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July 17, 2007
 Chief Counsel Ruling 2007-3

Re: Request for a Chief Counsel Ruling on Behalf of *****

Dear *****:

In your correspondence dated *****, you requested advice from the California Franchise Tax Board (the "FTB"), in the form of a Chief Counsel Ruling, regarding a series of transactions (the "*****"), involving sections 332, 351, 355, and 368 of the Internal Revenue Code of 1986, as amended (the "Code" or "IRC")¹, and certain other provisions of the Code, California's conformity thereto, and the application (or lack thereof) of section 19774 of the California Revenue and Taxation Code (the "CR&TC") to certain of the *****.²

FACTS

A. Federal Procedural Background

*****, ***** a ***** corporation ("*****"), submitted a private letter ruling request (the "IRS PLR") to the Internal Revenue Service (the "Service" or "IRS") with respect to the ***** by ***** of all of the stock of ***** ("****" or "*****"), a ***** corporation, ***** (the "*****").³ On *****, the Service issued a favorable IRS PLR to Taxpayer, in which it ruled, among other things, that the ***** qualifies for non-recognition treatment under IRC sections 355 and 368 of the Code. A copy of this IRS PLR has been provided to the FTB in connection with this Chief Counsel Ruling.

¹ All "Treas. Reg." references are to the final regulations promulgated under the Code as enacted on January 1, 2005.

² All CR&TC references are to the California Revenue and Taxation Code in effect as of the date of this Chief Counsel Ruling.

³ *****

B. Lack of Conformity with Recent Federal Legislation

IRC section 355(b) provides that, immediately after a *****, both the ***** corporation and the ***** corporation must be engaged in the active conduct of a trade or business. Such trade or business must have been actively conducted for the five-year period ending on the date of the ***** and must not have been acquired within such five-year period in a transaction in which gain or loss was recognized in whole or in part.⁴

As stated above, the Taxpayer received an IRS PLR in which the Service ruled, based on certain representations made by the Taxpayer, that the ***** will constitute a tax-free reorganization under sections 368(a)(1)(D) and 355. Under federal law, as reflected in the IRS PLR, ***** is permitted to satisfy the IRC section 355(b) active trade or business requirement indirectly through the active conduct of a trade or business by one or more of its affiliates. This is because section 202 of the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) ("TIPRA") effectively replaced the "holding company" test in IRC section 355(b)(2)(A), as in effect prior to TIPRA, with a test that permits a ***** or ***** corporation to indirectly satisfy the "active trade or business" requirement of IRC section 355(b)(2)(A) if the "separate affiliated group" (of which the ***** or ***** corporation is the common parent) is engaged in the active conduct of a trade or business. As a result, ***** would be treated for federal income tax purposes as having satisfied the five-year "active trade or business" requirement of IRC section 355(b)(2)(A), by reason of IRC section 355(b)(3), without the ***** of a subsidiary engaged in an active trade or business.

As of the date hereof, California has not conformed to, or adopted for purposes of income and franchise tax laws (in the CR&TC), the amendments to IRC section 355(b) made by section 202 of TIPRA. Thus, absent the ***** of a subsidiary engaged in an active trade or business, ***** would not satisfy the IRC section 355(b) requirements in effect prior to TIPRA and currently adopted by the CR&TC. This is because, at the time of the *****, ***** would not be engaged directly in the active conduct of a trade or business, nor would it satisfy the "holding company" test of IRC section 355(b)(2)(A) as in effect prior to TIPRA. As such, in order to qualify the ***** as an IRC Section 355 nonrecognition transaction for California franchise tax purposes, it was necessary for ***** to liquidate ***** ***** ***** ***** ***** ("*****"), as described in D. 1, below, in order to become directly engaged in the active conduct of a trade or business and satisfy the requirements of IRC section 355(b) for California franchise tax purposes.

C. Corporate Background and Capital Structure

⁴ See generally IRC §355(b).

California franchise tax purposes,⁶ to meet the active trade or business requirement of IRC section 355(b).

***** has only a single class of common stock outstanding. At the time of the *****, all **** shares of *****'s common stock were owned by *****. As described below, prior to the ***** , ***** ***** ***** ***** , ** ("*****") merged into ***** ***** ***** ***** , *** ("*****"), whereupon ***** distributed the stock of ***** to ***** , with the result that ***** was treated as owning all the shares of ***** for federal income tax and California franchise tax purposes at the time of the ***** .

3. *****

***** was incorporated in the State of ***** on ***** . In addition to owning the stock of ***** prior to the ***** ***** ***** (defined in D.1. below), ***** held all of the outstanding stock of the following companies:

- (i) ***** ***** ***** ***** ("*****"), a ***** corporation, which is principally engaged in the business of ***** ; and
- (ii) ***** ***** ***** ("*****"), ***** .

Prior to the ***** , ***** had held the stock of **** since ***** , and the stock of **** since ***** . Both **** and **** were previously owned by ***** . ***** also held other assets, including cash, a portfolio of ***** , intercompany receivables and preferred stock of ***** ***** ***** ***** ("*****"), a ***** corporation. **** has **** outstanding preferred shares, all of which were owned by ***** . Prior to the ***** , ***** had outstanding a single share of its single class of common stock, which was owned by ***** , a disregarded entity owned by ***** .⁷

⁶ Prior to ***** , **** , the business currently conducted by ***** was conducted by ***** , a ***** corporation. On ***** , ***** was converted into a limited liability company under ***** , and was renamed ***** .

⁷ In a transaction separate from and occurring prior to the Restructuring Transactions, *** of the ***** then outstanding preferred shares of ***** owned by ***** were redeemed in exchange for a cash payment of ***** , leaving ***** outstanding preferred shares.

D. The *****⁸

1. *****

To accomplish the germane corporate business purposes of the ***** and to otherwise facilitate the ***** , ***** has undertaken the following transactions before consummation of the ***** (the "*****").⁹ The ***** was preceded by a series of internal ***** ,¹⁰ including (i) the ***** of ***** ("*****"), ***** (the "*****"), a series of internal *****s (collectively, the "*****") intended to effect the separation of ***** in the ***** from *****'s other ***** and the transfer of the ***** ; (ii) the ***** merger of ***** , a ***** corporation, with and into ("*****"), a ***** limited liability company that is wholly owned by ***** and a disregarded entity for federal income tax and California franchise tax purposes, and (iii) a merger of ***** , a ***** corporation, with and into ***** ("*****"), a newly formed ***** limited liability company that is wholly owned by ***** and a disregarded entity for federal income and California franchise tax purposes (the "*****"). The ***** , the ***** , the ***** , the ***** (as defined in STEP 5 below) and the ***** (as defined in D.3. below) collectively will separate ***** from ***** ther businesses.

The ***** consist of the following set of transactions:¹¹

STEP 1: *****

On ***** , ***** declared a cash dividend to ***** in the amount of ***** , which was paid on ***** . On ***** , ***** declared and paid a ***** cash dividend to ***** , consistent with ***** capital requirements at the time of the ***** .

On ***** , ***** declared a dividend payable to ***** (the "*****"). Pursuant to the ***** , ***** was obligated to pay ***** an amount

⁸ The ***** and the ***** are hereinafter collectively referred to as the "Restructuring Transactions."

⁹ As described above, none of the Restructuring Transactions was undertaken to reduce the California franchise tax liability of ***** and its subsidiaries, except to the extent that such transactions enabled the ***** to qualify as a tax-free transaction for California franchise tax purposes.

¹⁰ Certain of these ***** were undertaken to place five-year active trade or businesses into ***** to enable it to satisfy the IRC §355(b) requirements for California franchise tax purposes.

¹¹ The ***** occurred before the date of the ***** (the "*****").

- b. ***** . ***** ***** ***** (“*****”) ***** all of the assets and liabilities associated with the **** ***** , and possibly cash, to ***** , a ***** and ***** , which will be a corporation for U.S. federal income tax and California franchise tax purposes, in exchange for all of the shares of ***** (the “*****”).
- c. ***** ***** . ***** ***** red all of the stock of ***** to ***** , an entity disregarded for federal income tax purposes, in exchange for cash, in a transaction that is disregarded for federal income tax and California franchise tax purposes (the “*****”).
- d. ***** ***** . ***** ***** all of the outstanding stock of ***** , and possibly cash, to ***** in exchange for shares of ***** (the “*****”).
- e. ***** ***** ***** . ***** distributed some of the stock of ***** to ***** and the remainder of the stock of ***** to ***** in a transaction that is disregarded for federal income tax purposes. ***** then transferred the stock of ***** it received to ***** (the two transactions collectively, the “*****”).
- f. ***** *** ***** . ***** distributed all of the stock of ***** pro rata to the holders of its common stock, ***** and ***** (the “*****”).
- g. ***** ***** ***** . ***** distributed all of the stock of ***** received by ***** in the ***** (which constituted approximately ***** of the outstanding stock of *****) to ***** (the “*****”).

STEP 4: *****

On ***** , ***** merged with and into ***** in a transaction that qualifies as a tax-free ***** pursuant to IRC sections 332 and 337.

Immediately prior to the ***** , ***** (through *****) was engaged in a five-year active trade or business within the meaning of IRC section 355(b). The ***** was consummated in order to ensure that ***** will similarly be treated as engaged directly in a five-year active trade or business immediately after the ***** for California franchise tax purposes as required under IRC section 355(b), as adopted and conformed to in the CR&TC.¹³

¹³ The Internal Revenue Code as applicable for California purposes as of the “specified date” of January 1, 2005.

As a result of the *****, the trade or business assets and activities of ***** will be treated as directly held by ***** for federal income tax and California franchise tax purposes.

STEP 5: *****¹⁴

***** On ***** to ***** all of the stock of *****, ***** and ***** (the "*****"), each of which owns assets that are associated with the ***** (the "*****").¹⁵

2. Business Purpose for *****

The *****, the *****, the *****, the ***** and the *****s (described herein), were each undertaken to facilitate the *****, which was motivated, in whole or substantial part, by the following "Corporate Business Purposes": (a) fit and focus, i.e., to allow the management of ***** and the ***** to focus their efforts on more closely aligned respective firm-wide strategic priorities; (b) to increase the ability of the ***** to pursue strategic transactions, including by using its own equity as an acquisition currency; (c) to enhance the ability of the ***** to attract, retain and properly incentivize key employees, particularly through the use of its own equity; and (d) to eliminate the possibility that ***** or the ***** will be placed at a competitive disadvantage relative to its peers because potential clients and strategic partners view the ***** or ***** , respectively, as a competitor.

In a presentation dated *****, ***** stated that the ***** will "*****

*****" [*****] *****
***** [*****] *****
*****" ¹⁶

Taxpayer has represented for purposes of obtaining the IRS PLR and this Chief Counsel Ruling that the business purposes described above are real and substantial non-federal and non-California tax purposes that are germane to the business of ***** and ***** and that satisfy (i) the requirement that the ***** be carried out for a business purpose under Treas. Reg. section 1.368-1(b), and (ii) the requirement that the ***** be carried out for one or more corporate business purposes within the meaning of Treas. Reg. section 1.355-2(b)(2) ("Corporate Business Purpose").

¹⁴ The ***** occurred in conjunction with the ***** (described in D.3. below). Pursuant to the IRS PLR, the ***** qualifies for nonrecognition treatment under IRC §368.

¹⁵ ***** to ***** in turn contributed the stock of ***** and ***** to ***** , a wholly-owned subsidiary of *****.

¹⁶ See ***** Overview (***** (IRS Private Letter Ruling Request Exhibit *)).

Taxpayer has further represented for purposes of obtaining this Chief Counsel Ruling that none of the ***** has been undertaken to reduce the California franchise tax liability of ***** and its subsidiaries, except to the extent that such transactions enable the ***** to qualify as a tax-free transaction for California franchise tax purposes.

3. The *****

On ***** , ***** distributed all of the stock of ***** pro rata to *****'s shareholders in the ***** .¹⁷

RULINGS REQUESTED

1. As a result of the ***** , ***** became directly engaged in the active conduct of a trade or business, and will thus satisfy the active trade or business requirement of IRC section 355(b) for California franchise tax purposes, as adopted in the CR&TC as of the date of this Chief Counsel Ruling.
2. For California franchise tax purposes, the FTB will respect the form and substance of the Relevant Transactions as described in and ruled on by the Service in the IRS PLR, and will otherwise apply the CR&TC to the Relevant Transactions in a manner that is consistent with such characterization described in the IRS PLR.
3. None of the Relevant Transactions will constitute a noneconomic substance transaction ("NEST") under CR&TC section 19774(c)(2), and thus, the NEST understatement penalty under CR&TC section 19774 will not apply to any of the Relevant Transactions.

REPRESENTATIONS

A. General Representations

1. ***** asserts that the identical issues in this ruling request are not in a prior California franchise tax return of the taxpayer or an affiliate for a previous year, and are not the subject of an existing California audit, protest, appeal or litigation concerning the taxpayer or an affiliate.

¹⁷ The ***** and the subsequent ***** were intended to qualify as tax-free transactions under IRC sections 368(a)(1)(D) and 355 for federal income tax and California franchise tax purposes, and were treated as such in the IRS PLR. See business purposes for ***** as represented by Taxpayer and discussed above.

2. Immediately before the *****, items of income, gain, loss, and deduction will be taken into account as required by the applicable intercompany transaction regulations (as determined under Cal. Code of Regs., tit. 18, section 25106.5-1).

B. IRC Section 355(b) Representations

3. Immediately prior to the *****, ***** was engaged in a five-year active trade or business within the meaning of IRC section 355(b) and ***** has continued such active trade or business following the *****. The five years of financial information submitted on behalf of ***** with respect to the ***** conducted by ***** is representative of *****'s present operations, and with regard to ***** and *****, there have been no substantial operational changes since the date of the last financial statements submitted. As a result of the *****, immediately after the *****, ***** was directly engaged in the active conduct of a trade or business within the meaning of IRC section 355(b).
4. ***** continuously owned 100 percent of the stock of ***** for at least the five-year period ending on the *****. ***** wholly owns *****.
5. Following the *****, *****, through *****, will continue the active conduct of its business independently and with its separate employees or employees of affiliated corporations.
6. ***** continuously, directly or indirectly, owned 100 percent of the stock of ***** for at least the five-year period ending on the ***** Date.
7. Immediately prior to the *****, ***** (through *****) was engaged in a five-year active trade or business within the meaning of IRC section 355(b). The five years of financial information submitted on behalf of ***** with respect to the ***** conducted by ***** (through *****) is representative of *****'s present operations, and with regard to *****, there have been no substantial operational changes since the date of the last financial statements submitted. Immediately after the *****, ***** will be directly engaged in a five-year active trade or business within the meaning of IRC section 355(b).
8. ***** continuously owned, directly or indirectly, 100 percent of the interests of ***** (or 100 percent of the stock of its predecessor, ***** ******) for at least the five-year period ending on the ***** Date.
9. Following the *****, ***** will continue the active conduct of its business independently and with its separate employees or employees of affiliated corporations.

C. CR&TC Section 19774 Representations

10. Each of the ***** other than the ***** was primarily carried out to facilitate the ***** or its Corporate Business Purposes.
11. None of the ***** was undertaken to reduce the California franchise tax liability of ***** and/or any of its subsidiaries, except to the extent that such transactions enabled the ***** to qualify for nonrecognition treatment under IRC section 355 as adopted in the CR&TC for California franchise tax purposes.

RULINGS

Based on the accuracy and completeness of the facts and representations provided by the Taxpayer as provided, and subject to field examination by the Service and/or FTB of the facts relating to the ***** , the FTB Chief Counsel rules as follows:

1. Based on the Taxpayer's receipt of the IRS PLR, and the facts and representations provided by the Taxpayer herein, the ***** will satisfy the active trade or business requirement of IRC section 355(b) for California franchise tax purposes, as adopted in the CR&TC as of the date of this Chief Counsel Ruling.
2. For California franchise tax purposes, the FTB will respect the form and substance of the Relevant Transactions as described in and ruled on by the Service in the IRS PLR, and will otherwise apply the CR&TC to the Relevant Transactions in a manner that is consistent with such characterization described in the IRS PLR.
3. Based on the facts and representations as provided by the Taxpayer herein, none of the Relevant Transactions will constitute a noneconomic substance transaction under CR&TC section 19774(c)(2), and thus, the NEST understatement penalty under CR&TC section 19774 will not apply to any of the Relevant Transactions.

LAW AND ANALYSIS

California Adoption of "Subchapter C"

Pursuant to CR&TC sections 24451 and 17321, California specifically adopts by reference Subchapter C of Chapter 1 of Subtitle A of the Code,¹⁸ without any modifications that are relevant to the legal analysis herein. These Subchapter C provisions include, but are not limited to, IRC sections 312, 332, 337, 351, 355, 358, 361 and 368. Furthermore, the related Treasury Regulations with respect to these federal statutes are also adopted by California pursuant to CR&TC sections 23051.5(d) and 17024.5(d). Therefore, all citations included herein to the aforementioned sections and related Treasury Regulations also refer to the corresponding provisions of California law.

¹⁸ California conforms to these provisions of the Internal Revenue Code as of the "specified date" of January 1, 2005.

Subchapter C Provisions Applicable to the *****

The IRS PLR provides that the ***** qualifies for nonrecognition treatment under IRC sections 355 and 368. California adopts by reference IRC sections 355 and 368 and the related regulations thereto through CR&TC sections 24451 and 23501.5(d) for corporate franchise tax purposes, and CR&TC sections 17321 and 17024.5(d) for personal income tax purposes. Additionally, as discussed in FTB Notice 89-277, California follows federal procedures and rulings where California law is in conformity to federal law as long as the FTB has not publicly indicated it will not follow the ruling or procedure.

IRC Section 355(b) "Active Trade or Business" Requirement

1. *****

As stated above, the Taxpayer has received an IRS PLR in which the Service has ruled that the ***** will constitute a tax-free reorganization under IRC sections 368(a)(1)(D) and 355; implicit in this IRS PLR is that the ***** will satisfy the "active trade or business" requirement of IRC section 355(b). As of the date of the ***** , California has not adopted the amendments to IRC section 355(b) made by section 202 of TIPRA. Thus, ***** liquidated ***** in the ***** ***** , described herein, in order to become directly engaged in the active conduct of a trade or business to satisfy the requirements of IRC section 355(b) as currently applicable for California franchise tax purposes.

Prior to the ***** , ***** , formerly a wholly owned subsidiary of ***** , was merged with and into ***** , a disregarded entity owned by ***** , in the ***** ***** , such that the trade or business assets and activities of ***** are currently treated as held directly by ***** for federal income tax purposes. Immediately after the ***** , ***** was directly engaged in the conduct of an active trade or business through ***** as a result of the ***** ***** .

Prior to the 2005 modifications to IRC section 355(b) in section 202 of TIPRA, the Service had consistently ruled that a company may engage in a tax-free restructuring transaction, such as the ***** ***** , in order to satisfy the active trade or business requirement.¹⁹ The Service has also consistently ruled that a company can satisfy the

¹⁹ See Rev. Rul. 74-79, 1974-1 C.B. 81 (holding that a parent corporation not engaged in the active conduct of a trade or business may satisfy the active trade or business requirement of IRC §355(b) by liquidating a wholly-owned subsidiary that meets such requirement and acquiring the subsidiary's business in a transaction in which no gain or loss is recognized). Rev. Rul. 74-79 was followed by the Service in PLR 200109027 (November 30, 2000) (***** liquidated subsidiaries that directly conducted an active trade or business into ***** in order to satisfy the active trade or business requirement of IRC §355(b)); PLR 200101006 (October 5, 2000); PLR 9447023 (August 23, 1994); PLR 200215027 (January 10, 2002) (***** acquired an active business via a tax-free reorganization with a sister corporation); PLR 200214025 (January 4, 2002) (***** created a newly formed limited liability company into which it merged an

active trade or business requirement notwithstanding the fact that during the relevant period it had no employees and that all of its business was conducted through the use of employees of affiliated corporations.²⁰

*Active Trade or Business Formerly conducted by ***** (and now by *****).* ***** conducts the ***** , which consists of *****

*****²¹ ***** undertakes these business activities

As part of the ***** Business, *****

For each year of the five-year period ending on the ***** Date, ***** and its predecessor, ***** , has had at least ** full time equivalency ("FTE") employees engaged in the ***** Business. Currently, ***** has ** FTE employees

existing subsidiary with a qualifying five-year active trade or business in order for ***** to satisfy the active trade or business requirement of IRC §355(b)); and PLR 9809035 (November 25, 1997) (***** engaged in pre-spin off restructuring which included checking-the-box (to be disregarded) on various existing subsidiaries so that an active trade or business could be attributed to ***** and ***** for purposes of satisfying IRC §355(b)). See also Mark J. Silverman, *Corporate Divisions Under Section 355*, Practising Law Institute, 2002 Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Proposed Restructurings, 547 PLI/Tax 9, 80 (discussing methods by which companies can reorganize their legal structure to satisfy the active business requirement of §355(b)); and Thomas F. Wessel, M. Todd Prewett, Richard D'Avino, Joseph M. Pari, *Corporate Distributions Under Section 355*, Practising Law Institute, 2002 Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Proposed Restructurings, 546 PLI/Tax 871, 1053.

²⁰ See Rev. Rul. 79-394, 1979-2 C.B. 141, as amplified by Rev. Rul. 80-181, 1980-2 C.B. 121; see also PLR 200634005 (May 25, 2006); PLR 200044017 (Nov. 3, 2000); PLR 9843033 (July 28, 1998); and PLR 9701060 (Oct. 9, 1996).

²¹ In addition to conducting the ***** , ***** also

engaged in the ***** Business. For the fiscal year ended ***** , ***** gross revenue from the ***** Business was ***** and it had gross assets of approximately ***** at year-end.

Since its formation in **** and prior to the **** , all of the outstanding stock of ***** was held by ***** . Other than the period between ***** , and ***** , when its name was ***** name remained unchanged since its formation.

***** (including through its predecessor, ****) will have continuously conducted an active business within the meaning of Treas. Reg. section 1.355-3(b) for the five-year period ending on the ***** Date. There has not been any substantial change during the five-year period ending on the ***** Date in the ***** Business actively conducted by ***** (and formerly conducted by ****). There has not been any cessation or substantial reduction in business activity of the ***** Business of ***** (or ****) for any significant period of time during the five-year period ending on the ***** Date. Finally, during the five-year period preceding the ***** Date, ***** (including through ****) has not acquired or disposed of any entity, nor has it been a party to a ***** , merger or any other type of taxable or tax-free reorganization, other than the acquisition of ***** .²²

The ***** has been undertaken to ensure that ***** is treated as engaged in an active trade or business immediately after the ***** for California and certain other states' franchise and income tax purposes.

As of the date hereof, California and certain other states have not adopted, for purposes of such states' franchise and income tax laws, the amendments to IRC section 355(b) made by section 202 of TIPRA. Section 202 of TIPRA effectively replaced the "holding company" test in IRC section 355(b)(2)(A) (as in effect prior to TIPRA) with a test that permits a ***** or ***** corporation to satisfy the "active trade or business" requirement of IRC section 355(b)(2)(A) if the "separate affiliated group," of which the ***** or ***** corporation is the common parent, is engaged in the active conduct of a trade or business.²³

Importantly, under both current IRC section 355(b)(2)(A) and former IRC section 355(b)(2)(A) (i.e., as in effect prior to TIPRA, and current California law), a corporation is treated as engaged in the active conduct of a trade or business if it is itself directly engaged in the active conduct of a trade or business.

Absent the ***** , at the time of the ***** , ***** would not be engaged directly in the active conduct of a trade or business, nor would it satisfy the "holding

²² ***** acquired the stock of ***** ("*****") in ***** . ***** , which is currently a subsidiary of ***** , conducts a ***** business that is separate from the ***** Business.

²³ IRC §355(b)(3).

***** revenue from the ***** of the ***** ,²⁴
was ***** for the year ended *****.²⁵ The other principal income stream
received by the ***** is ***** , which consist primarily of

***** for the year ended
***** .

For each year of the five-year period ending on the ***** Date, ***** has had at
least ** employees engaged in the ***** . Currently, ***** has more than
*** FTE employees engaged in the ***** .

Prior to ****, the business currently conducted by ***** was conducted by *****
***** (“*****”), a ***** corporation. **** was a wholly owned subsidiary of *****
at all times since **** through the date of its conversion to a limited liability company. On
***** , ***I was converted into a ***** limited liability company that is a
disregarded entity for federal income tax and California franchise tax purposes in a
transaction represented to have qualified as a tax-free ***** pursuant to IRC sections
332 and 337. In connection with the conversion, **** changed its name to *****
***** (“*****”). ***** has owned all of the interests in ***** since the date of
the conversion.

***** (including through its predecessor, ****) continuously conducted an active
business within the meaning of Treas. Reg. section 1.355-3(b), for the five-year period
ending on the ***** Date. There has not been any substantial change during the
five-year period ending on the ***** Date in the ***** actively conducted
by ***** (and formerly conducted by ****). There has not been any cessation or
substantial reduction in business activity of the ***** of ***** (or ****) for
any significant period of time during the five-year period ending on the ***** Date.
Finally, during the five-year period preceding the ***** Date, ***** (including
through its predecessor, ****) has not acquired or disposed of any entity (other than its

²⁴ The term “*****” refers to

²⁵ In addition to the ***** , ***** provides

acquisition of ***** in *****),²⁶ nor has it been a party to a *****, merger or any other type of taxable or tax-free reorganization.

Noneconomic Substance Transactions (NEST) Under CR&TC Section 19774

For tax years beginning on or after January 1, 2005, pursuant to CR&TC section 19774, if a taxpayer has a noneconomic substance transaction understatement, a penalty is imposed for an understatement attributable to any noneconomic substance transaction. The penalty is 40 percent of the understatement of tax.²⁷ If the transaction is adequately disclosed by a taxpayer in a return (or a statement attached to the return) the penalty is decreased to 20 percent of the understatement of tax.²⁸

A noneconomic substance transaction includes the disallowance of any loss, deduction or credit, or addition to income attributable to a determination that the disallowance or addition is attributable to a transaction or arrangement that lacks economic substance, including a transaction or arrangement in which an entity is disregarded as lacking economic substance.²⁹ A transaction is treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose in entering into the transaction.³⁰

The Taxpayer has represented that the ***** Merger, the ***** *****, the ***** *****, the ***** *****, the ***** *****, and the ***** were undertaken to facilitate the ***** , and that the ***** was motivated, in whole or in substantial part, by one or more of the valid nontax Corporate Business Purposes described above.³¹ In addition, the taxpayer has represented that none of the transactions

²⁶ In ***** , ***** acquired the ***** , which ***** , in a taxable transaction. Prior to the acquisition, ***** was owned by the ***** . The ***** is not part of the ***** .

²⁷ CR&TC §19774(a).

²⁸ CR&TC §19774(b)(1).

²⁹ CR&TC §19774(c)(2).

³⁰ *Id.*

³¹ See PLR 200532011 (April 29, 2005) (ruling that a number of internal Proposed Restructuring transactions that were carried out to facilitate a tax-free spin-off under §355 were tax-free reorganizations under IRC §368); see also, Sheryl Stratton, *Korb Holds Forth on Economic Substance Doctrine*, Tax Analysts, Jan. 24, 2007 (quoting IRS Chief Counsel, Donald Korb in a speech given at the 2007 University of Southern California Tax Institute in Los Angeles, stating that, "The economic substance doctrine will not be asserted to challenge routine business restructurings...[such as] when a subsidiary is formed solely for the purpose of facilitating a state law merger, and as part of the plan of reorganization, the subsidiary is required to go out of

described above was undertaken to reduce the California franchise tax liability of ***** and its subsidiaries, except to the extent that such transactions enabled the ***** to qualify as a tax-free transaction for California franchise tax purposes.

Each of the Relevant Transactions principally intended to further the relevant corporate business purposes described herein and/or to facilitate qualification of the ***** under IRC section 355(b), for federal or state tax purposes, will be considered to have a valid nontax California business purposes, such that the ***** Merger, the ***** , the *** ***** , the ***** , the ***** , and the ***** will not be treated as lacking economic substance for purposes of CR&TC section 19774(c)(2). Moreover, the form of the Relevant Transactions as reflected in the IRS PLR will be respected and none of the transactions described above should be disregarded or recharacterized as a "sham" because each of the transactions has been undertaken to facilitate the ***** , which has a valid nontax California business purpose.

Accordingly, none of the Relevant Transactions (i.e., the ***** Merger, the ***** , the ***** , the ***** , the ***** , the ***** and the *****) will constitute a noneconomic substance transaction and, as a result, the noneconomic substance transaction understatement penalty will not apply to any of the foregoing transactions for California franchise tax purposes.

SCOPE OF RULING

Please be advised that the California franchise tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts and representations you have submitted to the FTB. In the event of a change in relevant legislation, judicial or administrative case law, a change in federal interpretation of federal law, or a change in the material facts or circumstances relating to and on which this ruling is based, this ruling may no longer be applicable. It is your responsibility to be aware of and promptly notify the FTB should any of these circumstances occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of CR&TC section 21012. Please attach a copy of this letter and your request to the appropriate returns when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

existence by merging into the target corporation...[The IRS will] continue to recognize that the tax law has long allowed a corporation to reduce its ownership in a closely held corporation below 80 percent, even if the reduction is solely for the purpose of avoiding IRC §332, in order for the taxpayer to recognize a loss on the subsequent liquidation of that subsidiary...".

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