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04.07.17

Chief Counsel Ruling 2017- 01

 ***** *****

RE: Chief Counsel Ruling request for *****

Dear Mr. *****:

On August 5, 2016, you requested a Chief Counsel Ruling on the application of market-based sourcing rules for non-marketing services under California Revenue and Taxation Code section ("Revenue and Taxation Code") section 25136 and California Code of Regulations ("Regulation") section 25136-2.¹ Specifically, you requested the following rulings:

(1) Where the taxpayer's services do not market a product, service or other item and are properly considered a non-marketing service, those sales of services should be assigned to the location of the taxpayer's customer and not to the location of the taxpayer's customer's customers. Because the taxpayer's services do not market a product, service or other item, ***** request that its sales of services be considered non-marketing services and assigned to the location of the taxpayer's customer.

(2) Where a taxpayer's service is to fulfill the contractual obligations of its customers, the benefit received of that service by the taxpayer's customer is that of being discharged of the contractual obligation to perform business functions that Taxpayer's customers would otherwise be required to perform. In other words, the benefit received from the service of administering ***** on behalf of a Health Plan is that the Health Plan is relieved of its obligation to self-administer the benefits.

(3) Where a Health Plan administers other aspects of the Health Plan Agreement out of a base of operations, the taxpayer should be able to source the location of the benefit of its service to that same base of operations. In other words, the current base of operations is the best indicator of where the taxpayer's customer would have otherwise been obligated to self-administer the ***** portion of the Health Plan.

FACTS

¹ Unless otherwise specified, all section references are to the California Revenue and Taxation Code and all Regulation references are to the California Code of Regulations, title 18.

The taxpayer represents the following facts:

***** (*****
“Taxpayer”) is a full-service ***** company operating primarily in the United States.****, like ***** , contract 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”) to manage and administer the *****
*****that the Health Plans are contractually obligated to provide to their clients and members. By engaging a specialized ***** to administer the ***** **** benefit program, Health Plans can take advantage of operational efficiencies and cost savings established by the ***** , allowing the Health Plans to reinvest these savings and focus on other core functions.

Typically, a Health Plan will enter into a Health Benefit Plan Services Agreement (“Health Plan Agreement”) with its customers, *i.e.*, commercial employers, unions, or other groups (collectively “Plan Sponsor”) to provide a wide range of health insurance services to the Plan Sponsor’s employees or members (collectively “Members”). The Health Plans can either self-administer the ***** ***** portion of the Health Plan Agreement or outsource this function to an independent *** solely focused on this business model.

A Health Plan interested in subcontracting the ***** ***** portion of its benefit services will enter into a *****
***** with ***** . Under a ***** Agreement, ***** does not enter into any direct contracts with either the Plan Sponsors or Members. Rather, ***** assists the Health Plans with the various operational and transactional aspects of their ***** programs. These services include addressing ***** affordability concerns by developing cost- effective ***** , securing discounts ** ***** , providing technology and related services to ***** , processing payments, managing third-party ***** , providing customer service, and delivering specialty ***** services. These services do not include marketing the Health Plan’s services.

Although a Health Plan may utilize ***** services for the ***** benefits portion of its Health Plan Agreement, the Health Plan still conducts the primary management of the Health Plan Agreement and makes all material benefit plan design choices. ***** merely administers the ***** benefit as directed by the Health Plan. For instance, the Health Plan retains all of the following:

1. Determination of the benefit plan design, including *****
***** (*i.e.*, ***** are covered under the plan);
2. Benefit plan administration, including primary customer service, establishment of plans, Plan Sponsor relationship management, plan rate establishment, billing, etc.;

3. Eligibility establishment and governance, enrollment and health plan data services including maintaining the database of members and approved benefits;
4. The development of any *****;
5. Final determination as *****.

Typically, Health Plans conduct these functions at the location of their primary commercial and administrative base of operations, which is generally also the location at which ***** has contacts with the Health Plan in the course of providing its services. Some of these contacts 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 ***** benefits programs.

ISSUES

(1) Whether, under market based sourcing rules under Revenue and Taxation Code section 25136 and Regulation section 25136-2, sales from Taxpayer's services should be sourced to this state to the extent that its direct customers, *i.e.*, the Health Plans, not Taxpayer's customers' customers, receive the benefit of the service in this state.

(2) Whether the benefit of the service received by Taxpayer's direct customers *i.e.*, the Health Plans, is that of being discharged of the obligation to perform business functions that Taxpayer's direct customers would otherwise be required to perform themselves under their Health Plan Agreements.

(3) Whether the location of where the benefit is received for Taxpayer's services is determined with respect to the business location at which the Health Plans would have performed these business functions now handled by Taxpayer, as determined under the cascading rules of Regulation section 25136-2(c).

HOLDING FOR ISSUE 1

For purposes of assigning sales under Revenue and Taxation Code section 25136 and Regulation section 25136-2, ***** shall assign the sales of its services to this state to the extent its direct customers, *i.e.*, the Health Plans, and not its customer's customers, *i.e.*, the Plan Sponsors or their Members, receive the benefit of the service in this state.

HOLDING FOR ISSUE 2

For purposes of assigning sales under Revenue and Taxation Code section 25136 and Regulation section 25136-2, the benefit received by ***** customers, *i.e.*, the Health Plans, is that of being relieved of the obligation to perform the business functions required under their Health Plan Agreements.

HOLDING FOR ISSUE 3

For purposes of assigning sales under Revenue and Taxation Code section 25136 and Regulation section 25136-2, ***** shall assign the sales of its services to this state to the extent its direct customers received the benefit of the service in this state, as determined under the cascading rules in Regulation section 25136-2(c)(2).

APPLICABLE LAW

Sales from services are in this state to the extent the purchaser of the service receives the benefit of the service in this state. (Rev. & Tax. Code section 25136(a)(1).) “To the extent” means that if a customer of a service receives the benefit of a service in more than one state, the gross receipts from the performance of the service are included in the numerator of the sales factor according to the portion of the benefit of the services received in this state. (Reg. section 25136-2(b)(8).) The benefit of a service is received in the location where a taxpayer’s customer has either directly or indirectly received value from delivery of that service. (Reg. section 25136-2(b)(1).)

Regulation section 25136-2 proscribes cascading rules to determine the sourcing of service fees depending upon whether a taxpayer’s customers are individuals or business entities. (Reg. section 25136-2(c)(2).) In the case where a corporation or other business entity is the taxpayer’s customer, the cascading rules provide that the benefit of the service shall be determined as follows:

- (A) 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. This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing, based on a preponderance of the evidence, that the location (or locations) indicated by the contract or the taxpayer’s books and records was not the actual location where the benefit of the service was received.
- (B) If neither the contract nor the taxpayer’s books and records provide the location where the benefit of the service is received, or the presumption in subparagraph (A) is overcome, then the location (or locations) where the benefit is received shall be reasonably approximated.
- (C) If the location where the benefit of the service is received cannot be determined under subparagraph (A) or reasonably approximated under subparagraph (B), then the location where the benefit of the service is received shall be presumed to be in this state if the location from which the taxpayer’s customer placed the order for the service is in this state.

- (D) If the location where the benefit of the service is received cannot be determined pursuant to subparagraphs (A), (B), or (C), then the benefit of the service shall be in this state if the taxpayer's customer's billing address is in this state.

(Reg. Section 25136-2(c)(2)(A)-(D).)

Chief Counsel Ruling 2015-03 deals with a situation where a taxpayer provides a service to businesses and both its direct customer and its customer's customer receive a benefit. The Ruling analogizes the rules governing the sales of intangibles and explains that, unlike the rules for the sale of services, Regulation section 25136-2(d)(2) expressly makes the distinction between marketing and non-marketing intangibles. The rules provide that a marketing intangible is sourced to the location of the ultimate consumer, whereas a non-marketing intangible is sourced to the location where the direct customer uses the intangible in its business. The ruling concludes that "[i]n applying the guidance for assignment of sales of 'non-marketing' intangibles to assignment of sales [of] 'non-marketing' services, sales from these services would be sourced to the location where the taxpayer's customer receives a benefit of the service through its use in the business."² The author reasoned that "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."³

DISCUSSION – ISSUE 1

Revenue and Taxation Code section 25136(a)(1) provides that sales from services are in this state to the extent that the purchaser of the service received the benefit of the services in this state. Revenue and Taxation Code section 25136-2(b)(1) goes on to specify that the benefit of a service is received at the location where the taxpayer's customer has either *directly* or *indirectly* received value from delivery of that service. However, Revenue and Taxation Code section 25136 and Regulation section 25136-2 do not expressly specify how to determine which party receives the benefit of the service in the case of a non-marketing service where both the taxpayer's customer and the taxpayer's customer's customers receive a benefit from the service.

In applying the guidance from assignment of sales of "non-marketing" intangibles to assignment of sales of "non-marketing" services, Chief Counsel Ruling 2015-03 provides that just as sales of non-marketing services are sourced to the location where the taxpayer's customer receives a benefit of the service through its use in the business, the same approach should be used for sales of services.⁴ Additionally, each of the cascading rules under Regulation section 25136-2(c)(2) contemplate that it is the taxpayer's direct customer who is receiving the benefit of the service. Therefore, because ***** provides sales of non-marketing services to its Health Plan clients, the benefit received

² Chief Counsel Ruling 2015-03, pg. 7.

³ Chief Counsel Ruling 2015-03, pg. 7.

⁴ Chief Counsel Ruling 2015-03, pg. 7.

should be determined with respect to the Health Plan's direct benefit and not the indirect benefit received by the Health Plan's customers, *i.e.*, the Plan Sponsors or their Members.

DISCUSSION – ISSUE 2

Regulation section 25136-2(b) provides that “[b]enefit of a service is received’ means the location where the taxpayer’s customer has either directly or indirectly received value from delivery of that service.” Here, ***** contracts with the Health Plans to manage and administer the ***** benefits that the Health Plans are contractually obligated to provide under the Health Plan Agreements entered into with the Plan Sponsors or their Members. In order to take advantage of benefits such as operational efficiencies and costs savings, the Health Plans choose to outsource this function to *****, which is better suited to negotiate ***** with manufacturers, *****, provide technological solutions and other miscellaneous services. However, should the Health Plans choose to terminate their contracts with ***** *****, the Health Plans would be contractually obligated to administer the ***** benefits portion of the Health Plan Agreements themselves.

Therefore, the benefit to ***** customers, *i.e.*, the Health Plans, is 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 ***** .

DISCUSSION – ISSUE 3

Having determined that the benefit received by the Health Plans is that of being relieved of the obligation to administer the ***** benefits portion of the Health Plan Agreement, the final inquiry is to determine the location of the benefit of this service to the direct customer in accordance with the cascading rules of Regulation section 25136-2(c)(2).

In applying this regulation to the ***** benefit services for the Health Plans, it is necessary to determine how ***** would establish where the Health Plans receive value from not having to perform this service themselves. To the extent that this information is unavailable or unclear in ***** agreement" or its books and records, ***** should source the ***** services pursuant to the other cascading rules under Regulation section 25136-2(c)(2), including using reasonable approximation to determine the location where the Health Plans would perform the services based on existing information of the account managers and other publically available information regarding the Health Plans. Based on the facts presented, the best reasonable approximation of the location of where the benefits are received would be the location that the Health Plan clients would conduct the ***** benefit services, if they cancelled the ***** contracts. This would be the location where the Health Plans currently conduct the residual ***** benefit services and other health plan functions, *i.e.*, the current base of operations. It would seem that this may be the best indicator of where the Health Plan clients would perform the *** services themselves, especially since ***** generally has information in its books and records to

determine this location because of the ongoing working relationship between *****
***** and the Health Plans.

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 Williams
Tax Counsel IV