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CHIEF COUNSEL ANNOUNCEMENT 2003-1

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SUBJECT: Abusive Tax Shelters - California Listed Transactions

This Chief Counsel Announcement constitutes a published position of the Franchise Tax Board within the meaning of subparagraph (A) of paragraph (4) of subdivision (a) of section 18407 of the Revenue and Taxation Code.

A. California "Listed Transactions" Include All Federal Listed Transactions

Pursuant to paragraph (4) of subdivision (a) of Section 18407, all "listed transactions" identified by the Secretary of the Treasury for federal income tax purposes prior to this announcement (see, for example, Notice 2003-76, 2003-49 I.R.B. 1181, Notice 2003-77, 2003-49 I.R.B. 1182, and Notice 2003-81, 2003-51 I.R.B.1) as well as those identified as "listed transactions" after this announcement, constitute "listed transactions" for California income and franchise tax purposes.

In addition to any transaction that is the same as, or substantially similar to, a listed transaction specified by the Secretary of the Treasury for federal income tax purposes, the Franchise Tax Board specifically identifies the following tax avoidance transactions as "listed transactions" for California income or franchise tax purposes pursuant to paragraph (4) of subdivision (a) of section 18407 of the Revenue and Taxation Code.

B. Other California Listed Transactions

The transactions listed below and substantially similar transactions misuse tax-favored vehicles designed to act as a partial or complete conduit of income to its owners, so as to avoid taxation of income at both the entity and owner level.

1. Certain Real Estate Investment Trust (REIT) Transactions – The Franchise Tax Board has become aware of transactions involving Real Estate Investment Trusts where the REIT takes a deduction for a consent dividend but the REIT owners do not report the consent dividend as income. Although California has conformed generally to Subchapter M of Chapter 1 of Subtitle A of the Internal Revenue Code under Revenue and Taxation Code section 24870, California has not conformed to the federal consent dividend regime of Internal Revenue Code section 565. (See *Appeal of CRG Holdings*, 97-SBE-009.) In applying the federal REIT provisions under California law, the REIT is not entitled to deduct a consent dividend and the REIT is subject to California tax for amounts treated as a consent dividend under the federal tax law. The deduction for dividends paid, therefore, may differ for federal and California tax purposes. This

difference is recognized under subdivision (a) of section 24872 of the Revenue and Taxation Code, which provides that a REIT will be deemed to satisfy the dividends paid requirements of section 857(a)(1) of the Internal Revenue Code if the requirements of that section are met for federal purposes. Even though California does not allow the dividends paid deduction for consent dividends, the entity may still be qualified as a REIT so long as it meets the federal distribution requirements.

2. Certain Regulated Investment Company (RIC) Transactions – Certain corporations have formed wholly owned or controlled entities that registered as Regulated Investment Companies in contravention to the Investment Company Act of 1940 (the 1940 Act). The corporations transferred to the RICs some of the parents' income producing assets. The RICs claimed dividends paid deductions under Internal Revenue Code section 852 as conformed to by Revenue and Taxation Code section 24870 et seq. The parent corporation then claimed an intercompany dividend received deduction under Revenue and Taxation Code section 25106 so that no franchise or income tax was paid on the income earned by the income producing assets contributed to the RICs. The Securities and Exchange Commission (SEC) found that these RICs either violated or failed to meet certain statutory requirements of the 1940 Act in a substantial manner. Specifically, the shares of the RICs were not beneficially owned by more than 100 persons and any plans for a public or private offering were insubstantial or indefinite. Registration under the 1940 Act was voluntary and undertaken for the predominant purpose of allowing the parent to avoid the payment of state income or franchise tax. Thus, the predominant or sole purpose of registration was to obtain a tax advantage for a limited number of private investors, which violates SEC administrative policy. In addition, the transfer of income producing assets to the RICs violated provisions of the 1940 Act concerning transactions with affiliated persons. It is the position of the Franchise Tax Board that the formation and registration of these RICs were sham transactions designed to avoid the payment of California income or franchise tax. These RICs will be considered non-RIC entities and are not entitled to a dividend paid deduction under the RIC provisions.

The Franchise Tax Board may add to the list of "Other California Listed Transactions" as it identifies additional listed transactions for California income and franchise tax purposes.

The principal author of this Chief Counsel Announcement is Debra Petersen of the Franchise Tax Board, Legal Department. For further information regarding this notice, contact Ms. Petersen at P.O. Box 1720, Rancho Cordova, Ca 95741-1720.