

## Client Alert

---

November 17, 2014

# California FTB to Consider Revisions to Combination Regulations for Mixed Financial and Non-Financial Reporting Groups

By Eric J. Coffill

The California Franchise Tax Board (FTB) has announced the scheduling of an Interested Parties Meeting (IPM) for December 4, 2014 on the topic of possible regulatory efforts regarding the proper treatment of mixed bank/financial corporation and general corporation combined reporting groups. The meeting will take place at FTB headquarters in Sacramento, California, but parties can also participate by dial-in telephone conference.

California taxpayers that are part of a combined report which includes both general corporations and banks/financial corporations, and *especially* California taxpayers where the bank/financial corporation is predominant in such a combination, are well advised to carefully track FTB's upcoming activities in this area, beginning with the IPM.

Frequently, a California combined report does not include exclusively general corporations or exclusively banks/financial corporations. The combination of general corporations (i.e., non-financials) and banks and financial corporations into a single combined report has always posed challenges for FTB in terms of crafting an apportionment formula. Indeed, at one time, FTB took the position that the two groups simply could not be combined. However, in 1974, FTB changed course and issued Legal Ruling 370, which stated that general corporations and banks/financial corporations could be combined, and provided some basic, but questionable, rules for combination (e.g., "intangible personal property shall be excluded from the property factor"). Still later, FTB administratively (but never by regulation) adopted a method known as "pre-apportionment" for such mixed combinations, by which the total unitary income was divided between the general corporations and the banks/financial corporations using a three-factor formula consisting of payroll, property and a "resource" factor. FTB then withdrew Legal Ruling 370 in 1998, and also abandoned its pre-apportionment method.

Traditionally, the major problem in such a mixed combination has been the treatment of intangibles. Banks and financial corporations include intangibles in their property factors, whereas general corporations do not. At a time when banks/financial corporations and general corporations all apportioned their income on the basis of an equally weighted three-factor formula, the inclusion or non-inclusion of intangibles could have a significant effect. FTB Regulation<sup>1</sup> 25137-4.1 (effective for income years beginning before January 1, 1996) and Regulation 25137-4.2 (effective for income years beginning on or after January 1, 1996) set forth special apportionment rules for banks and financial corporations, which provide for the inclusion of intangibles (e.g., loans) in the property factor. FTB's current administrative position is that Regulation 25137-4 also applies where the combined report includes

---

<sup>1</sup> All citations herein to FTB "Regulations" are to sections of Title 18 of the California Code of Regulations.

# Client Alert

both general corporations and banks/financial corporations and the banks/financial corporations are predominant, with the general corporations' factors being determined in accordance with California Revenue and Taxation Code<sup>2</sup> and FTB Regulation sections 25129 through 25136.<sup>3</sup> For example, under this approach, a general corporation, such as a broker/dealer, would include its factors in accordance with sections 25129 through 25136, and the factors of the banks/financial corporations would be included under the provisions of Regulation 25137-4.

In late 1990, FTB adopted Regulation 25137-10, "Combination of General (Non-Financial) and Financial Corporations," which applies by its terms only where the combined report includes general corporations and banks or financial corporations and the general corporations' operations are predominant. ("Predominant" is determined by looking to the activity which gives rise to gross income which is more than fifty percent of the unitary business's gross income.) For example, Regulation 25137-10 applies to the combination of a department store and its credit card subsidiary, or to an automobile manufacturer and its customer credit subsidiary, i.e., where there is a predominant general corporation with a unitary bank/financial corporation subsidiary.

The discussion materials accompanying the announcement of the IPM state that "[w]hat remains unclear is what the appropriate apportionment rules should be when the financial entities are the predominant earners of income, but the group also contains general corporations, such as registered broker/dealers," and then posits an example where a broker/dealer generates high sales and low income relative to the operations of the (unitary) bank/financial corporation, which FTB believes causes a "mismatching of the income and apportionment factors..."

FTB goes on to identify six issues for discussion at the IPM:

1. Should FTB begin a regulatory effort to address the fact pattern above involving broker/dealers, or is it more appropriately addressed on a taxpayer-by-taxpayer basis?
2. If FTB were to proceed by regulation, what form would such a regulation take and should changes be made to existing Regulation 25137-10 to address the issue?
3. Is it feasible to use Regulation 25137-10 as a model where the financial entities are predominant?
4. Given California's move to mandatory single factor sales for most corporations, should FTB explore the definitional provisions for "qualified business activity" found in section 25138, which include the provision stating that banks and financial corporations are to use an equally weighted three-factor apportionment formula if more than fifty percent of "gross business receipts" are from such a qualified business activity? Should FTB "develop rules" for determining when an apportioning trade or business is receiving more than fifty percent of its gross business receipts from a banking or financial business activity?
5. Are there options that would involve only adjustments to the sales factor of the apportionment formula?
6. Are there other options that should be explored?

<sup>2</sup> All citations herein to "sections" are to sections of the California Revenue and Taxation Code.

<sup>3</sup> See FTB Bank & Financial Handbook, p. 270, Section 0908, "Combination of General and Financial Corporation." Note the version of the Handbook *currently* appearing on the FTB website states that it was revised in "October 2003."

## Client Alert

---

Those familiar with FTB's current audit plan and practices involving the combination of banks/financial corporations and general corporations are well aware of the current controversy surrounding the inclusion of (gross) receipts from unitary broker/dealers. As pointed out by FTB in the discussion materials for the IPM, FTB has been taking the position in its audit program, "under the authority of Revenue and Taxation Code section 25137," that "distortion" in this setting could be remedied by including the receipts of the non-financial entities at net gains, or by splitting the otherwise unitary group into two groups and then separately apportioning the income of the non-financial entities using the gross receipts from those activities and apportioning the income of the banks/financial corporations under Regulation 25137-4.2.

Those parties potentially affected by new regulatory activity in this area should embrace FTB's invitation "to elicit public input" at the December 4 IPM.

### Contact:

**Eric J. Coffill**

(916) 325-1324

[ecoffill@mofo.com](mailto:ecoffill@mofo.com)

### About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer's* A-List for 11 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at [www.mofo.com](http://www.mofo.com).

*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.*