APPORTIONMENT OF INCOME FOR COMBINED REPORTING GROUPS WITH FINANCIAL AND NON-FINANCIAL MEMBERS
INTERESTED PARTIES MEETING DISCUSSION PAPER

The Issue:

Around the time Congress enacted the Gramm-Leach-Bliley Act in 1999, many banking organizations in the United States began to acquire full ownership and control of security firms (security broker-dealers) as a means to expand into the securities business. Consequently, a bank's California combined reporting group is comprised of both banking entities and security broker-dealers that are non-financial entities. Within the combined reporting group, the banking entities generate significant business income but relatively small gross receipts, while the security broker-dealers generate small amounts of business income but huge amounts of gross receipts. Because the security broker-dealers gross receipts dominate the combined reporting group's sales factor, the majority of the group's income is assigned to the location of the security broker-dealer activities as opposed to the locations where the principal income generating activities – the banking activities – actually take place.

The Franchise Tax Board (FTB) found this fact pattern fails to fairly reflect the group's activities in California. Under the authority of Revenue and Taxation Code (R&TC) section 25137, the FTB sought to remedy this distortion by either including the receipts of the security broker-dealers at net gains, or by splitting the group into two groups, separately apportioning the income of the security broker-dealers using the gross receipts derived from securities activities and the income of the banking entities using the method provided in Regulation 25137-4.2.

Taxpayers have countered that the combination of the banking entities and the security broker-dealers is not distortive and that FTB improperly applies R&TC section 25137 to these cases.

Discussion Topics

In the first Interested Parties Meeting (IPM) held on December 4, 2014, participants discussed whether a regulation effort is warranted in this area, and if it is, what should be the proper scope of the regulation. Subsequent to the December 4, 2014 IPM, staff received several proposed approaches from the taxpayer community. Staff also researched, at a very high level, other states' rules to gain an understanding of how California's sister states deal with this issue. See the handout **Background** for more information.

To encourage the public's participation, staff is not proposing draft language at this time. Instead, the second IPM will include discussion of each possible approach as outlined below, with the goal to identify what approach the taxpayer community would like to see adopted in California that is fair and acceptable to both taxpayers and the FTB.

Staff hopes to receive comments from members of the industry that may be impacted differently by the various proposals. For example, combined reporting groups that:

- Include both commercial/consumer banking entities and security broker-dealers with the banking activities generating the majority of the group's gross business income;
- Include both commercial/consumer banking entities and security broker-dealers with the broker-dealers' principal trade activities generating the majority of the group's gross business income;
- Include commercial/consumer banking entities but not security broker-dealers, and the groups;
    - Operate within and without California; or
    - Operate within and without California, but predominantly within California;
- Include security broker-dealers but not commercial/consumer banking entities and the groups;
    - Operate within and without California; or
    - Operate within and without California, but predominantly within California.

Proposal 1: Inclusion of principal trade gross receipts based upon the percentage of security broker-dealer assets.

This approach includes security broker-dealer principal trade gross receipts in the sales factor based on the percentage the security broker-dealer's assets bear to the combined reporting group's total assets.

For example, in each of the last five years, the security broker-dealer's assets represented 10 percent of the total assets owned by the broker-dealer and bank combined. In computing the combined reporting group's current year's apportionment, the security broker-dealer would include 10 percent of its gross receipts in the sales factor. In this fact pattern, the bank is the primary business and therefore the combined calculation reflects more of a net approach. If the opposite fact pattern exists and the security broker-dealer actually owns 90 percent of the combined assets and is the primary business operation of the group, the security broker-dealer would include 90 percent of its gross receipts.

A standalone bank would include all net receipts and a standalone security broker-dealer would include all gross receipts.

Proposal 2: Sales factor reflecting a simple blend of net and gross receipts.

If a security broker-dealer's principal trades represent 95 percent of the combined reporting group's gross receipts, the combined reporting group's sales factor will include 95 percent of the net gain and 5 percent of the gross receipts of the security broker-dealer principal trades.

Proposal 3: Sales factor reflecting a weighted blend of net and gross receipts

This method calculates both a Gross Sales Factor that includes the gross receipts from principal trades and a Net Sales Factor that includes the net gain from principal trades. A Blended Sales Factor is then computed for inclusion in the overall apportionment formula that reflects a weighting of the Gross Sales Factor and the Net Sales Factor. The weighting is based on the income generating activities' contribution toward the combined reporting group's overall gross business income.

For example, assume that for a hypothetical unitary group, the Gross Sales Factor is 2 percent and the Net Sales Factor is 6 percent. If the security broker-dealer principal trade activity contributes 5 percent of the combined reporting group's total business income, and other activities including the traditional banking activities contribute 95 percent of the combined reporting group's business income, the Blended Sales Factor is computed as follows:

The Gross Sales Factor of 2 percent is multiplied by 5 percent to arrive at .1 percent, the Net Sales Factor of 6 percent is multiplied by 95 percent to arrive at 5.7 percent, and the products of both calculations are added together to derive the Blended Sales Factor of 5.8 percent (= .1% + 5.7%). The unitary group would use the 5.8 percent Blended Sales Factor in its apportionment formula, whether an evenly weighted 3-factor formula or a single sales factor formula, to apportion its total business income to California.

Proposal 4 (Staff): Net receipts approach

For purposes of apportionment, but not for purposes of imposing corporate franchise tax, treat security broker-dealers same as banks and financial corporations, i.e., the combined reporting group will include in sales factor to the extent of net gain from security broker-dealers principal trade transactions.