



June 24, 2016

John Su  
Franchise Tax Board  
Legal Division (MS-A260)  
P.O. Box 1720  
Rancho Cordova, CA 95741-1720.

**RE: Possible Amendments to California Code of Regulations, title 18, section 25137-10 (Combination of General and Financial Corporations) regarding the proper treatment of mixed financial and non-financial combined reporting groups**

Dear Mr. Su:

The Securities Industry and Financial Markets Association<sup>1</sup> (“SIFMA”) appreciates this opportunity to comment on the proposals made by the taxpayer community and staff of the Franchise Tax Board (“FTB”) for possible regulatory approaches to addressing the issues raised when broker-dealers and financial entities are included in the same combined reporting group. SIFMA and its member firms continue to believe that a collaborative resolution of difficult issues is in the best interests of all parties.

**I. Comments on the Proposals raised by FTB at the April 2016 Interested Parties Meeting**

A. Proposal 1 - Inclusion of principal trade gross receipts based upon the percentage of security broker-dealer assets.

This approach includes security broker-dealer principal trade gross receipts in the sales factor based on the percentage the security broker-dealer’s assets bear to the combined reporting group’s total assets.

For example, in each of the last five years, the security broker-dealer’s assets represented 10 percent of the total assets owned by the broker-dealer and bank combined. In computing the combined reporting group’s current year’s apportionment, the security broker-dealer would include 10 percent of its gross receipts in the sales factor. In this fact pattern, the bank is the primary business and therefore the combined calculation reflects more of a net approach. If the opposite fact pattern exists and the security broker-dealer actually owns 90 percent of the

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<sup>1</sup> SIFMA represents the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$20 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

combined assets and is the primary business operation of the group, the security broker-dealer would include 90 percent of its gross receipts.

A standalone bank would include all net receipts and a standalone security broker-dealer would include all gross receipts.

- SIFMA supports the adoption of this proposal and believes it is the best approach because:
  - It is simple and verifiable.
  - Of all of the proposals, Proposal 1 most fairly reflects the broker-dealer's contribution to the unitary group's activities.
  - It accomplishes the FTB's goal of reducing disagreements on audit.
- With respect to the statement that "A standalone bank would include all net receipts and a standalone security broker-dealer would include all gross receipts":
  - SIFMA agrees with this statement and strongly encourages that FTB include such a statement in the draft of the regulation, as an acknowledgment of the state of the California case law and regulations addressing standalone broker-dealers and financial entities.
  - Regarding the assets calculation method, SIFMA also suggests that FTB include in the regulation a safe harbor provision that sets forth a method for the asset ratio calculation that, if followed by the taxpayer, will serve to ensure that the asset ratio calculation will not be subject to additional adjustment by FTB under its authority provided by Revenue and Taxation Code section 25137.

B. Proposal 2 - Sales factor reflecting a simple blend of net and gross receipts.

If a security broker-dealer's principal trades represent 95 percent of the combined reporting group's gross receipts, the combined reporting group's sales factor will include 95 percent of the net gain and 5 percent of the gross receipts of the security broker-dealer principal trades.

- SIFMA is unclear on the reasoning behind this proposal other than possibly as a mathematical compromise methodology.
- We believe the approach in Proposal 1 is more appropriate as it better reflects the activities of both the broker-dealer and the bank and their relative contributions to the unitary group.

C. Proposal 3: Sales factor reflecting a weighted blend of net and gross receipts.

This method calculates both a Gross Sales Factor that includes the gross receipts from principal trades and a Net Sales Factor that includes the net gain from principal trades. A

Blended Sales Factor is then computed for inclusion in the overall apportionment formula that reflects a weighting of the Gross Sales Factor and the Net Sales Factor. The weighting is based on the income generating activities' contribution toward the combined reporting group's overall gross business income.

For example, assume that for a hypothetical unitary group, the Gross Sales Factor is 2 percent and the Net Sales Factor is 6 percent. If the security broker-dealer principal trade activity contributes 5 percent of the combined reporting group's total business income, and other activities including the traditional banking activities contribute 95 percent of the combined reporting group's business income, the Blended Sales Factor is computed as follows:

The Gross Sales Factor of 2 percent is multiplied by 5 percent to arrive at .1 percent, the Net Sales Factor of 6 percent is multiplied by 95 percent to arrive at 5.7 percent, and the products of both calculations are added together to derive the Blended Sales Factor of 5.8 percent ( $= .1\% + 5.7\%$ ). The unitary group would use the 5.8 percent Blended Sales Factor in its apportionment formula, whether an evenly weighted 3-factor formula or a single sales factor formula, to apportion its total business income to California.

- SIFMA opposes this approach because:
  - It is likely subject to much greater volatility from year to year as compared to Proposal 1.
  - It is unnecessarily complex, particularly in light of intrastate apportionment required for taxpayers within the combined reporting group, which is further compounded if there are post-apportionment attributes carried over from one year to another.
  - It does not result in an apportionment formula that reflects the activities of the broker-dealer adequately.
  - It is inconsistent with the unitary business principle, as it is based upon a separate accounting determination of income for both the broker-dealer entities and the banking entities, a determination that is not possible given the unitary nature of these businesses.

D. Proposal 4 (FTB Staff): Net receipts approach

For purposes of apportionment, but not for purposes of imposing corporate franchise tax, treat security broker-dealers same as banks and financial corporations, i.e., the combined reporting group will include in sales factor to the extent of net gain from security broker-dealers principal trade transactions.

- SIFMA opposes this approach because:
  - It fails to fairly represent the activities of the broker-dealer entities.

- It does not recognize that the broker-dealers' sales of securities represent sales of intangibles and should be reflected at gross as required by the *Appeal of Merrill Lynch, Pierce, Fenner and Smith Inc.* (89-SBE-017) and implied by Revenue and Taxation Code section 25120(f)(2)(K).

## II. Additional Comments

The potential inclusion amount of the broker-dealer's gross receipts and the impact on the unitary apportionment factor will not be determined with any certainty until full year data is available after year end. We ask that the FTB consider estimated payment relief perhaps in the form of a safe harbor if the prior year apportionment percentage was used for estimated payment purposes.

In addition, any change from the current statutes could result in material differences between the intrastate allocation percentage of prior year losses/attributes and future income. Taxpayers should be able to re-spread existing losses/attributes if the change in apportionment methodology results in material changes within intrastate apportionment.

## III. Conclusion

For the reasons noted above, we again note our support for the adoption of Proposal 1, our uncertainty about Proposal 2, and our opposition to Proposals 3 and 4.

We also respectfully ask the FTB to consider ways to ease any transition and to work with us regardless of which proposal may be adopted.

Thank you very much for your consideration of this important matter. Please contact me at 212-313-1311 for additional information or clarification of the aforementioned comments.

Sincerely,



Kim Chamberlain  
Managing Director and Associate General Counsel  
State Government Affairs