

How to Be Reasonable When Reasonably Approximating the Market: Part I

by Carley A. Roberts, Robert P. Merten III, and Malcolm A. Brudigam



Carley A. Roberts



Robert P. Merten III



Malcolm A. Brudigam

Carley A. Roberts is a partner, Robert P. Merten III is counsel, and Malcolm A. Brudigam is an associate in Pillsbury Winthrop Shaw Pittman LLP's Sacramento, California, office.

In this multipart series of SeeSALT Digest, the authors review the landscape of

market-based sourcing rules and provide an in-depth focus on states' use of reasonable approximation. Subsequent installments of the series will address practical problems in applying reasonable approximation rules and explore some recommendations on how reasonable approximation should be applied to make market-based sourcing as effective as possible.

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The U.S. and global economies have substantially transformed over time from the sale of goods toward the sale of services and intangibles, or from tangible personal property to "other than tangible personal property." Determining how to source these sales for state income tax purposes drives how much a company will pay in tax to states with a corporate income tax. While sourcing sales receipts from one state to the next is far from uniform, the market-based sourcing trend for sales of services and intangibles continues to grow. Representing a shift from the traditional cost of performance sourcing method used by many states that was focused on where the taxpayer's labor and capital were employed, market-based sourcing typically assigns receipts from sales of other than tangible personal property to the state where the taxpayer's customer receives the benefit of the service or uses the intangible. Thirty-nine states and the District of Columbia have enacted variations of such market-based sourcing legislation and/or regulations.¹

Historically, businesses operating in multiple states used a cost of performance method to apportion income for sales of other than tangible personal property. Under the original version of

¹ As of November 30, only seven states with income taxes have yet to adopt any legislative or regulatory market-based sourcing rules for sourcing sales of other than tangible personal property including Florida, Idaho, Kansas, North Dakota, Virginia, and West Virginia. New Hampshire has started the process of implementing market-based sourcing.

the Uniform Division of Income for Tax Purposes Act,² the cost of performance method assigns receipts from these sales to the state where the income-producing activity is performed. Typically, if the income-producing activity occurs in more than one state, the entire sale is assigned to the state in which a greater proportion of the income-producing activity occurs, measured by cost of performance.³ In other words, the cost of performance method requires a company to identify the activity that gives rise to the income in question and then consider its own costs associated with that activity to determine how to source the related sales receipts.

Taxpayers, taxing agencies, and practitioners frequently observed that *where* the income-producing activity occurred was sometimes difficult — if not impossible — to determine. What costs to include was not always clear, and tracing the costs often proved difficult and expensive, especially when taxpayers rarely kept such records in the ordinary course of their business.⁴ More fundamentally, the cost of performance method failed to reflect the relative contributions of the state that provided the market for the taxpayer's sales, thus subverting the sales factor's underlying purpose — that is, to reflect the market for the sale.⁵ As sales of intangibles and services grew, the cost of performance method became even less reliable. After all, UDITPA — originally drafted in 1957 —

was designed for manufacturing and mercantile businesses.⁶ This discrepancy resulted in uniform criticism. As one commentator noted: “There has been a chorus of criticism addressed to the difficulty of interpreting and complying with UDITPA’s attribution rule for service providers, and the voices from both the tax-paying and tax-collecting communities are in near (and rare) unison.”⁷

As a result, states have shifted to a market-based method for sourcing sales of services and intangibles. While the rules states have adopted vary widely, most include a cascading set of rules for determining the market location of receipts based in order of best possible evidence.

The economy's shift toward services and intangibles has also resulted in states placing greater emphasis on the sales factor. UDITPA's original apportionment formula was based on three equally weighted factors: the taxpayer's property, payroll, and sales in the taxing state. Now a single-factor formula dedicated exclusively to sales, that gives no weight to a taxpayer's in-state property or payroll, has become the new normal as states are finding that sales better reflect a taxpayer's presence and activity in their state.⁸ As such, how market-based sourcing rules are applied has a significant effect on the apportionment of taxable income.

While the shift away from cost of performance sourcing was intended to simplify apportionment-of-income rules, the application of new market-based sourcing rules has been anything but simple. In fact, some of the problems with cost of performance sourcing that market-based sourcing was meant to eliminate merely evolved into new versions of the same problems. For instance, just as taxpayers experienced recordkeeping difficulties relating to tracing costs of performance, similar recordkeeping problems exist relating to a taxpayer's ability to track where

² Issued in 1957 by the Uniform Law Commission, UDITPA provides a model law for allocating and apportioning income among the states. In the 1960s, threat of federal intervention made uniformity among the states a priority, and in furtherance of that goal many states adopted UDITPA. Over the course of the last 60 years, uniformity has become less of a priority and many states have adopted variances to the original UDITPA, most notably to place a higher emphasis on the sales factor for apportionment purposes, and the trend to move from cost of performance sourcing rules to market-based sourcing rules.

³ UDITPA, Art. IV, section 17. Generally, states that use this method apply either the preponderance (all or nothing) or proportionate (pro rata) method.

⁴ See, e.g., Jerome R. Hellerstein, Walter Hellerstein, and John A. Swain, *State Taxation*, para. 9.18[3][a].

⁵ Walter Hellerstein, “The Transformation of the State Corporate Income Tax Into a Market-Based Levy,” *J. Multistate Tax'n* 14 (June 2019). An example of this failure is when services are performed in one state but delivered to all states where the taxpayer's customers conduct business. Under the cost of performance method's all-or-nothing approach, the sale is assigned to the single state where the services are performed, ignoring the actual market states that are deriving value from the services.

⁶ Further, the UDITPA as originally drafted excluded sales generated from rendering of personal services altogether. Swain, “Reforming the State Corporate Income Tax: A Market State Approach to the Sourcing of Service Receipts,” 83 *Tul. L. Rev.* 285, 300 (2008).

⁷ *Id.* at 303.

⁸ UDITPA originally included the three-factor apportionment formula consisting of equally weighted sales, payroll, and property factors. In the early 1990s, states began adopting a four-factor formula, with double-weighted sales, and that trend soon gave way in the 2000s to a single-factor sales formula.

its customers use intangibles or receive the benefit of services purchased from the taxpayer. Additionally, some states do not define key terms — such as “received” or “delivered” or “market” — leaving regulators and taxpayers without meaningful guidance. Other states have not issued any clarifying regulations or issued administrative guidance.

Market-based sourcing has also paved the way for entirely new and in some ways more complex problems when it comes to applying the amorphous “reasonable approximation” rule. When direct evidence⁹ identifying the taxpayer’s market is not readily available, most states with market-based sourcing rules next attempt to look for a “reasonable approximation” of the market to source sales of services and intangible property. For example, California’s market-based sourcing rules for sales of services rely heavily on reasonable approximation to determine the location where a service’s benefit is received, including a focus on population for approximating the market.¹⁰ While a flexible standard like reasonable approximation is sound in principle and theoretically appropriate (if not necessary) to effect the goals of switching to a market-based sourcing method, its application has proven problematic.

This article is the first in a series that reviews the landscape of market-based sourcing rules, provides an in-depth focus on states’ use of reasonable approximation, and provides recommendations on how reasonable approximation should be applied to make market-based sourcing as effective as possible. In Part 1 of the series, we explore in greater detail the market-based sourcing method, explain the importance of reasonable approximation, and look at some representative and influential state approaches to reasonable approximation rules. Later in the series we will evaluate the application of reasonable approximation rules in various states, address practical problems facing taxpayers and tax agencies in applying reasonable approximation rules, and propose solutions for these problems so reasonable

approximation rules for market-based sourcing can be properly applied as effectively as possible.

Market-Based Sourcing Method

Implementing the traditional cost of performance sourcing method proved to be far from perfect and ultimately gave rise to today’s market-based sourcing rule variants. The shift to market-based sourcing was intended to capture the true purpose of the sales factor by reflecting the contribution of the market to the taxpayer’s income. This was easier said than done. In many ways, as states improperly apply reasonable approximation rules that were meant to cure the ills of yonder years, the cure has proven to be just as bad or worse than the original disease.

From the outset, defining market-based sourcing is somewhat problematic because states have not adopted uniform market-based sourcing rules. Generally, market-based sourcing is when income is attributed to states based on the taxpayer’s market for their sales without regard to where the taxpayer’s capital or labor are located.¹¹ By assigning sales based on the taxpayer’s market, the sales factor is intended to better reflect a taxpayer’s activity and presence in a way not captured by the payroll and property factors. States use various approaches to determining the taxpayer’s market for services and intangibles. For example, states may define the market for services as one or a combination of the following:

- where the service is received;¹²
- where the benefit of the service is received;¹³

¹¹ Hellerstein, *supra* note 5.

¹² See, e.g., 35 Ill. Comp. Stat. section 5/304(a)(3)(C-5)(iv) (“Sales of services are in this State if the services are received in this State”).

¹³ See, e.g., 18 CCR section 25136-2(c) (“Sales from services are assigned to this state to the extent the customer of the taxpayer receives the benefit of the service in this state”); and Ariz. Rev. Stat. section 43-1147(E)(2) (“‘Market sales’ means the total sales from services and sales of intangibles, as defined in paragraph 3, subdivision (a) of this subsection, for which the purchaser received the benefit of the service or intangibles in this state.”).

⁹ For example, the contract between the taxpayer and the customer identifying the location of the market.

¹⁰ 18 Cal. Code Regs. (CCR) section 25136-2(b)(7).

- where the service is delivered;¹⁴
- where the service is performed;¹⁵
- where the service is used;¹⁶ or
- where the customer is located.¹⁷

Each of these examples for identifying the market for services contains additional variations depending on the type of customer (that is, business entity or individual), the nature of the service, the appropriate method for approximating the market location, and whether the seller is taxable in the state where the service is received.

Similarly, states may define the market for intangibles in whole or in part as one or a combination of the following:

- location where the property is used;¹⁸
- customer's commercial domicile;¹⁹
- owner's commercial domicile (taxable situs of intangible);²⁰ or
- location of primary use.²¹

Like the examples for sales of services, each of these examples for identifying the market for

intangibles contains additional variations depending on the type of intangible (for example, marketing, non-marketing, and manufacturing intangibles such as trademarks and patents; software; digital goods; intangibles that resemble goods or services; or a mix of intangibles), whether there has been a complete or partial transfer of the intangible, the appropriate method for approximating the market location, and whether the seller is taxable in the state where the intangible is used.

Most states use a cascading set of sourcing rules — as opposed to one rule covering all circumstances — for determining the market location of receipts based in order of best possible evidence. Our discussion focuses on California, New York, and Massachusetts. The rules in these states, along with the Multistate Tax Commission's model rules (which relied on the Massachusetts rules as the starting point), tend to be the most influential on market-based sourcing because their respective promulgations, and subsequent amendments, were thorough and included an extensive amount of tax community involvement.²²

California created sets of cascading rules to source different types of sales. The rules were established, and are applied, in order of the evidence deemed best to identify the market where a particular type of sale should be sourced. This cascading rules approach — that is, systematically applying each subsection rule in order — ensures the taxpayer and tax agency can apply the rules uniformly and the best possible evidence is always used to identify the market in each instance.²³

Take for example California's cascading rules for sales of services to business entities (as opposed to individual customers, which sales have their own set of cascading rules). California statutorily assigns sales of services to the state where the customer receives the benefit of the services.²⁴ When the customer is a business entity, California's rules require the taxpayer and tax agency first look to the sales contract or the

¹⁴ See, e.g., Mass. Gen. Laws ch. 63, section 38(f) ("The corporation's market for a sale is in the commonwealth and the sale is thus assigned to the commonwealth for the purpose of this section in the case of sale of a service, if and to the extent the service is delivered to a location in the commonwealth."); and Ala. Admin. Code r. 810-27-1-.17(2) ("The taxpayer's market for a sale is in this state if and to the extent the service is delivered to a location in this state.").

¹⁵ See, e.g., Miss. Regs. section 35.III.08.06.402.09(3)(f)(ii) ("Gross receipts for the performance of personal services are attributable to this state to the extent such services are performed in this state.").

¹⁶ See, e.g., Conn. Gen. Stat. section 12-218(b)(2) ("The taxpayer's market for the services is in this state if and to the extent the service is used at a location in this state.").

¹⁷ N.Y. Tax Law section 210-A(10)(a) ("Receipts from services not addressed in subdivisions one through nine of this section and other business receipts not addressed in such subdivisions shall be included in the numerator of the apportionment fraction if the location of the customer is within the state.").

¹⁸ Almost all jurisdictions with market-based sourcing rules define the market for at least some intangible property sales as the location where the property is used. See, e.g., Cal. Rev. & Tax. Code section 25136-2(a)(2) ("Sales from intangible property are in this state to the extent the property is used in this state.").

¹⁹ See, e.g., 1 Colo. Code Regs. section 201-2:39-22-303.6-11(3) ("In the case of a license of a production intangible to a party, other than a related party where the location of actual use is unknown, it is presumed that the use of the intangible property takes place in the state of the licensee's commercial domicile (where the licensee is a business).").

²⁰ See, e.g., N.J. Admin. Code section 18:7-8.12(e) ("Intangible income not apportioned by other provisions of these rules is included in the numerator of the receipts fraction where the taxable situs of the intangible is in this State. The taxable situs of an intangible is the commercial domicile of the owner or creditor. . . .").

²¹ See, e.g., N.Y. Tax Law section 210-A(4)(c)(1) (providing that digital product sales are sourced to "the customer's primary use location of the digital product").

²² New York's rules are still in draft.

²³ 18 CCR section 25136-2(c)(2).

²⁴ Cal. Rev. & Tax. Code section 25136(a)(1).

taxpayer's books and records for direct evidence of the location where the customer receives the benefit of the service rendered.²⁵ If those records do not indicate where the benefit was received, or fail to rule out the state as the market for these sales, then the taxpayer and tax agency are required to move to the next rule: reasonably approximating the location where the customer received the benefit of the taxpayer's service.²⁶ To do so, the taxpayer and taxing agency are required to use all available sources of information (other than the sales contract and taxpayer's books and records used in the previous rule) to identify the location where the benefit was received.²⁷ If the location cannot be reasonably approximated, then the next rule provides that the sourcing location is presumed to be where the customer placed its order.²⁸ If these three rules do not yield an answer as to where the benefit is received, then the final rule requires that the sales be sourced to California if the customer's billing address is in the state.²⁹

The intentional ordering of cascading rules was recognized by the California Franchise Tax Board when promulgating its original market-based sourcing regulation.³⁰ In the FTB staff's official request to the agency's three-member board seeking approval to adopt the new rules, the written statement provided³¹:

After the third interested parties meeting, staff further revised the proposed language to provide that the cascading rules appear in order of what is the best available evidence to determine where the benefit of the services is received or the location of the use of the intangible property, 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. There are numerous definitions, examples and several special rules.

Massachusetts also uses a cascading rules approach, and model rules based on its market-based sourcing rules have in turn been adopted by other states.³² The primary sourcing rules assign receipts from the sale of a service to the location it is delivered³³ and assign receipts from a license or lease of intangibles to the location the intangible property is used.³⁴ Like California, Massachusetts has a hierarchy of rules to source the sale of a service or intangible. The Massachusetts market-based sourcing rules also must be "appl[ie]d sequentially in a hierarchy."³⁵ The taxpayer "must in good faith and with reasonable effort" attempt to apply each cascading rule in order.³⁶

For example, consider the Massachusetts cascading rules for sales of electronically delivered services to a business customer. According to the first rule, the taxpayer and tax agency must assign a sale to the location where the service is received by the customer, as indicated by direct evidence.³⁷ If it cannot be determined by direct evidence where the customer received the service, then any and all available information must be used to reasonably

²⁵ 18 CCR section 25136-2(c)(2)(A).

²⁶ 18 CCR section 25136-2(c)(2)(B).

²⁷ *Id.*

²⁸ 18 CCR section 25136-2(c)(2)(C).

²⁹ 18 CCR section 25136-2(c)(2)(D).

³⁰ 18 CCR section 25136-2.

³¹ FTB Meeting, Dec. 1, 2011, Agenda Item 3.c., Regulations — Board Approval/Adoption — Staff Report and Board Action, Proposed Reg. 25136-2 (Sales Other Than Sales of Tangible Personal Property), "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."

³² In July 2014 the MTC Executive Committee approved the section 17 Model Market-Sourcing Regulations project. The working group for this project drafted model market-sourcing regulations and implemented changes to the sourcing of sales other than of tangible property under UDITPA. The working group used the Massachusetts market-based sourcing regulations as a starting point, adopting the regulations nearly verbatim. Since the MTC's adoption of the Massachusetts-based regulations, multiple states have adopted the MTC's model regulations, including its reasonable approximation rule. *See, e.g.*, Colo. Code Regs. section 39-22-303.6-10(3)(b)(ii)(B)(II); Ky. Admin. Regs. 16:270 (Section 5)(9)(a)(2)(b); Mont. Admin. R. 42.26.248(3)(b)(ii)(B)(II); Or. Admin. R. 150-314-0435(4)(c)(B)(ii)(II)(II-b); R.I. Reg. CT 15-04 (Rule 8)(i)(8)(B)(ii)(a)(II)(B)(ii); and Tenn. Comp. R. & Regs. 1320-06-01-42(4)(c)(2)(ii)(II)(II).

³³ 830 Mass. Code Regs. section 63.38.1(9)(d)(4)(a).

³⁴ 830 Mass. Code Regs. section 63.38.1(9)(d)(5)(a)(i).

³⁵ 830 Mass. Code Regs. section 63.38.1(9)(d)(1)(d)(ii).

³⁶ *Id.*

³⁷ 830 Mass. Code Regs. section 63.38.1(9)(d)(4)(c)(ii)(B)(2)(a).

approximate where the customer received the service.³⁸ When the taxpayer and taxing agency cannot reasonably approximate where the service was received, then the steps in the “secondary rule of reasonable approximation” must be applied, in the following order (unless special circumstances apply, which are addressed next): the location where the customer principally manages the sales contract, the location where the customer placed the order, and the customer’s billing address.³⁹

When applying this secondary rule of reasonable approximation, there are two special circumstances to remember. First, if the taxpayer derives more than 5 percent of its sales from a given customer, the taxpayer is required to identify the state in which the contract of sales is principally managed by the customer (and thus cannot look to where the order was placed or the customer’s billing address).⁴⁰ Second, an optional safe harbor rule to use a business customer’s billing address is available only to taxpayers that, in the year at issue, (1) engage in substantially similar service transactions with more than 250 customers, whether business or individual, and (2) do not derive more than 5 percent of their sales of services from that customer.⁴¹

As a final representative example, New York’s market-based sourcing rules⁴² for services and intangibles also contain cascading structures. Under New York statute, the sale of a service is primarily sourced based on where the customer receives the benefit of that service and the sale of intangible property is primarily sourced⁴³ to where the property is used

(although various other sourcing variations exist in New York’s market-based sourcing rules, such as looking to the place of “primary use” of digital goods, where the customer receives the service or intangible property, where the customer is located, and how similar sales were sourced in the current or previous years).⁴⁴ As in California and Massachusetts, New York’s cascading rules must be applied systematically and in their specified order: “The taxpayer must exercise due diligence under each method described . . . before rejecting it and proceeding to the next method in the hierarchy, and must base its determination on information known to the taxpayer or information that would be known to the taxpayer upon reasonable inquiry.”⁴⁵

For sake of comparison to the California and Massachusetts approaches to sourcing sales of services to business customers, we also look at New York’s draft rules for this sale type. New York first requires the taxpayer and taxing agency to look at the taxpayer’s books and records for direct evidence of where the service’s benefit was received.⁴⁶ If the taxpayer’s books and records are inconclusive, the next rule requires the taxpayer and taxing agency to reasonably approximate where the customer received the benefit of the taxpayer’s service.⁴⁷ New York’s reasonable approximation rules in the current draft of the regulations have two components. First, the taxpayer and taxing agency are required to try to reasonably approximate where the benefit was received based on available information specific to the customer (including books and records, reasonable inquiries to the customer, and publicly available information about the customer).⁴⁸ If this information is lacking for at least a “substantial portion” of the receipts, then the taxpayer and taxing agency are permitted to turn to “general information” such as

³⁸ 830 Mass. Code Regs. section 63.38.1(9)(d)(4)(c)(ii)(B)(2)(b).

³⁹ 830 Mass. Code Regs. section 63.38.1(9)(d)(4)(c)(ii)(B)(2)(c).

⁴⁰ *Id.*

⁴¹ 830 Mass. Code Regs. section 63.38.1(9)(d)(4)(c)(ii)(B)(2)(d).

⁴² Although market-based sourcing was legislatively adopted in 2015 (N.Y. Tax Law section 210-A) the Department of Taxation and Finance is still promulgating interpretive regulations. The agency’s most recent draft is dated July 3, 2019. The change to market-based sourcing was part of a larger corporate income tax reform in New York. *See* New York Department of Taxation and Finance, Corporate Tax Reform Draft Regulations.

⁴³ Like Massachusetts, New York provides several specific market-based sourcing rules to apply to enumerated circumstances (*e.g.*, receipts from sales of advertising).

⁴⁴ *See* N.Y. Tax Law section 210-A(10); and N.Y. Draft Regulation section 4-2.18 (July 3, 2019).

⁴⁵ N.Y. Tax Law sections 210-A(4)(b), 210-A(10)(a) (providing same language); *see also* 210-A(5)(e) (providing similar language).

⁴⁶ N.Y. Draft Reg. sections 4-2.18(c)(2)(ii), 4-2.3(c)(2)(ii) (July 3, 2019).

⁴⁷ N.Y. Draft Reg. sections 4-2.18(c)(3)-(4), 4-2.3(c)(3)-(4) (July 3, 2019).

⁴⁸ N.Y. Draft Reg. sections 4-2.18(c)(3)(ii), 4-2.3(c)(3)(ii) (July 3, 2019).

population statistics.⁴⁹ If the taxpayer and tax agency exhaust these rules without success, the following order of remaining cascading rules must be used:

- where the service is delivered as indicated by where the contract of sale is managed by the customer;⁵⁰
- the customer's billing address;⁵¹
- the apportionment fraction for the preceding tax year for the same receipts;⁵² and
- the apportionment fraction for the current tax year for all receipts from sales of other than tangible personal property that can be sourced using New York's prescribed rules.⁵³

In all these examples, both taxpayers and tax agencies alike are required to apply one cascading market-based sourcing rule after another, systematically and in the correct order from top to bottom. Neither taxpayers nor taxing agencies can cherry-pick the rule they prefer. The order of the rules is not a coincidence. The rules are intentionally set to run from the best possible evidence (that is, typically a sales contract or related books and records that expressly memorialize a market) to the least reliable evidence, or catchall last resort (that is frequently the customer's billing address).⁵⁴

Using 'Reasonable Approximation' to Determine the Market

Taxpayers typically do not track in their books and records how or where their services or intangible property will be used by their customers after the sale, and it would be burdensome and costly to do so solely for easier application of market-based sourcing rules.

⁴⁹ N.Y. Draft Reg. sections 4-2.18(c)(4), 4-2.3(c)(4) (July 3, 2019).

⁵⁰ N.Y. Draft Reg. sections 4-2.18(d)(2), 4-2.3(d)(2) (July 3, 2019).

⁵¹ *Id.*

⁵² N.Y. Draft Reg. sections 4-2.18(e), 4-2.3(e) (July 3, 2019).

⁵³ N.Y. Draft Reg. sections 4-2.18(f), 4-2.3(f) (July 3, 2019).

⁵⁴ Although use of a business customer's billing address is frequently and rightfully considered the least reliable option for apportionment sourcing purposes, using this rule makes sense in some circumstances, such as from a compliance burden perspective when taxpayers have a high volume of customers (for example, broker-dealers).

Because of this difficulty, most market-based sourcing approaches include reasonable approximation rules. These rules require taxpayers and tax agencies to review all available information to reasonably approximate the market where the sale should be sourced, when direct evidence identifying the market is unavailable. Accordingly, an effective reasonable approximation rule will provide taxpayers and tax agencies with broad flexibility to look at and use all available information to reasonably approximate the location where sales of services and intangibles should be sourced.

States that have implemented reasonable approximation rules have generally kept the rules intentionally broad to apply on a case-by-case basis. After all, legislatures and tax authorities cannot conceive of every possible situation in which a taxpayer generates sales, and the fact patterns have many variations. As a result, for a state's market-based sourcing structure to be successful, reasonable approximation rules must be flexible. Put another way, it is the broadness of the reasonable approximation rule that makes it useful. To be clear, the broad and flexible nature of a reasonable approximate rule is not a symptom of the rule being underdeveloped or in need of specific definitions later. Instead, it is reflective of the need to have a rule that can be applied to as many circumstances as possible when more rigid rules, such as looking straight to a customer's billing address, fall short of capturing the taxpayer's actual market for its sales of other than tangible personal property.

California's Approach

California's reasonable approximation rule is the second step in the state's rule hierarchies for sourcing sales of services to business entities and sales of intangible property.⁵⁵ The rule is applied after a review of taxpayer records and books are exhausted, but before less reliable evidence — such as the location where the order was placed or the taxpayer's billing address — is used. The reasonable approximation rule was drafted for case-by-case application, hence the ability of a taxpayer and the tax agency to rely on "all sources

⁵⁵ 18 CCR section 25136-2(c)(2)(B) and (d)(1)(B).

of information other than the terms of the contract and the taxpayer's books and records kept in the normal course of business."⁵⁶ The rule's flexibility is further reflected in the broad language used: The location where the service's benefit is received or where the intangible property is used must be "determined in a manner that is consistent with the activities of the customer to the extent such information is available."⁵⁷ In other words, the reasonable approximation rule is meant for wide-ranging application, with the only limitations being the type of evidence used in the cascading rules above and below it in the market-based sourcing rules hierarchy.

Although a broad range of evidence can be used in applying California's reasonable approximation rule, the rule expressly addresses use of population data.⁵⁸ In fact, population is the only specifically identified method in California's general definition of reasonable approximation.⁵⁹ The definition provides that U.S. population should be used as determined by the most recent U.S. census data, and if the taxpayer can show "the benefit of the service is being substantially received or intangible property is being materially used outside the U.S., then the populations of those other countries . . . shall be added to the U.S. population."⁶⁰

California's regulation also provides the following example illustrating how population data can be used to reasonably approximate the taxpayer's market for its sales (here, sales of intangible property):

Moniker Corp enters into a license agreement with Sports Corp where Sports Corp is granted the right to use trademarks owned by Moniker Corp to brand sports equipment that is to be manufactured by Sports Corp or an unrelated entity, and to sell the manufactured product to unrelated companies that make retail sales in a specified geographic region. Although

the trademarks in question will be affixed to the tangible property to be manufactured, the license agreement confers a license of a marketing intangible. Neither the contract between the taxpayer and the licensee nor the taxpayer's books and records provide a method for determination of this state's customers of equipment manufactured with Moniker Corp's trademarks. The component of the licensing fee that constitutes sales of Moniker Corp in this state is reasonably approximated by multiplying the amount of the fee by the percentage of this state's population over the total population in the specified geographic region in which the retail sales are made.⁶¹

In this example, after first reviewing the contract with the customer and the taxpayer's books and records in an unsuccessful attempt to determine where the intangible property (that is, the trademarks) is used by the customer, the next rule that must be applied is the reasonable approximation rule. By using population data, the locations where the taxpayer's trademarks are ultimately used by the customer can be reasonably approximated.

Massachusetts's Approach

The reasonable approximation rules in Massachusetts apply to various enumerated sales of services and intangibles, and in most respects operate similarly to California's.⁶² Like California, Massachusetts requires use of reasonable approximation when direct evidence available to the taxpayer (for example, the taxpayer's books and records) does not definitively determine the market for the

⁵⁶ 18 CCR section 25136-2(b)(7).

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ 18 CCR section 25136-2(d)(2)(D)(2).

⁶² See 830 Mass. Code Regs. section 63.38.1(9)(d)(4)-(7) (providing reasonable approximation rules for sales of, among other services and intangibles, personal or professional services delivered to, through, or on behalf of either individual or business customers, by physical means or electronic transmission; marketing intangibles, production intangibles, mixed intangibles, and intangibles that resemble goods or services; software transactions; digital goods or services; and telecommunications or ancillary services).

taxpayer's sales of other than tangible personal property.⁶³ Massachusetts, like California, requires that its rules be applied on a case-by-case basis, stating that "a method of assignment that is reasonable for one taxpayer may not necessarily be reasonable for another taxpayer, depending upon the applicable facts."⁶⁴ Additionally, applications of the "method of approximation, where applicable, must reflect an attempt to obtain the most accurate assignment of sales."⁶⁵

Massachusetts not only provides a broad reasonable approximation rule like California's, calling for consideration of any and all available information to approximate the market for a sale of services or intangibles, but provides various specific "rules of reasonable approximation" applicable to enumerated types of sales (for example, use of population to source sales from licenses of marketing intangibles).⁶⁶ If a specific rule of approximation applies to a taxpayer's circumstances, that rule must be used; otherwise, the broader rule of approximation must be used.⁶⁷

New York's Approach

New York's approach to reasonable approximation in its draft rules⁶⁸ is more nuanced than the two other states' approaches, but nevertheless remains broad and flexible in nature. When direct evidence fails to identify where to source a sale of other than tangible property, or when identifying where to source the sale "would require the taxpayer to expend undue effort and expense beyond the standard amount of due diligence as required by this section," and the taxpayer has "sufficient information to reasonably approximate the location or locations," then reasonable approximation must be applied, under the draft rules.⁶⁹

The rules first require the taxpayer and tax agency to try to reasonably approximate based on customer information. This requires examining "all available information in [the taxpayer's] books and records, including information obtained upon reasonable inquiries where required, and information publicly available about the location or locations where its actual customers receive the benefit of the service or other business activity" or "primarily use the digital product or service."⁷⁰ The draft further provides that when reasonably approximating based on customer information, the taxpayer "must use a method that is intended to approximate where the customer derives value from the service or other business activity" or "where the customer primarily uses the digital product or digital services."⁷¹

Within its customer information reasonable approximation rules, the draft regulation also provides for a "sourced receipts method." In circumstances when a taxpayer can determine the location where a substantial portion of similar receipts are sourced — but not all of the receipts

⁶³ 830 Mass. Code Regs. section 63.38.1(9)(d).

⁶⁴ 830 Mass. Code Regs. section 63.38.1(9)(d)(1)(d)(iii).

⁶⁵ *Id.*

⁶⁶ See 830 Mass. Code Regs. sections 63.38.1(9)(d)(1)(e); and 63.38.1(9)(d)(5)(b) (providing a rule of reasonable approximation using population to source sales from licenses of marketing intangibles); 63.38.1(9)(d)(5)(f) (Example 3) (including a variation of the same marketing intangibles example with use of population to reasonably approximate the market as addressed above from California's market-based sourcing regulation). Massachusetts also provides a rule for "approximation based upon known sales" specific to sourcing sales of services. When a taxpayer can:

ascertain the state or states of assignment of a substantial portion of its sales of substantially similar services ("assigned sales") but not all of such sales, and the taxpayer reasonably believes, based on all available information, that the geographic distribution of some or all of the remainder of such sales generally tracks that of the assigned sales, it shall include those sales which it believes tracks the geographic distribution of the assigned sales in its sales factor in the same proportion as its assigned sales.

830 Mass. Code Regs. section 63.38.1(9)(d)(1)(e)(ii).

⁶⁷ 830 Mass. Code Regs. section 63.38.1(9)(d)(1)(e)(i).

⁶⁸ In the current draft, New York is proposing new sections 4-2.3 (Receipts From the Sale of, License to Use, and Granting of Remote Access to Digital Products) and 4.218 (Receipts From Other Services and Other Business Activities) of the New York State Business Corporation Franchise Tax Regulations. See New York Department of Taxation and Finance, Corporate Tax Reform Draft Regulations.

⁶⁹ N.Y. Draft Reg. sections 4-2.18(c)(3)(i), 4-2.3(c)(3)(i) (July 3, 2019).

⁷⁰ N.Y. Draft Reg. sections 4-2.18(c)(3)(ii)(a), 4-2.3(c)(3)(ii)(a) (July 3, 2019).

⁷¹ N.Y. Draft Reg. sections 4-2.18(c)(3)(ii)(b), 4-2.3(c)(3)(ii)(b) (July 3, 2019).

— and the taxpayer reasonably believes the geographic distribution of the remainder is substantially similar to the sourced receipts, then the taxpayer “may source such receipts in the same proportion as its sourced receipts.”⁷²

If reasonable approximation using customer information proves unsuccessful, reasonable approximation based on general information is required under the draft regulation, including “statistical information based on the general population or a subset of the general population (such as a specific demographic) of the entire country or a region of the country that reasonably approximates the population of customers who receive the benefit of the service or other business activity” or “primarily use the digital product or digital service.”⁷³

Conclusion

In this first installment of our reasonable approximation series, we have looked at the foundational background, context, and reasoning behind the nationwide rise of states adopting market-based sourcing to replace cost of performance sourcing for apportioning sales of services and intangible property for state income tax purposes. We have discussed the importance and basic principles of, the policy considerations underlying, and representative state approaches to, market-based sourcing states’ widespread adoption of reasonable approximation rules to identify the taxpayer’s market for these sales if direct evidence identifying the market proves unsuccessful.

Notwithstanding New York’s more detailed reasonable approximation regulations, all three representative states’ approaches to reasonable approximation are demonstratively flexible and allow a broad amount of information to be used to support the selected reasonable approximation method for the sales in question. In future installments we will explore the extent to which a taxing authority is required to accept the taxpayer’s reasonable approximation method and whether the taxing authority bears any type of

burden or has a due diligence requirement to establish the taxpayer’s method is unreasonable, is improperly applied, or otherwise is not representative of the taxpayer’s market.

Later in this series we will more closely examine the important interplay and distinctions between reasonable approximation rules and other rules for determining a taxpayer’s market in states’ market-based sourcing approaches, such as looking to the customer’s billing address. We will look at how various states are applying reasonable approximation rules in practice, including identifying problems we are seeing with the application and proposing corresponding solutions to these problems. It is our firm belief that reasonably applying reasonable approximation rules is necessary if taxpayers and tax agencies are ever to realize the lofty hopes of replacing cost of performance with market-based sourcing, as opposed to merely jumping out of a frying pan and into a fire. ■

⁷²N.Y. Draft Reg. sections 4-2.18(c)(3)(ii)(c), 4.2.3(c)(3)(ii)(c) (July 3, 2019).

⁷³N.Y. Draft Reg. sections 4-2.18(c)(4)(i)-(ii) (July 3, 2019).