0100 INTRODUCTION AND OVERVIEW OF THE BANKING AND FINANCIAL INDUSTRIES

The purpose of this handbook is to provide auditors with an overview of how the financial industry operates, identification of issues unique to the financial industry, techniques on how to develop the facts relative to the issues, and the department's position on the issues.

0101 Historical Background
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0110 Financial Corporations (RTC Section 23183)
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0101 HISTORICAL BACKGROUND

The Bank of North America was chartered on January 7, 1782 in Philadelphia. It became the first chartered commercial bank in the United States. It was the first to issue paper that was convertible into coined money. By 1800, twenty-nine commercial banks were in operation in the U.S.

The federal government established the Bank of the United States in 1791. This bank served as the federal government's financial agent and had branches in most major cities. The existence of a central bank was a major political issue causing the bank to close in 1811.

Alexander Hamilton, the first Secretary of the Treasury, believed that a national bank licensed and supported by the federal government would assist the new nation. Other "Founding Fathers" feared concentration of capital within a few states.

The Second Bank of the United States was formed in 1816 to act as a central bank. Again due to opposition to a central bank, the bank was closed in 1836. All remaining banks were state chartered although some states owned and operated the banks.

The role of the federal government in banking was limited to minting coin. The individual banks printed their own paper money.

The first income tax legislation directed at banks was the Revenue Act of 1862 that was needed to pay Civil War expenses.

The Civil War created a demand for a stable and uniform currency. The National Bank Act was passed in 1863. It established national banks chartered and regulated by the federal

government. The Office of the Comptroller of Currency, part of the U.S. Treasury Department, was created as the national bank regulator.

Only a small number of banks were organized under the National Bank Act of 1863, so Congress revised the law in 1864 to allow state-chartered banks to reorganize as national banks. To induce such reorganizations, Congress included a tax of 10 percent of all notes of state banks paid out by any bank. The 1864 Act, by establishing a permanent bank system, also established a national currency.

The National Bank Act led to the terminology of the "dual banking system," in which state banks and national banks are chartered and supervised at different levels. Under the dual banking system, national banks are supervised by a federal agency and regulated by federal rules while state chartered banks are supervised by a state agency and are regulated by a state-devised rules.
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With rapid economic growth during the late 1800's and early 1900's in the U.S., the number of state chartered banks increased rapidly. Several weaknesses of the National Bank Act were evidenced by the following:

- The state-chartered banks were beyond the control of the national government.
- The nation did not have an effective check collection and clearing system.
- The nation could not effectively control the supply of money.
- The reserve system was flawed. Many banks kept their reserves in a few national banks concentrated in New York City. The reserves were loaned short term. When the various banks needed additional funds they would draw on their reserves. The New York banks would have to call their loans in order to pay the reserve draw. This caused hardship throughout the entire economy.

As a result, U. S. enacted the Federal Reserve Act of 1913, which created the Federal Reserve System ("Fed") as the U.S. central bank.

The Fed consists of a seven-member Board of Governors and twelve district banks. The Board of Governors sets the overall policy. National banks are required to be a member of the Fed and maintain reserves in their district bank. California is within the 12th Federal Reserve System district.

The Fed provides for:

- Centralized check collection and processing.
- The supply of coin and currency.
- The issuance, safekeeping, and redemption of U.S. government obligations.
- The control of the supply of money.
- The regulation and examination of member banks to insure that sound banking practices are followed.

The Fed controls the supply of money in the economy by:

- Use of the discount rate. Member banks borrow funds from the district bank. The discount rate is the rate of interest charged by the district bank to the member bank.

  If the Fed wants to decrease the amount of money in the economy, it may increase the discount rate. As a higher discount rate increases the member banks' costs, the member banks react by increasing the interest rate offered to their customers. Higher interest rates decrease borrowing, effectively reducing the amount of money circulating in the economy.

  To increase the amount of money in the economy, the Fed may reduce the discount rate, which would then decrease the cost of funds to the member banks and result in a reduced interest rate offered to the banks' customers.

- Use of reserve requirements. Member banks are required to maintain reserves as cash in their vault and as non-interest bearing accounts with the Federal Reserve District Bank.

  To reduce the supply of money in the economy, the Fed may require that the member banks increase their reserve accounts, effectively reducing the amount of funds available for lending. Or, to increase lending, the Fed may reducing the reserve account requirements.

- Buying and selling securities (usually, U.S. Treasury bonds) to either increase or decrease the amount of money in the economy.

By controlling the supply of money the Fed impacts the overall health of the economy including inflation, the value of the dollar in relationship to other currencies, and recessions.

What is money? Money is anything that can be used to purchase goods or services. Most people think of money as cash, i.e., coin and paper bills. Cash is also called currency. Yet, most purchases are made by check. A check is money as it can be used as money.

Bankers and economists refer to the money supply as M-1 (which is further divided into M-1A and M-1B) and M-2.

M-1A is defined as currency and demand deposits.

M-1B is defined as M-1A plus NOW and similar accounts. A NOW account is short for Negotiated Order of Withdrawal. This is an interest bearing transaction account such as a checking account. Congress first authorized NOW accounts in the Depository Institutions and Monetary Control Act of 1980.

M-2 is defined as M-1B plus time deposits in banks and thrifts and shares in money market mutual funds.

Business sections of the newspapers frequently report the change in the supply of money by stating the weekly or monthly change in M-1 and M-2.

Banks are one of the most regulated industries in the United States because the banking industry has direct impact on the overall economy via their ability to create money through the multiplier effect of lending as explained below.

Assume a customer deposits $10,000 into a demand account such as checking, which has a reserve requirement of 10%. The bank has the authority to lend to $9,000 of that deposit. If the bank makes a $9,000 loan by crediting another customer's account, then demand accounts have increased by $9,000 yet the amount of currency in the economy has not changed.

If the borrower pays another $9,000 for goods and services, then that person will deposit the funds in a bank. That bank now has the authority to loan $8,100 (90% of $9,000).

This is the concept of the multiplier effect of lending. The multiplier effect can be determined by dividing 1 by the reserve requirement, and then multiplying that result by the deposit amount. Our $10,000 deposit results in:

1/10% x $10,000 = $100,000.

The multiplier effect resulted in the bank creating $90,000 from the original $10,000 deposit.

The Fed regulates member banks. Regulations issued by the Fed include:

- Regulation A establishes the conditions by which Federal Reserve Banks may extend credit to member banks.
- Regulation B prohibits discrimination by lenders on the basis of age, race, color, religion, national origin, or marital status.
- Regulation C requires annual public disclosure of the location of residential loans for those financial institutions that make federal related mortgages.
- Regulation D sets the bank’s legal reserve requirement.
- Regulation H defines membership and withdrawal requirements for state-chartered banks and procedures to attain approval of branches.
- Regulation J sets the terms and conditions for the collection and clearing of checks by the Federal Reserve.

- Regulation N establishes rules concerning foreign activities of member banks.

- Regulation Q establishes minimum capital requirements and overall capital adequacy standards for Board-regulated institutions.

- Regulation Z deals with truth-in-lending provisions.

The above is a summary of a few of the Fed regulations in order to give the reader an idea of the Fed's degree of regulatory oversight. In addition, the Comptroller of the Currency regulates banks.

The Revenue Act of 1913 adopted for the first time a permanent and comprehensive national tax on the net income of corporations, banks, and individuals.

The dual banking system (federal versus state charters) provided for unequal treatment of the different chartered banks because of the various state laws concerning branch banking.

The McFadden Act of 1927 placed federal and state banks on an equal footing by providing national banks the ability to branch banks to the same extent a given state law allows state banks to branch.

Branch banking can be defined as a bank that has more than one full service office. California allows branch banking. Bank of America or Wells Fargo Bank each have several hundred branches. Other states require that each branch be separately incorporated as a bank. Branch banking will be discussed further in this chapter.

Wall Street crashed in 1929 and the nation entered into a depression in the early 1930's. Thousands of banks failed in the 1930's and customers lost their deposits.

Then newly-elected President Franklin D. Roosevelt declared a "Bank Holiday" in March 1933. The closure of banks for a few days provided for a cooling off period in hopes that the run on deposits would stop.

To ensure public faith in the banking system, Congress passed the Glass-Steagall Act of 1933. The key reforms of the Glass-Steagall Act were (1) separation of investment banking from commercial banking and (2) creation of the Federal Deposit Insurance Corporation (FDIC).

(1) Separation of investment banking from commercial banking: Investment banking is the business of underwriting securities (stocks and bonds) for capital restructuring. For example, General Motors Corporation may wish to issue additional preferred stock. They may enter into a contract with an investment banker who will act as an intermediary to market the preferred stock. Investment bankers are active in initial public offerings, secondary offerings, mergers, acquisitions, and leveraged buyouts.

Major investment banks typically provide "firm commitment offerings," which means that the banker purchases the securities and sells them to investors. The investment banker has the risk of not being able to sell the securities or not being able to sell the security at the agreed value.

In contrast, commercial banking is the business of providing deposit, payment, and credit services to consumers and businesses. Of course, commercial banks may provide additional services.

Congress felt that investment banking was too risky for commercial banks. One provision of the Glass-Steagall Act was to prohibit commercial banks from underwriting securities and from investing in common stock for the banks' own portfolio.

The Glass-Steagall Act does provide some exceptions for underwriting securities. Commercial banks may underwrite debt. After reviewing the request of certain well capitalized banks, the Fed now allows a few banks to underwrite equity securities. Many large banks are dealers and market makers for government obligations.

(2) Creation of FDIC provided the following benefits:

- Insured deposits of member bank customers up to $ 2,500 at its conception (currently $250,000). National banks are required to be a member of the FDIC. State chartered banks may join the FDIC deposit insurance.
- Promoted safe banking standards.
- Performed bank audits to ensure compliance with its standards.
- Prevented troubled banks from failing.

The Bank Holding Company Act of 1956 defined bank holding company and authorized the Fed to regulate the activities of the holding company.

The Bank Holding Company Act was amended in 1970 to limit the business activities of non-bank subsidiaries of the holding company. The amendment also allowed the Fed's Board to decide which activities were permissible.

Banks and other financial institutions felt pressured to pay higher interest rates on deposits in the late 1970's. One reason was the growth of money market accounts and mutual funds that paid higher interest. Many bank customers withdrew their deposits, favoring other investment vehicles.

Congress responded with the Depository Institution Deregulation and Monetary Control Act of 1980 which:

- Allowed banks to compete for deposits by eliminating fixed (by the government) interest rates.

- Increased deposit insurance (FDIC) to $100,000.

- Opened Federal Reserve check clearing and collection services to outside competition.

- Authorized NOW accounts, which are interest bearing transaction accounts such as checking.

- Gave additional power to the Federal Reserve to control the supply of money.

The next major banking legislation was the Depository Institutions Act of 1982, which was also known as the Garn-St. Germain Act. This act provided additional authority and capital to rescue failed institutions, relaxed lending restrictions, and allowed new deposit instruments. The 1982 Garn-St. Germain Act amended the Bank Holding Company Act to prohibit banks from most insurance activities.

The Competitive Equality Banking Act of 1987 included provisions that expanded regulators' authority in cases of bank failures, created mandatory check clearing requirements, and set limitations on the growth of companies that performed some of the bank-permitted activities while falling short of being legally qualified as a bank, the so-called non-bank banks.

The most important banking legislation since Glass-Steagall in 1933 was the Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA). In regards to banks, FIRREA:

- Allowed banks to acquire healthy thrifts and convert them to banks.

- Provided for certain levels of capital to be obtained by 1995.

Much of FIRREA deals with the savings & loan industry and will be discussed at Section **0120.1**, Savings and Loan Associations.

In the past, federal law prevented companies in the securities, bank and financial, and insurance industries from operating as members of a commonly owned affiliated group of corporations. The following changes in federal law during the 1990s resulted in federal deregulation of the financial services industry to allow a number of financial service businesses to operate under common ownership.

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994:

- Permitted banks and bank holding companies to purchase banks or establish subsidiary banks in any state nationwide.

- Permitted national banks to open branches or convert subsidiary banks into branches across state lines.

Gramm-Leach-Bliley Financial Modernization Act of 1999 (GLBA):

- Created a financial holding company that may engage in all authorized financial service activities.
- Created a financial subsidiary for banks that can engage in most of the authorized financial service activities.
- Allowed for newly authorized activities – securities, insurance, merchant banking/equity investment, "financial in nature", and "complimentary activities."
- Repealed prohibition against affiliation of banks with a securities affiliate.
- Amended the Riegle–Neal Act to apply to any branch of a bank owned by an out-of-state bank holding company.
- Repealed prohibition against interstate branching by an out-of-state bank primarily to establish deposit production offices.
- Mandated state functional regulation of insurance sales activity (including a national bank exercising Federal Reserve Act agency powers.)
- Gave the Federal Reserve and the Treasury discretion to authorize new financial activities or complementary activities for financial holding companies.
- Established the Federal Reserve as the "umbrella" regulator for financial holding companies.

The 2008 Financial Crisis:

In 2008, twenty-five U.S. banks became insolvent and were closed by their respective chartering authority. On October 3, 2008, President George W. Bush signed the Emergency Economic Stabilization Act of 2008, which temporarily raised the basic limit on FDIC deposit insurance coverage from $100,000 to $250,000 per depositor. On May 20, 2009, the temporary increase was extended through December 31, 2013.

On July 21, 2010, President Obama signed into law the Dodd–Frank Wall Street Reform and Consumer Protection Act (P.L.111-203). The Dodd-Frank Act made significant changes to financial regulations. The Act is categorized into 16 titles, with the goal:

> To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.

The 16 titles covered in Dodd-Frank Act are as follows:

- Title I – Financial Stability, which outlines two new agencies to monitor systemic risk and research the state of the economy and clarifies supervision of bank holding companies. The two new agencies are Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR).

- Title II – Orderly Liquidation Authority, which expands upon prior law to potentially handle liquidations and receiverships that include insurance companies and non-bank financial companies.
- Title III – Transfer of Powers to the Comptroller of the Currency, the Corporation, and the Board of Governors, which transferred regulatory and rulemaking authority to the Comptroller, FDIC, and the Fed. It also reformed the FDIC, making $250,000 FDIC limit permanent.
- Title IV – Regulation of Advisers to Hedge Funds and Others, which clarifies the registration and record-keeping requirements for covered investment advisers to provide the Securities and Exchange Committee (SEC) and FDIC with information necessary to evaluate systemic risk of these private funds. Although the Title provides for three major exemptions under this rule, it also expands the registration requirements to include most private funds, including hedge funds, which could previously avoid registration and record-keeping requirements. The Title also addresses state registration requirements, establishes a standard for identifying accredited investors, and provides for periodic review and revision of the Title to account for inflation.
- Title V – Insurance - Subtitle A – Federal Insurance Office, which establishes a Federal Insurance Office (FIO) within the Department of the Treasury to promote national coordination in the insurance sector. The FIO has authority over all types of insurance, other than health, long-term care, and crop insurance, but does not have any supervisory role over the business of insurance providers. The supervisory authority of the insurance industry remains with state regulators. Additionally, Title V streamlines the regulation of surplus lines insurance and reinsurance through state-based reforms
- Title VI – Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions, which provides for heightened regulation of bank holding companies (BHCs), savings and loan holding companies (SLHCs), and depository institutions to ensure that these institutions do not threaten the United States' financial stability. This title also introduces the "Volcker Rule," which prohibits banking entities from engaging in proprietary trading.
- Title VII – Wall Street Transparency and Accountability, which creates a framework for the regulation of swap markets, grants the Commodity Futures Trading Commission (the "CFTC") regulatory authority over swaps, except for security-based swaps, which are regulated by the SEC, requires certain swaps to be cleared by a clearinghouse and executed or an electronic execution facility and imposes registration requires on dealers and major participants, which are entities that engage in very large swap transactions that can significantly impact the health of the U.S. financial system.
- Title VIII – Payment, Clearing and Settlement Supervision, which provides a new framework for assessing the systemic risk associated with financial institutions and financial market utilities involved in clearing activities for financial transactions. The Title grants authority to the Fed's Board of Governors, CFTC, SEC, and FDIC to work together to promulgate rules and standards of operation,

enforce those rules, and generally help manage the systemic risk of these clearing entities and other financial market utilities.

- Title IX – Investor Protections and Improvements to the Regulation of Securities, which revises the structure and power of the SEC, credit rating organizations, and the relationship between broker-dealers or investment advisers and their customers. Subtitles A-J provide for improvements and protection in greater specificity.
- Title X –Consumer Financial Protection Act of 2010, which establishes the Bureau of Consumer Financial Protection to regulate consumer financial products and services in compliance with federal law and is separated into six divisions.
- Title XI – Federal Reserve System Provisions, which provides for governance, oversight, and establishment of industry standards.
- Title XII – Improving Access to Mainstream Financial Institutions Act of 2010, which provides incentives for low-income and medium-income individuals to participate in the financial system.
- Title XIII – Pay It Back Act, which amends the Emergency Economic Stabilization Act of 2008 to limit the Troubled Asset Relief Program by reducing available funds by $225 billion.
- Title XIV – Mortgage Reform and Anti-Predatory Lending Act, which standardizes data collection for underwriting and imposes obligations on mortgage originators to only lend to borrowers who are likely to repay their loans. Includes sections on Residential Mortgages, High-Cost Mortgages, Minimum Mortgage Standards, and Appraisal Services among others.
- Title XV – Miscellaneous Provisions, which include seven miscellaneous provisions.
- Title XVI – Section 1256 Contracts, which addresses issues related to IRC Section 1256 regarding tax treatment of regulated futures contracts, foreign currency contract, and non-equity option.

Various government agencies license, regulate, and audit state and federal chartered banks, including:

- California Department of Business Oversight (DBO) protects consumers and oversees financial service providers and products. The DBO supervises the operations of state-licensed financial institutions, including banks, credit unions and money transmitters. Additionally, the DBO licenses and regulates a variety of financial service providers, including securities brokers and dealers, investment advisers, payday lenders and other consumer finance lenders. For a complete list of the types of financial services providers and industries regulated by the DBO, go to http://www.dbo.ca.gov/Licensees/default.asp.

- Federal Reserve Board System: A quasi-government agency established by the Federal Reserve Board Act. It issues banking regulations, sets safe lending and reserve limits, acts as a source of funding, provides related services to the banking industry, makes compliance audits of its member banks, and issues confidential examiners' reports.

- FDIC: A subsidiary of the Department of the Treasury—provides deposit insurance, and examines bank operations and loan reserves.

- The Office of the Comptroller of The Currency (OCC): The OCC is part of the Treasury Department and is the oldest bank regulatory agency. The OCC is responsible for:

    - The approval of all charters, mergers and branches of national banks.

    - The supervision of national banks, including periodic examinations.

    - The receipt of extensive quarterly financial statements called "call reports".

        - State/Federal Banking Laws: Provides banking operation criteria, asset safety, nondiscriminatory loan guidelines, structure flexibility for conversions and mergers, and recent deregulation to stimulate money market competition.

- Secretary of State: Issues corporate state charters.

0102 INTERSTATE BANKING

0102.1 Federal Law
0102.2 State Law

0102.1 Federal Law

Public policy as expressed by Congress over the past several decades has been one of opposition to nationwide interstate banking. The McFadden Act of 1927 permits national banks to establish and operate new branches to the same extent that state law of a particular state permits state banks to operate a branch banking system.

The intent of Congress in enacting the McFadden Act was to place national and state banks on par when it comes to branch banking. Congress was concerned not only about the risks of banks expanding geographically too quickly, but also about the concentration of banking in large cities versus rural areas.

Unless specifically authorized by state law, the Douglas Amendment (Section 3(d) of the Bank Holding Company Act of 1956) prohibited the Fed's Board from approving an application by a holding company to acquire a bank outside the holding company's principal state of operations. However, the interstate restrictions were repeated by the Riegle-Niele Interstate Banking and Branching Efficiency Act of 1994.

The Bank Holding Company Act of 1956 permits the following interstate bank activities:

- Ownership of companies that either accepts deposits or makes loans but not both without geographical limitations.
- Having loan production offices and national credit card solicitation.
- Ownership of investment banks, which are not subject to interstate limitations, but offer services similar to a traditional bank.
- Establishment of Edge Act corporations, which are banking institutions with a special charter from the U.S. Federal Reserve to conduct international banking operations and certain other forms of business without complying with state-by-state banking laws. By setting up or investing in Edge Act corporations, U.S. banks are able to gain portfolio exposure to financial investing operations not available under standard banking laws.
- The twelve interstate bank holding companies that were in existence when the Douglas Amendment was passed to continue interstate banking.

0102.2 State Law

The federal government placed the burden on the states in regard to interstate banking. Senate Bill 2300 and Assembly Bill 1492 was California's response to this burden.

Senate Bill 2300 effective July 1, 1987, provides for regional reciprocity. Regional reciprocity means:

- Region: Banks whose operations are principally conducted in Alaska, Arizona, Colorado, Hawaii, Idaho, Nevada, New Mexico, Oregon, Texas, Utah, or Washington.

  Principally conducted within a state is defined as the state in which the combined deposits of the bank holding company's subsidiary banks are the largest.

- Reciprocity: The California Superintendent of Banks must find that the out-of-state banking organization’s home state has substantially the same provisions concerning interstate banking as California.

  Assembly Bill 1492, effective January 1, 1991, eliminates the geographic restrictions of Senate Bill 2300 although still requires "substantial reciprocity." Both Senate Bill 2300 and Assembly Bill 1492 limit interstate banking to the acquisition of banks already located in California.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (H.R. 3841, P.L. 103-328) amends Section 3(d) of the Bank Holding Act of 1956 to allow state and nationally chartered banks to branch across state lines.

0103 BANK AND FINANCIAL TAX RATE

The federal government restricted the authority of a state in taxation of nationally chartered banks. National banks are generally publicly traded and established for profit. They have been considered to be instrumentalities of the federal government because they obtained their charters from and performed limited functions for the federal government. Because of this, taxation of national banks by the state could only be to the extent specifically permitted by Congress. Since 1864, Congress has from time to time added methods of taxation originally made available for the states to tax national banks.

Congress has allowed several states to impose a tax on national banks in one of four methods, so long as they are applied in a nondiscriminatory manner:

1. An ad valorem tax on the bank's outstanding shares.
2. A tax on the dividends from the shares.
3. A tax directly on the net income of the banks.
4. A tax according to or measured by the net income of the banks, including income from tax-exempt federal securities.

California adopted the fourth method above.

California corporation franchise tax imposed on banks is in lieu of all other taxes and licenses (state, county, and municipal) except taxes enumerated under R&TC Section 23182 such as real property tax. Banks escape various taxes which other corporations are assessed. If banks were assessed the same general corporate rate under R&TC Section 23151, the result would be substantial discrimination in favor of banks. To avoid such discrimination, the state adds an additional percentage to the general corporate rate. The combined rate is termed the "bank" or "financial" tax rate. It is the general rate plus a rate that is the percentage of all personal property taxes paid by other general corporations (excluding certain public utilities) to the general corporation's net income.

In *Security First National Bank vs. Franchise Tax Board* (1961) 55 Cal.2d 407, the California Supreme Court held that the bank tax rate is not a violation of the federal restriction on taxation of national banks.

The Franchise Tax Board must determine the total amount of personal property tax paid by general corporations in order to calculate the bank or financial tax rate. In the past, this required the review of tax returns and sometimes a request for additional information. Due to this procedure, the bank or financial corporation tax rate was not known until after the tax returns of the bank and financial corporations were filed.

For taxable years ending on or after 12/31/1995, however, R&TC Section 23186 imposes the tax rate on banks and financial corporations equal to the year’s general corporation tax rate (R&TC Section 23151) plus 2 percent.

0104 BANKS (IN GENERAL)

What is a bank? Generally, a bank is an entity in which a substantial part of its business consists of receiving deposits and making loans. Deposits may be in the form of certificates of deposits, savings accounts, checking accounts, money market accounts, etc. Loans may be commercial, consumer, mortgages, government obligations, etc.

R&TC Section 23039 defines "bank" as follows:

> "Bank" includes national banking associations. "Bank" includes any bank operated by a receiver, liquidator, referee, trustee or other officers or agents appointed by any court, or assignee for the benefit of creditors.

This definition is not all-inclusive. California Financial Code provides a more comprehensive definition of the term "bank" as follows:

- Section 103. The word "bank" as used in the Financial Institutions Law means any incorporated banking institution that shall have been incorporated to engage in commercial banking, industrial banking, or trust business.

- Section 105. Banks are divided into the following classes:

  (a) Commercial banks.
  (b) Industrial banks.
  (c) Trust companies.

- Section 107. "Commercial bank" means a corporation organized for the purpose of engaging in the commercial banking business.

- Section 109. "Commercial banking business" includes, but is not limited to, the business of soliciting, receiving, or accepting money or its equivalent on deposit as a regular business whether the deposit is made subject to check or is evidenced by a certificate of deposit, a passbook, a note, a receipt, or other writing, provided that nothing herein shall apply to or include money or its equivalent left in escrow, or left with an agent pending investment in the real estate or securities for, or on account of, his or her principal. In addition, "commercial banking business" means to lend money on the security of real or personal property or without security; to discount or deal in bills, notes, or other commercial paper; to buy and sell for the account of customers, and, if eligible for investment, for its own account, securities, gold and silver bullion, foreign coins, and bills of exchange; and generally to transact a commercial banking business.

- Section 111. "Industrial bank" means a corporation organized for the purpose of engaging in the industrial banking business.

- Section 113. "Industrial banking business" includes the making of loans and acceptance of deposits, including deposits evidences by investment or thrift certificates, but excluding demand deposits.

- Section 115. "Trust business" means the business of acting as executor, administrator, guardian, or conservator of estates, assignee, receiver, depositary or trustee under appointment of any court, or by authority of any law of this or any other state or of the United States, or as trustee for any purpose permitted by law.

- Section 117. "Trust company" means a corporation, industrial bank, or a commercial bank that is authorized to engage in the trust business.

- Section 119. "Bank" or "banks" includes commercial banks, industrial banks, and trust companies unless the context otherwise requires. However, "bank" does not include a savings association or a credit union.

0104.1 National Banks
0104.2 State Chartered Banks
0104.3 Trust Company
0104.4 Foreign International Banks
0104.5 Edge-Act Corporations
0104.6 International Banking Facility

0104.1 National Banks

- Federal chartered only
- Automatic Federal Reserve Board/FDIC members
- Can take deposits
- Can operate in multiple states and foreign countries through financial subsidiaries, e.g., Edge Act corporations and bank holding companies
- Can file combined reports
- Can have International Banking Facility
- Can borrow/lend money
- Can have offshore banking facilities (Cayman/Nassau/Bahamas)
- Can be related to bank holding companies
- Can be publicly or privately held

0104.2 State Chartered Banks

- Licensed and regulated by State Banking Department
- Can take deposits
- Insured by FDIC
- Can be members of Federal Reserve Board

- Can have financial subsidiaries
- Can have branches within the state only (see Section 0120 on interstate banking)
- Can file combined reports
- Can have International Banking Facility
- Can borrow/lend money
- Can be related to bank holding companies
- Can be privately or publicly held

0104.3 TRUST COMPANY

The issue of a trust company as a bank has been addressed in cases in protest. Issues include classification of a trust company as a bank for purposes of application of the bank tax rate (R&TC Section 23181), the exclusion from other taxes (R&TC Section 23182), and the correct method of apportionment for the unitary group that includes the trust company.

The facts in each of these cases were similar. The trust companies were organized under the authority of the California State Banking Department (now Division of Financial Institutions, or "DFI," a division of California Department of Business Oversight) and there was a copy of the State Banking Department's letter approving the application of the trust company for trust business. This is the single most significant piece of evidence in the determination that a trust company is within the definition of a bank.

Some of the following factors were also present in each of the cases. Although the trust was a limited purpose bank (as defined by the State Banking Department) governed by the laws of the State of California, the trust's management adopted the standards of Regulation 9 (12 CFR Part 9 Fiduciary Activities of National Banks.) This Regulation 9 is issued by the Office of the Comptroller of the Currency governing trust activities of national banks, as these standards generally reflect practices followed in the industry. The trust company's business activities involved serving as trustee for employee benefit plans and providing custody services for investment portfolios. The trust company serviced employee benefit trusts, such as defined benefit and defined contribution pension plans, and had ultimate responsibility for the plan level administration of the institutional trust accounts including liaison with third party plan administrators and record keepers. The trust company may or may not have exercised investment management decision-making authority in these accounts. Account administration included client accounting and reporting, participant loan administration, and compliance with the Employee Retirement Income Security Act.

Classification as a Bank: In addition to the sections of the California Financial Code that include a trust company within the definition of a bank, the courts and the State Board of Equalization have determined that the definition of banks in California includes trust companies. (See *Appeal of Title Insurance and Trust Co.*, 49-SBE-022, January 27, 1949; *Title Insurance and Trust Co. v. Franchise Tax Board* (1956) 145 Cal.App.2d 60 [302 P. 2d 79]; In re: *Wellings' Estate* (1924) 192 Cal. 506 [221 P. 628]; *First National*

Trust and Savings Bank of San Diego v. Industrial Accident Commission, Occidental Indemnity Co. (1931) 213 Cal. 322 [2 P.2d 347]; and *In re First Independent Trust Co.* (Bankr. E.D.Cal. 1989) 101 B.R. 206.

These trust companies did not meet the definition of a financial corporation in CCR Section 23183 because they failed the "deals in" test. The trust companies did not conduct transactions in the course of a trade or business on its own account. (See CCR Section 23183(b)(2).)

It was the conclusion as a part of the protests that these trust companies were within the definition of a bank under California Financial Code Sections 105, 115 and 117, and case law interpreting these sections. These trust companies were banks for purposes of the Revenue & Taxation Code. A trust company that meets the definition of a bank, if it is a California taxpayer, is subject to the bank tax rate.

Apportionment: CCR Section 25137-4.2 (CCR Section 25137-4.1 for taxable years beginning before January 1, 1996) provides guidance and rules for determining apportionment factors of banks and financial corporations. Regardless of being a California taxpayer, a trust company within the definition of a bank must apply CCR Section 25137-4.2 (or CCR Section 25137-4.1 in pre-1996 taxable years) to compute its apportionment factors. See Bank & Financial Handbook Section 1000, APPORTIONMENT FORMULA, for a discussion of CCR Sections 25137-4.1 and 25137-4.2.

0104.4 Foreign International Banks

- Multinational foreign banks wants to promote business trade and international financing of parent country
- Can have agency/branch/representative offices in the United States
- Are regulated by both state and federal banking authorities
- Can form/acquire subsidiary full-service banks
- Can have financial subsidiaries
- Can be members of Federal Reserve System and FDIC
- Can have International Banking Facility
- Can take foreign deposits
- Can have offshore banking facilities (Cayman/Nassau/Bahamas)
- Can file combined reports
- Operate in multiple states/countries worldwide
- Can be privately, publicly, or government owned

0104.5 Edge-Act Corporations

The Edge Act (12 U.S.C. Sections 611-631) was enacted in 1919 for the purpose of providing for federal chartering and control over corporations engaged in foreign or international banking or financial operations. The International Banking Act of 1978

substantially revised parts of the Edge Act, with the intent of making Edge Corporations more competitive with their foreign-based counterparts, and allowing foreign ownership of Edge Corporations.

The Federal Reserve Board must approve the formation of an Edge Corporation. The corporate existence of an Edge Corporation begins after the Federal Reserve Board issues a permit to the new corporation. A state-chartered corporation engaged in international or foreign banking may apply to the Federal Reserve Board to convert to a federal charter. Converted corporations have the same powers and responsibilities as corporations originally formed under the Edge Act.

An Edge-Act bank should be combined with its parent bank based on virtual certainty of unity.

0104.6 International Banking Facility

R&TC Section 23044 defines an International Banking Facility (IBF). An IBF is a set of asset and liability accounts segregated on the books and records of a commercial bank that may engage in limited international activities as provided by federal law.

At the federal level the purpose of the IBF was to allow U.S. banks to be competitive with foreign banks in international markets without sovereign risks.

California adopted R&TC Section 23044 and R&TC Section 25107 (Apportionment of income of IBF) so California banks would be competitive with New York banks, which already had similar legislation.

As provided by federal law, an IBF may only take deposits from a foreign entity, including a foreign subsidiary of an U.S. bank or corporation, nonresidents, or another IBF. The IBF may only make loans to another IBF, or foreign bank or foreign operations of an U.S. corporation provided that the funds are for use overseas.

For the purposes of allocation and apportionment of income, R&TC Section 25107 treats the IBF maintained by a bank within California as "doing business without the state." IBF's intangible personal property (receivables) and sales (interest income) reflected on the bank's segregated books are excluded from the bank's apportionment factor numerator.

0110 FINANCIAL CORPORATIONS (R&TC SECTION 23183)

The classification of a corporation as a financial corporation was the response of the California legislature to federal law that prohibits discriminatory state taxation of a national bank as compared to other competitive financial entities. Assessment of tax at a different

rate for national banks than financial corporations would be considered discriminatory. As such, the bank tax rate applies to financial corporations also.

Neither federal nor California statue defines the term "financial corporation." Rather, *Morris Plan Co., v. Johnson* (1940) 37 Cal. App. 2d 621, *Crown Finance Corp. vs. McColgan* (1943) 23 Cal. 2d 280, and *Marble Mortgage Co. vs. Franchise Tax Board* (1966) 241 Cal.App.2d 26 are leading California decisions which provide for the definition.

The courts held that a financial corporation is one that deals in moneyed capital, as opposed to other commodities, in substantial competition with the business of national banks. An example of a financial corporation is a savings & loan association.

The concepts of moneyed capital and substantial competition with the business of national banks are interdependent. To be classified as a financial, the corporation must deal in moneyed capital that is in substantial competition with the business of national banks. For example, a discount stock brokerage firm may allow customers to purchase stock through margin accounts. In margin purchases, the customer pays 50 percent of the stock purchase price and borrows the remaining amount from the brokerage firm. The firm charges interest on the margin account.

In this example, the discount brokerage firm competes in some aspects of the business of national banks, i.e. the firm loans funds on margin accounts. However, the firm is not a financial corporation if the firm derives more than 50 percent of its gross income from commissions for buying and selling securities on behalf of the customer, which does not involve dealing in (i.e., conducting transactions on its own account) money or moneyed capital.

CCR Section 23183, effective 3/31/1991, codifies California case laws and defines "financial corporation." CCR Section 23183(a) defines a financial corporation as a corporation which predominantly deals in money or moneyed capital in substantial competition with the business of national banks. This definition contains five requirements: "predominantly," "deals in," "money or moneyed capital," "in substantial competition," and "business of national banks." A corporation is a financial corporation only when it satisfies all five requirements set forth in the regulation.

Pursuant to CCR Section 23183(b)(1), "'predominantly' means over 50 percent of a corporation's total gross income is attributable to dealings in money or moneyed capital in substantial competition with the business of national banks."

Pursuant to CCR Section 23183(b)(2), "'Deals in' means conducting transactions in the course of a trade or business on its own account, as opposed to brokering the capital of others." For example, a corporation that buys and sells securities on behalf of its customers, not for its own account, is brokering its customers' capital thus is not dealing in money or moneyed capital.

Pursuant to CCR Section 23183(b)(3), "'money or moneyed capital' includes, but is not limited to, coin, cash, currency, mortgages, deeds of trust, conditional sales contracts, loans, commercial paper, installment notes, credit cards, and accounts receivable." Because the regulation specifically states "includes, but is not limited to," the items listed in the regulation are illustrative, not exclusive, examples of money and moneyed capital. Coin, cash, and currency fall within the description of "money." Other items: mortgages, deeds of trust, conditional sales contracts, loans, commercial paper, installment notes, credit cards, and accounts receivables, are examples of "moneyed capital." Note that the regulation's examples of "moneyed capital" all represent some forms of debt instrument.

"In substantial competition" means that a corporation and national banks both engage in seeking and securing in the same locality capital investments of the same class which are substantial in amount, even though the terms and conditions of the business transactions of the same class are not identical. CCR Section 23183(b)(4) provides that the activities of a corporation need not be identical to those performed by a national bank in order to constitute substantial competition. It is sufficient if there is competition with some phases of the business of national banks, or capital is invested in particular operations or investments like those of national banks.

In the *Appeal of Atlas Acceptance Corp.* 81-SBE-078, July 29, 1981, the Board explained:

> Whenever capital is employed either by a business or by private investors in the same type of transactions as those in which national banks engage and in the same locality in which they do business, those businesses or private investors are acting in competition with national banks. … In order to establish competition, it is not necessary to show that national banks and competing investors solicit the same customers for the same loans or investments. It is sufficient if both engage in seeking and securing, in the same locality, capital investments of the class now under consideration which are substantial in amount. Accordingly, since appellant is involved in the business of discounting commercial paper, an activity engaged in by national banks, we must find that appellant is in competition with national banks. That appellant's operations were significant enough to find that it was in substantial competition with national bank …

The Board held that substantial competition means doing business of a general activity that is also engaged in by national banks. Thus, the fact that Atlas was in the business of discounting commercial papers, an activity also engaged in by national banks, qualified the taxpayer as being in substantial competition with the business of national banks.

Pursuant to CCR Section 23183(b)(5), the "business of national banks" is defined as "the businesses in which national banks are permitted to operate." The Office of the Comptroller of the Currency regulates national banks and has detailed rules and regulations concerning permissible activities of a national bank.

The national bank law can be found in title 12 of the United States Code and related federal regulations (12 C.F.R) (SEE SECTION 200)

0120 FINANCIAL INSTITUTIONS

0120.1 – Savings and Loan Associations
0120.2 – Loan or Mortgage Company
0120.3 – Credit Card Company
0120.4 – Credit Unions
0120.5 – Small Business Investment Companies
0120.6 – Farm Credit Administration
0120.7 – Leasing Corporations
0120.8 – Broker-Dealers

0120.1 Savings And Loan Associations

A savings and loan association, or thrift institution, is a financial institution specializes in accepting savings, deposits, and making mortgages and other loans. A savings and loan association may have a federal or state charter.

Pursuant to title III of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, all functions of OTS relating to federal savings associations and the rulemaking authority of the OTS relating to all federal savings associations were transferred to the OCC on July 21, 2011 (transfer date). As a result, the OCC assumed the responsibility for the ongoing supervision, examination, and regulation of federal savings associations.

0120.2 Loan or Mortgage Company

These are corporations whose principal income is from making personal loans or real estate loans secured by trust deeds from their own moneyed capital.

0120.3 Credit Card Company

In the *Appeals of The Diners' Club Inc.*, 67-SBE-053, September 1, 1967, the State Board of Equalization held that a credit card company was taxable as a financial corporation because the corporate business was to deal in moneyed capital and was in substantial competition with national banks.

A department store may offer credit cards. Since the predominant activity of the department store, when measured by gross income, is making retail sales and not extending credit to earn interest income, the department store would be a general corporation. The department store may have a subsidiary whose only business activity is the unitary group’s credit card operation. The credit card subsidiary would be a financial

corporation if it satisfies all five requirements under CCR Section 23183. This could be true for auto manufacturers, companies engaged in retail gasoline sales, and other businesses.

See Bank & Financial Handbook Section 0900, COMBINATION OF GENERAL AND FINANCIAL CORPORATIONS.

0120.4 Credit Unions

California Financial Code Section 14002 defines a credit union as "a cooperative, organized for the purposes of promoting thrift and savings among its members, creating a source of credit for them at rates of interest set by the board of directors, and providing an opportunity for them to use and control their own money on a democratic basis in order to improve their economic and social conditions. As a cooperative, a credit union conducts its business for the mutual benefit and general welfare of its members with the earnings, savings, benefits, or services of the credit union being distributed to its members as patrons."

Credit unions have either state or federal charters.

Federally chartered credit unions are generally not taxable under federal and state law by operation of the Federal Credit Union Act (12 U.S.C. Sections 1751-1795k).

Operative for income years beginning on or after 1/1/99, SB 934 added R&TC Section 23701y to Chapter 4 (Exempt Corporations) of the Revenue and Taxation Code. That section provides for the exemption from California corporation income or franchise tax of state-chartered credit unions.

Prior to 1/1/99, state-chartered credit unions were found to be in substantial competition with national banks though they restrict their membership. They were taxed as financial corporations. They were allowed a deduction for all income resulting from or arising out of business activities with members or when done on a nonprofit basis for or with non-members as provided in R&TC Section 24405(a).

Prior to income year 1988, income from investments in bonds, savings deposits, etc., with non-members was held not deductible. The courts looked at the transaction to determine if the income was member or non-member income.

AB 1581 (Stats. 1987, Ch. 1465) added subdivision (c) to R&TC Section 24405, effective for income years beginning on or after January 1, 1988. R&TC Section 24405(c) provides for the deduction in computing taxable income, the income from credit union "surplus member savings capital". "Surplus member savings capital" is defined as the savings capital of the credit union members, which is in excess of the amount of savings capital loaned to its members.

AB 1581 (Stats. 1987, Ch. 1465) does not define income from surplus member capital or how to determine the amount of income. FTB Notice 92-7 provides direction in how to

determine the amount of income from surplus member savings capital (SMSC). In the *Appeal of San Francisco Police Credit Union*, 99-SBE-002, January 7, 1999, the SBE concluded, in assessing additional franchise tax against a member-owned credit union, the FTB must modify its application of the guidelines used to calculate the deduction for income from invested SMSC. Following the SBE decision in *San Francisco Police Credit Union*, the FTB issued Legal Ruling 2001-2 on May 11, 2001, modifying the language in FTB Notice 92-7 as required by the SBE.

FTB Notice 92-7 also concluded that credit unions were subject to Alternative Minimum Tax. However, legislation in 1993 provided that credit unions were not subject to AMT from member income. This resulted in regular tax equaling alternative minimum taxable income, thus no AMT. The 1993 legislation also provided that income from a reciprocal credit union is member income deductible under R&TC Section 24405(a).

The 1993 AMT and reciprocal credit union legislation was retroactive to all open years.

0120.5 Small Business Investment Companies

Small Business Investment Companies operate under the Small Business Investment Act of 1953 (15 U.S.C. Sections 661-697g).

0120.6 Farm Credit Administration

Congress established the Farm Credit Administration (FCA) in 1933 to consolidate within one entity substantially all powers and responsibilities of the federal government dealing with agricultural credit. The Act also provided additional resources for farm credit and formed the cooperative system of farming still in existence.

FCA is an independent federal agency that regulates and examines the banks, associations, and related entities of the Farm Credit System (FCS), including the Federal Agricultural Mortgage Corporation (Farmer Mac). Its three- member board of directors is appointed by the President.

Information regarding the various FCS Institution types can be found on the Farm Credit Administration website.

0120.7 Leasing Corporations

0120.71 Operating Lease
0120.72 Capital Lease
0120.73 Sales Lease
0120.74 Direct Financing Lease

The Comptroller of the Currency in a letter dated March 18, 1963, informed the presidents of national banks that direct lease transactions are "a lawful exercise of the powers of a

national bank. It is our conclusion that direct leasing transactions constitute legal and proper banking activities for national banks".

Prior to 1963, national banks were not permitted to directly engage in leasing. Accordingly, prior to 1963, the Franchise Tax Board would not classify a leasing corporation as a financial since it was not in substantial competition with national banks.

Prior to 1963, national banks would make loans to leasing companies in which the security for the loan was the leased property. Starting in 1963, the Office of the Comptroller of the Currency allowed national banks to lease property directly to the lessee rather than through a leasing company.

The California State Banking Department's Superintendent of Banks allowed state chartered banks to engage in direct leasing in 1964.

The Franchise Tax Board revised its position in regards to leasing companies due to the above changes in bank regulation. Certain leasing companies can be classified as financial corporations because national banks are permitted to engage in direct leasing.

In the *Appeal of Avcar Leasing, Inc.*, 82-SBE-143, March 31, 1982, the Board of Equalization considered the issue of whether a corporation engaged in the business of leasing automobiles was a financial corporation. The taxpayer did not maintain an inventory of automobiles. Avcar Leasing, Inc. asked the potential customer to choose their car, which would be procured at the time of the lease. The customers were screened as to their credit worthiness and the customer was responsible for the maintenance, repair, licensing, registration, and insuring of the leased vehicles.

The Board concluded that the leases were functionally interchangeable with secured loans in substantial competition with national banks, and that the taxpayer was properly classified as a financial corporation.

Federal Accounting Standards Board Statement #13 provides guidelines for financial accounting purposes for leases and Rev. Rul. 55-540 provides guidelines for tax purposes in determining if a lease is in fact a financing arrangement. Basically, leases are classified as operating leases or capital leases. The following chart will help distinguish between the two types of leases:

0120.71 Operating Lease

Lessee:

- Rental payments

Lessor:

- Rental income
- Asset on balance sheet
- Depreciates asset

0120.72 Capital Lease

Lessee:

- Principal & interest payments
- Asset on balance sheet
- Depreciates asset

Lessor:

- Interest income or sale

Capital leases for the lessor may be divided into sales-type leases and direct-financing leases. The difference between the two is that sales-type leases include profit from manufacturing while direct financing leases include interest and principal only.

0120.73 Sales Lease

Ace Corporation manufactures product z. A customer wants to purchase product z and agrees to lease it under terms that qualify as a capital lease. The customer's monthly lease payment to Ace Corporation includes Ace Corporation's cost to manufacture the product, interest and Ace Corporation's profit on the product sale.

0120.74 Direct Financing Lease

A customer wants to acquire product z manufactured by Ace Corporation. Instead of selling directly to the customer, Ace Corporation sells product z to Bank B. Bank B then leases product z to the customer through a capital lease.

In November 1976, the Financial Accounting Standards Board issued FASB No. 13. It provides that, for book purposes, a lease will be treated as a financial transaction if **any** of the following four transfer of ownership tests are met:

1. Ownership transfers at the end of the lease.
2. The asset can be purchased for a nominal amount (less than fair market value) at the end of the lease.
3. The term of the lease exceeds 75 percent of the property's estimated economic life.
4. The present value of the minimum lease payments exceeds 90 percent of leased equipment's fair market value, less any investment credit retained by the lessor.

The Internal Revenue Service in Rev. Rul. 55-540 provided guidance for determining if a transaction was indeed an operating lease. The test for determining if a lease agreement is in substance a purchase is whether the lessee acquires from the lessor the predominant benefits and burdens of ownership during substantially all of the leased property's useful life.

In Rev. Proc. 75-21, 1975-1 CB 715, the Internal Revenue Service established guidelines for advance rulings if a transaction was a sale or lease for tax purposes. If the following are met the IRS will likely rule that the transaction is a lease:

- The investor group must have a 20-percent equity at all times in the property.
- The lessee must not finance or guarantee financing for the equipment.
- The purchase option at the end of the lease cannot be less than the fair market value of the property.
- The lessor must be able to show a profit from the transaction absent of tax benefits.

The fair market value at the end of the lease must be at least 20% of the original cost and a remaining useful life longer than one year or 20% of the original useful life.

Rev. Proc. 75-21 has been modified by Rev. Proc. 76-30, 1976-2 CB 647, Rev. Proc. 79-48, 1979-2 CB 529, and Rev. Proc. 81-71, 1981-2 CB 731, and modified and superseded by Rev. Proc. 2001-28, 2001-1 CB 1156. Rev. Proc. 2001-28 states, in relevant part:

> This revenue procedure applies in the case of transactions commonly called "leveraged leases." Such leases generally involve three parties: a lessor, a lessee and a lender to the lessor. In general, these leases are net leases, the lease term covers a substantial part of the useful life of the leased property, and the lessee's payments to the lessor are sufficient to discharge the lessor's payments to the lender….
>
> Unless other facts and circumstances indicate a contrary intent, for advance ruling purposes only, the Service will consider the lessor in a leveraged lease transaction to be the owner of the property and the transaction a valid lease if all the guidelines described below are met. If all of these guidelines are not met, the Service nevertheless will consider ruling in appropriate cases on the basis of all the facts and circumstances.

FTB auditors should review Rev. Proc. 2001-28 guidelines when relevant.

Much of the federal tax law concerning leasing was developed by the courts and not in the Internal Revenue Code. Congress enacted statutory lease guidelines as part of the Economic Recovery Tax Act of 1981 (ERTA). Taxpayers following ERTA's "safe-harbor" provisions were assured that their transaction would be treated as a lease.

Criticism of ERTA's safe-harbor leasing rules prompted Congress to repeal the safe-harbor provisions in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and a new set of leasing rules were adopted. However, the Deficit Reduction Act of 1984

deferred the effective date of the new leasing rules until January 1, 1988 and the Tax Reform Act of 1986 eliminated the new rules, known as finance leases for the most part.

Currently, Rev. Rul. 55-540 and relevant court cases continue to provide guidance for determining whether a transaction is an operating lease or a financing lease.

AB 66 (Stats. 1979, Ch. 1150) added subdivision (b) to R&TC Section 23183. R&TC Section 23183(b) provides that a financial corporation does not include any corporation, including a wholly owned subsidiary of a bank or bank holding company, if the principal business activity of such entity consists of leasing tangible personal property.

In reading R&TC Section 23183(b), auditors may question if the law applies to both operating and capital leases or only to operating leases. The Department answered the question in FTB Notice 91-4.

FTB Notice 91-4 (subsequently superseded by FTB Legal Ruling 94-2, see below) concluded that R&TC Section 23183(b) is ambiguous because the term leasing is not defined. Given the ambiguity, one must look to legislative intent rather than to the law section alone.

The legislative intent is expressed in the un-codified preamble of AB 66, which was to reaffirm the legislature's long-standing purpose of ensuring "competitive parity" and "equal treatment" of banks and financial corporations. To assess a corporation whose principal business activity consists of finance leasing tangible personal property in substantial competition with a national bank at a rate of tax lower than that a national bank would pay would frustrate the legislature’s intent of ensuring competitive parity and equal tax treatment of banks and financial corporations.

Legal Ruling 94-2 superseded and withdrew FTB Notice 91-4, but incorporated the Notice's analysis and conclusions. In addition, Legal Ruling 94-2 provides a definition of finance lease. A finance lease, for the purposes of determining whether a corporation is a financial corporation, is a lease that is the type of lease allowed to national banks and is economically equivalent to the extension of credit. The lease is not treated as a true lease for federal income tax purposes. For example, the lessor is not entitled to a deduction for depreciation.

National banks are restricted by the OCC in the nature of the leasing they can do. For example, a national bank cannot enter into a vehicle lease that includes a maintenance contract.

In addition to the Legal Ruling 94-2, FTB auditors should be aware of the *Appeal of Avcar Leasing, Inc.* (82-SBE-143) issued on March 31, 1982. The question before the Board was if a leasing corporation was a financial corporation for 1977. Although the Board held that the leasing corporation was a financial corporation, it also added the following footnote 4:

> Pursuant to subdivision (b) of [R&TC] section 23183, operative for income years beginning on or after January 1, 1979, appellant would apparently no longer qualify as a financial corporation.

The Franchise Tax Board petitioned for rehearing to have Footnote 4 stricken from the opinion. Petition for rehearing was denied. Notwithstanding, Footnote 4 of the *Appeal of Avcar Leasing, Inc.,* does not clearly establish that the finance leasing activities do not qualify the taxpayer as financial corporation.

See also *Appeal of Alameda Bancorporation, Inc., Alameda First National Bank, First Leasing Corporation,* (95-SBE-001) issued on March 9, 1995, where the Board treated First Leasing Corporation's transactions are conditional sales and not leases. This case provides a thorough analysis of the factors relating to the benefits and burdens of ownership, in determining whether a transaction is an operating lease or a financing arrangement.

0120.8 Broker-Dealers

The Securities Exchange Act of 1934 (the "1934 Act") generally regulates the trading of securities in the secondary market by providing for public availability of information about companies whose securities are publicly traded and by substantive regulation of securities exchanges and market participants such as brokers and dealers. Most "brokers" and "dealers" must register with the SEC and join a self-regulatory organization ("SRO"). The national securities exchanges (e.g., NYSE, NASDAQ) are examples of SROs.

Who is a "Broker"?

The 1934 Act Section 3(a)(4)(A) generally defines a 'broker" as "any person engaged in the business of effecting transactions in securities for the account of others."

Example of a broker includes:

- A person that effects securities transactions for the account of others for a fee/commission (e.g., stockbrokers).
- A person that acts as a "placement agent" for private placements of securities.
- A person that markets insurance products that are securities in nature, e.g., variable annuities.

Who is a "Dealer"?

The 1934 Act Section 3(a)(5)(A) generally defines a "dealer" as "any person engaged in the business of buying and selling securities … for such person's own account through a broker or otherwise." Unlike a broker, who acts as an agent, a dealer acts as a principal.

Typical dealer functions include:

- Providing two-sided quotations or otherwise indicating an ongoing willingness to buy or sell particular securities (i.e., market maker); or
- Underwriting by issuing or originating securities in the primary markets that others buy and sell in the secondary markets.

Types of Securities Typically Transacted by Broker-Dealers:

1) Fixed Income, Currency and Commodities, including:

- Commodities and commodity derivatives,
- Credit products, including the trading of and investing in credit derivatives, investment grade corporate securities, high-yield securities, bank loans, municipal securities, emerging market debt and other distressed debt,
- Currencies and currency derivatives,
- Interest rate products, including interest rate derivatives, global government securities and money market instruments, including matched book,
- Mortgage-backed securities and loans and other asset-backed securities.

2) Equities:

- Equity securities and equity derivatives

A derivative is a security with a price that is dependent upon or derived from one or more underlying assets. The derivative itself is a contract between two or more parties based upon the asset or assets. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes.

Derivatives can either be traded over-the-counter (OTC) or on an exchange. OTC derivatives constitute the greater proportion of derivatives in existence and are unregulated, whereas derivatives traded on exchanges are standardized. OTC derivatives generally have greater risk for the counter-party than do standardized derivatives.

Securities Law relating to Bank's Securities Transactions

Historically, banks in the United States had always engaged in security activities. But banks were not subject to SEC's regulation because, prior to the enactment of GLBA in 1999, the 1934 Act excluded a bank from the definitions of the terms "broker" and "dealer" and banks were not required to register with the SEC as brokers and dealers. Beginning on May 12, 2001, as the result of the functional regulation provisions of the GLBA, banks lost their statutory exemption from registration as broker-dealers under the 1934 Act with respect to their securities brokerage or dealing activities. However, in order to avoid disrupting traditional bank brokerage and dealing activities, the GLBA amended the 1934 Act to create certain exemptions allowing banks to continue to engage in certain activities

without registering as broker-dealer. Under the GLBA, a bank shall not be considered to be a "dealer" because the bank engages in any of the following activities:

1) Permissible Securities Transactions

The bank buys and sells commercial paper, banker's acceptances, or commercial bills; exempt securities; certain qualified Canadian government obligations, or obligations of the North American Development Bank; and Brady bonds.

2) Investment, Trustee, and Fiduciary Transactions

The bank buys and sells securities for investment purposes for the bank itself and for its trustee and fiduciary accounts. It does not apply to transactions between the bank and its customers.

3) Asset-Backed Transactions

This exemption permits banks, through a grantor trust or another separate entity, to issue and sell certain asset-backed securities to "qualified investors." These securities must represent obligations predominantly (85% or more) originated by the bank, or an affiliate of the bank that is not a broker-dealer. The term "qualified investor" is defined in Section 3(a)(54) of the 1934 Act to include other banks, broker-dealers, savings associations, and other parties that meet specified criteria. This exemption is limited to the original placement of these securities. A bank is not permitted to repurchase and resell these securities in the secondary market.

4) Identified Banking Products

This exemption permits banks to buy and sell certain "identified banking products," which include deposit accounts, savings accounts, certificates of deposit, other deposits instruments issued by a bank, banker's acceptances, bank issued letters of credit, bank loans, and debit accounts. "Identified banking products" also include loan participations if they are sold to "qualified investors," or to other persons who have the opportunity to review and access any material information. In addition, "identified banking products" include (i) credit swaps and (ii) equity swap that are sold directly to "qualified investors."

In addition to the statutory exemptions noted above, the SEC adopted several regulatory exemptions:

1) Riskless Principal Transactions

This exemption permits banks to engage in a limited number (up to 500) of "riskless principal" transaction per calendar year. A "riskless principal" transaction is one in which, after having received an order to buy from a customer, a bank purchases the security from another person to offset the contemporaneous sale. Alternatively a riskless principal

transaction is one in which after having received an order to sell from a customer, a bank sells the security to another person to offset that contemporaneous purchase.

2) Securities Lending Transactions

This exemption permits banks to engage in, or effect, securities lending transactions with certain counterparties. A "securities lending transaction" is a transaction in which the owner of a securities lends the security temporarily to another party under a written securities lending agreement. Through this agreement, the lender retains the economic interests of an owner of the securities. Subject to any terms agreed upon by the parties, including an agreement to loan the securities for a fixed term, the lender also has the right to terminate the transaction and to recall the loaned securities.

As long as a bank's securities transactions are limited to activities within any of these exemptions, a bank is not required to register with the SEC as a "dealer."

Banking Law Relating to Securities Transactions:

The OCC prescribes standards under which national banks may purchase, sell, deal in, underwrite, and hold securities. (*See* Code of Federal Regulations, Title 12 (Banks & Banking), Chapter 1 (Comptroller of the Currency, Department of the Treasury), Part 1 (Investment Securities).)

Under 12 CFR Section1.3, the OCC permits national banks to underwrite, deal in, purchase and sell certain types of investment securities. The OCC's definition of "investment securities" refers to debt securities not equity securities. These debt securities include, but are not limited to:

- US government and agency obligations
- State and municipal bonds
- Mortgages related securities

These debt securities are considered "moneyed capital" as defined in CCR Section 23183(b)(3). Depending on the facts, a broker-dealer may or may not be a financial corporation under CCR Section 23183.

0130 COMBINATION OF GENERAL AND FINANCIAL CORPORATIONS (INCLUDING BANKS)

For California tax purposes, in many respects banks and financial corporations are treated differently from general corporations at both the entity and the combined reporting group levels. At the entity level, for example, a higher franchise tax rate (10.84%) is imposed on California taxpayers that are banks and financial corporations, than the tax rate (8.84%) imposed on general corporations. Banks and financial corporations' apportionment factors are determined pursuant to CCR Section 25137-4.2 (*See* HANDBOOK SECTION 1000).

At the combined report group level, if the combined group includes both bank and/or financial and general corporations, several factors must be considered before selecting the appropriate apportionment formula and factors rules:

(a) If an apportioning trade or business (a combined reporting group) derives more than 50 percent of its gross business receipts from conducting a savings and loan activity and/or a banking or financial business activity, the combined reporting group must apportion its income to California using the evenly weighted 3-factor apportionment formula set forth in R&TC Section 25128(b).

2025 Change in law effective for taxable years beginning on or after January 1, 2025: Pursuant to SB 132 (2025), the definition of the term "qualified business activity" set forth in R&TC Section 25128 was amended to exclude (1) savings and loan activity and (2) banking or financial business activity as applicable to the apportioning trade or business filing California returns for taxable years beginning on or after January 1, 2025. Consequently, for taxable years that begin on or after January 1, 2025, unless an apportioning trade or business derives more than 50 percent of its gross business receipts from "agricultural business activity" and/or "extractive business activity," the apportioning trade or business is subject to a single sales factor apportionment formula, regardless of its percentage of gross business receipts from (1) "savings and loan activity" or (2) "banking or financial business activity."

(b) Regardless of which apportionment formula is required under R&TC Sections 25128.7 and 25128, if the combined report group's non-financial/non-banking activities generate more than 50 percent of the group's gross business income during the year at issue, the applicable apportionment factors rules are set forth in CCR Section 25137-10. Under CCR Section 25137-10:

2025 Change in law effective for taxable years beginning on or after January 1, 2025: Pursuant to SB 132 (2025) and amended R&TC Section 25128, for the taxable years beginning on or after January 1, 2025, only the receipts factor rules set forth in CCR Section 25137-4.2 and CCR Section 25137-10 should apply, unless an apportioning trade or business derives more than 50 percent of its gross business receipts from "agricultural business activity" and/or "extractive business activity."

i. For calculating sales/property factors for banking/financial corporations in the group, apply CCR Section 25137-4.2 rules, with modifications for property factor as provided in CCR Section 25137-10(d)(1) and sales factor in (d)(3)(B)(2). For calculating payroll factor, use R&TC Sections 25132 and 25133 rules.

ii. For calculating factors for the group's general corporations, apply normal rules with modifications to the property factor, where applicable, as set forth in CCR Section 25137-10(d)(1) and sales factor in (d)(3)(B)(1).

iii. NOTE: the 20 percent rule under CCR Section 25137-10(d)(1)(C) for intangibles included in the property factor applies only when a combined report group falls within the scope of CCR Section 25137-10.

(See Handbook Section 900 for further reference.)

As such, three tests are relevant for California tax purposes when banks and financial corporations are present in the combined group. The following table sets forth the basic rules pertaining to the various tests relating to financial corporations for California tax purposes.

California Authority	Corporation/Group	Gross Income/Gross Receipts
CCR Section 23183(a)	Corporation	Gross Income
R&TC Section 25128(b)	Group	Gross Receipts
CCR Section 25137-10	Group	Gross Income