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California: Taxpayer Required to Use Mutual Fund Service Provider Sourcing Rule

The California Office of Tax Appeals or OTA recently addressed whether (1) the OTA had jurisdiction to determine if California Code of Regulations (CCR) section 25137-14 was properly promulgated, and (2) a mutual fund service provider taxpayer was required to use CCR section 25137-14 to apportion its service receipts. California Code Regulation section 25137-14 was adopted in 2007 and provides a "look-through approach" for sourcing service receipts of a mutual fund service provider. Under this approach, a mutual fund service provider selling services to regulated investment companies, including mutual funds, must assign those sales to the domicile of the funds' shareholders. In contrast, the statutory rule for sourcing service receipts is to source such receipts to the location where the taxpayer's customer (the purchaser of the services) received the benefit of the service. The taxpayer, a mutual fund service provider, first argued that CCR section 25137-14 was not adopted in accordance with the state's Administrative Procedures Act (APA). The taxpayer further asserted that the FTB failed to follow APA notice and evidentiary procedures when FTB promulgated CCR section 25136-2(g)(3), which generally provides that the alternative apportionment method for mutual fund service providers will be applicable in lieu of the state's general market-based sourcing rules for service receipts. The OTA observed that the promulgation of regulations is governed by the Office of Administrative Law, which is the sole California agency vested with the authority to determine whether a regulation of another agency was adopted in compliance with the APA. As such, the OTA concluded that it lacked jurisdiction to consider the merits of appellant's arguments that the Franchise Tax Board (FTB) failed to follow APA procedures when promulgating CCR sections 25137-14 and 25136-2.

The OTA next rejected the taxpayer's position that the look-through approach in CCR 25137-14 was improper because it conflicted with the statutory market-based sourcing rules and that the FTB was required to show clear and convincing evidence of distortion before it could require the taxpayer to use CCR section 25137-14. California's alternative apportionment statute, R&TC section 25137, allowed the FTB to require a taxpayer to use an alternative method of apportionment and the FTB had authority to promulgate alterative apportionment regulations. Once a special apportionment formula is promulgated under R&TC section 25137, it becomes the standard method, and taxpayers and the FTB are bound to follow it unless a party seeking to deviate from the alternative method establishes by clear and convincing evidence that the regulation does not fairly represent the extent of the taxpayer's activities in California and the party's proposed alternative is reasonable. The OTA further rejected the taxpayer's position that alternative apportionment was inappropriate because the receipts at issue were not "nonrecurring" or "unique" as required under R&TC 25137. While the alternative apportionment statute ordinarily applies to non-recurring situations, it can be applied when application of the statutory formula would create distortion for an industry as a whole, which was the case at hand for mutual fund service providers. The OTA next determined that the taxpayer had not provided any evidence, let alone clear and convincing evidence, demonstrating that its apportionment percentage should have been calculated using a different method.

As such, the OTA concluded that CCR section 25137-14 was the appropriate rule for assigning the taxpayer's receipts. One Administrative Law Judge concurred in the result, but noted that in his view, even if the taxpayer's receipts had been sourced under the statutory market sourcing rules, the taxpayer had not established that the purchasers of its services received the benefit in their states of domicile. The taxpayer's contracts did not indicate where the benefit of the service was received, and the taxpayer provided no evidence to reasonably approximate where purchasers received the benefit, as required under California's cascading rules for determining where the benefit of a service is received. Please contact Oksana Jaffe with questions on *Appeal of Janus Capital Group, Inc. and Subsidiaries.*