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LEGAL RULING 2005-1

SUBJECT: Personal Services for Sales Factor Purposes

ISSUE

What constitutes a "personal service" for purposes of attributing gross receipts to this state using the time-spread method provided by regulation section 25136, subsection (d)(2)(C)?¹

FACTS

Situation 1:

Corporation A, a company located in state C that provides computer system consulting services, enters into a consulting contract with Customer. The contract calls for Corporation A to design a computer system at each of Customer's regional offices, located in states X, Y, and Z. The contract calls for Corporation A to design the network, provide specifications for hardware and software requirements for the network, oversee the configuration and testing of the network, and provide maintenance and network modifications and upgrades for two years after initial installation and testing. Under the contract, Corporation A will not supply any hardware, equipment, repair parts, or other material. Because Corporation A's employees will be required to customize the network at each regional office and oversee all phases of installation and testing, individual employees will be assigned to each of Customer's regional offices with a manager assigned responsibility for the entire project. The manager is located at Corporation A's headquarters in state C, but travels to each of Customer's regional offices periodically, in order to oversee the different aspects of the project.

Situation 2:

Corporation B, a heavy equipment construction company located in state D, enters into an earth-moving contract with Customer located in another state. Corporation B prepares the bid for the contract in state R and performs the service in state S.

¹ All section references are to the Revenue and Taxation Code, and all references to regulations are to the California Code of Regulations, title 18, unless otherwise specifically noted.

Corporation B rents heavy equipment in state S. Corporation B's employees spend 25 percent of their time in state R estimating and preparing the bid, and 75 percent of their time performing the construction activities in state S. Employee costs are \$800,000 and the equipment rental cost is \$5,000,000, entirely dedicated to a single earth-moving contract in state S.

LAW AND ANALYSIS

Receipts from a sale "other than a sale of tangible personal property" are included in the sales factor under the rules set forth in section 25136 and regulations thereunder. Section 25136 assigns receipts from sales of other than tangible personal property to the state where the income-producing activity occurs. If the income-producing activity occurred in more than one state, the sale is assigned to the state in which the greater costs of performance occurred.

Regulation section 25136, subsection (d)(2), provides *special* rules for determining when receipts from income-producing activities are in this state. Subsection (d)(2)(C) addresses gross receipts from the performance of personal services and provides that the time each employee spends in each state will constitute a separate income-producing activity for purposes of the sales factor. This method, known as the time-spread method, provides for a "ratio which the time spent in performing such services in this state bears to the total time spent in performing such services everywhere."

The factual situations addressed in this ruling raise the question of the extent to which a service is considered a *personal* service under regulation section 25136, subsection (d)(2)(C). Although the concept of personal services has been used in different contexts in the California income and franchise tax regulations, the term "personal service" is not defined in Part 11 of the Revenue and Taxation Code.

The concept of personal services has been part of California's apportionment of income regulations for over fifty years. Prior to the adoption of the Uniform Division of Income for Tax Purposes Act (UDITPA), former regulation section 25101, subsection (a),² provided that "[i]n the case of personal service organizations, such as advertising agencies, business management firms, etc., the property factor is generally omitted since it is not a material income producing factor in this type of business." This regulation was discussed in *Appeal of Woodward, Baldwin & Co., Inc.*, 63-SBE-072, May 28, 1963, and *Appeal of John Blair & Company*, 65-SBE-009, March 4, 1965.³

² Cal. Admin. Code, tit. 18, § 25101, sub. (a). Register 58, No. 9 (May 19, 1958).

³ The concept of personal services was addressed in another apportionment context in a Wisconsin case. In *Shelley v. Wisconsin Dept. of Revenue* (1975) 70 Wis.2d 551 [235 N.W.2d 515], Wisconsin's statute provided that corporation income from personal services performed by the employees was business income that followed the situs of

In addition, the concept of personal services is found in regulation section 17951-4. This regulation provides rules to compute the payroll factor for nonresident sole proprietors and partners engaged in the practice of a profession, which is defined in subsection (h) as "the practice of law, accounting, medicine, scientific or engineering discipline and the practice of any other profession involving personal services where capital is not a material income-producing factor."

The terms "personal services" or "personal service income" are also used throughout the Internal Revenue Code (IRC). For example, compensation for personal services is listed as part of the definition of earned income in IRC section 911. Former IRC section 1348⁴ imposed a ceiling on the graduated tax rate applicable to personal service income, which was defined by reference to IRC sections 911(b) and 401(c)(2)(C). In general, under former IRC section 1348, a taxpayer was not entitled to the benefits of the maximum graduated tax rate limitation on personal service income if capital was a material income-producing factor with respect to that service. The IRC also defines a personal service corporation as one that has the performance of personal services (as defined in IRC § 448(d)(2)(A)) as its principal activity. IRC section 448(d)(2)(A) lists the performance of services in the fields of "health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting" as activities of the taxpayer that constitute personal services. (See also, Treas. Reg. § 1.441-3(d).)

Personal services might be construed narrowly, as in the context of a specialized service performed by one individual for the personal benefit of another, such as the services of a doctor or a lawyer, or in the context of professional services such as those specifically listed in regulation section 17951-4, subsection (h). However, the examples under regulation section 25136, subsection (d)(2)(C), those dealing with a traveling road show or with opinion surveying, indicate that personal services should not be construed that narrowly.

On the other hand, personal services might be construed broadly, such that virtually all services are personal services. But, regulation section 25136 suggests otherwise. For instance, the language of regulation section 25136, subsection (b)(1), consists of two parts separated by the disjunctive "or" and reads: "the rendering of personal services or the utilization of tangible and intangible property by the taxpayer in performing a

the business. The court held that the phrase "income derived from personal services" meant such income or gains as result from the performance of services or labor without the material aid of capital.

⁴ Repealed by the Economic Recovery Tax Act of 1981, P.L. 97-34, § 101(c)(1).

service.” The word “service” in the second clause is not modified by the word “personal,” indicating that there are services that are not personal services.⁵

The fact that the rule for personal services is characterized as a *special* rule under regulation section 25136, subsection (d)(2)(C), is also indicative that the term "personal service" does not include all services. The focus of the special rule is on the performance of "personal" services and not on any other type of service, such as the performance of a service that may include the utilization of tangible or intangible personal property. If every service, no matter how capital intensive, were governed by the time-spread mechanism, there would be no circumstance under which the general rule, the cost of performance rule, would ever operate: all services would solely be governed by time spent by employees. Thus, the concept of cost of performance as provided by section 25136, subdivision (b), would be rendered irrelevant with regard to services.

Although the term "personal service" is defined in different contexts, no authorities extend the concept of personal services to those services in which capital is a material income-producing factor. Furthermore, the language of regulation section 25136, subsection (b)(1), is consistent with the above-cited authorities that limit personal services to those services in which capital is not a material income-producing factor.

The personal service rule of regulation section 25136, subsection (d)(2)(C), includes any service performed where capital is not a material income-producing factor. Furthermore, personal services are not limited to professional services or to specialized services performed by one individual.

HOLDING

Situation 1:

The contract between Corporation A and Customer calls for a personal service where capital is not a material income-producing factor. Corporation A will perform the contracted-for services utilizing the labor of its employees with little or no utilization of tangible or intangible property. Accordingly, the time-spread method will be used to determine Corporation A's costs of performance. The time each employee, including the project manager, spends in each state will constitute a separate income-producing activity for purposes of determining the numerator of the sales factor.

⁵ In the *Appeal of Pacificorp*, 2002-SBE-005, September 12, 2002, order denying petition for rehearing dated December 19, 2002, the State Board of Equalization acknowledged that regulation section 25136, subsection (b)(1), identifies income-producing activity as encompassing not only personal services, but also services that utilize tangible or intangible property.

Situation 2:

Because capital is a material income-producing factor in this situation, the special time-spread rule does not apply in this situation. Therefore, considering both personnel costs and heavy equipment costs, the standard cost of performance rule would assign the receipt to the state with the greater cost of performance; in this case, to state S.

CONTACT INFORMATION

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