0900 COMBINATION OF GENERAL AND FINANCIAL CORPORATIONS

At the combined reporting group level, if the apportioning trade or business includes banking and/or financial business activity, R&TC Section 25128 sets forth the rules to determine the apportionment formula the group must apply to apportion its income to California, and, if applicable, CCR Section 25137-10 modifies the apportionment factors of the combined reporting group members.

CCR Section 25137-10, effective 1/1/89, applies where the combined report includes general corporations and bank or financial corporations, and the general corporation's operations are predominant. The combination of a department store and its credit card subsidiary or an automobile manufacturer and its customer credit subsidiary are examples of a dominant general corporation with a unitary financial subsidiary.

0901 Apportionment Formula (R&TC Section 25128(b))

On November 6, 2012 the California voters approved Proposition 39, which was codified as R&TC Section 25128.7. It provides that for taxable years beginning on or after January 1, 2013, all business income of an apportioning trade or business shall be apportioned to California using only the sales factor, unless the apportioning trade or business is one described in R&TC Section 25128(b).

R&TC Section 25128(b) provides that if an apportioning trade or business derives more than 50 percent of its "gross business receipts" from conducting one or more qualified business activities, it shall use the evenly weighted three-factor formula to apportion its business income. R&TC Section 25128(c)(4) identifies a banking or financial business activity as a qualified business activity.

R&TC Section 25128(d)(1) provides that “gross business receipts” means gross receipts described in R&TC Section 25120, subdivision (e) or (f), excluding intercompany receipts between members of a combined group, whether or not the receipts are excluded from the sales factor by operation of R&TC Section 25137.

It is important to note that for purposes of determining if a taxpayer is required to utilize the three-factor formula (a sum of property, payroll and sales factors divided by 3,) essentially all gross receipts are considered, irrespective of whether they would be considered distortive for other purposes. For example, while banks and financial corporations include only net gains from the sale of loans in their sales factor under CCR Section 25137-4.2(c)(3)(E), the gross receipts from the loan sales must be used for the predominant test purpose under R&TC Section 25128(b).

R&TC Section 25120(e) is the definition of gross receipts that existed for years prior to January 1, 2011. R&TC Section 25120(f) is applicable for years beginning on or after January 1, 2011. It excludes gross receipts from treasury function and hedging transactions (See RTC Section 25120(f)(2)(K) and (L)).

$$\text{Predominant Test} = \frac{\text{Gross business receipts from a banking/financial business activity}}{\text{Total gross business receipts of the combined group}}$$

The numerator of the predominant test is all gross business receipts from a banking and/or financial business activity of the combined group excluding intercompany receipts. R&TC Section 25128(d)(5) provides that "banking or financial business activity" means activities attributable to dealings in money or moneyed capital in substantial competition with the business of national banks. For the purpose of predominant test of R&TC Section 25128(b), some of the fee income (e.g. trust department fees, investment management fees, etc.) that banks generate in their regular trade/business may not be considered as gross receipts from banking or financial business activity under R&TC Section 25128(d)(5) because of lacking components of "deals in" and "money or moneyed capital".

The denominator of the predominant test is total gross business receipts of the combined group excluding intercompany receipts.

If predominant test results in more than 50 percent of gross business receipts from banking and/or financial business activity, a apportioning trade/business should use the three-factor formula, i.e. a sum of property, payroll and sales factors divided by 3.

Federal banking law permits national banks to underwrite and deal in certain types of securities. The OCC's definition of "investment securities" refers to debt securities not equity securities. Examples of these debt securities include, and are not limited to, US government and agency obligations, state and municipal bonds. They are also generally referred to as Type I and Type II securities under OCC regulations.

Are gross business receipts from a registered broker-dealer's principal trading activities involving these securities gross business receipts from conducting banking or financial business activity under R&TC Section 25128(b)? If so, what impact will it have on the predominant test (i.e. more than 50 percent of total "gross business receipts") for the combined group?

To the extent one or more members of the combined group conducts broker-dealer activities, the gross business receipts from the broker-dealer's principal trading activities may have a significant impact on the predominant test under R&TC Section 25128(b).

If a registered broker-dealer's principal trading activities relate to buying and selling for its own accounts, debt securities such as US government and agency obligations, state and municipal bonds and certain mortgages, such principal trading activities may satisfy the elements of "deal in," "money or moneyed capital," "in substantial competition," and "business of national banks".

As explained, gross income is considered for purposes of determining if a corporation qualifies as a financial corporation. However, gross receipts are used for purposes of determining if the apportioning trade or business must use the three-factor formula. Therefore, if a corporation within the combined group is selling Type I or Type II governmental debt securities, its gross receipts from such transactions might cause more than 50 percent of the combined report group's total gross business receipts to be attributable to a banking or financial business activity. On the other hand, the net gain from such transactions on an individual company basis might not generate enough gross income to satisfy the test to qualify a corporation as a financial corporation. This would lead to the result where the apportioning trade or business must utilize the three-factor formula, without a bank or a financial corporation in that apportioning trade or business.

Under the above scenario, the possibility exists for the combined group to be required to use the three-factor formula even if the broker-dealer affiliate may not be classified as a financial corporation under CCR Section 23183. This is typically true when the broker-dealer generates significant amount of gross business receipts from such qualified financial activity relating to its principal trading transactions, but small margins (i.e., gains/losses) resulted from such principal trading transactions.

Predominance Test Computation Example

R&TC Section 25128 Analysis (performed on a group basis)

Year		**20XX**	
Entity	**Gross Receipts**	**Financial Activity**	**General Activity**
ABC Corp. (General)	Gross Receipts Sales		25,000
	Gross Receipts (sale of equip.)		1,000
	Interest Income (lending activity)	50	
XYZ Mort. Co. (Financial)	Interest Income (lending activity)	1,000	
	Escrow Fee Income		50
	Gross Receipt (sale of loans)	1,000	
	Gross Receipts (sale of equip.)		1,000
Broker-Dealer Corp.	Gross Receipts (Principal Trading sales of Type I & II		

	securities	50,000		
	Commission Income		500	
Total Gross Business Receipts		52,050	27,550	79,600
		65.39%	34.61%	100.00%

In this example, the bank and financial activity is predominant and the taxpayer is required to use a three-factor formula.

0902 Combination of General (Non-Financial) and Financial Corporations (CCR Section 25137-10)

CCR Section 25137-10 applies only when "Financial" and "Non-Financial (General")" corporations are included in the same combined report and activity of the combined group is not predominantly financial, i.e. is predominantly general/non-financial.

CCR Section 25137-10(a)(2) explains that CCR Section 25137-10 is intended to address a situation where a combined reporting group is engaged in a manufacturing, mercantile, or service business and there is a subsidiary that was formed to perform financial functions, such as providing financing to customers. CCR Section 25137-10(a)(1) provides that , CCR Section 25137-10 applies if the combined reporting group's predominant activity is other than financial activity.

CCR Section 25137-10(b)(2) defines financial activity as "an activity involving the use of moneyed capital in activities which are in competition with and which are substantially similar to those which national banks are permitted to conduct." The definition is similar, but not exactly the same, as the definition provided in CCR Section 23183(a).

To determine the combined reporting group's predominant activity, CCR Section 25137-10(b)(4) provides that the group's gross *income* must be considered. It also provides that in determining "predominant activity", the classification will not change based on an occasional year of fluctuation. In addition, unlike CCR Section 23183(b)(1), CCR Section 25137-10(b)(4) does not apply a three-year moving average rule.

$$\text{Predominant Test} = \frac{\text{Total gross income from a banking/financial business activity}}{\text{Total gross income of the combined group}}$$

If equal to or less than 50 percent of the gross income relate to financial activities, i.e. if more than 50 percent of the gross income is from nonfinancial activities, the group will determine its apportionment factors pursuant to CCR Section 25137-10.

In the case that the unitary group involves a broker-dealer and its principal trading activities relate to buying and selling Type I and Type II securities which banks are also allowed to transact, such principal trading activities may satisfy the elements under CCR Section 25137-10(b)(2), i.e. "an activity involving the use of moneyed capital in activities which are in competition with and which are substantially similar to those which national banks are permitted to conduct." Therefore, for the purpose of predominant activity test of the combined group, the gross income (i.e. net gain) from such activities may be included in the numerator.

Predominance Test Computation Example

CCR Section 25137-10 Analysis (performed on a group basis)

Year		**20XX**		
Entity	**Source Income**	**Financial Activity**	**General Activity**	
ABC Corp. (general)	Gain on Sales		2,500	
	Net Gain (sale of equip.)		100	
	Interest Income (lending activity)	50		
XYZ Mort. Co. (Financial)	Interest Income (lending activity)	1,000		
	Escrow Fee Income		50	
	Net Gain (sale of loans)	100		
	Net Gain (sale of equip.)		100	
Broker-Dealer Corp.	Net Gain (Principal Trading sales of Type I & II securities	50		
	Commission Income		500	
Total Gross Business Income		1,200	3,250	4,450
		26.97%	**73.03%**	100.00%

In this example, the general activity is predominant and CCR Section 25137-10 applies.

The regulation references CCR Section 25137-4.2 for the apportionment factors rules for a stand-alone bank or a financial corporation as determined pursuant to CCR Section 23183(a) but also provides some modification for the property factor. CCR Section 25137-4.2 provides that a bank or financial corporation can include certain intangibles, namely loan receivables and credit card receivables in the property factor. (HANDBOOK SECION 1000) However, CCR Section 25137-10(d)(1)(C) modifies such rules and limits the inclusion of intangible property value at 20 percent (rather than 100 percent) of the property's federal income tax basis.

CCR Section 25137-10(b)(5) provides that receivables arising from financial activities of the general (non-financial) corporation are receivables arising from the sale of *tangible* property through extension of credit, such as charge account sales, credit card sales, installment sales, floor financing and financial leases. Such receivables of the general corporation from the sale of *tangible* property are included at 20 percent federal income tax basis as well.

However, the property factor modification may no longer be relevant for taxable years beginning on or after 1/1/2013 if the combined group must apportion its business income using single sales factor apportionment formula. See CCR Section 25137-10(g).