



Legal Division MS A260  
PO Box 1720  
Rancho Cordova, CA 95741-1720  
tel: 916.845.7831 fax: 916.843.2114  
ftb.ca.gov

12.31.15

Chief Counsel Ruling 2015-03

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Dear Ms. \*\*\*\*\*

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<sup>1</sup>. Specifically, you requested the following rulings:

(1) Where both the taxpayer's customer and the taxpayer's customer's customers receive the benefit of a service, the assignment rules for sales of a service should be similar to the rules of assigning sales of marketing and non-marketing intangibles. In other words, sales of services where the taxpayer's services do not market a product, service or other item are properly considered a non-marketing service, and, as a result, 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, \*\*\*\*\* requests that its sales of services be considered non-marketing services and assigned to the location of the taxpayer's customer.

(2) Where the location of where the benefit of the service is received is identifiable and measurable by the Central Processing Unit ("CPU")<sup>2</sup> usage of the taxpayer's customer as indicated by the taxpayer's books and records kept in the regular course of business, the

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<sup>1</sup> 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.

<sup>2</sup> CPU is a standard term in information technology and refers to the area of the computer system that carries out the functions of the computer, to perform the basic arithmetical, logical, and input/output operations of the system. CPU plays a role somewhat analogous to the brain in the computer and refers to how much work the computer is doing to produce the required output.

taxpayer should be able to use this proxy for determining the location and measure of the benefit received by the taxpayer's customers in this state when the taxpayer cannot reasonably extrapolate data from its financial records maintained 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.

## FACTS

The taxpayer represents the following facts:

\*\*\*\*\* or "Taxpayer") is a service provider engaged in the business of providing integrated financial information and analytical applications to its global investment community business entity customers who in turn provide financial services to their business entity customers. By consolidating content from hundreds of databases and then providing the ability to analyze that data, \*\*\*\*\* applications offer \*\*\*\*\* customers one-stop access to real-time news and quotes, company and portfolio analyses, multi-company comparisons, industry analysis, company screening, portfolio optimization and simulation, predictive risk measurements, alpha-testing, and tools to value and analyze fixed income securities and portfolios. A key component of \*\*\*\*\* service offerings to its customers is \*\*\*\*\* ability to rapidly and efficiently process substantial volumes of data on its computer-based network and systems for its business entity customers' use.

\*\*\*\*\* customers are typically portfolio managers, market research and performance analysts, risk managers, marketing professionals, sell-side equity researchers, investment bankers, and fixed income professionals. These customers use \*\*\*\*\* for various reasons including performing portfolio attribution analyses, quantitative analyses, and other analytics necessary to manage their portfolios or to create product offerings for their own customers. \*\*\*\*\* customers use \*\*\*\*\* to manage risk, make better management decisions, and increase productivity. \*\*\*\*\* has customers who can have numerous users of \*\*\*\*\* services.

\*\*\*\*\* customers have different use patterns based on the type of user. For example, investment managers will typically be a heavy user of \*\*\*\*\* analytical applications, accessing databases and consolidating volumes of worldwide data for long periods of time. An investment manager might wish to compare his portfolio against a certain set of criteria. As such, he or she would use \*\*\*\*\* to obtain financial data for companies that have particular characteristics such as all manufacturers located in the Northeastern United States with revenues, gross margins and debt ratios within certain parameters. The application would then scan literally thousands of databases to locate companies that meet the profile, extract the data points that the customer requested, compile the information in a

usable format, perform analytics such as comparisons to industry averages, and then perform further searches for follow up information for which the \*\*\*\*\* customer wants to drill down. In contrast, investment bankers would typically be light users, looking for a specific piece of information about a particular company, accessing only fundamental data relative to that specific company and then using that information to assist him or her in providing the right service to the banker's clients. Light users require less computing power because fewer resources are accessed for one item of information for one company than that needed for access to and consolidation of worldwide databases for multiple pieces of information on numerous companies.

\*\*\*\*\* assigns a User ID to each user. Customers provide a work location for each user when they sign up for the service. When users access \*\*\*\*\* services, \*\*\*\*\* can track the amount of processing power or CPU that is used, and match that usage to the geographic location associated with that user ID. Thus, CPU usage is a measure of computing and processing power required for \*\*\*\*\* to provide services to its users. As stated above, the CPU used to provide services to investment managers, who spend more time using \*\*\*\*\* more sophisticated applications, is far greater than that used to provide services to investment bankers, who generally spend less time using more basic functions. In other words, \*\*\*\*\* receives higher fees from investment managers and other customers that are heavy users of the computing power than it receives from investment bankers. \*\*\*\*\* has the ability to track the amount and location of CPU usage by user ID. \*\*\*\*\* books and records kept in the regular course of business reflect that CPU usage is relative to the fees received by \*\*\*\*\* from its customers.

As a result of \*\*\*\*\* services, \*\*\*\*\* customers are more efficient and productive, and have a greater ability to analyze in detail complex data. \*\*\*\*\* services to its customers allows \*\*\*\*\* customers to provide enhanced service and product offerings to their own customers, thereby making \*\*\*\*\* services also beneficial to \*\*\*\*\* customer's customers.

\*\*\*\*\* does not have the resources to extrapolate financial data from its books and records kept in the regular course of its business in order to obtain the necessary financial data for each customer to determine the location and measure of the benefit of the service received by each customer in this state.

## ISSUES

(1) Whether, under market based sourcing rules under Revenue and Taxation Code section 25136 and Regulation section 25136-2, sales from a non-marketing service should be sourced to this state to the extent \*\*\*\*\* customer receives the benefit of the service in this state or sourced to this state to the extent the taxpayer's customer's customer receives the benefit of the service in this state.

(2) Whether, under market based sourcing rules under Revenue and Taxation Code section 25136 and Regulation section 25136-2, CPU data from a taxpayer's books and records kept in the regular course of business that indicate the location and extent of the benefit of the service received by a taxpayer's customer in this state is a reasonable proxy of the financial data in the taxpayer's books and records kept in the regular course of business that cannot be reasonably extrapolated to determine the location and extent of the benefit of the service received by the taxpayer's customers in this state.

#### HOLDING FOR ISSUE (1)

For purposes of assigning sales of non-marketing services 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 customers and *not* its customer's customers receive the benefit of the service in this state.

#### HOLDING FOR ISSUE (2)

For purposes of assigning sales of non-marketing services under Revenue Taxation Code section 25136 and Regulation section 25136-2, \*\*\*\*\* may use CPU data from its books and records kept in the regular course of business as a reasonable proxy for financial data in the taxpayer's books and records kept in the regular course of business that cannot be reasonably extrapolated to determine the location and extent of the benefit of the service received by the taxpayer's customers in this state.

#### 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. Revenue and Taxation Code section 25136(a)(1). "To the extent" means that if a customer of a service receives the benefit of a service or uses intangible property in more than one state, the gross receipts from the performance of the service or the sale of intangible property are included in the numerator of the sales factor according to the portion of the benefit of the services received and/or the use of the intangible property in this state. Regulation section 25136-2(b)(8). The benefit of a service is received in the location where taxpayer's customer has either directly or indirectly received value from delivery of that service. Regulation 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. Regulation section 25136-2(c). In the case where a corporation or other business entity is the taxpayer's customer, the first and pertinent cascading rule provides 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. Regulation section 25136-2(c)(2)(A).

In some situations, the location where the benefit of the service is received might actually be the location of the customers of the taxpayer's customer who directly benefit from the taxpayer's services. The above-referenced statute and regulation do not specify when a sale of a service should be assigned to a taxpayer's customer or when the sale of a service should be assigned to an ultimate customer (the taxpayer's customer's customer.) While there are a number of examples in Regulation section 25136-2 that illustrate how to apply the basic cascading rules for assigning the sale of a service, there are no examples which address assigning the sale of a service where the service gives value to the taxpayer's customer by its use in the customer's business, but which service also adds value to the services provided by the taxpayer's customer to its own customers. However, there are provisions in the regulation addressing the sale of the licensing of intangible property, and those provisions provide guidance to this analogous situation.<sup>3</sup> Regulation section 25136-2(d)(2).

Regulation 25136-2(d)(2) distinguishes between the sale of a marketing intangible and the sale of a non-marketing intangible. Under the general definitions section of the regulation, a "marketing intangible" 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. Regulation section 25136-2(b)(4)(A). "Marketing" is defined as the action or business of promoting and selling products or services, including market research and advertising. (Oxford Dictionaries. Oxford University Press, n.d. Web. 02 April 2014.) A "non-marketing and manufacturing 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 predominately in its use in such process. Regulation section 25136-2(b)(4)(B).

The initial cascading rule applicable to the sale of the licensing marketing intangibles provides in relevant part:

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<sup>3</sup> It should be noted that there is a difference in the assignment rules for sales of services and for sales of intangible property. For sales of services, the assignment rule is the location of where the benefit of the services is received. For sales of intangible property, the assignment rule is the location of the use of the intangible property.

Where a license is granted for the right to use intangible property in connection with the sale, lease, license, or other marketing of goods, services, or other items, the royalties or other licensing fees paid by the licensee for such right(s) are attributable to this state to the extent that the fees are attributable to the sale or other provision of goods, services, or other items purchased or otherwise acquired by the ultimate customers in this state. The contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the regular course of business shall be presumed to provide a method for determination of the ultimate customers... Regulation section 25136-2(d)(2)(A)1.

The initial cascading rule applicable to the sale of the licensing of non-marketing and manufacturing intangibles provides in relevant part:

Where a license is granted for the right to use intangible property other than in connection with the sale, lease, license, or other marketing of goods, services, or other items, the licensing fees paid by the licensee for such right(s) are attributable to this state to the extent that the use for which the fees are paid takes place in this state. The terms of the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business shall be presumed to provide a method for determination of the extent of the use of the intangible property in this state... Regulation section 25136-2(d)(2)(B)1.

The examples in Regulation section 25136-2 that address assignment of “marketing intangibles” all relate to intangible property that is involved in selling or promoting a company’s products or service. Conversely, the examples in the regulation relating to “non-marketing intangibles” do not relate to selling or promoting a company’s products or service. In connection with sales of services, only the Web Corp example addresses assignment of the benefit of the service to the taxpayer's customers' customer. In that example, Web Corp provides internet content to its viewers and receives revenue from providing advertising services to other businesses. The advertisements are shown via the website to Web Corp viewers and the fee collected is determined by reference to the number of times the advertisement is viewed and/or clicked on by viewers of the website. Web Corp’s customers are the advertisers, and its advertising services are marketing services. The example explains that the sales from Web Corp’s services are sourced to the location from which the advertisement is viewed and/or clicked on by viewers of the website, which is the location of the ultimate customer. Regulation section 25136-2(c)(2)(E), Examples 4. & 5.

Lastly, Regulation section 25136-2(g)(1) provides that:

In assigning sales to the sales factor numerator pursuant to Revenue and Taxation Code section 25136(b), the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information, as well as the resources of the

taxpayer seeking to obtain this information, and may accept a reasonable approximation when appropriate, such as when the necessary data of a smaller business cannot be reasonably developed from financial records maintained in the regular course of business."

#### DISCUSSION – ISSUE 1

Revenue and Taxation Code section 25136 and Regulation section 25136-2 do not specify how to determine where the benefit of the service is received for a non-marketing service where both the taxpayer's customer and the taxpayer's customer's customers receive a benefit from use of the service in the taxpayer's customer's business operations.

In the context of a sale in connection with the licensing, leasing, rental or other use of intangible property, the rules in Regulation section 25136-2(d)(2) provide guidance in the analogous situation for the sale of services. Specifically, Regulation section 25136-2(d)(2) makes a distinction between "marketing" and "non-marketing" intangibles whereby a marketing intangible is sourced to the location of the ultimate consumer, but a non-marketing intangible is sourced to the location where the customer uses the intangible in its business. Using this same approach to sales of services would be consistent with the Web Corp example under Regulation 25136-2(c)(2)(E), Example 4. and Example 5.

In applying the guidance for assignment of sales of "non-marketing" intangibles to assignment of sales "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. As 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. \*\*\*\*\* web-based service of providing integrated financial information and analytical applications to its customers is not a marketing service used to sell, promote, or advertise its customer's product, service or other item. Rather, \*\*\*\*\* service is analogous to a non-marketing intangible that is used in its customers' business operations. Therefore, similar to the assignment rules for sourcing non-marketing intangibles, \*\*\*\*\* sales receipts for non-marketing services should be sourced to the this state to the extent its customers receive the benefit of the service in this state.

#### DISCUSSION – ISSUE 2

Regulation section 25136-2 does not specify which data from a taxpayer's books and records is permissible to determine where the benefit of the services is received by a customer. The regulation specifically excludes the customer's billing address as being indicative of the location where the customer received the benefit of the service.

\*\*\*\*\* services are used by its customers at the location(s) where the customer accesses \*\*\*\*\* services. In other words, the location of the customer (e.g. business or home office) is where the benefit of the service is received. To measure the benefit of the service received, \*\*\*\*\* measures each customer's relative CPU usage at the work location(s) provided by the taxpayer for its customer(s) using the User ID assigned to that customer. Those customers who have complicated and sophisticated needs for their business operations using \*\*\*\*\* services, i.e. an investment manager who accesses thousands of databases and analytical applications for long periods of time, incur higher CPU usage than a customer using only basic services from \*\*\*\*\* i.e. an investment banker who needs one piece of information in connection with one company accessing fewer databases for a lesser period of time. Because of the greater computing power needed by this type of customer, the benefit of the service for more sophisticated customers is greater than the benefit of the service for the basic-need customer. \*\*\*\*\* books and records kept in the regular course of business indicate that CPU usage directly correlates with the fees received by \*\*\*\*\* from its customers. In other words, a customer who is a heavy CPU consumer pays correspondingly higher fees to \*\*\*\*\* For these reasons, CPU usage is a reasonable indicator of the location and extent of the benefit of the service received by the taxpayer's customers.

\*\*\*\*\* does not have the ability or resources to reasonably develop data from financial records maintained in its regular course of business to determine the location of the benefit received by each customer of the taxpayer. The 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.

\*\*\*\*\* may assign sales of non-marketing services to the location where its customers receive the benefit of the service as identified and measured by relative CPU usage stored in the taxpayer's books and records kept in the regular course of business.

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.

Melissa Williams  
Tax Counsel IV