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Chief Counsel Ruling 2012-01

Subject: Chief Counsel Ruling Request for **********

Dear Mr. *******:

You requested by letter dated July 29, 2011, a Chief Counsel Ruling concerning the application of Revenue and Taxation Code ("RTC") sections 25120 and 25137 to ****** **********("Company"). Specifically, you requested a Chief Counsel Ruling advising whether the standard apportionment formula, contained in RTC sections 25120 through 25136, would result in the entire sales price received from certain trades being included in the sales factors of ********** pursuant to RTC section 25120(f) and, if so, whether the effect of this inclusion on intrastate apportionment would allow Company to use an alternative method of apportionment under the authority of RTC section 25137.

FACTS

Company consists of ********** which is the holding company for **** **********, ****** and various other non-banking subsidiaries. ***** is a national banking association, as provided by the National Bank Act,[1] and conducts business in California, Nevada, and New York, among other states.

*****, a wholly-owned subsidiary of *****, is a registered broker-dealer and a member of the National Association of Securities Dealers. ***** is not a financial corporation as defined under California Code of Regulations, title 18, section 23183 and does not generate gross business receipts from banking and financial business activity pursuant to RTC section 25128. ***** engages primarily in two types of transactions:

1. Principal Trades — ***** buys and sells securities from the Company's own account and generates gain or loss on the sale of the securities; and

2. Agency Trades — ***** buys and sells securities to third parties on behalf of its customers and collects a fee or commission for each transaction.

Pursuant to RTC section 25136, the greater cost of performance of ***** transactions

[1] 12 USCS § 21 et seq.

occurred in California; therefore, receipts from Principal Trades and Agency Trades are included in ***** California sales factor numerator and denominator. Historically, ***** included net gains (not less than zero) from Principal Trades, interest and dividends from securities held for sale, and commissions generated from Agency Trades in the California sales factor.

With ***** sales factor computed on this basis, Company's California sales factors for taxable years ended ("TYE") 12/31/2005 through 12/31/2009 averaged 93.66 percent. If, for example, ***** includes the entire amount received from Principal Trades (i.e., net gain plus return of capital) in its California sales factors, Company's California sales factors for the TYE 12/31/2005 through 12/31/2009 would increase to an average of 97.66 percent (a change of 4 percent and an increase in the factor of approximately 4.3 percent).[2]

ISSUES

1. Under the standard method of apportionment, should ***** include the entire sales price received from Principal Trades in its sales factors, including return of capital?

2. If return of capital is included in ***** sales factors under standard method apportionment, does this lead to apportionment that, for purposes of RTC section 25137, does not fairly represent the extent of the unitary business' California business activities because it effects the intrastate apportionment between ***** and the financial corporation members of the combined reporting group?

HOLDINGS

1. Under the general rules of RTC section 25120(f), ***** would include the entire sales price received from Principal Trades in its sales factors, including return of capital.

2. Intrastate apportionment is not a proper subject for analysis under RTC section 25137. Therefore, the change in intrastate apportionment by including gross receipts from Principal Trades does not, by itself, establish distortion adequate to apply the provisions of RTC section 25137.

LAW AND ANALYSIS

Standard Apportionment

RTC section 25120(f)(1) provides that for taxable years beginning on or after January 1, 2011, sales, for sales factor purposes, is defined as all gross receipts not allocated under RTC sections 25123 through 25127. RTC section 25120(f)(2)(K) provides gross receipts exclude "[a]mounts received from transactions in intangible assets held in

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[2] Company's average combined California apportionment factor for TYE 12/31/2005 through 12/31/2009 averaged 93.6820 percent. If ***** included the entire amount received from Principal Trades in its California sales factors, Company's combined California apportionment factor for TYE 12/31/2005 through 12/31/2009 would increase to an average of 95.6767 percent.

connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets." However, RTC section 25120(f)(2)(K) goes on to state that a "taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function, such as a registered broker-dealer, is not performing a treasury function, for purposes of this subparagraph, with respect to income so produced." Hence, upon sale of a marketable security, broker-dealers may include the entire sales price in the sales factor, including return of capital, unless such inclusion gives rise to apportionment that unfairly represents the extent of a taxpayer's activity in California such that the Franchise Tax Board requires an alternative formula under the authority of RTC section 25137.[3]

Here, ***** engages in Principal Trades but only includes the net gain or loss from the disposition of these securities. Under RTC section 25120(f)(2)(K), *****, a registered broker-dealer, may include the entire amount received from the sale, including the return of capital, in the sales factor under the standard apportionment formula pursuant to RTC sections 25120 and 25134.

Intrastate Apportionment and RTC Section 25137

RTC section 25137 provides that an alternate apportionment method may be used if the standard method does not fairly represent the extent of the taxpayer's business *in the state*. In contrast, intrastate apportionment is not part of the Uniform Division of Income for Tax Purposes Act (UDITPA) (codified in RTC sections 25120 through 25139), but rather is a method to determine the individual California tax liabilities of the taxpayer members of a combined reporting group. The applicable rules for intrastate apportionment are set forth in California Code of Regulations, title 18 ("Regulation"), 25106.5. In general, combined California business income is divided among taxpayer members having activities in California in accordance with the ratio that the California factors of each taxpayer member bears to the total California factors of the group. The specific steps to arrive at each taxpayer member's California business income are set forth in Regulation section 25106.5(c)(7).

It is well established that RTC section 25137 relief is limited to correcting unfair reflections of activity resulting from the application of the standard allocation and apportionment provisions of UDITPA. (*Appeal of CTI Holdings, Inc*, 96-SBE-003, Feb. 22, 1996.)

Furthermore, RTC section 25137 by its terms may be invoked only when the standard

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[3] Franchise Tax Board takes no position in this Chief Counsel Ruling regarding the application of RTC section 25137 to the facts set forth herein. Chief Counsel Rulings are not an appropriate venue for the analysis of whether or not RTC section 25137 applies in a specific fact pattern. RTC section 25137 and the regulations thereunder provide a separate mechanism whereby a taxpayer may request, or Franchise Tax Board may impose, an alternative apportionment methodology. The determination of the staff of Franchise Tax Board may be reviewed by the three-member Franchise Tax Board itself as set forth in the regulations promulgated under the statute.

apportionment formula does not fairly represent the extent of a taxpayer's activities *in this state*. In other words, RTC section 25137 requires a comparison of a taxpayer's activity in California to the California activities reflected in the apportionment formula. In contrast, intrastate apportionment involves the assignment of California source apportioned income amongst the California taxpayer members of a unitary group. Income is assigned to the California taxpayer members according to the relative weight of each member's California factors. Thus, intrastate apportionment is not concerned with in-state versus out-of-state activities or the geographic sourcing of income; it is concerned with the relative weight of the California taxpayer's in-state activities. Therefore, intrastate apportionment is not a proper subject for analysis under RTC section 25137.

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer for future years[4] and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the Revenue and Taxation Code. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

Shail Shah
Tax Counsel

[4] Taxable years ending on or after 12/31/2011.