations, title 18 ("CCR"), section 25136(d)(3)(D).

The request relates to the cost of performance analysis under CCR section 25136 in connection with payments made by Company to third party agents or independent contractors acting on its behalf. Specifically, payments made by Company to third party publishers for internet advertising space on which to display the advertisements of its customers must be accounted for under CCR section 25136(d)(3) because they are includable as payments made to third party agents or independent contractors. Company requests that those payments be assigned based on the location of the customer's billing address instead of the customers' "commercial domicile" under CCR section 25136(d)(3)(D).

FACTS

Company represents the following facts:

Company is an online ******* company that uses proprietary software to enable its customers to reach highly focused audiences with online advertisements. Company places advertisements across a broad network of online publishers ("Publishers"), i.e. web site owners or operators, from which Company buys space, "page views," where Company displays advertisements provided by its customers. Company has a number of Publishers from which it regularly buys a specified amount of "page views" to place the advertisements.

Company's customers ("Advertisers") typically are advertising agencies that serve regionally-based or large companies. Less typically, Advertisers are large companies that direct their own advertising and have customers throughout the U.S. or worldwide. Advertisers contract with Company to place online ads on publisher

websites whose viewers match the Advertiser's target audience. Company works with the Advertisers to determine demographic, geographic and other profiles of the targeted audience. Company applies its proprietary processes to place its Advertisers' online advertisements on the "page views" displayed to the targeted audience.

Company reports income on a worldwide basis and calculates its California sales factor pursuant to California Revenue and Taxation Code ("RTC") 25136 and CCR section 25136, which provide that sales of services are sourced for apportionment purposes to the state where the greater cost of performance occurs. For tax years prior to January 1, 2008, Company's payments to agents and contractors were not taken into consideration when determining a taxpayer's costs of performance. Beginning January 1, 2008, CCR section 25136 was amended to include a taxpayer's payments to agents and contractors when analyzing a taxpayer's costs of performance. As a result of this change in the law, for taxable years beginning on or after January 1, 2008, Company believes it must take into account its payments to Publishers in determining its costs of performance.

The largest cost of performance that generates Company's income is money spent to purchase space on Publishers' web sites for the display of the Advertisers' advertisements. However, the contracts between Company and its Publishers do not specify the state in which the income-producing activities are to be performed or the portion of the payment to the Publishers associated with the performance in such state. A few of Company's contracts with its Advertisers reference the states in which the advertising will be displayed but none of those contracts indicates the portion of the Advertisers' payments to Company that is attributable to the performance of the income-producing activities by the Publishers in such state. Although Company is able to track the actual state locations where viewers' computers access the ads that are displayed, its records kept in the ordinary course of business do not track the states in which the income-producing activities are performed or the portion of the payment to the Publishers associated with the performance in such state.

RULING REQUESTED

Company requests a ruling that Company may treat the billing address of its customers as a reasonable proxy for "commercial domicile" for purposes of CCR section 25136(d)(3)(D).

HOLDING

For purposes of assigning sales of other than tangible personal property under CCR section 25136(d)(3)(D), Company may use its customers' billing addresses maintained in ordinary course of business as a reasonable proxy for its customers' commercial domicile.

APPLICABLE LAW

For purposes of the sales factor, RTC section 25136 provides that sales of services are attributable to California if "a greater proportion of the income-producing activity is performed in [California] than in any other state, based on costs of performance." Prior to January 1, 2008, payments to agents and independent contractors could not be included in a taxpayer's cost of performance analysis. Beginning January 1, 2008, CCR section 25136 was amended to require that a taxpayer must include payments made to agents and independent contractors when making its costs of performance analysis. As amended, CCR section 25136 contains cascading rules to determine whether income-producing activity is in California.

Specifically, CCR section 25136(d)(3), in pertinent part, provides:

> Services on Behalf of Taxpayer. An income-producing activity performed on behalf of a taxpayer by an agent or independent contractor is attributed to a state if such income-producing activity is in such state.
>
> > (A) Such income-producing activity is in a state if the taxpayer can reasonably determine at the time of filing its return that all of the income-producing activity is actually performed in such state by the agent or independent contractor.
> >
> > [Example.]
> >
> > (B) If the income-producing activity occurs in more than one state, subsection (d)(3)(A) does not apply. The income-producing activity is in a state to the extent that the contract between the taxpayer and the agent or independent contractor or the taxpayer's records indicate it is to be performed in such state and the portion of the taxpayer's payment to the agent or independent contractor associated with the performance in such state is determinable under the contract.
> >
> > [Example.]
> >
> > (C) If the location of the income-producing activity cannot be assigned pursuant to subsection (d)(3)(A) or (B), the income-producing activity is in a state to the extent the contract between the taxpayer and the taxpayer's customer or the taxpayer's records indicate it is to be performed in such state and the portion of the taxpayer's payment to the agent or independent contractor associated with the performance in such state is determinable under the contract.
> >
> > [Example.]

(D) If the location of the income-producing activity cannot be assigned pursuant to subsections (d)(3)(A), (B), or (C), the income-producing activity is in a state if the domicile of the taxpayer's customer is in that state. If the taxpayer's customer is not an individual, “domicile” means commercial domicile.

[Example.]

(E) If the location of the income-producing activity cannot be assigned pursuant to subsections (d)(3)(A), (B), or (C), or the customer's domicile cannot be determined, or such income-producing activity is in a state in which the taxpayer is not taxable, such income-producing activity shall be disregarded in determining the taxpayer's income-producing activity.

[Example.]

DISCUSSION

For purposes of the California sales factor, RTC section 25136 provides that sales of intangibles and services are attributable to California if "a greater proportion of the income-producing activity is performed in [California] than in any other state, based on costs of performance." Under the version of CCR section 25136 in effect prior to 2008, the term "income-producing activity" did not include "transactions or activities performed on behalf of a taxpayer" and, as such, costs incurred to pay third parties were not taken into account as costs of performance. Consistent with that rule, Company did not include its costs to pay Publishers in its costs of performance, even though its cost to pay Publishers comprised the single largest component of expense related to Company's revenue streams.

For taxable years beginning on or after January 1, 2008, CCR section 25136 requires taxpayers to include in their income-producing activity/cost of performance analysis the activities of, and payments made to, agents and independent contractors who perform activities on behalf of a taxpayer. For Company, this includes the activities of its Publishers as well as its payments made to the Publishers.

However, assigning the location of the Publishers' income-producing activities is problematic under the cascading rules of CCR section 25136. Company represents that subsection (d)(3)(A) of the regulation does not apply because the income-producing activity occurs in more than one state. Further, Company represents that subsection (d)(3)(B) would be impractical to apply because Company's contracts with its Publishers do not indicate the state in which the income-producing activities will be performed by Publishers on behalf of Company or the portion of Company's payments to its Publishers that is associated with the performance of the income-producing activities in such state. Although Company represents that a few of Company's contracts with its Advertisers reference the state in which the advertisements will be displayed, Company represents that most of Company's contracts with its Advertisers do not provide this information, and none of the contracts indentifies the

portion of the Advertiser's payments to Company that is associated with the performance of the income-producing activities by Publishers on behalf of Company in such state. Therefore, subsection (d)(3)(C) would be impractical to apply. Lastly, Company's represents that its books and records do not indicate the states in which the income-producing activities by Publishers are to be performed, and therefore the provisions concerning a taxpayer's records in subsections (d)(3)(B) and (C) are impractical to apply.

Because Company's income-producing activities in connection with its Publishers cannot be assigned under subsection (d)(3)(A)-(C), Company concludes that they must be assigned under subsection (d)(3)(D) to the "commercial domicile" of Company's customer. RTC section 25120(b) defines "commercial domicile" as the "principal place from which the trade or business of the Company is directed or managed." *Southern Pacific Company v. McColgan* ("*Southern Pacific*") (1945) 68 Cal.App.2d 48, is a leading case for the proposition that "commercial domicile" is determined by a facts and circumstances test focusing on where the corporation is actually and actively managed, directed, or controlled. Company states its customers' billing address kept in the ordinary course of its business is a reasonable proxy for each customer's commercial domicile for purposes of assigning costs associated with Company's Publishers income-producing activities.

Due to the unique facts presented concerning the nature of the business activities of the Publishers and the lack of information available about Company's customers' commercial domiciles, in this situation it is reasonable to assume that the customers' activities are actively managed, directed, or controlled from the customers' billing address. Therefore, under the facts presented, Company may use its customers' billing addresses maintained in ordinary course of business as a reasonable proxy for its customers' commercial domicile for purposes of CCR section 25136(d)(3).

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the Revenue and Taxation Code. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

Melissa Potter
Tax Counsel IV