

Sales Sourcing Study Finds  
Misapportionment of Revenue, Saving  
eSports Team \$1.65M in Taxes

CASE STUDY

armanino 

## Client Challenge

A multimedia solutions company owned a popular and successful eSports team. Managing this large group of professional gamers represented their largest revenue stream, as they receive a cut on sponsorship deals, livestream events, prize money, merchandise, etc.

As a Southern California-based company, they had been attributing 100% of their revenue to California and paid over \$2M in state income taxes over a four-year period. As the eSports team's success grew, the company's accounting became more complex, and they were looking for a firm with tech industry expertise to help reduce their tax liability and improve their internal processes.

They needed to find an accounting firm with a deep understanding of the eSports industry and expertise in state and local tax (SALT) law. Armanino was recommended to them by a long-standing client of the firm and had just the team of specialists to assess the company's needs and provide guidance regarding the tax implications of their complicated revenue model.

## The Tax Issue

The company has a non-traditional way of making money because of their eSports team. While they are based in California, their audience is located all over the world. The basis for income attribution within California follows a "market-based" model, meaning that income is attributed based on where your audience or customer is located.

While the laws and regulations are still evolving in that they haven't caught up with emerging industries like eSports, it's necessary to analyze this business model according to existing laws and apply them.

## Our Solution

Our SALT specialists identified that the company may have significantly overpaid California income taxes. Before they could seek any type of refund, Armanino needed to support a position that the company had overpaid their taxes. Determining the proper apportionment would require a full analysis of their revenue and the taxable jurisdiction where their audience resided. The multimedia company engaged our SALT team to:

- Confirm that, despite similarities to more mainstream sports teams, because of their non-exclusive membership in a prominent eSports league, the eSports team wouldn't be considered a professional athletic team by the Franchise Tax Board under California statutes.
- Establish the company's right to apportionment by sorting through company records and conducting extensive data analysis, including review of 16 revenue streams such as league revenues, advertising revenues and players' prize money, identifying that portions of this income fell within a taxable jurisdiction outside of California.
- Determine how under California rules to segment their revenue according to the market-based method. States operate under different sourcing methods, so it was necessary to determine the correct apportionment by state.
- File amended returns and seek refunds in California for the four previous tax years, dating back to 2016.

- File and pay the existing and past-due tax liabilities in other states where they had proven apportionment.
- Develop a methodology that could be replicated each year moving forward, but that could also withstand an audit going back several years.

## The Result

After the comprehensive sales sourcing project, Armanino determined that for 2019 and prior years:

- 42% of the eSports team's audience was foreign, meaning that there weren't any state taxes due on that revenue.
- Only 5% of the revenue was apportioned to California – a stark comparison to the 100% that it had been previously paying. The company would be eligible to claim refunds from California in the amount of \$1.65M in overpaid state tax liability.
- 12% of their apportionment was in states that follow the cost of performance basis (origin versus destination) according to where the gamers were streaming from, meaning none of that income would be subject to income tax.
- 15-20% of their income was taxable in other states.

While the company was overpaying in California, we determined that they were also under-filing and underpaying in some states where they did have jurisdiction. By establishing the correct apportionment for state tax liability and accurately filing the necessary returns, the company gained compliance and avoided the risk of penalties had they been challenged or audited.

This in-depth analysis paid off for the multimedia company, as they were able to significantly reduce their actual California tax liability, decreasing it by \$1.65M between 2016 and 2019. If the apportionment methodology is correctly executed in future filings, the company has a prospective benefit of approximately \$150K per year, depending on their taxable income in that year.