FINAL STATEMENT OF REASONS
FOR ADOPTION OF CALIFORNIA CODE OF REGULATIONS,
TITLE 18, SECTION 25137-14

The proposed regulations do not impose any mandate on local agencies or school districts.

Update of Initial Statement of Reasons

The Initial Statement of Reasons, under "Technical, Theoretical, and/or Empirical Studies, Reports, or Documents," included the following incorrect sentence due to a "cut and paste" error: "The Franchise Tax Board examined and considered the regulatory history of 18 Cal. Code of Reg. Section 25137(c)(1)(A), including notices, statements of reasons, public hearing documents, written comments and responses thereto, and the reasoning and language of Legal Ruling 97-1." The Franchise Tax Board did not, in fact, rely upon the materials referenced in this sentence in this rulemaking (the materials relate to a previous rulemaking action). The Initial Statement of Reasons should have stated the following: "The Franchise Tax Board did not rely on any technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation." Interested members of the public analyzing the regulations during the public comment period would have determined that the incorrect sentence was irrelevant to this rulemaking.

The public Notice required by Section 11346.4 of the Government Code was mailed and published in the California Notice register on October 27, 2006. The hearing was held, as noticed, on December 18, 2006, to consider the adoption of proposed regulation section 25137-14 that addresses the apportionment formula for mutual fund service providers. There were 14 attendees at the hearing and oral testimony was received from six individuals representing various interests. Sixteen written comments were received during the comment period, which ended on January 15, 2007, due to a request for an extension of the comment period by an attendee at the hearing. A summary of and responses to the comments received was prepared and is included in the rulemaking file as Tab 16.

As a result of comments received, changes were made to the initial proposed regulation. The changes were noticed in a 15-day change notice, mailed on February 21, 2007. Four comments were received regarding the 15-day changes, with one making a substantive comment regarding the 15-day changes.

The final version of the regulation was presented to the Franchise Tax Board for its approval at its April 4, 2007, public meeting. The Board was provided with all of the comments received during the regulatory process as well as responses to the comments. The Board approved the regulation by a vote of 3-0. A transcript of that meeting is included in the rulemaking file as Tab 17.

The proposed regulation provides a special apportionment formula for taxpayers who provide services to mutual funds. As was identified in the initial statement of reasons, members of this industry have successfully petitioned the Franchise Tax Board under section 25137 of the Revenue and Taxation Code (RTC) to allow them to utilize an alternative formula for the sales factor of the apportionment formula. These petitions were based upon a showing that the use of the normal apportionment factor rules for the sales factor do not reflect the market for their services, but simply assign most of their receipts to their home state based on the activities of their employees. Therefore, the petitions requested the use of a sales factor based on the location of the shareholders in the mutual funds. Because market reflection is the underlying reason for the use of a sales factor in the apportionment formula, the Franchise Tax Board granted the petitions. This regulation provides all taxpayers in the mutual fund industry with the same shareholder apportionment methodology approved by the Board through the RTC section 25137 petition process.

The shareholder location methodology is the uniform rule in at least fourteen other states and is the predominate rule in states where mutual fund service providers are headquartered. Testimony was received that, once California adopts this regulation, approximately 80% of services receipts from all mutual fund service providers will be assigned utilizing this method. The methodology provides a better reflection of the activities of these taxpayers by providing a sales factor that reflects the market. The standard rule for sales of services, income producing activity location, was recognized as problematic as far back as the original drafting of the uniform act. Even at that time it was thought that there would be a need to resort to the use of alternative formulas to properly reflect the activities of some industries. Because mutual fund service providers are generally providing the majority of their services from their home state with customers who benefit from these services located throughout the country, the standard rules' reliance on activities performed by the taxpayer necessarily fails to reflect the actual market for the services. In-state service providers have very high sales factors and out-of-state service providers have almost no sales factor at all. The alternative formula provided in the regulation replaces this over and under assignment with an assignment that is based on actual customer location.

The major objections to the regulation fell in the areas of throwback and the use of the "Finnigan methodology" for the assignment of receipts to the numerator of the apportionment formula.

In-state taxpayers raised concerns about the need for a throwback rule. A throwback provision serves to include receipts in the California sales factor numerator that would otherwise be assigned to a state where the taxpayer is not taxable. The standard apportionment rules provide for throwback in RTC section 25135(b), which deals with assigning receipts from sales of tangible personal property. There is no throwback provision contained in RTC section 25136, which addresses all other sales receipts, including services receipts. In-state mutual fund service providers argue that because the normal rule for services receipts does not contain a throwback, that no throwback should be included in the special industry regulation. This argument is not persuasive for three reasons:

1. The inclusion of the throwback provision is necessary to prevent income from escaping taxation. It is a core principle of the UDITPA that 100 percent of the taxpayer's income (no more or less) should be assigned to jurisdictions where the taxpayer is taxable, whether that jurisdiction chooses to tax the income or not. That is why throwback is included in RTC section 25135. This principle is concerned with providing a level playing field between apportioning and non-apportioning taxpayers. Without a throwback rule a taxpayer who makes sales to customers outside of the state would have a lower tax liability than a solely in-state competitor because of the ability to apportion income to locations where the taxpayer pays no tax. These concerns are not limited to the corporate franchise tax. In the personal income tax arena, a resident is subject to tax in the home state on all of his/her income and only receives a reduction for activities in other states if they show that they had nexus and paid tax in other states. This methodology assures that 100 percent of the resident's income is taxed, which addresses the same underlying concerns as throwback.

2. The inclusion of a throwback rule is not precluded because the standard formula for these receipts does not contain such a provision. The argument made by the in-state companies seems to suggest that there should be linkage between the standard formula rule of RTC section 25136 and this special industry regulation under RTC section 25137. Clearly there is no such requirement. The FTB has adopted three regulations under the authority of RTC section 25137 that include a throwback rule despite addressing receipts that would have been assigned by RTC section 25136 prior to the adoption of the special industry regulation[1].

3. The change from an "income producing activity" approach under RTC section 25136 to a market approach based on location of shareholders gives rise to the need for throwback. Under the standard formula rule, receipts from services would generally be assigned to the location where the employees who performed the services were located, as these employees would be performing the income producing activity. Nexus is not an issue in most of these cases, as employee presence would create nexus. This is not the case when you go to a customer location approach. Just as the customer location approach under RTC section 25135 needed a throwback provision, it is also necessary in this regulation. Without such a rule, it is highly likely that income will be assigned to a location that cannot impose a tax upon that income.

[1] Regulation section 25137-3 dealing with franchisors contains such a rule for royalty receipts in 25137-3(b)(2)(B); Regulation section 25137-4.2 for banks and financials contains such a rule in 25137-4.2 (c)(2)(N); Regulation section 25137-12 for print media companies adopts such a rule for advertising services in 25137-12 (c)(4).

The other major objection came mostly from out of state service providers and focuses on the use of the Finnigan methodology in the regulation. This methodology treats the unitary group as one taxpayer for purposes of determining taxability. Therefore, as long as there are members of the unitary group that are taxpayers in this state, all of the receipts assignable to this state through the shareholder ratio calculation will be included in the California numerator, regardless of whether the specific entity in the unitary group that is receiving the receipts is itself a California taxpayer. This methodology is legally permissible[2] and is necessary for the following reasons:

1. RTC Section 25137 provides the FTB with broad authority to formulate an alternative formula to fairly reflect the activities of taxpayers. This authority would include the use of the Finnigan methodology even though the standard apportionment rules do not utilize such a method. The unique nature of the mutual fund service provider industry supports the conclusion that a Finnigan methodology is necessary to properly reflect activities of taxpayers in this state.

   Mutual fund service providers are almost always set up as a group of separate entities that are highly interdependent. This is done in order to meet regulatory requirements imposed by the SEC and other agencies. Because of this, the use of the Finnigan method works better for this industry. Commentators in this process have endorsed the use of Finnigan. As described by one of the commentators:

   > In a highly regulated enterprise, such as is found in among Mutual Fund Service Companies, companies operate in a manner that is inconsistent with the separate company apportionment methodology of *Joyce*, and in a manner that is far more consistent with the unitary apportionment methodology of *Finnigan*.[3]

   Many other commentators have also endorsed this approach as necessary to reflect the activities of the mutual fund service providers and have similarly rejected the Joyce approach.

2. The use of Finnigan will allow California to pick up the receipts that are assigned here by other states that have a similar shareholder location methodology[4]. Service providers based in these states are receiving a denominator inclusion for receipts

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[2] See Citicorp North America, Inc v. Franchise Tax Board (2000) 100 Cal Rptr. 2d 509. The court there recognized that the *Finnigan* methodology was legally valid and theoretically sound, noting that the State Board of Equalization, in Appeal of Huffy, only reverted prospectively to the separate company apportionment approach of Appeal of Joyce. The current general application of the *Joyce* approach is thus an administrative position rather than the product of a statutory or regulatory requirement.

[3] This quote is part of a submittal made by Franklin Templeton Investments to the Franchise Tax Board at its June 19, 2006 meeting. The submittal was made in support of the regulation project proceeding to the formal regulatory stage.

[4] A large portion of the mutual fund industry is located in states that already utilize the shareholder location method of this regulation. This includes the states of New York, Massachusetts, New Jersey, Connecticut, Rhode Island, Missouri, Texas, Kansas, Utah, Kentucky, Maryland, Maine, Georgia, and Wisconsin.

derived from investments by shareholders located in California. Without the Finnigan methodology, California will not include these denominator amounts in the California numerator. Instead, the receipts simply are never counted anywhere. This will put out-of-state businesses at a competitive advantage over in-state companies due to their lower tax burden. Obviously this should not happen. Similarly situated taxpayers should be treated the same for tax purposes, and Finnigan is necessary to accomplish this goal.

3. Utilizing Finnigan will make the throwback provision function as intended. If each entity in the highly interdependent group of companies were to be treated as separate for purposes of determining nexus, the result would be that in-state based service providers would have most of their sales receipts thrown back to California, thus recreating the overstatement of receipts that the regulation is designed to cure. This will occur because there are only a few members of the group that have nexus in a large number of states, and these entities do not generate most of the receipts being assigned. Instead, it is the companies that have nexus in very few states that generate most of the receipts. These receipts will therefore be thrown back unless the nexus created by the other group members is recognized through the use of Finnigan. Many industry members have supported the use of Finnigan in this regulation for this reason.

No other major concerns were raised, and technical changes made through a 15-day notice were widely accepted as proper.

Alternatives Determined

The Franchise Tax Board has not received any proposed alternatives that would be more effective in carrying out the purpose of the proposed regulation or would be as effective and less burdensome to affected private persons or small businesses than the proposed regulation. In addition, the proposed regulation pertains to corporate taxpayers and therefore does not affect private individuals.