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External Multistate Tax Alert
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California: Office of Tax Appeals determines Value Added Tax (VAT) on services includible in sales factor

Overview

In November of 2019, the California Office of Tax Appeals (OTA) issued an opinion providing that Value Added Tax (VAT), charged on services, were includable in the California sales factor denominator for the 2008 tax year.[1] For the 2008 tax year, the taxpayer at issue had included the VAT imposed on services that were collected from its customers and remitted to foreign jurisdictions as gross receipts in the sales factor, pursuant to Cal. Rev. & Tax Code 25120(e). The FTB challenged this determination, relying primarily on Cal. Reg. 25134(a)(1) that explicitly stated that excise and sales taxes were included in the sales factor for sales of tangible personal property, but did not specifically state that it was allowed for sales of services. The OTA decision evaluated the scope of gross receipts for the California sales factor and held that VAT was properly includible under the definition of gross receipts in Cal. Rev. & Tax Code 25120(e).

This tax alert summarizes the facts and key points from the OTA's decision.

Factual background

Robert Half International, Inc. & Subs. (Taxpayer) is a global human resource consulting firm, providing services to customers in the United States, as well as foreign customers. During 2008, the Taxpayer charged VAT and collected it from foreign customers on certain foreign service fees. The Taxpayer included the total amount of the foreign service fees invoiced, including VAT, in its sales factor denominator on its 2008 California corporation franchise tax return.[2]

Subsequently, the California Franchise Tax Board (FTB) instituted an examination including the Taxpayer's 2008 return. On exam, the FTB asserted VAT should not have been included in the sales factor. Thus, the FTB proposed to increase the Taxpayer's California apportionment factor, due to the removal of the VAT amounts from the denominator, which resulted in additional California tax and interest. The Taxpayer appealed this determination to the OTA.

Analysis and Decision

For tax year 2008, California generally required corporate taxpayers to apportion business income to California pursuant to an apportionment factor consisting of a property factor, payroll factor, and a double-weighted sales factor. The Taxpayer argued that VAT was properly includible in the denominator of its 2008 sales factor and pointed towards the definition of "all gross receipts" in Cal. Rev. & Tax Code 25120(e). The Taxpayer further asserted that this provision has been broadly interpreted by the courts to include the "whole amount received".

Conversely, the FTB argued, among other things, that Cal. Code Reg. 25134(a)(1) was the proper administrative interpretation and specifically addressed the sales factor by providing a listing of items that should be included as "gross receipts." As the regulation provided for the inclusion of excise or sales tax (which included VAT)[3] only for sales of tangible personal property (TPP), the amounts related to services were not properly includible. Further, the FTB asserted that its interpretation should be given deference.

The OTA noted the California Supreme Court has interpreted the phrase "all gross receipts" in Cal. Rev. & Tax Code 25120(e) as the "whole amount received, without deduction"[4] and other courts have similarly taken an expansive view. Further, the OTA stated that before concluding a statute was ambiguous, thus potentially deferring to an agency's interpretation, all the traditional tools of construction should be evaluated. In this analysis, the OTA found the plain

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[1] *In the Matter of the Appeal of: Robert Half International Inc. and Subsidiaries,* OTA Case No. 18011756 (October 3, 2019). (*Robert Half*).
[2] As the Taxpayer was only required to collect VAT on foreign services, which were outside California, these amounts were only reflected in the denominator.
[3] For California purposes, the VAT is treated as an excise or indirect tax.
[4] *Robert Half,* OTA Case No. 18011756, *citing Microsoft Corp v. Franchise Tax Bd.*, 39 Cal 4th 750, 759 (2006).

language of "gross receipts" to be inclusive (not exclusive) and thus the FTB's exclusionary interpretation was beyond the statute.

The OTA also rejected the FTB's policy argument that the inclusion of VAT on services would provide an advantage for foreign trade taxpayers over similarly situated U.S. trade taxpayers. The OTA noted that the same potential inconsistency could exist for VAT on TPP, which is included in Cal. Code Reg. 25134(a)(1)(A). The OTA also noted the option of alternative apportionment under Cal. Rev. & Tax Code 25137 might, but the FTB conceded Rev. & Tax. Code 25137 should not be invoked due to the lack of distortion under the present facts.

Based on the above analysis, the OTA held that VAT on sales of services was properly includible as "gross receipts" in the Taxpayer's California sales factor for the 2008 tax year.

Considerations

Taxpayers who are required to charge VAT on foreign sales of services may want to consider the analysis in the OTA decision. Although the OTA's decision is not binding beyond the Taxpayer, it does provide some indication of the OTA's position on this issue.

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