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"CheckFree" Provides Distinction Between Services and "Other Receipts"

By: Joseph Lipari

Two years ago, this column discussed the trend in New York and other states to move from apportioning income of corporations under the so-called three factor formula (property, payroll, and receipts) to one largely or wholly based on receipts only.[1] Unlike property and payroll, however, where location is usually easy to determine, the location to which a "receipt" should properly be attributed is far more subject to interpretation particularly with regard to services. Historically, services were apportioned to where the provider of the service performed the service.[2] Thus, if a consultant located in New York were to prepare a report for a client in California, New York would treat those receipts as sourced to this state. Over the years, however, in response to claims by certain industry groups that this sourcing rule made it disadvantageous to operate in New York, various exceptions were adopted under which certain categories of receipts were allocated to where the customers were located. New York moved to establish customer based sourcing when it enacted in 2014 comprehensive corporate tax reform, which was generally effective January 1, 2015 (and discussed in more detail below). Nonetheless, cases under previous law, like the recent administrative law judge ("ALJ") determination from the New York State Division of Tax Appeals in *CheckFree Services Corp.*,[3] still offer guidance for issues of classification and location of "receipts" earned by a business.

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In *CheckFree*, petitioner was a corporation that was in the business of providing electronic bill payment and presentment ("EBPP") services.[4] CheckFree's EBPP customers included financial institutions and "large[] merchants" such as AT&T, Macy's, Home Depot, and Verizon. CheckFree's EBPP services allowed "consumers" (the customers of CheckFree's customers) to view and pay bills from such merchants via a website. CheckFree's website was branded for each merchant, so it appeared to the consumer that he or she is directly utilizing the website of a CheckFree customer (AT&T, for example). Presumably under the guise of its financial institution customers, CheckFree also permitted consumers to electronically pay a bill of "any individual or entity that has a mailing address within the United States."

Via a proprietary system, CheckFree processed such payments—debiting from consumers and crediting to its customers' or other merchants' accounts. With respect to certain small merchants CheckFree debited consumers' accounts and cut checks to such merchants. In order to provide quick payment, CheckFree credited merchants' accounts before it actually received funds from consumers (that is, CheckFree bore the risk that "consumer's debit [would be] returned for insufficient funds").

During the periods at issue, CheckFree had 3,050–4,500 employees—none of whom were in New York. CheckFree likewise had no assets or offices in New York. CheckFree was incorporated in Delaware. CheckFree's only connection to New York was that New York was the location of some of its customers and consumers.

Under the law applicable during the periods at issue, CheckFree would be subject to the "Franchise Tax on Business Corporations" (Article 9-A of the New York Tax Law)[5] under the net income base.[6] The amount subject to tax would be the product of CheckFree's (a) business income and (b) "business allocation percentage" ("BAP").[7] CheckFree's BAP was equal to the quotient of (x) CheckFree's receipts allocated to New York divided by (y) all of CheckFree's receipts.[8] Receipts allocated to New York, included, among other things, receipts from "services performed within [New York]" and "other business receipts earned within [New York] ["other receipts"]."[9]

The dispute in <u>CheckFree</u> was whether the receipts at issue (1) were receipts from services or other receipts, and (2) the source of such receipts inside or outside New York. The Division of Taxation (the "Division") asserted on

audit and again at trial that receipts from New York customers of CheckFree's EBPP business were other receipts earned in New York (that is, such receipts should be allocated to New York). CheckFree's position was that receipts from the EBPP business were for "services performed" outside New York (since as noted above, the regulations in effect for those years attributed receipts from services to where the providers of the services were located. In the alternative, CheckFree argued that, even if the receipts were other receipts, they were earned outside of New York. The ALJ held in favor of CheckFree under both arguments, i.e. the receipts were from services performed outside of New York and even if the receipts were characterized as "other receipts", they would still be allocated outside New York).

In determining that the receipts were from services, the ALJ found that, contrary to the Division's position, there is no statutory or regulatory requirement of human involvement in order for receipts to be from services (as, among other reasons, such an interpretation read additional language into the statute). Further, the ALJ found that, even if such a requirement existed, there was indeed human involvement in the execution of the EBPP services (for example, customer services, setting up merchant sites, and effectuating the transfers of cash).

The ALJ next addressed the Division's argument that CheckFree actually sold technology licenses (intangibles) rather than providing services. The ALJ held that to determine the nature of the receipts, one must "ascertain[] the primary purpose and true nature of petitioner's EBPP business . . . viewed in its entirety and from the perspective of its customers—what they buy and pay for."[10] The ALJ found that CheckFree did not simply charge for access to system, but rather was "involved throughout the entire process of carrying out payments." It was not the software that CheckFree's customers wanted; it was the service of processing payments. The software was merely a tool to effectuate such service.

Citing to *Siemens Corp. v. Tax Appeals Tribunal*[11] (a case involving other receipts), the ALJ held that "in analyzing the allocation of receipts generally . . . the location of the activities performed that gave rise to income in connection with the transaction is determinative." In *Siemens*, petitioner acted as a "financial conduit," borrowing money from third parties then "re-lending" to its affiliates. As all work done in connection with this conduit activity (such as "accounting" and "general support and stewardship services") was done in New York, the *Siemens* court held that the receipts should be allocated to New York.

The ALJ also pointed out that the 2015 corporate tax reform included a change to the allocation of services receipts from place of performance to a "customer sourcing approach." The ALJ observed that "[s]uch a change would be unnecessary if former [law] was interpreted as the Division suggests."

Among the issues that the ALJ did not address was whether (as the *CheckFree* petitioner argued) "the Division's position lack[ed] a rational basis" as the Notice of Deficiency with respect to taxable year ending December 31, 2009, "[was] issued without the completion of an adequate audit process and solely for the purpose of avoiding expiration of the period of limitation on assessment." It is interesting to consider whether an argument such as petitioner's could have gotten a Notice of Deficiency cancelled.

Under the recent changes, there is no longer a discrete services classification for receipts. Rather, services may be found in several enumerated categories of allocation. If *CheckFree* had been decided on current law, the ALJ likely would have considered whether the receipts were from "digital product[s]" or "other services [receipts] and other business receipts" (the latter of which is a catch-all category).[12] Digital products are any property or services that are delivered electronically. Receipts from digital products are allocated to the "customer's primary use location of the digital product," or, if such location cannot be determined, to the customer's place of receipt of the product (or to certain alternatives, if both determinations are impossible). Receipts in the catch-all category are also allocated in a hierarchy, first to the place "[t]he benefit is received," and then, if the first is unknowable, to the "[d]elivery destination" (and then an alternative).

Nevertheless, it is not clear what the answer would be in *CheckFree* under the new law since in determining either the primary allocation place for digital products ("primary use location") or "other" services (the place "[t]he benefit is received"), there is still some ambiguity. Is the primary use location where the consumer is located, or the location of the merchant receiving payment who is CheckFree's customer? Similarly, it is unclear whether the benefit received is where the consumer (who has convenient payment) or merchant (or receives payment) is located.

The other major issue with customer based sourcing is that in many cases it will involve corporations that have no connection with New York other than the location of some of their customers and therefore there will be questions as to whether New York can constitutionally tax such corporations. CheckFree raised the nexus issue but the ALJ did not need to address it in light of the conclusions he reached on the other issues. Nevertheless, there will be, in many other cases, questions as to whether there is sufficient nexus to assert tax.[13] Thus, disputes over apportionment will continue to keep tax practitioners busy.

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[1] *See* Joseph Lipari, '*Expedia' Highlights Ambiguity of Corporate Allocation Rules*, N.Y.L.J. (Mar. 13, 2015).

[2] *See* N.Y. TAX LAW § former 210(3)(a)(2)(B) (discussed in more detail below).

[3] *In re Checkfree Services Corp.*, DTA Nos. 825971 and 825972 (N.Y. Div. Tax App., Jan. 5, 2017).

[4] CheckFree was also in other lines of business, not relevant to the instant matter.

[5] N.Y. TAX LAW former §209(1).

[6] N.Y. TAX LAW former §210(1). There were also alternative tax bases, not relevant to the instant matter.

[7] N.Y. TAX LAW former §210(3)(a).

[8] N.Y. TAX LAW former §210(3)(a)(2). During the earlier years at issue, New York still used a "three factor" formula to calculate BAP—property, payroll, and receipts. N.Y. TAX LAW former §210(3)(a). However, as there was no dispute as to the location of CheckFree's property and payroll, only receipts were at issue in the instant matter.

[9] N.Y. TAX LAW former §210(3)(a)(2)(B) and (D).

[10] Internal citations omitted.

[11] 679 N.E.2d 1072 (N.Y. 1997).

[12] N.Y. TAX LAW §210-A(4) and (10).

[13] As the petitioner in *CheckFree* raised.

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