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California - gross receipts from a broker-dealer's trading activity are included in the sales factor, alternative apportionment does not apply to intrastate distortion

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In brief

In a Chief Counsel ruling, the California Franchise Tax Board concluded that gross receipts, as opposed to net gains, resulting from a non-financial Broker-Dealer's principal security trading activity should be included in the California sales factor. The FTB also found that intrastate apportionment (the relative share of the group's California activities that is conducted by each taxpayer member of the group) is not a proper subject for alternative apportionment distortion relief under CRTS § 25137.

In detail

In [Chief Counsel Ruling 2012-01](#), the taxpayer is a holding company with banking and non-banking subsidiaries. One of its subsidiaries is a California-based, non-financial Broker-Dealer that buys and sells securities from the taxpayer's own account and generates gain or loss on the sale of the securities (the "Principal Trades"). For tax years 2005 through 2009, the Broker-Dealer included net gains from the Principal Trades in its California sales factor, resulting in an average California sales factor of 93.66%. If gross revenues from the Principal Trades were included in the factor, as opposed to net gains, the average California sales factor for



the same years would be 97.66%. The Broker-Dealer had the greater cost of performance of its trading activities in California. Therefore, Principal Trading receipts (on either a gross or net basis) would be included in both the California numerator and denominator.

The taxpayer requested a ruling asking: (1) under the standard method of apportionment whether the gross sales received from the Principal Trades should be used in the California sales factor; and (2) if so, whether the effect of the gross receipts inclusion would lead to the use of an alternative apportionment method under CRTC § 25137 due to *intrastate* apportionment distortion. The Chief Counsel Ruling held that:

- (1) the entire sales prices received from Principal Trades by the Broker-Dealer should be included in the sales factor, including return of capital.
- (2) intrastate apportionment is not a proper subject for analysis under CRTC § 25137 and therefore the change in intrastate apportionment by including gross receipts from Principal Trades does not, by itself, establish distortion under CRTC § 25137.

The FTB is essentially confirming that a non-financial Broker-Dealer will still include Principal Trades at gross, not net, in the sales factor, even after CRTC § 25120 was amended to exclude treasury receipts from the sales factor. Because the treasury receipts exclusion does not apply to registered Broker-Dealers, the prohibition does not apply to the Broker-Dealer in this ruling.

Also of interest is the *intrastate* apportionment holding. Including gross receipts in the California sales factor numerator and denominator changed the relative *intrastate* apportionment between general and financial corporations, though the ruling did not provide any details. The FTB held that since CRTC § 25137 speaks only to fair representation of activities "in this state," CRTC § 25137 cannot be used to remedy *intrastate* apportionment issues.

The ruling specifically does not address whether or not including such receipts would have caused *interstate* apportionment distortion. The difference between these two terms is as follows:

Intrastate apportionment refers to the relative proportion of the group's overall California activity that is conducted by each taxpayer member.

Interstate apportionment refers to the overall California activity of the entire group as compared to the overall everywhere activity of the entire group.

PwC Observes

Ben Muilenburg, a Director in PwC's Sacramento office, makes the following observation:

Whether to include the gross receipts or merely the net gains from a Broker-Dealer's principal trades in the California sales factor has been the subject of many disputes over the last few years. However, as a result of this Chief Counsel ruling and similarly situated controversies known to PwC, it is now clear that the FTB believes gross

receipts should be included in the California sales factor when dealing with the principal trading activity of a non-financial Broker-Dealer.

It is important to recognize the limitation of this ruling. For example, it is stipulated in the facts that the Broker-Dealer in question is a general corporation that does not generate financial receipts from dealing in money or moneyed capital in competition with the business of national banks. While these facts are assumed for this Chief Counsel ruling, whether or not a Broker-Dealer generates financial receipts from dealing in money or moneyed capital in competition with the business of national banks continues to be a hotly contested issue in California. In fact, when the Broker-Dealer in question is organized outside of California, creating large receipts in the denominator only, the FTB has routinely suggested that the activity is financial in nature, possibly requiring the entire combined reporting group to use an equal-weighted, three-factor apportionment formula under CRTS § 25128. As a result, taxpayers should be careful to recognize the nature of their own principal trades and not assume that the same conclusions would apply to their particular case.

It is also important to put the ruling in context with respect to distortion. As mentioned above, the ruling only answers the specific question of whether or not *intrastate* apportionment changes can be considered distortive and remedied through CRTS § 25137. The ruling expressly states that no decision was rendered with regard to *interstate* apportionment. While the FTB has historically tried to limit taxpayers' application of CRTS § 25137 to matters of geographical apportionment, this is the first time that it has affirmatively stated that matters of *intrastate* apportionment should be excluded from consideration. Therefore, given the difference between intrastate and interstate apportionment, taxpayers should also be careful not to apply this portion of the ruling too broadly.

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