Discussion Topic

Apportionment of Income for Combined Reporting Groups with Financial and Non-Financial Members

The Issue:

When unitary combination requires financial entities to be included in a combined reporting group with general corporations, issues arise as to the proper apportionment rules to be applied in order to properly apportion the business income of the group. The Franchise Tax Board has recognized these issues for a long time and has attempted to deal with them in various ways over the years. In 1974 the FTB issued Legal Ruling 370, which addressed the combination of general and financial corporations. The Ruling sets forth a set of rules for combination, and at the end provided:

> It is recognized that the combination of general and financial corporations represents a change in the administrative practice of the department. It is further recognized that the activities of the business community are dynamic and that new forms of organization and new transactional practices and techniques are emerging frequently. The rules set forth above may not in all cases result in a fair representation of the extent of a taxpayer's business activity in this state. Problems of this type are expected to arise particularly in cases where the financial corporation is the dominant factor in the combination. Where such is the case, a reasonable treatment shall be devised under Section 25137 of the Revenue and Taxation Code. Section 25137, however, will only be invoked in specific cases where unusual fact situations produce incongruous results. See Cal. Admin. Code, tit. 18, Reg. 25137.

Many years later, the Franchise Tax Board issued Regulation 25137-10, which now provides a blended apportionment formula when financial and non-financial entities are included in a combined report. Unfortunately, the regulation is only applicable in situations where the general corporation is the dominant provider of the income subject to apportionment. This regulation therefore only addresses part of the problem, usually in combined reporting groups where a retailer of tangible goods also has a financing arm, perhaps a credit card company, through which it offers financing to facilitate sales of its products.

What remains unclear is what the appropriate apportionment rules should be when the financial entities are the predominant earners of income, but the group also contains general corporations, such as registered broker/dealers. Assume, for example, the following:

> Combined Reporting Group A is comprised of both financial and non-financial entities. The financial entities are banks, and together they generate five billion dollars in apportionable income in a given taxable year. In the same year, the non-financial entities, primarily broker/dealers, generate one

hundred million dollars of income, less than five percent of the group's income subject to apportionment. The sales factor for the same year shows a quite different picture. The gross receipts from the activities of broker/dealer entities dominate the sales factor accounting for ninety five percent of the sales factor denominator because the banking entities, pursuant to Regulation 25137-4.2, only include the interest income and net gains from their transactions in the sales factor while the non-banking entities include gross receipts. The result of this mismatching of the income and the apportionment factors is that a large amount of the group's income is assigned to the location of the brokerage activities as opposed to the locations where their principal money making activities (banking) are actually occurring.

In the past this fact pattern has given rise to adjustments at audit, with the Franchise Tax Board finding that the described fact pattern does not fairly represent the activities of the group in California. Under the authority of Revenue and Taxation Code section 25137, the Franchise Tax Board has sought to remedy this distortion by either including the receipts of the non-financial entities at net gains, to match the rules used by the financial entities, or by splitting the group into two groups, separately apportioning the income of the non-financial entities using the gross receipts derived from those activities and the income of the financial entities by the use of the formula provided in Regulation 25137-4.2.

Taxpayers have countered that the combination of the financial and non-financial entities is not distortive and that Franchise Tax Board improperly applies Revenue and Taxation Code section 25137 to these cases.

<u>Issues for Discussion</u>

1. Should the Franchise Tax Board begin a regulatory effort to address the fact pattern described herein or is this issue simply one that is more appropriately addressed on an individual taxpayer by taxpayer basis such that a regulation is not feasible?

2. If the Franchise Tax Board were to regulate in this area, what are the possible forms for such a regulation to take? Should Franchise Tax Board undertake an effort to create a new regulation that attempts to blend the apportionment rules for financial and non-financial entities specifically addressing the situation where the financial activity is the predominant earner of the income subject to apportionment? Is it easier to simply make additions to existing Regulation 25137-10 to address the issue?

3. Currently, Regulation 25137-10 attempts to deal with the combination of financials and general corporations through a combination of changes to standard rules for both the sales factor and the property factor. Is this approach feasible when the financial entities are predominant?

4. Given California's move to mandatory single sales factor apportionment for all apportioning trade or businesses other than those "qualified business activities" described in Revenue and Taxation Code section 25128(b), should the issues inherent in making the

Revenue and Taxation Code section 25128(b) determination also be addressed as part of any regulatory effort? This would include developing rules to determine when an apportioning trade or business is receiving more than fifty percent of its gross business receipts, as defined in Revenue and Taxation Code section 25128(d), from a banking or financial business activity.

5. Are there options that would just involve adjustments to the sales factor of the apportionment formula such that the Revenue and Taxation Code section 25128 issues need not be addressed? Should such an approach try to balance the receipts of the broker/dealer with those of the financials in such a way as to assign more weight to the financial activities or simply "net out" or otherwise reduce the sales factor gross receipts of the non-financial entities?

6. Are there other options that should be explored?