

Intrastate Apportionment: Ripe for Equitable Relief?

by Prentiss Willson, Carley A. Roberts, and Maria M. Todorova



Prentiss Willson Carley A. Roberts Maria M. Todorova

The California Franchise Tax Board has issued a chief counsel ruling stating that a registered broker-dealer must include the entire sales price received from the sale of securities — including the return of capital — in the sales apportionment factor.¹ Interestingly, the chief counsel determined that California's alternative apportionment provisions do *not* apply to the combined group's intrastate apportionment results.

Background

The chief counsel ruling was requested by a combined reporting group of companies that included financial and nonfinancial subsidiaries, including a banking association. The ruling request focused on the banking association's wholly owned subsidiary, which was a registered broker-dealer and a member of the National Association of Securities Dealers. The broker-dealer was not a financial corporation under FTB reg. 23183.²

The broker-dealer traded securities from its own account, generating gains and losses on the sales of securities (principal trades).³ Receipts from those principal trades were sourced to California under

Cal. Rev. & Tax. Code section 25136 because the greater costs of performance of the broker-dealer's transactions occurred in California. Therefore, the broker-dealer's receipts from the principal trades were included in the broker-dealer's California sales factor numerator and denominator.

Historically, the broker-dealer included only the net proceeds of its principal trades in the sales factor. Under that approach, and as a result of California's costs of performance rules, the taxpayer's sales factor historically averaged 93.66 percent. However, if the taxpayer included the gross (not net) sales proceeds of the broker-dealer's principal trades in the sales factor (for example, net gains plus return of capital) for the same historic period, the sales factor would increase to an average of 97.66 percent, changing the sales factor by 4 percent and increasing the apportionment formula by 4.3 percent.

Chief Counsel Ruling Part I: Inclusion of Treasury Receipts in the California Sales Factor

The inclusion of treasury receipts in the California sales apportionment factor has evolved over the past several years.

In 2006 the California Supreme Court held that the entire receipts from treasury operations (principal and interest) must be included in the sales factor.⁴ The court further held that Cal. Rev. & Tax. Code section 25137, which permits deviation from the standard apportionment provisions when they "do not fairly represent the extent of the taxpayer's

¹Chief Counsel Ruling 2012-01, California Franchise Tax Board, Apr. 30, 2012 (released June 2012).

²18 Cal. Code Regs. section 23183.

³The broker-dealer also made brokerage sales, in which the broker-dealer earned commission income from buying and selling securities to customers (agency trades). The chief counsel ruling focused on the taxpayer's principal trades.

⁴*Microsoft Corp. v. Franchise Tax Board*, 39 Cal. 4th 750 (2006); *General Motors Corp. v. Franchise Tax Board*, 139 P.3d 1183 (Cal. 2006). Repurchase agreements are an exception to the general rule. In *General Motors*, the court held that repurchase agreements and maturities are not sales, and thus only the interest generated from those transactions was includable in the sales factor as gross receipts. *General Motors*, 139 P.3d at 1192. For the decision in *Microsoft*, see *Doc 2006-15737* or *2006 STT 162-3*; for the decision in *General Motors*, see *Doc 2006-15758* or *2006 STT 162-4*.

business activity in this state,” authorized the exclusion of the return of capital from the apportionment formula.

The California State Board of Equalization had previously ruled that a broker-dealer’s gross receipts — rather than net receipts — from principal trades were includable in the sales factor.⁵

Effective January 1, 2011, California amended its law to require that receipts from the maturity, redemption, sale, exchange, or other disposition of intangible assets held in connection with a taxpayer’s treasury function (that is, principal trades) be excluded from the computation of the sales factor.⁶

However, California continues to require some financial institutions to include gross receipts from treasury transactions. Taxpayers principally engaged in purchasing and selling intangible assets of the type typically held in a taxpayer’s treasury function (for example, a registered broker-dealer) are not performing a treasury function.⁷ Therefore, a taxpayer whose primary line of business consists of trading securities must include gross receipts from sales of securities in its sales factor under section 25120, unless the inclusion of those proceeds causes the taxpayer’s apportionment formula to not fairly represent the taxpayer’s business activity in California under section 25137.

In applying the new law, the chief counsel determined that the broker-dealer’s principal trades generated gross receipts under section 25120 and that therefore, the entire sales proceeds (including the return of capital) must be included in the sales factor.

This portion of the chief counsel ruling is not surprising. The determination is not only consistent with section 25120(f)(2)(K), but is also consistent with *Appeal of Merrill, Lynch*. The BOE further determined that when the operation of a large treasury function is related to the taxpayer’s primary line of business, the application of an alternative apportionment formula under Cal. Rev. & Tax. Code section 25137 will not be warranted.

Chief Counsel Ruling Part II: Application of Section 25137 to Intrastate Apportionment

The taxpayer also requested a ruling on whether the inclusion of the broker-dealer’s entire proceeds in the sales factor justifies the application of alternative apportionment under section 25137. The issue was framed as follows:

If return of capital is included in [the broker-dealer’s] sales factor under [the] standard method apportionment, does this lead to apportionment that, for purposes of RTC section 25137, does not fairly represent the extent of the unitary business’ California business activities because it effects the intrastate apportionment between [the nonfinancial broker-dealer] and the financial corporation members of the combined report group?⁸

In California the business income of a combined reporting group is apportioned to California through *interstate* apportionment and then is assigned to each member of the unitary group through *intrastate* apportionment.⁹ Determining each member’s separate California taxable income and tax liability is a two-step process. The first step is to determine the group’s California apportionment factor to arrive at the group’s California-source business income. The second step is to determine each taxpayer member’s intrastate apportionment percentage to arrive at the respective member’s California-source business income and individual tax liability.

Section 25137 authorizes a taxpayer or the FTB to apply an alternative apportionment method if the standard apportionment method does not fairly represent the extent of the taxpayer’s business activity in California. Several questions arise about how to apply this provision, including:

- Which apportionment method does Cal. Rev. & Tax. Code section 25137 apply to — the interstate apportionment method used by the combined reporting group or the intrastate apportionment formula used by each group member or both?
- Who is the taxpayer — the combined reporting group or each individual member?

The chief counsel ruled that the alternative apportionment provisions in section 25137 apply only when the standard apportionment method does not fairly represent the extent of the taxpayer’s business in California. Because *intrastate* apportionment is not concerned with the geographic sourcing of income among states but rather with the relative weight of the taxpayer’s in-state activities among the group members, the chief counsel concluded that section 25137 does not apply to adjust intrastate apportionment results.

Application of section 25137 to the apportionment method of the entire combined reporting group is consistent with California’s reversion to the *Finnigan* method for calculating a combined return effective January 1, 2011, which requires that sales from

⁵*Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 89-SBE-017 (Calif. State BOE, June 2, 1989).

⁶Cal. Rev. & Tax. Code section 25120(f)(2)(K).

⁷*Id.*

⁸Chief Counsel Ruling 2012-01, *supra* note 1, at p. 2.

⁹Cal. Rev. & Tax. Code sections 25128 and 25135.

all members of the unitary combined group be included in the sales factor numerator regardless of whether the individual group member has nexus with the state.¹⁰

Upon a first reading, the ruling seems unfavorable to the taxpayer making the request. However, upon closer examination of the facts and the specific issues presented by the taxpayer, the result appears likely to be favorable to the taxpayer.

California taxes financial corporations differently from general (that is, nonfinancial) corporations. General corporations are subject to tax under section 23151 (currently 8.84 percent). Financial corporations, which include entities that predominantly deal with money or moneyed capital in substantial competition with banks, pay the tax imposed on general corporations, plus the in lieu of tax (currently 2 percent) under section 23186 (for a total of 10.84 percent). The inclusion of the gross receipts from the principal trades in the numerator and denominator of the broker-dealer's California sales factor increased the combined group's overall apportionment ratio by 4.3 percent, which increased the group's income subject to tax in California. However, the taxpayer may have been able to assign a greater portion of its taxable income to a general (that is, nonfinancial) corporation subject to a lower income tax rate, which ultimately might have reduced its overall California tax liability.

The chief counsel's determination that section 25137 has no application to California's intrastate apportionment seems to serve as an affirmation to the taxpayer that its intrastate apportionment would not be adjusted. The ruling appears to be a taxpayer-favorable decision since the company may have reduced its California tax obligation.

Taking a broader perspective, however, the ruling is not so taxpayer friendly. California's intrastate apportionment rules greatly affect taxpayers' tax liabilities, particularly since California restricts (or "traps") the use of credits and net operating losses to individual members of a combined group. Assume, for example, that Company A, a member of a combined reporting group, derives its income from intercompany sales and has generated extensive research and development credits. California regulations require that income from intercompany sales between affiliated members of a combined group be eliminated. Credits are generally applied against the tax on a separate company basis, and specific credits are

available only to the taxpayer corporation that incurred the expense to generate the credits. Because all Company A's income would be eliminated as intercompany revenue, Company A would be deemed to have no sales factor and zero California tax liability, and thus would not be able to claim its research and development credits.

By restricting the application of section 25137 only to interstate apportionment, the chief counsel has foreclosed taxpayers' ability to adjust for inequities created by California's intrastate apportionment rules. Would a particularly egregious level of intrastate apportionment distortion combined with the appropriate facts lead to a constitutional infirmity sufficient to challenge the FTB's position on this issue?

Chief Counsel Ruling Part III: FTB Will Not Issue Rulings on Distortion

The chief counsel also made clear that the FTB was not taking a position in the ruling regarding the application of section 25137 to the facts set forth in the ruling. The ruling provides that "Chief Counsel Rulings are not an appropriate venue for the analysis of whether or not RTC section 25137 applies in a specific fact pattern."¹¹ Instead, taxpayers seeking application of California's alternative apportionment provisions are directed in the ruling to the petition process in section 25137 and the regulations thereunder. ☆

Prentiss Willson is of counsel, Carley A. Roberts is a partner, and Maria M. Todorova is an associate with Sutherland Asbill & Brennan LLP. All are members of the State and Local Tax (SALT) team of Sutherland's Tax Practice Group.

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¹⁰Cal. Rev. & Tax. Code section 25135(b).

¹¹Chief Counsel Ruling 2012-01, *supra* note 1, fn. 3.