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In this installment of SeeSALT Digest, the authors discuss the interplay and distinctions between reasonable approximation and other market-based sourcing rules, including the practical problems faced by taxpayers and tax agencies in applying reasonable approximation rules.

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One of the hottest trends in the U.S. state and local tax world continues to be the adoption and implementation of market-based sourcing regimes by states seeking to source taxpayers' sales of services and intangibles (that is, sales of other than tangible personal property) based on the location of the market for those sales for income tax, and frequently gross receipts tax, purposes. The shift to market-based sourcing is meant to align with the evolution of the U.S. and global economies from predominantly goods-based to more service-based and digital-based economies. The states' collective embrace of the market-based sourcing method is also meant to improve upon and rectify problems recognized by tax agencies and taxpayers alike with the historic cost of performance method, which focused on the location of the taxpayer's labor and capital contributing to its sales of services and intangibles rather than the taxpayer's market.

However, the practical implementation and application of market-based sourcing has proven to be rife with problems of its own, including new and complicated difficulties associated with applying "reasonable approximation" rules included in and crucially important to the effectiveness and success of most states' market-based sourcing regimes. Reasonable approximation rules are meant to help identify the market for a taxpayer's sales of services and intangibles when direct evidence identifying the market is not readily available. Thus, the primary keys to success for reasonable approximation — and in turn the market-based sourcing method —

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are flexibility and case-by-case analyses rather than rigid rules or strict uniformity. Although these concepts are simple enough to acknowledge in theory, the failure of tax agencies to properly apply them in practice has raised serious concerns.

In Part I of this series,[1] we explored the reasons for the shift from traditional cost of performance sourcing to market-based sourcing and the relevant contextual history; identified the essential components, policies, and objectives of the market-based sourcing method; explained the important role of reasonable approximation; and examined the approaches to reasonable approximation taken by three influential states (California, New York, and Massachusetts). In Part II of this series, we discuss the interplay and distinctions between reasonable approximation and other market-based sourcing rules, including the practical problems faced by taxpayers and tax agencies in applying reasonable approximation rules. We also address policy considerations behind limiting a state's ability to challenge a taxpayer's reasonable approximation method. Last, we provide a glimpse of how courts and tax tribunals may approach the application and interpretation of reasonable approximation rules.

Applying Reasonable Approximation: How It's Supposed to Work and How It's Going

The ultimate purpose of the sales factor is to reflect the market for the taxpayer's sales. States take different approaches in deciding what information best reflects the market and where to turn next if that "best evidence" information identifying the market is not available. Some states may provide special rules to address specific industries or fact patterns,[2] but most states' general market-based sourcing regimes provide a series of cascading rules that rank potential sources of information in a hierarchy, from best to worst, based on what the state believes most accurately reflects the taxpayer's market.

Most states have also implemented flexible reasonable approximation rules as a potential option for accurately approximating the taxpayer's market. It is important to understand what situations reasonable approximation is best (and not best) suited for, its inherent conflict with uniformity, efforts by states to rigidly control or restrict its application, and where it stacks up against other market-based sourcing rules.

Reasonable Approximation: Key Components to When and How It Should Be Used

Reasonable approximation is an all-purpose rule based on a flexible, fact-specific, and practical approach to accurately reflect the market and is intended to incorporate any source of information when the taxpayer's records are inconclusive.[3]

The primary drafter of California's market-based sourcing regulations succinctly clarified the concept of reasonable approximation and how tax agencies and taxpayers should be able to use it:

> This is an area where California and taxpayers alike are going to have to experience real-life situations applying this particular provision in order to be able to identify all the various reliable sources of information that will enable California and taxpayers to reasonably approximate, when necessary, the location where the benefit of the service is received, or the location of where the intangible property is used. This provision will be applied on a case-by-case basis.[4]

The comments by the regulation's author provide two important guidelines for how reasonable approximation rules should be interpreted and applied. First, the information taxpayers can rely on is meant to range broadly, without any limitations. Flexibility is key. Reasonable approximation is meant to encompass any and all information that is not already

[1] Carley A. Roberts, Robert P. Merten III, and Malcolm A. Brudigam, "How to Be Reasonable When Reasonably Approximating the Market: Part I," *Tax Notes State*, Jan. 4, 2021, p. 7.

[2] *See, e.g.*, N.Y. Tax Law section 210-A.5.(c) (providing specific assignment rules for receipts derived from credit card services based on mailing address, merchant address, or proportion of credit card access points within the state); and 830 Mass. Code regs. sections 63.318.11 and 63.38.1(9)(d)(7)(b)(ii) (providing specific assignment rules for telecommunications services).

[3] *See, e.g.*, California Franchise Tax Board, "Initial Statement of Reasons for the Adoption of California Code of Regulations, Title 18, Section 25136," p. 4.

[4] Waltreese Carroll, "California FTB Official Explains Market-Based Sourcing Regulations," *State Tax Notes*, Apr. 2, 2012, p. 10.

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accounted for in the other cascading rules. Second, the information taxpayers can rely on is meant to be case-specific, taking into consideration the particular business activities of the taxpayer's customers.[5]

The Franchise Tax Board's Initial Statement of Reasons provided two additional principles to follow when designing a reasonable approximation method: The concept of "reasonable approximation" is a reliable alternative if the approximation is done in a way that takes into account the business activities of the taxpayer's customer. Specific information should be used over general information for reasonable approximations.

Indeed, the chosen reasonable approximation method should always directly or indirectly tie to customer activity, using the most specific information available. If used in this manner, reasonable approximation can consistently and accurately reflect a taxpayer's market. This is the exact approach set forth in both New York's proposed and Massachusetts's adopted reasonable approximation rules. In New York, reasonable approximation must be based on information specific to the customer (including books and records, reasonable inquiries to the customer, and public information about the customer)[6] before turning to general information, such as population statistics.[7] Massachusetts's reasonable approximation rules also express a preference for specific information over general information. For example, when reasonably approximating the market for advertising, Massachusetts's rules first call for a method based on subscribers in a geographic area before more general information such as population is used.[8]

To illustrate how reasonable approximation can be used in practice, assume for example that a technology company's services benefit a customer's overall business operations, but the technology company has no other data about where the customer is receiving the benefit from the technology company's services. One reasonable method may rely on the customer's public filings, news articles, job listings, and web traffic data to infer where the customer's business operations are likely located. To the extent a segment of the customer's business operates only outside the United States, it would be reasonable to assume that no receipts would be sourced to any state in proportion to that non-U.S. segment's value to the customer's overall business. To the extent a business segment operates both in the United States and abroad, the ratio of U.S. to international assets disclosed in public filings may be a reliable source of information to estimate the portion of the remaining receipts attributable to the United States. Of the U.S. receipts, search engine queries for the customer's business operations may be a reliable source of information to estimate the level of demand for the taxpayer's products or services in each state. In this example, the reasonable approximation methods being employed can accurately and reliably estimate the taxpayer's market because they incorporate information about the activities of the taxpayer's customer and use specific customer information when available.

While there are intentionally an infinite number of possibilities that can be used to properly apply a reasonable approximation method under a given set of facts, both taxpayers and tax agencies alike can use similar methods to accurately estimate the taxpayer's market. Extra skepticism must be exercised when a proposed method neither takes into consideration the intentionally flexible and case-by-case nature of reasonable approximation nor uses information that directly or indirectly ties to customer activity.

Sourcing With a Scalpel or a Chain Saw: Cascading Market-Based Sourcing Rules Prioritize Accuracy Over Bright-Line Standards

States' market-based sourcing regimes typically include a series of cascading rules for sourcing the location of a sale that must be applied in sequential order. For instance, one rule may require sales to be sourced according to the underlying contract or the taxpayer's books and records, while subsequent cascading rules may source sales based on reasonable approximation or customer billing address. Without

[5]These guidelines were echoed by the FTB in its "Initial Statement of Reasons for the Adoption of California Code of Regulations, Title 18, section 25136," at 3-4.

[6]N.Y. Draft reg. sections 4-2.18(c)(3)(ii), 4-2.3(c)(3)(ii) (July 3, 2019).

[7]N.Y. Draft reg. sections 4-2.18(c)(4), 4-2.3(c)(4) (July 3, 2019).

[8]830 Mass. Code regs. section 63.38.1(9)(d)(4)(c)(ii)(C)(3)(i).

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understanding the rationale behind the ordering of rules, taxpayers may be left wondering whether tax agencies expect sourcing to be performed with extreme precision (that is, by a scalpel) or with a "close enough" approach based on readily available records (that is, by a chain saw).

When it comes to business customers, states have largely recognized that use of customer billing address as a bright-line standard does not likely provide the most accurate or reliable identification of the taxpayer's market for those sales.[9] After all, businesses tend to have centralized administrative functions, such as account payable functions, in one jurisdiction (for example, at the customer's headquarters). In contrast, the business customer locales that receive the benefit of a service or use an intangible (that is, the most common market-based sourcing focuses for sourcing sales of services and intangibles, respectively) may span numerous jurisdictions or may not even include the location handling the customer's centralized administrative functions. Accordingly, it is widely recognized that sourcing such sales for business customers typically requires a broader approach than sourcing merely based on a business's billing address.

Most states with cascading market-based sourcing rules either place reasonable approximation ahead of customer billing address or exclude the sales receipt entirely if reasonable approximation is not possible (that is, without resorting to billing address). States that place reasonable approximation before customer billing address include California,[10] Connecticut,[11] Massachusetts,[12] New Jersey,[13] New York,[14] and Rhode Island.[15] States that follow the Multistate Tax Commission's model regulations[16] and use reasonable approximation but throw out the sales receipt if reasonable approximation is not possible, rather than ever resorting to billing address, include Colorado,[17] Kentucky,[18] Montana,[19] New Hampshire,[20] New Mexico,[21] North Carolina,[22] and Tennessee,[23] and also the District of Columbia.[24]

There are situations, however, in which customer billing address is a better approach to identifying the taxpayer's market. This is especially true for sales of services rendered to individuals because it is generally recognized that an individual's billing address will typically correspond with where the customer receives the benefit of a service, and the amount at issue in each service transaction to an individual is likely to be relatively small. For these reasons, states such as New York,[25] Massachusetts,[26] and California (under its current rules; amendments are pending)[27] provide cascading rules that list customer billing address as the first cascading rule (that is, best evidence of the market) for sourcing sales of services to individual customers. Customer billing address can also be preferable in the context of large volume sales by service providers, in the interest of reducing compliance costs or offering such taxpayers more certainty and consistency.

In the interest of administrative ease, California's proposed amendments to its market-based sourcing rules would require that taxpayers providing substantially similar professional services to more than 250 customers source

[9] *See, e.g.*, FTB meeting, Feb. 10, 2010, "Summary of Interested Parties Meeting Regulation Section 25136, Sales of Other than Sales of Tangible Personal Property" (stating "it might be overly narrow to use the billing address. The benefit may be received in a different location than the billing address. . . . Not all benefits are necessarily realized by the purchaser [but can also benefit] others.").

[10] California's cascading rules for services rendered to individuals (as opposed to business entities) place billing address first.

[11] Connecticut Department of Revenue Services, Special Notice 2017(1) (Apr. 17, 2017).

[12] 830 Mass. Code regs. section 63.38.1(9)(d)(4)(c)(ii)(B)(2)(c).

[13] N.J. Rev. Stat. section 54:10A-6(B)(4).

[14] N.Y. Draft reg. sections 4-2.18(c)(3)(ii), 4-2.3(c)(3)(ii) (July 3, 2019).

[15] 280 R.I. Code rule 20-25-9.8(K)(3)(b)(3).

[16] Multistate Tax Commission, "Model Compact Article IV. Division of Income." (July 29, 2015) (section 17).

[17] Colo. Rev. Stat. section 39-22-303.6.

[18] Ky. Rev. Stat. section 141.120(11).

[19] Mont. Code Ann. sections 15-31-311; 15-1-601.

[20] N.H. Rev. Stat. Ann. section 77-A:3.

[21] N.M. Stat. Ann. section 7-4-18.

[22] N.C.G.S. section 105-130.4(l).

[23] Tenn. Code Ann. section 67-4-2012(i).

[24] D.C. Code section 47-1810.02(g)(3).

[25] N.Y. Draft reg. sections 4-2.18(c)(2)-(3) (July 3, 2019).

[26] 830 Mass. Code regs. section 63.38.1(9)(d)(4)(c)(ii)(B)(1).

[27] 18 Cal. Code regs. (CCR) section 25136-2(c)(1).

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receipts according to customer billing address, irrespective of whether the customers are individuals or businesses.[28] Similarly, Massachusetts,[29] Kentucky,[30] and Montana[31] permit service providers with high-volume sales (that is, substantially similar service transactions with over 250 customers) to use billing address as a safe harbor regardless of whether the customer is an individual or a business.

Although states take different approaches, the order of a state's cascading market-based sourcing rules is significant. The cascading rules intentionally provide sourcing methods in order from most accurate and most reliable sources of information evidencing the market for the sale to least accurate and least reliable, as determined by that state. Accordingly, it is imperative that each rule in the cascading order be exhausted in sequential order before either a taxpayer or a tax agency attempts to move on to the next rule.[32] Also, if at any point one of the rules is successful, the analysis must end, and less reliable evidence (that is, lower cascading rules) must not be considered.

While the order of states' cascading rules is intentional and carefully considered during the regulatory process, in practice tax agencies have not consistently adhered to the order of the cascading rules as required. For example, we have observed auditors in jurisdictions with customer billing address as the last cascading rule nonetheless choose to use customer billing address to source the taxpayer's sales while refusing to accept reasonable approximation methods offered by taxpayers under a higher cascading rule. These auditors have concluded the taxpayer's books and records, which is notably the first cascading rule in these jurisdictions, do not contain sufficient detail to support the taxpayer's reasonable approximation methods. By taking this approach, such auditors have effectively skipped from the highest cascading rule in their jurisdictions (that is, direct evidence in books and records) to the lowest cascading rule (that is, customer billing address) without fully exhausting all the rules in between, including reasonable approximation.[33] Notably, it has always been the case in these situations that sourcing the taxpayer's sales under customer billing address resulted in a higher tax liability for the taxpayer than the taxpayer's offered reasonable approximation method.

Neither reasonable approximation nor market-based sourcing will work correctly if tax agencies or taxpayers are able to cherry-pick rules solely based on what is easier or yields a higher/lower tax liability. Rather, special care must be taken to fully exhaust each of the cascading rules in sequential order (including reasonable approximation) before moving to the next rule and to stop the analysis as soon as a rule works.

Sacrificing Uniformity for Accuracy

While the flexibility of reasonable approximation rules serves the overall purpose of the sales factor well if they are applied correctly, the rules do not come without trade-offs. By their very nature, reasonable approximation rules are not meant to be applied to all taxpayers uniformly. The flexible nature of reasonable approximation means that taxpayers that appear to be in the same type of business may not necessarily use the same method, even if each method is independently reasonable. For instance, variations can occur if a taxpayer has greater access to market data, a greater level of transparency with its customers, or simply comes up with a different but equally reasonable approach.

Oftentimes, tax agencies have a hard time letting go of uniformity in favor of case-by-case accuracy. Although states may have an interest in using bright-line rules to afford similar treatment

[28] 18 CCR section 25136-2(c)(3) (proposed June 4, 2021).

[29] 830 Mass Code regs. section 63.38.1(9)(d)(4)(d)(iii)(A)(3).

[30] Ky. Admin. regs. section 16:270-5(9)(a)(2)(d).

[31] Mont. Admin. rule 42.26.248(3)(b)(ii)(B)(IV).

[32] *See, e.g.*, FTB's Dec. 1, 2011, "Request for Adoption of Proposed Amendments to Regulation Section 25136, California Code of Regulations, Title 18, Relating to the Market-Based Rules of Sales other than Sales of Tangible Personal Property" ("FTB's Official Request for Adoption of Regulation 25136-2") (stating staff further revised the proposed language to "provide that the cascading rules appear in order of what is the best available evidence . . . with the requirement that the taxpayer or the Franchise Tax Board *must* use the first rule which is presented as a presumption before it may avail itself of the next cascading rule, and may then only use the 3rd or 4th rule if none of the rules above provide a methodology for the location of the market" (emphasis added)).

[33] *See, e.g.*, 18 CCR section 25136-2(c)(2).

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to similarly situated taxpayers, they must refrain from attempting to apply such bright-line rules to reasonable approximation. Auditors should not be permitted to informally limit taxpayer access to reasonable approximation by attempting to require a taxpayer to "substantiate" its proposed reasonable approximation method by providing direct evidence from its records, such as sales by location or specific project data. This practice completely misses the point that reasonable approximation is meant to approximate the taxpayer's market in the absence of direct evidence in the taxpayer's books and records. After all, if taxpayers had such data, they would not need to move on to reasonable approximation in the first place. To add insult to injury, when the taxpayer is inevitably unable to respond to the auditor's request for such "substantiation," auditors then feel enabled to dismiss the taxpayer's proposed method as unsubstantiated and therefore unreasonable and instead substitute another method from a lower cascading rule that just so happens to result in a higher tax liability. Placing taxpayers in a Catch-22 situation like this is a perfect example of how reasonable approximation is *not* supposed to work.

Grappling With Uniformity: The Population Problem

Another problem we are observing involves auditors refusing to consider proposed reasonable approximation methods other than rigid applications of an apportionment percentage reflecting the state population over the U.S. population, especially in large states like California (12 percent of U.S. population) and New York (6 percent of U.S. population).

While population is one of the reasonable approximation methods considered acceptable in various states' market-based sourcing regimes, using population assumes there is no material variation in the demand for a taxpayer's products or services in different jurisdictions. To the extent demand may not be uniform across different jurisdictions,[34] taxpayers and tax agencies should carefully consider whether a strict population-based method is in fact an accurate reflection of the market. If not, other methods should be considered.

For instance, special rules enable broadcasters to reflect the market for their services based on a more tailored and accurate variation of a population method. In *Comcast Corp. v. Department of Revenue*,[35] the court approved a method using Nielsen ratings data to determine the audience for a taxpayer's over-the-air broadcasting activity. Similarly, in *Hegar v. Sirius XM Radio Inc.*,[36] the taxpayer's receipts were sourced according to the location of satellite-enabled radios as determined by the subscriber's address associated with each radio. Both of these cases are similar to special rules in California that estimate the market for print media and motion pictures based on the ratio of subscribers or customers within the state rather than the general population.[37] This approach more accurately reflects these taxpayers' markets than an unmodified population approach because it is based on specific data from a narrowly tailored subset of the general population that closely represents, or in fact represents, the taxpayer's actual customers.

Using only a strict state population over U.S. population approach also presumes a taxpayer's market is wholly inside the United States. However, even when publicly available data show a taxpayer's customers clearly have an international presence and the taxpayer's sales of services benefit, or intangibles are used by, the customers at the international locations, auditors have nonetheless been consistently disfavoring any efforts to include the population of the foreign country in the population ratio. As a result, these auditors are not giving proper representation to the taxpayer's foreign markets.

For example, California's regulation provides "the populations of those other *countries* where the benefit of the service is being substantially received . . . shall be added to the U.S. population" (emphasis added).[38] In practice, however, even if a

[34] *E.g.*, when consumer preferences vary in different regions or when public information shows where the customer has property or payroll.

[35] *Comcast Corp. & Subsidiaries v. Department of Revenue*, Nos. T.C. 5265, 5346, 2020 WL 6948453, at 11 (Or. T.C. Nov. 25, 2020).

[36] 604 S.W.3d 125, 133 (Tex. App. Austin 2020).

[37] 18 CCR sections 25137-12 and 25137-8.1.

[38] 18 CCR section 25136-2(b)(7).

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taxpayer can directly substantiate through its books and records that material sales were made to another country, auditors will typically seek to either throw out a limited number of sales receipts attributable to such foreign markets or, on rare occasion, include the limited populations of the immediate *region or city* where the taxpayer has made sales and not the population of the *country*[39] as stated in the regulation.[40] Not only does this practice disregard the language of the regulation, but it requires the taxpayer to directly substantiate a reasonable approximation method with sales information from its books and records, which again misses the point of reasonable approximation (that is, reasonable approximation looks to all other available information beyond the contract and taxpayer's books and records).

This issue is a major problem with attempts to apply reasonable approximation, especially for taxpayers that have large markets outside the United States. If a taxpayer's market is partially outside the United States, that fact must be represented in the sourcing method or else the method fails to accurately reflect the market. It is as simple as that.

Again, for reasonable approximation — and in turn, market-based sourcing — to work correctly, a state's reasonable approximation rules must be applied as intended by taxpayers and tax agencies alike. In jurisdictions where auditors do not understand or refuse to comply with these rules, checks and balances need to be put in place to educate such auditors and also provide taxpayers with options to easily escalate such concerns to representatives of the tax agency who are familiar with and fully understand how these rules are meant to be applied.

Accepting Reasonable Approximation Methods: Legal Standard Concerns

The intent behind reasonable approximation is to provide taxpayers with a versatile and flexible way to accurately reflect the market for their sales of services and intangibles. For this intent to be achieved, the tenants of sound tax policy, including transparency and effective tax administration, demand there be genuine and effective limitations on states' abilities to unreasonably challenge reasonable approximation methods proposed by taxpayers. A legal presumption in favor of taxpayers' offered methods, and a burden of proof standard imposed on tax agencies to overcome that presumption, should be implemented by all states with reasonable approximation rules to place necessary limitations on the state's discretion.

Generally, legal presumptions require the party against whom a presumption is directed to have the burden of producing evidence to rebut the presumption.[41] For example, in California there is a regulatory presumption of unity if either the state or the taxpayer establish the entities in question have strong central management and centralized departments.[42] Once the presumption applies, the burden of proof is on the opposing party to overcome the presumption with "concrete evidence."[43] If the opposing party satisfies this burden, the presumption of unity disappears, and unity must be established based on a preponderance of the evidence.[44]

For reasonable approximation rules to function as intended, taxpayers' reasonable approximation methods should be presumed reasonable because state tax agencies are not in the position to substitute their own judgment for taxpayers' knowledge of their own business operations in deciding what approximation method is reasonable to approximate the market

[39] The authors are not advocating or suggesting the entire population of a foreign country should be *blindly* included in a reasonable approximation population ratio, especially when the taxpayer's sales in that foreign country are immaterial and the country's population is extremely high. As the title to this series of articles suggests, the authors believe taxpayers and tax agencies should be *reasonable* when advancing and considering reasonable approximation methods, including fair representation of a taxpayer's foreign market if a population ratio is being used.

[40] Note the FTB has proposed amendments to 18 CCR section 25136-2(b)(7) that would state that the population of "foreign jurisdictions or geographic areas," rather than "countries," may be included in the population-based method. These amendments have not yet been finalized.

[41] *See Matter of Appeal of Abbott*, OTA Case No. 18010909 (Apr. 8, 2019), 2019-OTA-121 (non-precedential); *Todd v. McColgan*, 89 Cal.App.2d 509 (1949); and *Appeal of Brockett*, 86-SBE-109 (June 18, 1986).

[42] 18 CCR section 25120(b).

[43] *See Appeal of Sierra Production Service Inc.*, 90-SBE-010 (Sept. 12, 1990).

[44] *Id.*

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or not.[45] Taxpayers develop reasonable approximation methods based on intimate firsthand knowledge of their business operations acquired close in time or contemporaneous with original return filings. Nevertheless, as many reasonable approximation rules now stand, tax agencies upon audit — typically several years after the fact — are permitted to second-guess the taxpayer's knowledge of its business and unilaterally dismiss the taxpayer's judgments and method if the auditor determines another method (typically resulting in a higher tax liability) is also reasonable. To this end, tax agencies should bear the burden of proving the taxpayer's method does not reasonably reflect the market based on something comparable to a reasonableness or substantial evidence standard of review.

Further, to allow for more efficient administration and certainty, on appeal no presumption of correctness or deference should apply to a tax agency's determination regarding a taxpayer's reasonable approximation method, and no presumption of reasonableness should apply to any alternative method proposed by the agency. Removing any such presumption of correctness or deference will allow reasonable approximation to function as designed by providing a more effective limit on a tax agency's ability to unreasonably second-guess the taxpayer's personal knowledge of its business operations and customers.

As a step in the right direction, California's proposed amendments to its market-based sourcing rules would provide that a taxpayer's reasonable approximation method *shall* be used, unless the FTB shows by a preponderance of the evidence the taxpayer's method is unreasonable.[46] If the FTB meets its burden to show the taxpayer's method is unreasonable, the FTB must reasonably approximate the source of the receipt.[47] This proposed change was formulated in response to concerns about which method of reasonable approximation would control if both the taxpayer and the FTB proposed methods that were reasonable.[48] The proposed language provides clarity and more certainty for taxpayers and the FTB by requiring use of the taxpayer's method unless the FTB shows by a preponderance of the evidence the taxpayer's method is unreasonable. Given the shift in the burden of proof to the FTB, this rule would operate similarly to a legal presumption.

Massachusetts's existing rules go one step further than California's, at least in part. Massachusetts expressly prohibits both the agency and the taxpayer from modifying the taxpayer's reasonable approximation method aside from limited, specifically prescribed administrative processes that the agency may use to correct either a factual or calculation error regarding the taxpayer's filing method.[49] Although the regulation requires a taxpayer's reasonable approximation method to reflect an attempt to obtain the most accurate assignment of sales, as opposed to an attempt to lower the taxpayer's tax liability, the taxpayer's method is presumed to be correct.[50] However, other Massachusetts rules unfortunately serve to potentially weaken and seemingly contradict the effect of these promising rules. The tax agency is separately afforded the ability to deem a taxpayer's reasonable approximation method unreasonable and substitute it with an alternative method of the tax agency's choosing or exclude the subject sales receipts from the taxpayer's sales factor.[51]

As agencies responsible for neutrally administering the law, there is a broad and important interest in maintaining the public's confidence in the legitimacy of tax collection by requiring tax agencies to approach tax issues neutrally, on the legal merits, and without regard to what interpretation will yield the highest tax liability. This leads to transparency and effective tax administration, thereby facilitating increased

[45] *See, e.g.*, *Kansas City Power & Light Co. v. Director of Revenue*, Missouri Administrative Hearing Commission, Dkt. No. 06–1589 RS (Mar. 12, 2008) (stating the state's estimate of electricity use in customer spaces was not based on competent and substantial evidence because it was based on speculation and not on personal knowledge; in contrast, the taxpayer's method was based on the square footage and vacancy rates at the hotel and was a reasonable method of making an approximation).

[46] 18 CCR section 25136-2(i)(2) (proposed June 4, 2021).

[47] *Id.*

[48] FTB, "Explanation of Draft Language Amending California Code of Regulations, Title 18, (CCR) Section 25136-2" (May 14, 2021).

[49] 830 Mass. Code regs. section 63.38.1(9)(d)(1)(b)(vii)(g)(i).

[50] 830 Mass. Code regs. section 63.38.1(9)(d)(1)(g)(i).

[51] 830 Mass. Code regs. section 63.38.1(9)(d)(1)(g)(ii).

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and more accurate voluntary compliance by taxpayers. To adequately safeguard taxpayers, the taxpayer's reasonable approximation method should be presumed reasonable, and the tax agency should bear the burden to prove by at least a preponderance of the evidence — if not by clear and convincing evidence[52] — the taxpayer's method is unreasonable without regard to the tax effect. Absent such a showing, the tax agency should only then be able to modify the taxpayer's method to correct either a factual or calculation error. Similarly, on appeal, no presumption of correctness or deference should apply to a tax agency's determination regarding a taxpayer's reasonable approximation method, and no presumption of reasonableness should apply to any alternative method proposed by the tax agency.

How Courts and Tax Tribunals May Approach Reasonable Approximation Disputes in the Future

As market-based sourcing rules are still a relatively new development, precedential guidance by courts and independent tax appeal tribunals on how reasonable approximation rules should be interpreted and applied is scarce. This is largely because state tax challenges take a long time to reach the court system or a public administrative appeals forum. Like most tax disputes, reasonable approximation cases must complete the process of tax return filing, audit, and confidential administrative appeals before reaching public administrative appeals forums and the courts, a process that takes several years. Nevertheless, there are recent income tax and gross receipts tax market-based sourcing decisions and guidance that are instructive for providing us with a glimpse of what is sure to be a decadeslong future precedent addressing the application of states' reasonable approximation rules.

The California Office of Tax Appeals (OTA) is one of the few public administrative appeals forums that has issued reasonable approximation decisions, albeit most are non-precedential. The OTA's reasoning may nonetheless serve as a guidepost for acceptable reasonable approximation methods.

The reasonable approximation methods used by the OTA in its decisions are rarely based on population and instead frequently incorporate publicly available information about the taxpayer's customer to estimate the market. For example, in *Appeal of Dakers*,[53] a Texas sole proprietor[54] provided contract staffing services to a California-headquartered company. The agreement between the taxpayer and his customer listed the customer's headquarters in Redwood City, California, and also had a reference to a Los Angeles address. Based on these references in the agreement, the FTB argued the benefit of the taxpayer's services was in California. The OTA disagreed, finding neither the agreement nor the taxpayer's limited books and records identified where the benefit of the services was received. The OTA looked to the type of services the taxpayer provided under the agreement, which included finding prospective employees for the customer. The agreement stated the taxpayer was compensated based on a percentage of the first-year base salary of candidates hired by his customer but did not state the location where the candidates were to be hired. Thus, the OTA concluded the first market-based sourcing cascading rule (that is, direct evidence from the contract or taxpayer's books and records) could not be applied, and it moved to reasonable approximation. Relying on evidence submitted by the taxpayer from the customer's website, the OTA determined the customer had two other business locations outside California, one in Nevada and the other in India, and the benefit of the taxpayer's services would have been potentially received at all three

[52] Because reasonable approximation is a rule within many states' standard apportionment rules, there are valid arguments for why the burden of proof should be clear and convincing evidence similar to what is required for a party to deviate from the standard apportionment rules for equitable apportionment purposes. *See, e.g.*, *Microsoft Corp. v. Franchise Tax Board*, 39 Cal. 4th 750, 765 (2006) (stating the party invoking section 25137, California's equivalent to section 18 of the Uniform Division of Income for Tax Purposes Act, carries the burden of proof with a clear and convincing evidentiary standard).

[53] *Matter of the Appeal of A. Dakers*, OTA Case No. 19034411 (Feb. 20, 2020), 2020-OTA-096 (non-precedential).

[54] For reasons that are beyond the scope of this series, the FTB has begun to apply the corporate apportionment statutes to unincorporated individual taxpayers. Although the following cases involve personal income taxpayers, they nevertheless apply California's corporate apportionment rules.

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business locations.[55] As a result, the OTA reasonably approximated the benefit received in California using a ratio of the customer's California location to all its locations, which produced a ratio of one-third. Thus, a ratio of the customer's business locations may be a viable means of reasonably approximating where the benefit is received for services.

The OTA has issued other decisions that rely on publicly available information about the taxpayer's customer. In *Appeal of Moro*,[56] a nonresident taxpayer provided services to a pharmaceutical company that had a California location. The record did not contain the taxpayer's contract or books and records, and the taxpayer did not provide any evidence to explain where the benefit of his services was received. The OTA used information about the taxpayer's customer gathered from the secretary of state and LexisNexis websites to reasonably approximate the taxpayer's California market.[57] Similarly, in *Appeal of Bindley*,[58] the OTA used information about the taxpayer's customers gathered from the secretary of state to approximate the taxpayer's California market.

In *Appeal of Wood*,[59] a Texas sole proprietor provided services for a fixed fee to a California-based limited liability company involving the design of user experiences for the products and services of the LLC's client. Wood was retained in the capacity of a subcontractor for the LLC, but neither the contract nor books and records specified the location of the benefit to be received by his services, except that Wood would work from his home in Texas. As a subcontractor, Wood provided services to the LLC's client. Because there was no direct evidence of the market, the OTA reasonably approximated Wood's market as being in Canada, based on a written statement that Wood had presented his designs to the LLC's client through web meetings and that the LLC's client was primarily located in Vancouver, Canada. Thus, absent any contrary information, a taxpayer's statements may be a basis for reasonably approximating the market.[60]

Another issue that comes up with some frequency in administrative rulings and case law is whether the taxpayer should "look through" to the customer's customers (that is, the ultimate customer) and not the taxpayer's direct customer in identifying where the benefit of the sale is received. This situation typically arises when a taxpayer/service provider is performing services for another service provider and the benefit received is the direct customer being relieved of having to perform some or all of its contractual obligations for its own customers.

In FTB Chief Counsel Ruling 2017-01,[61] a taxpayer requested clarity regarding the application of California's market-based sourcing rules to its subcontracting services. The taxpayer provided health plan administration services on behalf of its customers (for example, managed care organizations, health insurers, and employers). The taxpayer's customers were in the business of providing comprehensive healthcare services to employers and other ultimate customers. Although both the taxpayer's customer and the customer's customers received benefits from the taxpayer's services, the ruling concluded the taxpayer's services should be sourced to the location where the direct customer received the benefit. If that location is not readily apparent in the contract or the taxpayer's books and records, the ruling provides "the best reasonable approximation" of the location where the benefits are received would be the location where the taxpayer's customer would have conducted the function the taxpayer is providing, in the event the customer canceled its contract with the taxpayer.[62] Accordingly, in situations involving subcontract services and outsourcing,

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[55] There was no evidence or argument in the record on where candidates identified by the taxpayer may have been actually hired.

[56] *Matter of the Appeal of Glenn J. Moro*, OTA Case No. 18011757 (Nov. 6, 2019), 2019-OTA-381 at 1 (non-precedential).

[57] *Id.* at 5.

[58] *Matter of Appeal of Blair S. Bindley*, OTA Case No. 18032402 (May 30, 2019), 2019-OTA-179P.

[59] *Matter of the Appeal of Christopher J. Wood*, OTA Case No. 18042717 (July 8, 2019), 2019-OTA-264 (non-precedential).

[60] *See also Matter of the Appeal of S. Krown*, OTA Case No. 19024335 (Nov. 23, 2020), 2021-OTA-078 (non-precedential) (The OTA reasonably approximated the market for services to Africa and Latin America based on the taxpayer's corroborated representation that she worked from New York and her duties involved periodic trips to Africa and Latin America, even though she was hired by a California university).

[61] FTB, Chief Counsel Ruling 2017-01 (Apr. 7, 2017).

[62] FTB, CCR 2017-01; *see also*, FTB CCR 2015-02 (Dec. 31, 2015) (determining CPU usage was a reasonable indicator of the location and extent of the benefit of taxpayer's services).

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the location where the taxpayer's customer would have conducted the services the taxpayer is providing may be a basis for reasonably approximating the market.

Somewhat analogous results were reached by the courts in Washington and Ohio. In *LendingTree LLC v. Department of Revenue*,[63] Washington's tax agency argued the market for the taxpayer's services was its customer's customers.[64] The taxpayer operated an online marketplace that matched prospective borrowers with the taxpayer's customers, which were potential lenders.[65] The Washington Court of Appeal disagreed with the tax agency and held the benefit of the taxpayer's services was at the location where its direct customers received and used the information (that is, referrals) provided by the taxpayer.[66] In *Defender Security Co. v. McClain*,[67] the Ohio Supreme Court also examined a set of facts whereby the state was arguing the receipts in question should be sourced to the ultimate customer and not the taxpayer's direct customer. The taxpayer was an Indianapolis-based authorized dealer of security systems that made sales of security monitoring services contracts to Ohio consumers. The taxpayer's direct customer was an alarm service company located outside Ohio. The taxpayer assigned its sales receipts to the location of the direct customer. The Ohio Department of Taxation disagreed, contending the receipts should have been sourced to the customer's customers in Ohio — that is, the consumers that purchased the security monitoring services contracts. While the taxpayer operated four branch locations in Ohio and sold contracts related to Ohio consumers, the court held the alarm services company purchased intangible contract rights and the alarm services company's business locations outside Ohio were the places where it used and received the benefit of those contractual rights. In other words, the taxpayer's market was similarly determined to be where its direct customer — that is, the alarm services company — was physically located and not the customers of the alarm services company in Ohio.

The foregoing cases and rulings provide a few helpful breadcrumbs to follow for taxpayers looking to predict how their reasonable approximation methods may fare in future court and tax tribunal appeals without a plethora of existing precedential rulings to rely on. Acceptable reasonable approximation methods may look to the taxpayer's own statements, publicly available information such as secretary of state filings or public records databases, or information from the customer's websites or books and records. Special caution should be taken with sales of services to customers who are themselves service providers. If *LendingTree* and *Defender* are any indication of states' positions on when a look-through method should apply, taxpayers should anticipate continued resistance by state revenue agencies when the look-through approach yields greater in-state apportionment of sales.

Conclusion

If market-based sourcing is to fulfill its lofty potential as a worthy successor and cure to the ills inherent in cost of performance sourcing, reasonable approximation rules must be applied fairly and correctly and exhausted appropriately in the order they are included in each state's series of cascading market-based sourcing rules. Reasonable approximation rules must be flexibly applied on a case-by-case basis with the goal of accurately assigning sales of services and intangibles to the taxpayer's estimated market without the benefit of direct evidence from the customer contract or the taxpayer's books and records. To this end, the only standard the taxpayer should have to meet in presenting a reasonable approximation method to tax agencies is whether it is in fact *reasonable*. The intended benefit of reasonable approximation is defeated when tax agencies fail to comply with the rules in practice or when the burden is on the taxpayer to not only substantiate methods that by their nature have limited direct evidence but to also prove its method is more reasonable than competing methods proposed by the state taxing agency.

[63] *LendingTree LLC v. Department of Revenue*, 12 Wash. App. 2d 887 (App. Div. 1 2020).

[64] *Id.* at 889.

[65] *Id.* at 888-889.

[66] *Id.* at 893-894.

[67] *Defender Security Co. v. McClain*, 162 Ohio St. 3d 473, 2020-Ohio-4594 (Ohio 2020).

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Although the problems outlined in this article may appear daunting, there are available solutions. Importantly, states must make efforts to fully educate their audit and legal staff on the proper application of reasonable approximation rules in their jurisdictions. Taxpayers should also be provided with convenient and practical options to escalate concerns related to reasonable approximation to representatives of the tax agency who are familiar with and fully understand how these rules are meant to be applied.

To adequately protect taxpayers, additional procedural safeguards are also necessary. The taxpayer's proposed reasonable approximation method should be presumed reasonable, and the burden should be on the state agency to prove by at least a preponderance of the evidence, if not clear and convincing evidence, that the taxpayer's method is unreasonable, without any reliance on tax effect. While the authors recognize a reasonableness, or substantial evidence, standard of review is reserved for appellate courts reviewing lower court or administrative decisions, we believe tax agencies should be required to adhere to a comparable standard when reviewing taxpayers' selected reasonable approximation methods. The reasonableness or substantial evidence standard of review is highly deferential to the finder of fact on questions of fact and reasonable inferences drawn therefrom. Similar to a finder of fact who sits in the position of listening to testimony, reviewing the entirety of the evidence in the record, and then making a contemporaneous decision, the taxpayer sits in the position of witnessing firsthand the entirety of its business operations and then making a contemporaneous reasonable approximation determination based on that knowledge. Taxpayers should be afforded the same highly deferential standard as a procedural safeguard if states are serious about making their new market-based sourcing regimes a success.

Further, if the state is unable to overcome the presumption of reasonableness afforded to the taxpayer's reasonable approximation method, the state should only be able to modify the taxpayer's method to correct either a factual or calculation error. Also, rules should be created to remove any presumption of correctness in favor of a tax agency's determinations regarding a taxpayer's reasonable approximation method, including whether the taxpayer's selected method is reasonable or whether an alternative method proposed by the tax agency is reasonable.

With these additional safeguards, taxpayers and tax agencies can efficiently work toward the common goal of accurately reflecting the taxpayer's market via reasonable approximation.

Pillsbury will continue to monitor reasonable approximation developments among the states. If you need assistance understanding, applying, or dealing with a tax agency dispute regarding the market-based sourcing rules in your state, please reach out to a member of Pillsbury's state and local tax team. ■

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