OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **WEDBUSH CAPITAL**	OTA Case No. 22019441

OPINION

Representing the Parties:

For Appellant: Michele Chang, Attorney

For Respondent: Ryan J. Ivanusich, Attorney

For Office of Tax Appeals: William J. Stafford, Attorney

S. HOSEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, Wedbush Capital (formerly known as Wedbush, Inc.) (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of $41,230 for the tax year ending June 30, 2011; also, pursuant to R&TC section 19324, appellant appeals FTB's denials of appellant's claims for refund of $138,878 and $180,669, each for the tax year ending June 30, 2011.[1]

Appellant waived the right to an oral hearing; therefore, the matter was submitted to the Office of Tax Appeals (OTA) on the written record pursuant to California Code of Regulations, title 18, (Regulation) section 30209(a).

[1] FTB's records provide that appellant filed claims for refund of $138,878 and $180,699—each for the tax year ending June 30, 2011—on June 2, 2015, and January 20, 2016, respectively. Copies of those claims for refund are not in the appeal record. Appellant asserts that its original claim for refund was filed on August 17, 2015.

In a Notice of Action on Cancellation, Credit, or Refund dated December 9, 2021, FTB states that appellant's claims for refund, filed on April 2, 2015, and January 20, 2016, are disallowed. Appellant lists a claim for refund amount of "$542,729, plus applicable interest, or such higher amounts as determined to be due," for the tax year ending June 30, 2011, which appellant states is based on FTB's "legal position"; however, appellant states that under its "legal position," the refund due is $462,519. In contrast, FTB states that "[t]he amount originally requested in the claim for refund that is now the subject of this appeal was $180,669." In addition, FTB states that the amount of $542,729, as stated by appellant, "has not been verified" by FTB.

ISSUES

1. Whether appellant has demonstrated that its costs of purchasing securities should be included as part of its costs of performance (COP) analysis.
2. If appellant's costs of purchasing securities are not properly included in appellant's COP analysis, has appellant otherwise demonstrated that FTB improperly sourced receipts from appellant's principal, institutional, and retail sales.

INTRODUCTION

Appellant is a global financial services firm. Its wholly-owned subsidiary, Wedbush Securities, Inc. (Wedbush Securities), is an investment bank that is registered with the United States Securities and Exchange Commission as a securities broker-dealer. Further, Wedbush Securities is a registered investment advisor under the Investment Advisers Act of 1940. During the relevant tax year, Wedbush Securities was headquartered in Los Angeles, California, but had offices throughout the United States. Appellant and its subsidiaries, including Wedbush Securities, will collectively be referred to as appellant, unless otherwise noted.

During the applicable tax year, appellant engaged in three types of securities trading transactions: (1) principal trading sales; (2) institutional agency trading sales; and (3) retail agency trading sales. The issue on appeal is how to source appellant's receipts from those transactions for sales factor purposes under the COP rules set forth in former R&TC section 25136 (as applicable to the tax year at issue) and Regulation section 25136.

Appellant's primary argument is that its costs of purchasing the underlying securities (e.g., stocks and marketable securities) are relevant to its COP analysis and that those costs should be assigned to the states where the companies (target companies) whose securities were purchased and sold were headquartered.

In contrast, FTB asserts that the costs of purchasing the target companies' securities are not relevant to appellant's COP analysis and that, based on the limited evidence provided in the appeal record, receipts from each type of trading transaction must be assigned to the locations of the employees that conducted the transactions.

FACTUAL FINDINGS

1. As relevant herein, appellant generated gross receipts from two types of trading sales: (1) principal sales; and (2) agency sales.
2. Principal sales consisted of buying and selling securities for appellant's own account. The activities related to appellant's principal sales—including research, the decisions to

buy and sell, and the execution of sales—were performed by employees referred to as Decision Makers.

3. Appellant's agency sales were similar to its principal sales—i.e., the securities were bought and sold for appellant's own account—with a significant difference being that appellant secured a buyer (or buyers) prior to buying the securities.[2] For agency sales, appellant bought the securities at the gross sales price and then sold those securities to its customers at the gross sales price, typically earning a fee ranging from 1 to 5 percent.
4. Agency sales were divided into two types: institutional sales and retail sales.
5. Institutional sales were made to institutional investors that pooled money to purchase securities, such as banks, insurance companies, and pensions funds. There were two employee groups directly connected to the revenue received under institutional sales: Researchers and Dealers.
6. Researchers were the employees who researched and investigated whether purchasing the securities of the target companies were sound and viable investments. Appellant's Researchers were based out of its offices in San Francisco, Los Angeles, and New York. The Researchers in California accounted for 80 percent of appellant's total Researchers and 65 percent of the total wages paid to its Researchers.
7. Dealers were the employees who negotiated and executed the sales. They generally conducted their activities from their home states, as there was no business need for them to travel. The majority of the Dealers' time associated with institutional sales was for sales solicitations, sales negotiations, and the development and maintenance of customer relationships.
8. Retail sales were made to retail investors, who were non-institutional investors, such as companies and individuals. The activities related to appellant's retail sales—including research, the decisions to buy and sell, and the execution of sales—were performed by its Dealers, who handled all aspects of the transactions from start to finish.

<u>Return</u>

9. On appellant's California Corporation Franchise or Income Tax Return (Form 100) for the tax year ending June 30, 2011(the 2010 tax year),[3] appellant reported its trading

[2] Appellant's agency sales differed from traditional marketplace agency sales, where a broker merely brings a buyer and seller of securities together and collects a fee for that service (without owning the securities and being a party to the transaction).

[3] A copy of appellant's California return has not been provided as part of the appeal record.

sales (i.e., its principal and agency sales)— for sales factor purposes —based on its net profits/losses, instead of gross receipts.[4] Further, appellant sourced those trading sales to the headquarter locations of the departments that generated the sales.

Audit Proceedings

10. On July 3, 2013, FTB initiated an audit of appellant's California return for the tax year ending June 30, 2011.

11. During the audit proceedings, appellant filed claims for refund of $138,878 and $180,669, each for the tax year ending June 30, 2011. FTB's records provide that appellant submitted those claims, respectively, on April 2, 2015, and January 20, 2016.[5]

12. On July 13, 2016, FTB issued an Audit Issue Presentation Sheet (AIPS), wherein FTB stated, among other things, that because appellant's subsidiary, Wedbush Securities, was a registered broker-dealer, its sales of marketable securities did not constitute a treasury function and appellant should have reported those sales on its return using gross receipts (not net profits/losses) for sales factor purposes. Appellant agreed with that finding.

13. FTB also stated in the AIPS that Wedbush Securities' trading sales (hereinafter, for sake of simplicity, simply referred to as appellant's trading sales) should have been assigned as follows:

- For principal sales, 79.4766 percent of those sales should have been sourced to California based on the locations of the Decision Makers that performed the relevant income-producing activities.
- For institutional sales, 80 percent of those sales should have been sourced to California because appellant's Researchers performed the overwhelming majority of the income-producing activities and 80 percent of the Researchers were based in appellant's California offices.
- For retail sales, 53.2686 percent of those sales should have been sourced to California based on the fact that, during audit, appellant estimated that 53.2686 percent of its Dealers were in California.

[4] In computing its California apportionment percentage, appellant used the standard four-factor formula for the 2010 tax year, which was comprised of a property factor, a payroll factor, and a double sales factor. (R&TC, § 25128(a).)

[5] Appellant, however, states that its "original claim for refund was contained in its letter entitled 'Taxpayer's Reply re Trading Sales,' dated August 17, 2015 . . . ."

14. In response to FTB's AIPS, appellant submitted a letter dated September 30, 2016, objecting to FTB's finding that 80 percent of institutional sales should be assigned to California. However, appellant did not object to FTB's findings as to principal sales and retail sales. In relation to institutional sales, appellant noted that Regulation section 25136(b) provides that the term "income-producing activity" applies to "each separate item of income." Based on the foregoing, appellant argued that the COP provisions set forth in R&TC section 25136 must be applied on a transaction-by-transaction basis to generate a reasonable apportionment result for institutional sales.

15. After reviewing the matter, however, FTB determined that based on the limited evidence provided, FTB's findings—as set forth in the AIPS—correctly assigned receipts from each type of trading transaction.

16. On February 13, 2017, FTB issued a Notice of Proposed Assessment (NPA) for the tax year ending June 30, 2011, which set forth additional tax of $41,230. The NPA stated that "[t]his notice takes into consideration" claims for refund that appellant filed on April 2, 2015, and January 1, 2016.

17. In response, appellant filed a timely protest.

<u>Protest Proceedings</u>

18. During protest, appellant argued that, pursuant to Regulation section 25136(b)(1) and FTB Legal Ruling 2005-1, appellant's use of capital to purchase securities of the target companies should be included in the COP analysis and that those costs should be assigned to the headquarter locations of the target companies. Appellant also stated that its original claim for refund, which appellant asserts was filed on August 17, 2015, incorporated all of the combined group's trading sales, not just institutional sales. In addition, appellant stated that it was revising/amending the dollar amount of its original refund claim to $392,504, plus applicable interest.

19. In a protest closing letter dated October 28, 2021, FTB stated that Legal Ruling 2005-1 was inapplicable to the facts at hand and, furthermore, that the costs of purchasing securities of the target companies should not be included in the COP analysis. In addition, FTB determined that, based on the limited evidence provided, FTB's findings, as set forth in the AIPS, correctly assigned receipts from each type of trading transaction. FTB also stated that because appellant had not provided a breakdown of the direct costs for each item of income, FTB was "unable to bifurcate the COP to each revenue stream."

20. On December 9, 2021, FTB issued a Notice of Action (NOA) for the tax year ending June 30, 2011, which affirmed the NPA and set forth additional tax of $41,230. The NPA states that "[t]he issues raised in your claims for refund were considered, and to the extent allowable, are reflected in this notice." In addition, the NOA states that "[t]his notice does not take into account the payment of $41,504.94 on May 1, 2017 applied from TYE 06/2012."
21. On December 9, 2021, FTB also issued a Notice of Action on Cancellation, Credit, or Refund, which denied appellant's claims for refund of $138,878 and $180,669, both for the tax year ending June 30, 2011.
22. In response, appellant filed this timely appeal.

DISCUSSION

Issue 1: Whether appellant has demonstrated that its costs of purchasing securities should be included as part of its COP analysis.

Applicable Law

Sourcing Service Revenue

For the tax year at issue, Regulation section 25136 provided that sales, other than sales of tangible personal property, are in this state if the income-producing activity is performed (1) in this state, or (2) both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on COP. (Cal. Code Regs., tit. 18, § 25136(a).)[6] This is sometimes referred to as the "greater costs of performance" rule or the "all-or-nothing" rule.

Defining Income-Producing Activity

Although the R&TC does not define an "income-producing activity," Regulation section 25136(b) states that the term "income-producing activity" "applies to each separate item of income and means the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income." (Cal. Code Regs., tit. 18, § 25136(b).) Regulation section 25136 provides that the term "income-producing activity" includes, but is not limited to, "[t]he rendering of *personal services* by employees or by an agent or independent contractor acting on behalf of the taxpayer or *the utilization of tangible and intangible property* by the taxpayer or by an agent or independent

[6] All references to former R&TC section 25136 are to the version as amended in 2010 and repealed on December 1, 2013. (Stats. 2010, ch. 721, § 27, repealed by Prop. 39, eff. Nov. 7, 2012.)

contractor acting on behalf of the taxpayer in performing a service." (Cal. Code Regs., tit. 18, § 25136(b)(1), italics added.) The term "income-producing activities" also includes the "*sale*, licensing or *other use* of intangible personal property." (Cal. Code Regs., tit. 18, § 25136(b)(4), italics added.) However, "[t]he mere holding of intangible personal property is not, of itself, an income producing activity." (Cal. Code Regs., tit. 18, § 25136(b).)

Defining Costs of Performance

"Costs of performance" (or COP) is defined, as relevant here, as the "direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer incurred to perform the income-producing activity which gives rise to the particular item of income." (Cal. Code Regs., tit. 18, § 25136(c).)

Arguments

Appellant's Arguments

Appellant argues that its costs of purchasing the underlying securities (e.g., stocks and marketable securities) are relevant to its COP analysis and that those costs should be assigned to the states where the target companies, whose securities were purchased and sold, were headquartered.

Elaborating further, appellant asserts that it is a service provider (i.e., a securities broker/dealer/advisor) that materially utilized tangible or intangible property (i.e., capital to purchase securities) in the performance of a service and, therefore, under Regulation section 25136(b)(1) and FTB Legal Ruling 2005-1, appellant's use of capital to purchase securities of the target companies should be included in its COP analysis, with the all-or-nothing test being applied and with such costs being assigned to the headquarter locations of the target companies.

Building on the above-listed argument, appellant asserts that to generate revenue from its trading sales, it was required to utilize a significant amount of capital, as it had to purchase the securities of the target companies, which it then sold to its third-party customers. Appellant contends that without the employment of its capital, it would have been incapable of providing its services or generating its trading sales as a securities dealer. Appellant further contends that without the use of its capital, it would not have been a "securities dealer," asserting that very definition of a securities dealer means those that are engaged in the business of buying and selling securities under their own accounts. In addition, appellant contends that if it had provided services to customers without the employment of its capital, then it would have played the role of a broker and the gross receipts from its trading sales could not have been used to calculate its sales factor.

Appellant also contends that because California requires the *gross* trading sales of registered securities dealers to be included in the sales factor, the costs of purchasing securities—which appellant asserts represent a vast portion of the direct costs it incurred to generate its gross trading sales amounts—should be reflected in the COP analysis.

FTB's Arguments

FTB asserts that appellant's sales of securities were sales of intangible property, not sales of services, citing *Appeal of PacifiCorp* (2002-SBE-005) 2002 WL 31153476. FTB further asserts that appellant's provision of financial services (e.g., securities research, etc.) in various aspects of its business does not convert sales of intangible property (i.e., securities) into sales of services.

In addition, FTB contends that regardless of whether appellant's sales of securities are considered to be sales of services or sales of intangible assets, appellant's costs of purchasing the securities should not be included as part of the COP analysis because appellant was merely holding the securities as inventory and, therefore, was not using (i.e., not utilizing) the securities to perform services.

Appellant's Reply

In reply, appellant contends that it is a service provider. Specifically, appellant states that it is a full-service registered investment advisor, as well as a registered broker-dealer. Appellant also contends that if it was merely buying and selling securities on behalf of its customers, without providing advisory services, appellant would have had no need for its Researchers and Dealers.

Next, in relation to FTB's argument that appellant was merely holding the securities as inventory and, thus, was not *utilizing* capital to perform services, appellant notes that Regulation section 25136(b)(4) states that the term "income-producing activities" includes, but is not limited to, the "sale" of intangible personal property. Based on the foregoing, appellant contends that its "sales" of the securities constituted income-producing activities and, therefore, its activities cannot properly be described as merely holding such securities as inventory.

Analysis[7]

Based on the language of Regulation section 25136(b)(1), appellant contends that the use of its own capital (i.e., costs of purchasing the securities) was a material income-producing factor, and therefore, both (i) appellant's costs of purchasing the securities and (ii) appellant's personnel costs (i.e., payments to Decision Makers, Researchers, and/or Dealers) should be used to assign receipts under the standard (all-or-nothing) rule of R&TC section 25136. In addition, appellant argues that because its costs of purchasing the securities was so large in comparison to its personnel costs, its personnel costs are irrelevant to the COP analysis under the standard (all-or-nothing) rule of R&TC section 25136 and, furthermore, that the costs of purchasing the underlying securities should be assigned to the states where the target companies whose securities were purchased and sold were headquartered.

As set forth below, California cases and decisions that have discussed sourcing sales of securities or other trading activities under COP rules have consistently assigned receipts from trading activities to the state (or states) where the office or department conducting the transactions was located, while making no reference to the costs used to purchase the underlying securities. Nor did those cases or decisions assign said costs of purchasing the underlying securities to the state (or states) where the headquarters of the underlying securities (i.e., the target companies) were located. Accordingly, appellant's argument that its costs of purchasing the underlying securities should be included as part of its COP analysis must be rejected.

For example, in *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750 (*Microsoft*), the taxpayer maintained a treasury department which invested its excess cash in various short-term marketable securities, some of which were resold to third parties. (*Id*. at p. 757.) Citing R&TC section 25136, the California Supreme Court stated that "[u]nder the [Uniform Division of Income for Tax Purposes Act], the operations and gross receipts of a treasury department are properly attributed to the state where the department operates—here, Washington." (*Id*. at p. 768.) The Court made no reference to the costs used to purchase the underlying securities, nor did it assign said costs to the state where the target headquarters of the underlying

[7] Although FTB states, on appeal, that (i) sales of services and (ii) sales of intangible property are sourced in the same manner, OTA notes that Regulation section 25136(d)(2)(C) provides that a particular category of services, titled "personal services," are subject to a special rule—i.e., the time-spread method, instead of the standard (all-or-nothing) rule of R&TC section 25136. Nevertheless, based on OTA's analysis below, a discussion of whether appellant was selling services or selling intangible property (or, alternatively, a combination of both) is not necessary for a resolution of this appeal.

securities were located. Rather, the gross receipts were sourced to the location of the taxpayer's treasury department because that was where the income-producing activity occurred.

Likewise, in *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc*. (89-SBE-017) 1989 WL 95886, the taxpayer engaged in securities transactions both as a broker and as a principal or underwriter. (*Id*. at p. 2.) When trading in securities as a principal or underwriter, the taxpayer purchased securities for its own account and attempted to remarket them. (*Ibid*.) The Board of Equalization (BOE), the predecessor to OTA, stated that "[m]ost of [the taxpayer's] securities transactions as principal were conducted in New York, so they were included in the denominator of the sales factor, but not in the California numerator." (*Id*. at p. 3.) BOE found that the income-producing activities did not consist of the primarily ministerial functions in relation to the margin accounts, such as the recordkeeping and billing that were conducted in New York. (*Ibid*.) Rather, BOE found that it is the rendering of personal services by the brokers in California that is the income-producing activity because the local brokers deal directly with the California customers in taking and placing orders, which create the debts on which the interest is paid, and handle most other day-to-day transactions, which affect the balance of the customers' margin accounts. (*Ibid*.) Therefore, BOE found that the margin account interest paid by California customers should be included in the California numerator. In short, in its analysis, BOE did not consider whether the headquarter state of the target companies, whose underlying securities were purchased and remarketed, was not relevant. (*Ibid*.)

In *Appeals of Pacific Telephone & Telegraph Company* (78-SBE-028) 1978 WL 3941, a number of the taxpayer's companies had pools of working capital that were invested in various types of short-term securities. The gross receipts at issue arose from the turnover of those investments. (*Ibid.*) The largest pool of funds was held and maintained by the taxpayer's parent at its New York headquarters and managed by a full-time special staff of its treasury department in New York. (*Ibid*.) In applying R&TC section 25136, BOE stated that it appeared "the income-producing activity associated with each pool of funds [was] performed exclusively in the state where that particular pool is located." (*Ibid.*) As such, all of the investment receipts from the taxpayer's California-based pool were includable in the California numerator; the receipts from the larger New York pools were not includable. (*Ibid*.) Again, there was no reference to the costs of the securities that generated the receipts or where those companies were headquartered.

In *General Mills, Inc. v. Franchise Tax Bd.* (2012) 208 Cal.App.4th 1290, the taxpayer engaged in trading agricultural commodity futures as a hedging strategy to protect against price fluctuations in the basic materials needed for its business. (*Id*. at pp. 1294, 1296.) While the issue in that case concerned the application of R&TC section 25137, the Court of Appeal noted that the trading activity did not occur in California, so the resulting receipts were not included in the California sales factor numerator. (*Ibid*.) Rather, the receipts from the trading activity were assigned to Minnesota, which was the location of the taxpayer's principal place of business. (*Id*. at pp. 1294, 1309.) Thus, the receipts were properly assigned to the state where the trading activity was conducted, and not based on a method appellant argues in this appeal.

Based on the above-listed cases and decisions, receipts from trading activities, such as appellant's, are properly assigned to the state (or states) where the trading activity was conducted because that is where the income-producing activity occurred. The costs to purchase the underlying securities have no relevance. Indeed, Regulation section 25136(b)(4), which provides that the income-producing activity includes the "sale" of intangible property, is consistent with this conclusion because nowhere in that subdivision does it use the word "purchase." Furthermore, as Regulation section 25136(b) states, the "income-producing activity" applies to each separate item of income, which means the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the "ultimate purpose" of producing that item of income. Therefore, the purchase of the securities is not what *ultimately led to* what generated the trading sales at issue in this appeal. Accordingly, appellant's argument that its costs of purchasing the underlying securities should be included as part of its COP analysis must be rejected.

Issue 2: If appellant's costs of purchasing securities are not properly included in appellant's COP analysis, has appellant otherwise demonstrated that FTB improperly sourced receipts from appellant's principal, institutional, and retail sales.

Principal Sales

Appellant asserts that if OTA finds appellant's costs of purchasing the underlying securities should not be included in appellant's COP analysis (as OTA has determined in Issue 1 above), then appellant will not dispute FTB's finding (as set forth in the AIPS) that 79.4766 percent of appellant's principal sales should be assigned to appellant's California sales factor numerator based on the locations of the Decision Makers that performed the relevant income-producing activities. Thus, the sourcing of appellant's principal sales is no longer being contested by appellant at this point in the Opinion. Accordingly, only appellant's agency sales (i.e., institutional sales and retail sales) are at issue.

Agency Sales

Institutional Sales

For appellant's institutional sales, the relevant income-producing activities consisted of (1) researching the underlying target companies, as performed by the Researchers, and (2) conducting sales activities, as performed by the Dealers. During audit, appellant estimated that its Researchers accounted for 75 percent of the income-related activities related to the institutional sales, while the Dealers accounted for the remaining 25 percent.[8] Nearly all (i.e., approximately 75 to 99 percent) of the income-producing activities were therefore performed by the Researchers. Appellant could not provide any reports or information identifying which Dealer or Researcher, at which location, participated in a particular institutional sale; but appellant did provide information showing that 80 percent of its Researchers were based out of its offices in California (i.e., Los Angeles and San Francisco).

Based on the foregoing, FTB asserts that it acted reasonably in assigning 80 percent of the gross receipts from appellant's institutional sales to appellant's California sales factor numerator. Further, FTB argues such an approach is consistent with the principle that under R&TC section 25136, receipts from trading activities are properly assigned to the states where the offices conducting the trading activities are located, citing *Microsoft*, *supra*. FTB asserts, however, that because income-producing activities under Regulation section 25136 are measured by COP, an alternative approach that may be reasonable would be a method based on wages paid to appellant's California Researchers compared to wages paid to all Researchers, which FTB asserts would result in 65 percent of the institutional sales receipts being assigned to California.

After considering the appeal record as a whole, OTA agrees with FTB's approach, wherein 80 percent of institutional sales receipts are assigned to appellant's California sales factor numerator based on the locations of appellant's California Researchers—and appellant has not demonstrated error with such approach.[9]

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[8] Those estimates were made by G. Wedbush, the Chief Executive Officer (CEO) and Director of Wedbush Securities. Appellant later clarified that the CEO's estimate, which designated 75 percent of the income-producing activities to Researchers, was "highly understated." Appellant then revised its estimate so that 99 percent of the income-producing activities for its institutional sales were performed by its Researchers, and the remaining 1 percent was performed by its Dealers.

[9] OTA rejects FTB's alternative approach (based on wages), as neither FTB nor appellant has elaborated on such approach, showing that it better reflects California sales.

Appellant, however, contends that target company headquarters data (which appellant asserts shows that 16.79 percent of securities purchased and sold by appellant were headquartered in California) is the “best available proxy for the Researchers’ COP activities.”

Appellant’s method of approximating where its Researchers’ activities were performed based on the headquarter locations of the target companies is problematic. First, the headquarters’ data was generated from a sample taken from 2014, a tax year not at issue. Second, it is unlikely that appellant’s Researchers visited the headquarters of every target company, given that the spreadsheet provided by appellant shows over 5,100 target companies—and appellant has not demonstrated otherwise. Third, appellant has not demonstrated the percentage of time Researchers spent investigating the target companies at the target companies’ headquarters verses the percentage of time they spent researching target companies from the Researchers’ home offices. Fourth, the target company data provided by appellant includes a number of index funds; however, there is no apparent reason for appellant’s Researchers to travel to the headquarter locations of the index funds—and appellant has not shown otherwise.

Next, as an alternative to estimating its Researchers’ income-producing activities in California, appellant argues that a percentage based on a sample of its California-based Researchers travel claims would be a better approach, which appellant contends results in 33.75 percent of its institutional sales being sourced to California. That figure, however, is not appropriate, as the data provided by appellant is from 2014, a tax year not at issue. Further, the Researchers’ travel schedules may have varied significantly from year-to-year—and appellant has not shown otherwise.

In summary, OTA finds that 80 percent of institutional sales receipts should be assigned to appellant’s California sales factor numerator, as determined by FTB—and appellant has not demonstrated otherwise.

Retail Sales

During audit, appellant and FTB agreed that the relevant income-producing activities included (i) researching the underlying securities, (ii) the decisions to buy and sell the securities, and (iii) the execution of the sales — all of which were performed by Dealers.

The Dealers consisted of appellant’s employees and independent contractors, both of whom performed the income-producing activities from their home states. Appellant and FTB agreed, during audit, that the gross receipts from appellant’s retail sales should have been assigned to the Dealers’ home states; however, appellant did not maintain any reports or information identifying (1) which Dealer, at which location, participated in a particular trading sale transaction, and (2) the number of Dealers by location.

Appellant, however, estimated during audit that 53.2686 percent of its Dealers were in California, and therefore, appellant assigned 53.2686 percent of the gross receipts from its retail sales to California. FTB's auditor accepted appellant's estimate.

On appeal, however, appellant contends that the data showing the home states of its Dealers should not be used because, during audit, appellant identified approximately 7,400 active Dealers, when in reality, it only had about 1,000 Dealers in any given year. Instead, appellant argues that 18.76 percent is the "best and most reliable proxy available for the location of the California Dealers." Appellant allegedly derived the 18.76 percentage based on its agency sales customers in California for the tax year ending *June 30, 2012*, using market-based sourcing rules.

Appellant's approach, however, is not acceptable. First, appellant's argument that it only employed about 1,000 Dealers in any given tax year is based on appellant's unsupported assertion. Further, even if there was a discrepancy between the number of Dealers contained in the list provided by appellant at audit and the number of appellant's active Dealers, that discrepancy might be explained, in part, by the fact that the list provided at audit duplicates numerous names.

Second, the market-based sourcing data relied upon by appellant—based on its customers' billing addresses—is from the tax year ending June 30, 2012, a tax year not at issue.

Third, as support for using market-based sourcing data, appellant asserts that "[i]t is a reasonable assumption that the state of the Dealer is often the same as the state of the customer." Appellant, however, has not provided evidence in the appeal record (i) demonstrating such assumption is reasonable, and (ii) showing that the assumption, if reasonable, should control the issue herein.

Finally, appellant relies, in part, on Regulation section 25136(d)(3), which provides cascading rules for determining the location of "[a]n income-producing activity performed on behalf of a taxpayer by an *agent or independent contractor*." (Italics added.) OTA notes, however, that appellant's Dealers consisted of both appellant's own employees and independent contractors. Here, appellant has not provided evidence demonstrating (i) the number of independent contractors it utilized, and (ii) which transactions were conducted by independent contractors verses the Dealers appellant employed. In addition, OTA notes that the rule assigning the income-producing activity to the customer's domicile only applies if it cannot be reasonably determined where the income-producing activity was actually performed. Here, there is no indication in the appeal record that Dealers traveled to conduct appellant's agency sales—and, according to appellant, the Dealers "generally conducted all their activities from their home states, i.e., unlike the [R]esearchers, there is no business need for them to travel."

After considering the appeal record as a whole, OTA agrees with FTB's approach, wherein 53.2686 percent of retail sales receipts should be assigned to appellant's California sales factor numerator.

HOLDINGS

1. Appellant has not demonstrated that its costs of purchasing securities should be included as part of its COP analysis.
2. Appellant has not demonstrated that FTB improperly sourced receipts from appellant's principal, institutional, and retail sales.

DISPOSITION

FTB's proposed assessment of an additional tax of $41,230 for the tax year ending June 30, 2011, is sustained in full. FTB's actions denying appellant's claims for refund of $138,878 and $180,669 for the tax year ending June 30, 2011, are also sustained in full.

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Sara A Hosey
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Sara A. Hosey
Administrative Law Judge

We concur:

DocuSigned by:
Kenneth Gast
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Kenneth Gast
Administrative Law Judge

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Huy "Mike" Le
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Huy "Mike" Le
Administrative Law Judge

Dated: 5/22/2026