



March 25, 2022

LEGAL RULING – 2022-01

SUBJECT: Numerator Assignment of Gross Receipts from Sales of Services to Business Entities.

ISSUE

What are the relevant considerations and proper analysis to determine the assignment of gross receipts from the sales of services pursuant to California Revenue and Taxation Code ("R&TC") section 25136(a)(1) as supplemented by California Code of Regulations, title 18, ("Regulation") section 25136-2.

SITUATION ONE

Planner Corp, an event planning company, offers services to plan and coordinate corporate events. Every year Box Corp, a box manufacturer located in State X, puts on a cancer charity event. This year Box Corp enters into a contract with Planner Corp to plan a cancer charity event in State Y. Planner Corp performs most of its work remotely in its office in State Z.

SITUATION TWO

Pharmacy Benefit Manager ("PBM") is a company that administers drug benefit programs for employers, unions, government entities, and health plans. PBM is responsible for developing and maintaining formulary, contracting with pharmacies, and negotiating discounts and rebates with drug manufacturers. However, PBM's primary activity is the processing and fulfillment of prescription drug claims.

PBM contracts with Health Company, a health plan provider. Health Company is contractually obligated to provide pharmaceuticals to its members. PBM's primary receipts from Health Company are from processing member claims and fulfilling delivery of pharmaceuticals to members, whether directly sent to the member's home or picked up at a pharmacy.

SITUATION THREE

Tracker Corp provides consulting services for companies looking to efficiently manage their power consumption used in manufacturing. Tracker Corp is located in State X. Manufacturing Corp enters into an agreement for Tracker Corp's services. Manufacturing

Corp has its manufacturing plant in State Y. Tracker Corp engages Niche Corp, a subcontractor based in State Z, to assist with advising on certain aspects of Manufacturing Corp's manufacturing plant's power consumption.

LAW AND ANALYSIS

R&TC section 25136(a)(1), provides:

Sales from services are in this state to the extent the purchaser of the service received the benefit of the services in this state.

In addition, Regulation section 25136-2(b)(1) states:

“Benefit 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.

Based on the language of R&TC section 25136 and Regulation section 25136-2, it is essential that certain determinations be made to ascertain how sales of services are to be assigned. Specifically, to properly assign receipts from the sales of services under the cascading rules¹ in Regulation section 25136-2, we must first ascertain:

1. Who is the customer?
2. What is the service being provided?
3. What is the benefit of the service being received by the customer?
4. Where is the benefit of the service being received by the customer?

What follows are guidelines to assist in ascertaining the preceding determinations.

Who is the customer?

R&TC section 25136(a)(1) and Regulation section 25136-2(b)(1) provide it is always the value to the taxpayer's customer that is analyzed and not the value provided to any other party. A common misconception in analyzing where gross receipts from the performance of a service should be assigned occurs when a benefit from the taxpayer's service is received by a third party and then this benefitted third party is assumed to be the taxpayer's customer for purposes of the analysis. While third parties may benefit from a taxpayer's service, it is only the *customer's* benefit that is relevant to the analysis, even though a third party might also benefit from the performance of the service.

What is the Service Provided?

Generally, the contract evidencing the service agreement will identify the specific service that is to be performed. If there is no contract, or the contract does not describe the service performed, the taxpayer will have to identify the activities engaged in for consideration.

¹ "Cascading Rules" refers to the rules in Regulation section 25136-2(c)(2)(A) through (D).

What is the Benefit Being Received?

Usually, the value of the service is the direct effect of the action or function being performed. This view is consistent with each of the examples in Regulation section 25136-2 which apply the books and records or reasonable approximation cascading rules.

Consider the Web Corp example in Example 4 of Regulation section 25136-2(c)(2)(E). The direct effect of the action, i.e., of placing the online advertisement, results in the garnering of engagement and interest in the "other businesses[]" product(s), i.e., taxpayer's customers' product(s), from the viewers. Thus, the benefit of the service received by the taxpayer's customer is potential sales and interest from the viewers of the advertisement.

Where is the Benefit of the Service Received by the Customer?

When the value of the service is the direct effect of the action or function being performed, the location of the benefit will be where the direct effect impacts the taxpayer's customer.

For instance, in the Web Corp example in Example 4 of Regulation section 25136-2(c)(2)(E), the benefit received by the "other businesses" for the advertising services provided by Web Corp is located where the viewers are clicking or viewing the advertising, using a ratio of the number of clicks/views. The click/view location is where the direct effect of the advertisement impacts the "other businesses."

When the service provided by the taxpayer is directed at the customer's customer(s), the benefit received by the customer is likely located at the customer's customer(s)' location. This is most common when the taxpayer's services directly engage or principally concern the customer's customer(s). Common examples of direct engagement include sales and marketing services, customer support services, in-person services involving a third party contractor, and subcontracting arrangements. As mentioned above, the taxpayer's customer receives a benefit from the services performed even though a third party might also receive a benefit.

In particular, subcontracting arrangements by a business entity with a corporate subcontractor may involve the location of the customer's customer, because the service provided is directed towards persons or things other than the subcontractor's customer. There should be no difference in where gross receipts are assigned when the service is performed by a subcontractor instead of directly by the subcontractor's customer.

Cascading Rules

After the above issues have been determined, the cascading rules provide guidance on measuring the location of where the benefit was received. Application of the cascading rules is demonstrated in the Web Corp examples in Example 4 and Example 5 of Regulation section 25136-2(c)(2)(E). In both examples, it has been determined that assignment should be based on click/view location. In the first Web Corp example, the taxpayer has sufficient information in its books and records to locate the actual click/view locations. However, in the second Web Corp example, the taxpayer does not have sufficient information in its

books and records to locate the actual click/view locations and thus reasonable approximation of such locations is necessary.

HOLDING – SITUATION ONE

Who is the customer?

The taxpayer, Planner Corp, entered into a contract with Box Corp to plan an event. Planner Corp's customer is Box Corp.

What is the service being provided by the taxpayer?

Planner Corp provides planning and coordination for the cancer charity event.

What is the benefit of the service received by the customer?

The direct effect and benefit of Planner Corp's service is Box Corp has a planned and coordinated event.

Where is the benefit of the service being received?

Box Corp, the customer, receives the benefit of having a planned and coordinated event where the event will occur in State Y.

Cascading Rules

Planner Corp should assign the gross receipts from the planning services to the location where Box Corp's event takes place, State Y. Due to the nature of the work, it is anticipated that Planner Corp will have this information in its books and records.

HOLDING – SITUATION TWO

Who is the customer?

The taxpayer, PBM, entered into a contract with Health Company. PBM's customer is Health Company.

What is the service being provided?

For PBM's primary receipts, PBM provides processing and fulfillment of prescription drug claims for Health Company.

What is the benefit of the service being provided to the customer?

The direct effect and benefit of the service being provided to Health Company is that its customers, i.e. the members, are able to obtain pharmaceuticals. This improves Health Company's service performance to its members.

Where is the benefit of the service received?

The service provided by PBM directly engages the customer's customer, i.e. Health Company's members. The location of the benefit to the Health Company is where the pharmaceuticals are delivered to the members, and this is the location where the impact of the benefit occurs for Health Company. Therefore, the benefit of the service is received at the location of the Health Company's members.

Cascading Rules

PBM should assign the gross receipts from its processing and fulfillment services to the location where Health Company's members are located. Due to the nature of the work, it is anticipated that PBM will have this information in its books and records. However, if a member retrieves the pharmaceuticals at a pharmacy and PBM only has data as to the pharmacy locations for these transactions, then for measurement purposes it is reasonable to presume that the pharmacy would be located in the same jurisdiction as the member.

HOLDING – SITUATION THREE

Who is the customer?

The taxpayer, Niche Corp, entered into a contract with Tracker Corp to assist with providing consulting to Manufacturing Corp. Niche Corp's customer is Tracker Corp.

What is the service being provided?

Niche Corp entered into a contract with Tracker Corp to assist with providing consulting to Manufacturing Corp. Taxpayer's service is providing consulting to Manufacturing Corp.

What is the benefit of the service being provided to the customer?

The direct effect and benefit of the service being provided to Tracker Corp is that its customer, Manufacturing Corp, receives consulting. This improves Tracker Corp's service performance to Manufacturing Corp.

Where is the benefit of the service received?

The service provided by Niche Corp directly engages the customer's customer, i.e. Manufacturing Corp. Manufacturing Corp's manufacturing plant is where Niche Corp's consulting is utilized, and this is where the impact of this benefit occurs for Tracker Corp. Thus, Tracker Corp receives the benefit of having consulting services for its customers where those services are utilized.

Cascading Rules

Niche Corp should assign the gross receipts from the consulting services to the location of Manufacturing Corp's manufacturing plant location. Due to the nature of the work, it is anticipated that Niche Corp will have this information in its books and records.

PRIOR GUIDANCE

Pursuant to FTB Notice 2009-08, Chief Counsel Rulings 2015-03 and 2017-01 are revoked. To the extent this Legal Ruling conflicts with any other prior guidance of the FTB, this Legal Ruling shall supersede such guidance.

DRAFTING INFORMATION

The principal author of this Legal Ruling is Amanda Smith of the Franchise Tax Board, Legal Division. For further information regarding this ruling, contact Ms. Smith at the Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, California 95741-1720.