OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **JANUS CAPITAL GROUP, INC. AND SUBSIDIARIES**	) OTA Case No. 20096605))

)

OPINION

Representing the Parties:

For Appellant:	Yoni Fix, Attorney Paul E. Meiniczak, Attorney
For Respondent:	Amanda Smith, Tax Counsel III Marguerite Mosnier, Tax Counsel IV Delinda Tamagni, Assistant Chief Counsel
For Office of Tax Appeals:	William J. Stafford, Tax Counsel III

S. HOSEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, Janus Capital Group, Inc. and Subsidiaries (appellant) appeals respondent Franchise Tax Board's (FTB) denials of appellant's claims for refund of $1,014,327; $1,075,073; $1,055,450; and $1,096,870 for the 2013 through 2016 tax years, respectively.

Office of Tax Appeals (OTA) Administrative Law Judges Sara A. Hosey, Sheriene Anne Ridenour, and Ovsep Akopchikyan held an oral hearing for this matter in Sacramento, California, on April 19, 2023. At the conclusion of the hearing, the record was closed, and this matter was submitted for an opinion.

ISSUES

1. Whether OTA has jurisdiction to determine if FTB properly promulgated California Code of Regulations, title 18, (Regulation) section 25137-14 under the California Administrative Procedure Act (APA).
2. Whether Regulation section 25137- 14 is the standard apportionment rule for assigning appellant's service receipts.

FACTUAL FINDINGS

1. Appellant is an investment management company headquartered in the state of Colorado.
2. Appellant provides management, administrative, and distribution services to mutual funds and other institutions. Only the services appellant provided as a mutual fund service provider[1] are at issue in this appeal.
3. Appellant timely filed its California tax returns for the 2013 through 2016 tax years utilizing a single-sales factor formula[2] and the method prescribed by Regulation section 25137-14, which provides special rules for the apportionment of income of mutual fund service providers.
4. In accordance with Regulation section 25137-14, appellant assigned the gross receipts it received from sales of services to mutual funds to the locations of the mutual funds' shareholders for the 2013 through 2016 tax years.
5. Later, appellant timely filed claims for refund for the 2013 through 2016 tax years, seeking to assign its mutual fund service receipts to the locations of the mutual funds themselves (not to the locations of the mutual funds' shareholders),[3] asserting that Regulation section 25137-14 should not be applied and, alternatively, that FTB was required to make a showing of distortion before applying the regulation.
6. After reviewing the matter, FTB rejected appellant's arguments and denied appellant's claims for refund. In response, appellant filed this timely appeal.

[1] A mutual fund service provider is defined as "any unitary business that derives income from the direct or indirect provision of management, distribution or administration services to or on behalf of a regulated investment company." (Cal. Code Regs., tit. 18, § 25137-14(a)(5).) A regulated investment company is defined in Internal Revenue Code section 851. (Cal. Code Regs., tit. 18, § 25137-14(a)(6).)

[2] The singe-sales factor formula is the taxpayer's sales in California divided by its sales everywhere, then this ratio is multiplied by the taxpayer's business income to determine its post-apportioned taxable income. (R&TC, § 25128.7.)

[3] Appellant's mutual funds were not located in California, whereas the mutual funds' shareholders largely were.

DISCUSSION

Issue 1: Whether OTA has jurisdiction to determine if FTB properly promulgated Regulation section 25137-14 under the APA.

Appellant contends that the sourcing method provided by Regulation section 25137-14 (i.e., a look-through approach) is invalid. Specifically, appellant contends that because FTB did not provide evidence and make findings regarding the economic impact of Regulation section 25137-14 on taxpayers when the regulation was adopted in 2007, the regulation was not adopted in accordance with the APA. Elaborating further, appellant contends that when Regulation section 25137-14 was adopted in 2007, FTB merely considered evidence showing the *fiscal* impact of Regulation section 25137-14 on California, but did not consider evidence (or make findings) regarding the *economic* impact of the then-proposed regulation on taxpayers, as was required under the APA.

In addition, appellant contends that when R&TC section 25136 was later amended in 2012 to strike the "cost-of-performance" rule (which essentially assigned service receipts to where the taxpayer performed its services) and replaced with a rule focusing on where a "purchaser" received the "benefit of the services" (i.e., a purchaser-of-the-service rule that is not tied to where the taxpayer performed its services), FTB failed to follow APA notice and evidentiary procedures when FTB promulgated Regulation section 25136-2(g)(3).[4] Regulation section 25136-2(g)(3) generally provides that the method of apportionment for mutual fund service providers prescribed by Regulation section 25137-14 (i.e., the look-through approach) will still be applicable to mutual fund service providers, despite the amendment of R&TC section 25136 in 2012, which created the purchaser-of-the-service rule.

OTA is an independent administrative tribunal whose jurisdiction to hear taxpayer appeals—like that of its predecessor, the State Board of Equalization (BOE)[5]—is limited by its enabling legislation, Assembly Bill Nos. 102 and 131 (2017-2018 Reg. Sess.). (*Appeal of Eric H. Liljestrand Irrevocable Trust*, 2019-OTA-012P.) It is well settled that administrative agencies, such as OTA, have only those powers that have been conferred on them, expressly or

[4] Regulation section 25136-2(g)(3) was renumbered as Regulation section 25136-2(h)(3) in 2017.

[5] With certain exceptions not relevant to this appeal, OTA "is the successor to, and is vested with, all of the duties, powers, and responsibilities of [BOE] necessary or appropriate to conduct appeals hearings." (Gov. Code, § 15672(a).)

by implication, by constitution or by statute. (*Ferdig v. State Personnel Board* (1969) 71 Cal.2d 96, 103.) An administrative agency must act within the powers conferred upon it by law and may not validly act in excess of those powers. (*Id*. at p. 104.) Accordingly, when an administrative agency acts in excess of, or in violation of, the powers conferred upon it, that action is void. (*City and County of San Francisco v. Padilla* (1972) 23 Cal.App.3d 388, 400.)

OTA is not a court. (Gov. Code, § 15672; *Appeal of Talavera*, 2020-OTA-022P.) Rather, OTA is an administrative agency and is precluded by the California Constitution from declaring a statute unenforceable or refusing to enforce a statute on the basis that the statute is unconstitutional, unless an appellate court has determined that the statute is unconstitutional. (Cal. Const., Art. III, § 3.5; *Appeal of Talavera*, *supra*.) No such determination is required because appellant's challenge of Regulation section 25137-14 is not on constitutional grounds.

The California Legislature has decided that the promulgation of regulations is governed by the provisions of the APA, which are found in California Government Code section 11340, et seq. The APA contains a comprehensive procedure for the adoption, amendment, and repeal of regulations by state agencies. The purpose of the APA is to establish basic minimum procedural requirements for the adoption, amendment, or repeal of administrative regulations. (Gov. Code, § 11346.) Under the APA, the sole state agency vested with the authority to determine whether *another* agency's regulation was issued in compliance with the APA is the Office of Administrative Law (OAL) and therefore not OTA. (Gov. Code, §§ 11340.1, 11340.7.) As relevant here, one avenue of remedy the statute provides is judicial:

> Any interested person may obtain a judicial declaration as to the validity of any regulation . . . by bringing an action for declaratory relief in the superior court . . . (Gov. Code, § 11350.)

Conversely, there is no statute that confers upon OTA the authority to determine whether a regulation of another agency was adopted in compliance with the APA. For that reason, OTA lacks jurisdiction to consider the merits of appellant's arguments that FTB failed to follow APA procedures when promulgating Regulation sections 25137-14 and 25136-2.

Issue 2: Whether Regulation section 25137- 14 is the standard apportionment rule for assigning appellant's service receipts.

As OTA does not have jurisdiction to rule on the validity of Regulation section 25137-14, the next issue to consider is whether the sales factor sourcing methodology (i.e., a look-through approach) under Regulation section 25137-14 or the sourcing methodology (i.e., looking to the location of the mutual funds themselves) under R&TC section 25136 should apply under the facts of this case. Under California law, a taxpayer (including any entity taxed as corporation) with income from sources both within and without California generally must follow a statutory formula to determine what portion of its net income is allocated or apportioned to California and therefore subject to California taxation. (R&TC, § 25120 et seq.) As a result of the passage of Proposition 39 in 2012,[6] multistate businesses are generally required to determine their California income according to a single-sales factor. (R&TC, § 25128.7.)[7] Under R&TC section 25134, the sales factor is ordinarily determined by dividing the business's total sales within California by the business's total sales everywhere.

Prior to 2013, and if certain taxpayers did not make a single-sales factor election for the 2011 and 2012 tax years (see former R&TC, § 25128.5), R&TC section 25136(a) assigned sales to California if a greater proportion of the income-producing activity was in California than in any other state, based on costs of performance (i.e., a cost-of-performance rule). (R&TC, § 25136(a) [as in effect prior to 2013].) In 2012, R&TC section 25136 was amended, for tax years beginning on or after January 1, 2013, to replace the cost-of-performance rule with a rule requiring that gross receipts from the sale of a service be sourced to the location where the "purchaser of the service" received the "benefit of the services" (i.e., a purchaser-of-the-service rule).[8]

R&TC section 25137 provides that if the standard allocation and apportionment provisions (such as R&TC section 25136) do not fairly represent (i.e., distort) the extent of the

[6] Prior to tax years beginning on or January 1, 2013, if a single-sales factor election was not made under R&TC section 25128.5, taxpayers were required to use a three-factor property, payroll, and double-weighted sales formula. (R&TC, § 25128(a).)

[7] Proposition 39 was codified, in part, as R&TC section 25128.7.

[8] R&TC section 25136 was also amended by Proposition 39, which was approved by California voters during the November 6, 2012 general election.

taxpayer's business activity in this state, the taxpayer may petition for or FTB may require, if reasonable, the use of an alternative apportionment methodology.

R&TC section 19503(a) provides that FTB "shall prescribe all rules and regulations necessary for enforcement of Part 10 (commencing with [R&TC section] 17001), Part 10.7 (commencing with [R&TC section] 21001), Part 11 (commencing with [R&TC section] 23001), and this part and may prescribe the extent to which any ruling (including any judicial decision or any administrative determination other than by regulation) shall be applied without retroactive effect."

In 2007, FTB promulgated Regulation section 25137-14, which requires that mutual fund service providers selling services to regulated investment companies, including mutual funds,[9] must assign those sales to the domicile of the funds' shareholders (i.e., a look-through approach).[10] It provides, in part:

> Receipts from the direct or indirect provision of management, distribution or administration services to or on behalf of a regulated investment company are assigned by the use of a shareholder ratio. This ratio is calculated by multiplying total receipts for the taxable year from each separate regulated investment company for which the mutual fund service provider performs management, distribution or administration services by a fraction, the numerator of which is the average of the number of shares owned by the regulated investment company's shareholders domiciled in the State at the beginning of and at the end of the regulated investment company's taxable year, and the denominator of which is the average of the number of the shares owned by the regulated investment company's shareholders everywhere at the beginning of and at the end of the regulated investment company's taxable year.

(Cal. Code Regs., tit. 18, § 25137-14(b)(1)(A)).

In 2012, pursuant to the authority of R&TC section 25136(b), FTB promulgated Regulation section 25136-2(g)(3). It generally provides that the look-through approach of Regulation section 25137-14 remains applicable to mutual fund service providers after the

[9] For simplicity and ease of reading, OTA will generally refer to the term "mutual fund(s)" instead of the broader term "regulated investment company(ies)."

[10] Regulation section 25137-14 became operative on July 20, 2007, and was made applicable to tax years beginning on or after January 1, 2007. Subsequently, Regulation section 25137-14 was amended, in various respects that are not material to this appeal, effective December 9, 2013.

amendment of R&TC section 25136 in 2012 (which established the general purchaser-of-the-service rule).[11]

The party invoking R&TC section 25137 must prove by clear and convincing evidence that: (1) "the approximation provided by the standard formula is not a fair representation;" and (2) the party's "proposed alternative is reasonable." (*Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 765 (*Microsoft*).) "What must be shown is sufficient distortion that appellant's business activity in the state is not fairly reflected." (*Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc*.(89-SBE-017) 1989 WL 95886 (*Merrill Lynch*).)

Where a special apportionment formula promulgated under R&TC section 25137 applies, it is the standard by which the parties are to compute the taxpayer's apportionment formula. (*Appeal of Fluor Corp.* (95-SBE-016) 1995 WL 799363 (*Fluor*); *Appeals of Amarr Co*. *et al*., 2022-OTA-041P (*Amarr*).) Therefore, where such a special apportionment formula applies by its terms, the taxpayer and FTB are bound to follow it, unless a party seeking to deviate from it establishes by clear and convincing evidence that the regulation does not fairly represent the extent of the taxpayer's activities in this state and the party's proposed alternative is reasonable. (*Fluor*, *supra*; *Amarr*, *supra*.)

A fundamental task in construing a statute is to ascertain the intent of the lawmakers so as to effectuate the purpose of the statute. A beginning point is to examine the statutory language, giving words their usual and ordinary meaning. If there is no ambiguity, the presumption is that the lawmakers meant what they said, and the plain meaning of the language governs. If, however, the statutory terms are ambiguous, then a court may resort to extrinsic sources, such as legislative history. (*Hoechst Celanese Corp. v. Franchise Tax Bd.* (2001) 25 Cal.4th 508, 519.)

In *Yamaha Corp. of America v. State Board of Equalization* (1998) 19 Cal.4th 1, the California Supreme Court contrasted "quasi-legislative" and "interpretive" regulations. The Court stated that quasi-legislative regulations are those "adopted by an agency to which the Legislature has confided the power to 'make law,'" and that such regulations "have the dignity of statutes." (*Id*. at pp. 7, 10.) In contrast, the Court stated that interpretive regulations are those that involve "an agency's interpretation of a statute or regulation," and that "the binding power of an agency's interpretation of a statute or regulation is contextual: Its power to persuade is

[11] Regulation section 25136-2 was subsequently amended, in various respects that are not material to this appeal, effective January 1, 2017.

both circumstantial and dependent on the presence or absence of factors that support the merit of the interpretation." (*Id*. at p. 7, italics omitted.) The Court also noted, however, that "administrative rules do not always fall neatly into one category or the other; the terms designate opposite ends of an administrative continuum, depending on the breadth of the authority delegated by the Legislature." (*Id*. at p. 6, fn. 3.)

Later, in *Ramirez v. Yosemite Water Co*. (1999) 20 Cal.4th 785, 799, the California Supreme Court held that regulations falling somewhere in the administrative continuum between quasi-legislative and interpretive may have both quasi-legislative and interpretive characteristics, as when an administrative agency exercises a legislatively delegated power to interpret key statutory terms.

Analysis

As noted above, in filing its California tax returns for the 2013 through 2016 tax years, appellant used the method prescribed by Regulation section 25137-14. Under Regulation section 25137-14, appellant did not assign its mutual fund service receipts based on the locations of the mutual funds themselves. Instead, following Regulation section 25137-14, appellant assigned those receipts based on where the mutual funds' shareholders were located (i.e., a look-through approach).

On appeal, appellant contends that the methodology prescribed by Regulation section 25137-14 is improper because it conflicts with R&TC section 25136, and under R&TC section 25137, FTB has not shown clear and convincing evidence of distortion that would require appellant to use Regulation 25137-14 to source its mutual fund service receipts.

However, pursuant to R&TC section 25137, FTB may cure distortion in the apportionment of income by *requiring* that taxpayers (including appellant) use an alternative method of apportionment when the standard method of apportionment unfairly represents the extent of a taxpayer's business activity in this state.[12] Furthermore, FTB has the authority to make its own rules and regulations necessary to enforce its regulations, including those

[12] Specifically, R&TC section 25137 provides: "If the allocation and apportionment provisions of this act do not fairly represent that extent of the taxpayer's business activity in this state, . . . the taxpayer may petition for or [FTB] may *require*, in respect to all or any part of the taxpayer's business activity, if reasonable: [¶] (a) Separate accounting; [¶] (b) The exclusion of any one or more of the factors; [¶] (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or [¶] (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." (R&TC, § 25137, italics added.)

pertaining to the allocation or apportionment of business income. (R&TC, § 19503(a).) As noted in the Initial Statement of Reasons for the Adoption of California Code of Regulations, title 18, section 25137-14, Regulation section 25137-14 was promulgated to remedy distortion of application of R&TC section 25136 for members of the mutual fund services providers. FTB's regulations, adopted pursuant to a legislative grant of authority under R&TC section 19503 are "quasi-legislative rules," and such regulations have the dignity of statutes. (*Yamaha*, *supra*, at p. 3.)

Here, OTA finds that FTB properly invoked its authority under R&TC section 19503 to cure distortion in relation to the industry of mutual fund service providers. Further, as BOE stated in *Fluor*, once FTB has promulgated such a special apportionment regulation, the apportionment methodology set forth in that regulation becomes the standard apportionment methodology, unless the party seeking to deviate from that methodology shows distortion. (*Fluor*, *supra*; see also *Amarr*, *supra*.)

Appellant argues, however, that BOE's decision in *Fluor* was made in the context of the "occasional sale rule" of Regulation section 25137(c)(1)(A), which appellant asserts complemented the existing sales factor sourcing statute by covering an infrequently encountered situation that was not directly covered by the statute itself—i.e., how to treat large amounts of receipts from an occasional sale of property. In contrast, appellant contends, the look-through approach set forth in Regulation section 25137-14 (which focuses on the locations of the mutual funds' shareholders) contradicts the rule set forth in R&TC section 25136 (which focuses on the location where a "purchaser of the service" received the "benefit of the services").

Appellant is incorrect. R&TC section 25137 does not limit alternative apportionment methodologies to those that complement the standard apportionment provisions. There are numerous special industry apportionment regulations under Regulation section 25137 et seq. promulgated by FTB that significantly deviate from the standard apportionment rules to cure distortions in certain industry-wide fact patterns. OTA finds that: (1) FTB properly invoked its authority under R&TC sections 19503 to promulgate alternative apportionment regulations;[13] and (2) both the occasional sale rule of Regulation section 25137(c)(1)(A) and the look-though

[13] Unlike the regulations at issue in *Whitcomb Hotel v. California Employment Commission* (1944) 24 Cal.2d 753 and *Appeal of Save Mart Supermarkets & Subsidiary* (2002-SBE-002) 2002 WL 245682, as raised by appellant, Regulation section 25137 does not exceed the bounds of the underlying statute. Regulation section 25137 et seq. provides alternative apportionment formulas that are reasonably designed to avoid an unfair representation of business activity under R&TC section 25137.

approach of Regulation section 25137-14 properly set forth alternative apportionment methods that, naturally, differ from the standard apportionment rules that would otherwise apply.

Appellant also contends that BOE's decision in *Fluor* was issued because the occasional sale rule of Regulation section 25137(c) carried out the "main purpose" of R&TC section 25137, which appellant asserts is to address "unusual fact situations" which ordinarily will be "nonrecurring" and "unique." (*Microsoft*, *supra*, at p. 770, citing Cal. Code Regs., tit. 18, § 25137(a).) Appellant argues that there is nothing "nonrecurring" or "unique" about its mutual fund service receipts.

While R&TC section 25137 ordinarily applies to nonrecurring situations, it can also apply to recurring situations where the statutory apportionment formula does not fairly represent a unitary business's activities in a given state. As the California Supreme Court's decision in *Microsoft* observed:

> While Revenue and Taxation Code section 25137 "ordinarily" applies to nonrecurring situations, it does not apply only to such situations; the statutory touchstone remains an inquiry into whether the formula "fairly represent[s]" a unitary business's activities in a given state, and when is does not, the relief provision may apply.

(*Microsoft*, *supra*, at p. 770.)

Here, OTA finds that Regulation section 25137-14 was properly applied to the mutual fund service receipts at issue, even though such receipts might be classified as reoccurring. Further, in relation to appellant's argument that there is nothing "unique" about its mutual fund service receipts, OTA finds—as already discussed above—that FTB properly invoked its authority under R&TC sections 19503 to cure distortion in relation to the industry of mutual fund service providers, as declining to apply the relief provided by Regulation section 25137-14 to the industry would allow significant tax loopholes that would be susceptible to manipulation.

Appellant further asserts that even if OTA was to apply Regulation section 25137-14 to the facts in this appeal, the use of a single-sales factor nonetheless results in distortion. Appellant contends that the solution to such distortion is to calculate appellant's apportionment percentage by including a property factor and a payroll factor, in addition to a sales factor.

As indicated above, the party invoking R&TC section 25137 must prove by clear and convincing evidence that the approximation provided by the standard formula is not a fair

representation, and the party's proposed alternative is reasonable. (*Microsoft*, *supra*, at p. 765.) The party must show sufficient distortion that appellant's business activity in the state is not fairly reflected. (*Merrill Lynch*, *supra*.) Appellant has not provided any evidence, let alone clear and convincing evidence, demonstrating that its apportionment percentage should have been calculated differently, either with an equally-weighted three-factor formula (property, payroll, sales) or by some other combination of factors. OTA thus finds that Regulation section 25137-14 is the standard apportionment rule for assigning appellant's service receipts.

HOLDINGS

1. OTA does not have jurisdiction to determine if FTB properly promulgated Regulation section 25137-14 under the APA.
2. Regulation section 25137-14 is the standard apportionment rule for assigning appellant's service receipts.

DISPOSITION

FTB's denials of appellant's claims for refund for the 2013 through 2016 tax years are sustained in full.

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Sara A Hosey
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Sara A. Hosey
Administrative Law Judge

I concur:

DocuSigned by:
Sheriene Anne Ridenour
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Sheriene Anne Ridenour
Administrative Law Judge

O. AKOPCHIKYAN, Concurring:

I agree with the outcome of this appeal, but I would have sustained the Franchise Tax Board's (FTB's) denial of the refund claims on a different basis—namely, even assuming the Office of Tax Appeals (OTA) has jurisdiction to invalidate a regulation, Janus Capital Group, Inc. and Subsidiaries (appellant) has not met its burden of establishing that it is entitled to a refund for the 2013 through 2016 tax years.

I. Summary of Appellant's Position

Appellant, a mutual fund service provider, contends that it is entitled to a refund because it should have sourced its receipts from its purchasers under the standard market-based sourcing rules in Revenue and Taxation Code (R&TC) section 25136, which source appellant's receipts to the location where its purchasers received the benefit of appellant's investment advisory services—and not under the special apportionment rule in California Code of Regulations, title 18, (Regulation) section 25137-14, which sources appellant's receipts based on the location of its purchasers' shareholders. More specifically, appellant contends that: (1) R&TC section 25136 sources appellant's receipts to the location where its purchasers received the benefit of its investment advisory services; (2) appellant's purchasers received the benefit of appellant's services at their states of domicile, as determined by the mailing addresses in appellant's records; (3) appellant's refund claims involve only purchasers domiciled in Colorado; and (4) appellant's receipts from its Colorado-domiciled purchasers should therefore be sourced entirely to Colorado under R&TC section 25136, and not at least partially to California under the shareholder sourcing methodology in Regulation section 25137-14.

However, even assuming, without deciding, that appellant's mutual fund service receipts should be sourced under R&TC section 25136, appellant's position fails because the evidence does not establish where appellant's purchasers received the benefit of appellant's services.

II. Discussion

Appellant has the burden of proving that it is entitled to a refund, which includes the burden of producing evidence to establish the correct amount of tax. (*Appeal of Jali, LLC*, 2019-OTA-204P.) To establish the correct amount of tax in this case, appellant has the burden of

producing evidence to support its proposed sourcing methodology under R&TC section 25136 and Regulation section 25136-2.

R&TC section 25136(a)(1) sources a sale of service to where the purchaser of the service received the benefit of the service. Regulation section 25136-2(b)(1) defines the phrase "benefit of a service is received" as the location where a purchaser has "either directly or indirectly received value from delivery of that service." Where, as here, a taxpayer sells services to a business entity, Regulation section 25136-2(c)(2)(A) through (D) provides cascading rules for determining where the benefit of the service is received. Appellant is required to apply these cascading rules, which are in order of the best evidence and applied in sequential order, to determine where its purchasers received the benefit of appellant's investment advisory services under its proposed use of R&TC section 25136.

Without expressly stating so, appellant seems to rely on the presumption in the first cascading rule, which states:

> The location of the benefit of the service shall be presumed to be received in this state to the extent the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the normal course of business, notwithstanding the billing address of the taxpayer's customer, indicate the benefit of the service is in this state. This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing, based on a preponderance of the evidence, that the location (or locations) indicated by the contract or the taxpayer's books and records was not the actual location where the benefit of the service was received.

(Cal. Code Regs., tit. 18, § 25136-2(c)(2)(A).)

Appellant seems to contend that this rebuttable presumption applies because: (1) appellant's sales contracts with its purchasers indicate that appellant provided investment advisory and other services to its purchasers; (2) appellant's sales contracts and books and records indicate that appellant's purchasers received the benefit of appellant's services at their states of domicile, as determined by the mailing addresses in appellant's records; and (3) this presumption controls because FTB has not argued or established that appellant's purchasers received the benefit of appellant's services at some other location. However, appellant's evidence does not establish where its purchasers received the benefit of appellant's investment advisory services and, therefore, this presumption does not apply in the first instance.

With respect to the evidence, appellant produced three sample sales contracts, only one involving a Colorado customer, even though it seeks to remove all receipts from approximately 50 purported Colorado-domiciled purchasers from each year's California sales factor numerator. The contracts state that appellant will provide investment advisory and other services to its purchasers, and that appellant's purchasers will provide investment guidelines and other information to appellant on an ongoing basis. The contracts do not provide sufficient details about appellant's and its purchasers' business activities or their location or locations. For example, although a sample contract states that appellant "shall furnish continuous advice and recommendations to the [purchaser]," it does not indicate the location or locations where the purchaser uses appellant's advice and recommendations. In addition, although the contracts indicate that appellant's purchasers must provide investment guidelines and other information to appellant, it does not indicate the location or locations from where the purchasers provide that information to appellant. In fact, the only contract that appears to involve a Colorado customer does not reference an address or location at all. Accordingly, the three sample sales contracts do not indicate that appellant's purchasers received the benefit of appellant's services at their states of domicile and, therefore, do not give rise to the presumption in the first cascading rule.

The only other meaningful evidence that appellant submitted to establish that its purchasers received the benefit of its investment advisory services at their states of domicile is a two-page affidavit signed by appellant's Senior Vice President – Global Head of Tax. The affidavit states that appellant calculated its refund claims by sourcing its receipts to the "domicile of each purchaser, based on the mailing address that [appellant] maintains in its records." In other words, in applying R&TC section 25136, appellant used a mailing address as a proxy for where a purchaser received the benefit of its services. But as a threshold matter, the affidavit does not explain how or why appellant determined that its purchasers received the benefit of its investment advisory services at their states of domicile or mailing addresses. The affidavit does not provide details about appellant's and its purchasers' business activities or their location or locations. Therefore, even assuming a purchaser's state of domicile can be supported by a mailing address, the affidavit does not give rise to the presumption in the first cascading rule.

Without the benefit of the rebuttable presumption, appellant cannot shift the burden to FTB to argue or establish that appellant's purchasers received the benefit of appellant's services at some other location. Rather, without the benefit of the presumption, appellant was required to

establish that its proposed sourcing method is reasonable under the second cascading rule. In applying the reasonable approximation cascading rule, a fact-specific analysis, a taxpayer must consider "all sources of information *other than* the terms of the contracts and the taxpayer's books and records" to determine the location of the benefit of the services "in a manner that is consistent with the activities of the customer to the extent such information is available to the taxpayer." (Cal. Code Regs., tit. 18, § 25136-2(b)(7), italics added.) Appellant has not met its burden of establishing that its proposed sourcing method is reasonable under the second cascading rule because appellant has not produced any evidence, other than the three sample contracts and affidavit above, to reasonably approximate where its purchasers received the benefit of appellant's services. Regulation section 25136-2(c)(2) does not presume appellant's purchasers received the benefit of appellant's services at their states of domicile. (Compare Cal. Code Regs., tit. 18, § 25136-2(c)(2) [including example 1] with § 25136-2(e).)

Appellant contends that it need not reasonably approximate where its purchasers received the benefit of its services because FTB never argued that appellant's purchasers received the benefit of appellant's services at some other location. However, FTB argued on appeal that: (1) R&TC section 25136 and Regulation section 25136-2 do not state that a mutual fund service provider should source its receipts to the location of its purchasers, and (2) appellant has not supported its proposed sourcing method under R&TC section 25136 with analysis or evidence. In short, FTB never stipulated or conceded that appellant's proposed sourcing method under R&TC section 25136 is reasonable. Appellant therefore has the burden of producing evidence establishing why its purchasers' states of domicile, as determined by their mailing addresses, is a reasonable approximation of where its purchasers received the benefit of appellant's services in this case. Appellant cannot satisfy this burden by asserting its purchasers received the benefit of appellant's services at their states of domicile without providing support.

Appellant relies on a Minnesota Supreme Court decision entitled *Lutheran Brotherhood Research Corp. v. Commissioner* (Minn. 2003) 656 N.W.2d 375 (*Lutheran*) for its position that it should source its receipts to the location of its purchasers. *Lutheran* is distinguishable. Although the sourcing statute in *Lutheran* may sound conceptually similar to R&TC section 25136, it is in fact different from R&TC section 25136 and does not involve the cascading rules in Regulation section 25136-2(c)(2). (Compare *id*. at pp. 378-79 ["Receipts from the performance of services must be attributed to the state in which the benefits of the services

are consumed"] with R&TC section 25136(a)(1) ["Sales from services are in this state to the extent the purchaser of the service received the benefit of the services in this state"]; see *Corporate Executive Board Company v. Va. Dept. of Taxation* (2019) 297 Va. 57, 78-80 [although market-based sourcing rules employed by states share conceptual similarities, there are often subtle but distinct differences].) In addition, *Lutheran* has limited relevance to the fact-specific question of whether appellant's proposed use of its purchasers' states of domicile, as determined by their mailing addresses, is a reasonable approximation under the second cascading rule.

Accordingly, I would have sustained FTB's denial of appellant's refund claims for these reasons, regardless of whether OTA has jurisdiction to invalidate Regulation section 25137-14.

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Ovsep Akopchikyan
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Ovsep Akopchikyan
Administrative Law Judge

Dated: 7/27/2023