State of California
Franchise Tax Board

08.11.2008

CHIEF COUNSEL RULING 2008 - 1
Subject ********************, ********* Corp.
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Dear *********:

In your correspondence dated May 7, 2008, you requested advice from the California Franchise Tax Board (the "FTB"), in the form of a Chief Counsel Ruling ("CCR"), regarding a distribution (the "Proposed Distribution"), involving section 355 of the Internal Revenue Code of 1986, as amended (the "Code" or "IRC"), California's conformity thereto, and the application (or lack thereof) of section 19774 of the California Revenue and Taxation Code (the "R&TC") to the Proposed Distribution, which is discussed below.

PROCEDURAL HISTORY

On **************, ***************** Corporation ("Distributing," the "Distributing Corporation," or "Taxpayer") received from the Internal Revenue Service ("the "Service" or the "IRS") a favorable private letter ruling ("IRS PLR") with respect to the Proposed Distribution by Distributing of all of the stock of ******** Corporation ("Controlled" or the "Controlled Corporation") owned by Distributing to Distributing's shareholders. In the IRS PLR, the Service ruled, among other things, that the Proposed Distribution qualifies for non-recognition treatment under IRC section 355 of the Code. This conclusion was based in part upon the amendment of IRC section 355, which added subsection (b)(3) in section 202 of the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222, 120 Stat. 348) ("TIPRA").[1] A copy of this IRS PLR was provided to the FTB in connection with this CCR, and is attached hereto as "EXHIBIT A." As of the date of this CCR, California has not conformed to, nor has it adopted for purposes of California income or franchise tax laws, IRC section 355(b)(3) or any of the other provisions of section 202 of TIPRA.[2]

[1] Section 355(b)(3) was enacted on May 17, 2006, and is applicable to distributions made after that date of enactment.
[2] As such, except where indicated, references to IRC section 355 and the California conformity thereof, are to section 355 as unmodified by TIPRA.

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RULINGS REQUESTED

1. For California franchise tax purposes, the Proposed Distribution will satisfy the active trade or business requirement of IRC section 355(b), as adopted in the R&TC as of the date of this CCR.
2. For California franchise tax purposes, the FTB will respect the form and substance of the Proposed Distribution as described in and ruled on by the Service in the IRS PLR, and will otherwise apply the R&TC to the Proposed Distribution in a manner that results in the Proposed Distribution qualifying as a non-taxable distribution pursuant to IRC section 355, as adopted in the R&TC as of the date of this CCR.
3. The Proposed Distribution will not constitute a noneconomic substance transaction ("NEST") under R&TC section 19774, and thus, the NEST understatement penalty will not apply to the Proposed Distribution.

FACTS

A. Corporate Background and Capital Structure

Distributing is a U.S. publicly held company headquartered in ********, **********. Distributing files a consolidated U.S. federal income tax return with its affiliated group and Controlled files a separate consolidated U.S. federal income tax return with its affiliated group. Distributing is the parent corporation of a ********* unitary group, of which Controlled is a member. Distributing, Controlled and the other unitary group members jointly file a ******** combined report. Controlled is a U.S. publicly held company headquartered on the same campus as Distributing in ********, ********.

Beginning in **** and ending in ****, Distributing undertook a series of transactions that ultimately resulted in its acquisition of a controlling interest in Controlled's stock (collectively referred to as the "Acquisition of Controlled"). On ************, Distributing purchased approximately **** million of Controlled's Series **************** stock (the "**** Acquisition"), which represented approximately ** percent of the value and the total combined voting power of all classes of stock entitled to vote (both common and preferred stock). On *************, Distributing acquired the balance (approximately ** percent) of all non-employee owned outstanding Controlled stock (the "**** Acquisition") in a reverse subsidiary merger intended to qualify under section 368(a)(1)(B), in which Distributing's common stock was used as the consideration. Due to Distributing's existing ownership of ** percent, Distributing was not able to acquire the non-employee owned outstanding Controlled shares in a transaction under IRC section 368(a)(2)(E). As part of the **** Acquisition, the acquired shares were cancelled such that virtually all of Controlled's equity (except for a relatively small amount of ******* stock issued and outstanding held by employees and management of Controlled) was comprised of the **** million shares of Controlled's ***************** voting shares held by Distributing.

These ********* shares gave Distributing approximately ** percent of the value and the total combined voting power of all classes of Controlled voting stock (both common and preferred stock), which constituted IRC section 368(c) control, since Controlled had no nonvoting stock issued at that time. After the **** Acquisition, Distributing's ownership of Controlled also qualified as IRC section 1504(a)(2) control since Distributing at that time owned approximately ** percent of the total voting power and total value of Controlled's stock.

In ****, Distributing contributed additional capital for additional stock of Controlled. Distributing acquired ** million shares of Controlled's **************** stock and ** million shares of Controlled's ******* common stock in ********************, respectively. In *********, Distributing converted approximately $** million of convertible indebtedness into **** million shares of Controlled class A common stock.[3]
During ***********, Controlled underwent a recapitalization (the "Recapitalization") in which all ***********, **********, and ***** common shares held by Distributing were exchanged for ***** million shares of Controlled's ***** common stock. The minority shareholders of Controlled exchanged their common shares for new class A common shares. No gain or loss was recognized in whole or in part in connection with the Recapitalization.

Also during **********, following the Recapitalization, Controlled effected a reverse 1-for-2 stock split in which the ***** million Controlled ****** shares held by Distributing were converted into approximately ** million ****** Controlled shares. As a result, the **** million **** Control Shares became **** million ***** common shares. After the reverse split, the ***** common shares continued to have eight votes per share, while the ****** shares continued to have one vote per share.

Following the reverse stock split, during ************, Controlled sold * million ******* common shares in an initial public offering. As a result of the initial public offering, Distributing's ownership for IRC section 368(c) purposes was reduced to approximately ** percent. Distributing's ownership for IRC section 1504(a) purposes at this time was reduced to approximately ** percent of the total value of the issued and outstanding shares.

During **********, Controlled sold * million ****** common shares in a secondary public offering. As a result of the secondary public offering, Distributing's ownership for IRC section 368(c) purposes was then reduced to approximately ** percent. Distributing's ownership for IRC section 1504(a) purposes at this time was reduced to approximately ** percent (less than 80 percent). Accordingly, Controlled became deconsolidated from the Distributing affiliated group and discontinued filing a federal consolidated tax return with Distributing and Distributing's subsidiaries. However, Distributing and Controlled continued filing a combined California return as members of the same California unitary group.

On **********, Distributing sold *** million shares of Controlled ***** common stock in a private offering. As a result of the sale, and in accordance with the terms of the ***** common stock, the ***** shares immediately converted into ***** shares. The ******

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[3] Following these transactions, Distributing held approximately **** million ************** shares, ** million *********** shares and **** million ***** common shares in Controlled for a total of ***** million common and preferred shares. These additional share issuances resulted in the further dilution of the minority shareholders of Controlled.

common shares sold at this time were specifically identified to include the **** million **** Control Shares (the "Control Share Sale"). Therefore, the **** Control shares will not be distributed to Distributing's shareholders as part of the Proposed Distribution. Distributing currently owns approximately **** million ****** common shares, which represents a greater than 80 percent ownership in Controlled for section 368(c) purposes as of ***************.

Both Controlled and Distributing are in the ****** manufacturing business and produce products that use similar processes. In issuing the IRS PLR, the Service determined, based upon review of financial information submitted to it by Taxpayer, that Distributing and Controlled each had gross receipts and operating expenses representing the active conduct of a trade or business for each of five years.

B. <u>The Proposed Distribution</u>

The Proposed Distribution will consist of Distributing distributing all of its Controlled ***** common shares to its shareholders on a pro-rata basis in accordance with IRC section 355.

C. <u>Business Purpose</u>

Taxpayer has represented the Proposed Distribution is expected to enable both Distributing and Controlled greater access to capital markets, and to result in a higher share value for both Distributing and Controlled, which will help both companies more efficiently acquire needed assets and services. The Proposed Distribution is motivated, in whole or substantial part, by these corporate business purposes, which are real and substantial purposes, which are not federal and/or California tax purposes, and which are germane to the business of Distributing and Controlled.

REPRESENTATIONS

1. Taxpayer asserts that the none of the issues in this CCR are included or described in a prior California franchise tax return of the Taxpayer or group member for a previous year, and are not the subject of an existing California audit, protest, appeal or litigation concerning the Taxpayer or a group member.
2. Immediately before the Proposed Distribution, Distributing and Controlled will be members of the same California combined unitary group. Controlled will no longer be a member of Distributing's California combined unitary group as a result of the Proposed Distribution.
3. Immediately before the Proposed Distribution, 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). Likewise, any deferred intercompany stock accounts ("DISAs") will be taken into account as required by the applicable DISA regulations (as determined under Cal. Code of Regs., tit. 18, section R&TC §25106.5-1(f)).

4. On *************, Distributing acquired the balance (approximately ** percent) of all non-employee owned outstanding Controlled shares in the **** Acquisition. This was preceded by an earlier acquisition of ** percent of the total combined voting power of Controlled in the **** Acquisition. As a result of these two transactions, Distributing obtained IRC section 1504(a) and IRC section 368(c) control of Controlled.

5. At the time of the **** Acquisition, the ******************************* manufactured and marketed by Controlled were substantially similar to products manufactured and marketed by Distributing.

6. At the time of the **** Acquisition, Controlled employed manufacturing techniques similar to those employed by Distributing.

7. Controlled's design, manufacturing, and testing techniques were dramatically improved by drawing upon the existing experience and know-how of Distributing.

8. Following the **** Acquisition, as a result of Distributing's reputation within the ********* manufacturing industry, Controlled was able to attract and retain highly qualified specialists essential to expanding Controlled's business.

9. Prior to the Proposed Distribution, Distributing may sell additional shares of Controlled stock to unrelated third parties. Following the sale, Distributing will continue to maintain a greater than 80 percent stock interest in Controlled for IRC section 368(c) purposes.

10. With the possible exception of the issuance of shares pursuant to adjustments to Distributing's existing compensatory options, restricted stock, deferred share arrangements and the issuance of stock or shares pursuant to Distributing's existing convertible debentures, no part of the Controlled shares to be distributed by Distributing to its shareholders will be received by a shareholder as a creditor, employee or in any capacity other than that of a shareholder of Distributing.

11. Following the Proposed Distribution, Distributing will continue the active conduct of its business independently and with its separate employees or employees of the other members of its affiliated group.

12. Following the Proposed Distribution, Controlled will continue the active conduct of its business independently and with its separate employees or employees of the other members of its affiliated group.

13. No person will hold a 50 percent or greater interest in the shares of Distributing or stock of Controlled after the Proposed Distribution, within the meaning of IRC section 355(g), who did not hold such an interest immediately before the transaction.

14. The Proposed Distribution is not used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.

15. Other than trade account indebtedness created in the ordinary course of business through continuing transactions at terms arrived at by the parties bargaining at arm's length, payables created for all transitional services, and debt being repaid in

connection with the Proposed Distribution, no inter-corporate debt will exist between Distributing and Controlled after all the steps of the distribution are completed.

16. The indebtedness, if any, owed by Controlled to Distributing after the Proposed Distribution will not constitute stock or securities.

17. Distributing, Controlled and Distributing shareholders will each pay their respective expenses, if any, incurred in connection with the Proposed Distribution.

18. Payments made in connection with all continuing transactions, if any, between Distributing and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arms' length.

19. No two parties to the transaction are investment companies as defined in IRC sections 368(a)(2)(F)(iii) and (iv).

20. Immediately before the Proposed Distribution, items of income, gain, loss, deduction, and credit will be taken into account as required by the applicable inter-company transaction regulations (see Treas. Reg. sections 1.1502-13 and 1.1502-14 as in effect before the publication of T.D. 8597, 1995-2 C.B. 147, and as currently in effect; Treas. Reg. section 1.1502-13 as published by T.D. 8597). Furthermore, Distributing's excess loss account, if any, with respect to Controlled common stock or the excess loss account that Distributing may have in the stock of another member that is required to be taken into account by Treas. Reg. section 1.1502-19 will be included immediately before the Proposed Distribution.

21. The Proposed Distribution is not part of a plan or series of related transactions (within the meaning of Treas. Reg. section 1.355-7) pursuant to which one or more persons will acquire, directly or indirectly, stock representing a 50 percent or greater interest (within the meaning of IRC section 355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation).

22. For purposes of IRC section 355(d), immediately after the Proposed Distribution no person (determined after applying the aggregation rules of IRC section 355(d)(7)) will hold shares possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote or 50 percent or more of the total value of all classes of Distributing stock that was acquired by purchase (as defined in IRC 355(d)(5) and (8)) during the five-year period (determined after applying IRC section 355(d)(6)) ending on the date of the Proposed Distribution.

23. For purposes of IRC section 355(d), immediately after the Proposed Distribution no person (determined after applying the aggregation rules of IRC section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled stock entitled to vote or 50 percent or more of the total value of shares of all classes of Controlled stock that was acquired by:

(i) purchase (as defined in IRC section 355(d)(5) and (8)) during the five-year period (determined after applying section 355(d)(6)) ending on the date of the Proposed Distribution, or

(ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in IRC sections 355(d)(5) and (8)) during the five-year period (determined after applying IRC section 355(d)(6) ending on the date of the Proposed Distribution.

24. The financial information for the five years immediately preceding the Proposed Distribution that was submitted on behalf of Controlled is representative of Controlled's present operations and, with regard to Controlled, there have been no substantial changes since the date of the last financial statements submitted.

25. The financial information for the five years immediately preceding the Proposed Distribution that was submitted on behalf of Distributing is representative of Distributing's present operations and, with regard to Distributing, there have been no substantial changes since the date of the last financial statements submitted.

26. The Proposed Distribution is expected to enable both Distributing and Controlled greater access to capital markets, and to result in a higher share value for both Distributing and Controlled, which will help both companies more efficiently acquire needed assets and services. The Proposed Distribution is motivated, in whole or substantial part, by these corporate business purposes, which are real and substantial purposes, which are not federal and/or California tax purposes, and which are germane to the business of Distributing and Controlled.

27. The Recapitalization qualified as a tax-free reorganization pursuant to IRC section 368(a)(1)(E).

28. Distributing's acquisition of ** million shares of Controlled's ************** ******** stock and ** million of Controlled's ***** common stock in **** qualified as a tax-free IRC section 351 exchange.

29. The Proposed Distribution is not being undertaken to reduce California franchise tax liability of Distributing or Controlled, any other affiliated or combined report group member, or any subsidiary.

30. The Taxpayer has fully disclosed all relevant facts in receiving the IRS PLR and in the submission of this CCR request to the FTB. The Taxpayer will immediately notify the FTB in the event that the facts relating to this CCR change, including but not limited to, a revocation of the IRS PLR or the submission of a supplemental or additional IRS private letter ruling request relating to the Proposed Distribution or the IRS PLR. (*See* EXHIBIT B" DECLARATION OF FACTS AND REPRESENTATIONS).

RULINGS

Subject to examination by the Service and/or FTB of the facts and representations relating to the Proposed Distribution, and based on the accuracy and completeness of the facts and representations provided by the Taxpayer in the IRS PLR and herein, and only so long as the IRS PLR remains valid, the FTB Chief Counsel rules as follows:

1. The Acquisition of Controlled will qualify as an expansion of business under Treas. Reg. section 1.355-3(b)(3)(ii), and will satisfy for California franchise tax purposes the active trade or business requirement of IRC section 355(b), as adopted in the R&TC, as of the date of this CCR.

In the IRS PLR, the Service viewed the Acquisition of Controlled as an business expansion of an existing five-year trade or business under the "Business Expansion Doctrine," and concluded that such purchase did not run afoul of the requirements of IRC section 355(b).[4] The Service applied the separate affiliated group ("SAG") rule of recently enacted IRC section 355(b)(3), and analyzed this business expansion occurring via a taxable purchase of *assets* addressed in IRC section 355(b)(2)(C). Because the SAG rule of IRC section 355(b)(3) has not been adopted or conformed to in the R&TC, the Acquisition of Controlled would still be viewed as a taxable purchase of *stock* for California franchise tax purposes, which is addressed in IRC section 355(b)(2)(D).

Since the Service ruled in the IRS PLR that the Acquisition of Controlled was a bona fide business expansion of Distributing's existing five-year active trade or business, and that it comported with IRC section 355(b)(2)(C), the Acquisition of Controlled will similarly be viewed for California franchise tax purposes as a valid business expansion that comports with IRC section 355(b)(2)(D).

2. For California franchise tax purposes, the FTB will respect the form and substance of the Proposed Distribution as described in and ruled on by the Service in the IRS PLR, and will otherwise apply the R&TC to the Proposed Distribution in a manner that results in the Proposed Distribution qualifying as a non-taxable distribution pursuant to IRC section 355, as adopted by California.

3. The Proposed Distribution will not constitute a noneconomic substance transaction (NEST) under R&TC section 19774, and thus, the NEST understatement penalty under R&TC section 19774 will not apply to the Proposed Distribution.

LAW AND ANALYSIS

A. California Adoption of Federal Law

The IRS PLR provides that the Proposed Distribution qualifies for nonrecognition treatment under IRC section 355. Pursuant to R&TC sections 24451 and 17321, California specifically adopts by reference Subchapter C of Chapter 1 of Subtitle A of the Code, without any modifications that are relevant to the legal analysis herein. These Subchapter C provisions include, but are not limited to, IRC sections 351, 355 and 368. Furthermore, the related Treasury Regulations with respect to these federal statutes are also adopted by California pursuant to R&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. 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.

[4] Specifically, the Service analyzed the **** Acquisition only, because the **** Acquisition occurred prior to the five-year period immediately preceding the Proposed Distribution.

B. IRC Section 355(b) Active Trade of Business Requirement

In order to satisfy the active trade or business requirement of section 355(b), both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business immediately after the distribution.[5] For purposes of the active trade or business test, a corporation is treated as engaged in the active conduct of a trade or business only if: (A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged;[6] (B) such trade or business has been actively conducted throughout the five (5) year period ending on the date of the distribution ("Relevant Period");[7] (C) such trade or business was not acquired within the Relevant Period in a transaction in which gain or loss was recognized in whole or in part ("Taxable Asset Acquisition");[8] and (D) control of a corporation (which at the time of the acquisition of control) was conducting such trade or business was not acquired within the Relevant Period in a transaction in which gain or loss was recognized within the five-year period ending on the date of distribution ("Taxable Stock Acquisition").[9]

C. IRC Section 355(b)(3) SAG Rule Enacted in Section 202 of TIPRA

In TIPRA, Congress amended IRC section 355 to add subsection (b)(3), adopting a separate affiliated group (SAG) rule to be used in the application of the mechanical provisions of IRC Section 355(b)(2). Prior to the enactment of IRC Section 355(b)(3) in TIPRA, taxpayers often had to undergo extensive and costly restructuring to meet the literal requirements of IRC Section 355(b)(2). To alleviate this restructuring burden, Congress added IRC Section 355(b)(3), which provides in relevant part, that "all members of such corporation's [Distributing and/or Controlled] separate affiliated group (SAG) shall be treated as one corporation."

California has not adopted or conformed to IRC section 355(b)(3). As a result, California does not currently have the SAG rule that permits corporations to treat assets of other affiliated group members as assets held by that corporation for purposes of applying the requirements of IRC Section 355(b). As discussed below, this lack of conformity to IRC section 355(b)(3), causes expansions of existing trades or businesses to be evaluated in a slightly different manner for federal and California purposes.

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[5] IRC section 355(b)(1)(A).
[6] IRC section 355(b)(2)(A). The second part of IRC section 355(b)(2)(A), providing that a corporation meets the active trade or business test of IRC section 355 where substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged, is commonly referred to as the "holding company test."
[7] IRC section 355(b)(2)(B).
[8] IRC section 355(b)(2)(C).
[9] IRC section 355(b)(2)(D).

D. The Business Expansion Doctrine

As discussed above, Distributing acquired the stock of Controlled in a series of transactions that included taxable stock acquisitions within the five-year period immediately preceding the Proposed Distribution.

The Business Expansion Doctrine provides an exception to the general rule that prohibits a change in the active trade or business through a taxable acquisition of assets or stock. The fact that active trade or business assets, or control of a corporation engaged in an active trade or business, were acquired in a taxable transaction during the five-year period preceding a distribution does not necessarily disqualify the distribution from meeting the requirements of section 355(b) if the acquired business is in the same line of business and can be properly viewed as an expansion of an existing active trade or business. This exception only applies to the extent the acquired business does not amount to the acquisition of a new or different business.[10] In particular, "[i]f a corporation engaged in the active conduct of one trade or business during the [Relevant Period] purchased, created, or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is treated as having been actively conducted during the [Relevant Period]. . . ."[11]

Because of the SAG rule of IRC section 355(b)(3), the business expansion via the taxable stock purchase of Controlled is now analyzed under federal law as a business expansion via a taxable *asset* acquisition, which is addressed in IRC section 355(b)(2)(C). However, because California has not adopted or conformed to the SAG rule of IRC section 355(b)(3), the Acquisition of Controlled is analyzed as a taxable *stock* purchase, addressed in IRC section 355(b)(2)(D), for California income and franchise tax purposes. Relevant statutory, regulatory and judicial authorities discussed below clearly support the application of the pre-TIPRA business expansion doctrine to taxable stock acquisitions, particularly in a case where the IRS has analyzed the taxable stock acquisition as a taxable asset acquisition and concluded that it comports with the requirements of IRC section 355(b).

1. *Business Expansion Doctrine: Same Line of Business*

Federal and California law are in conformity with respect to guidance determining when two businesses are in the same line of business for expansion purposes.[12] The determination that Distributing and Controlled are engaged in the same line of business was made by the Service in its IRS PLR. Therefore, in this CCR, the FTB analysis focuses on the method by which Distributing's existing five-year active trade or business was expanded.

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[10] Treas. Reg. section 1.355-3(b)(3)(ii).
[11] Id.
[12] Id.

2. *Business Expansion Doctrine: Methods of Expansion under Pre-TIPRA Authorities*

A corporation will generally fail the active trade or business test of IRC section 355(b) if the active trade or business relied upon was directly or indirectly acquired within the Relevant Period in a transaction in which gain or loss is recognized in whole or in part.[13] The principal purpose behind these limitations is to prevent a corporation from bypassing the five-year rule contained in IRC section 355(b) by acquiring an active trade or business using corporate earnings and then distributing such business in a non-taxable manner.[14]

Despite this general prohibition, the legislative history of IRC sections 355(b)(2)(C) and (D) state that, "a trade or business, which has been actively conducted throughout the 5-year period…will meet the requirements of [section 355(b)] even though such trade or business underwent change during such 5-year period…provided the changes are not of such a character as to constitute the acquisition of a new or different business."[15]

An acquisition of an active trade or business may be accomplished through either a direct acquisition of assets or an indirect acquisition of assets via an acquisition of stock of the corporation holding the active trade or business assets. Since the promulgation of the Business Expansion Doctrine, a direct asset acquisition by Distributing of another trade or business within the same line of business served as the most common fact pattern tested by the courts and used by the Service in regulatory examples and revenue rulings. For example, in Rev. Rul. 2003-18,[16] a corporation that had been engaged under a dealer franchise in the sale and service of brand X automobiles acquired the assets of a franchise that engaged in the sale and service of brand Y automobiles.[17]

In 1989, final regulations were issued under IRC section 355(b) (the "Regulations"). These Regulations incorporated the expansion language contained in the legislative history of IRC sections 355(b)(2)(C) and (D) by stating, "the fact that a trade or business underwent change during the five-year period preceding the distribution shall be disregarded, provided that the changes are not of such a character as to constitute the acquisition of a new or different business."[18] In addition, the Regulations provided several examples of the Business Expansion Doctrine. Although Treas. Reg. section 1.355-3(b)(3)(ii) does not specify the manner in which an expansion of a trade or business may be accomplished, examples (5), (7), and (8) in Treas. Reg. section 1.355-3(c) describe expansions of a trade or business through asset acquisitions. While there are no examples of expansion relating to

[13] IRC sections 355(b)(2)(C) and 355(b)(2)(D).
[14] *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 50-51 (1954).
[15] H.R. Rep. No. 2543, 83d Cong., 2d Sess. 37 (1954). This language was later incorporated in Treas. Reg. section 1.355-3(b)(3)(ii).
[16] 2003-1 C.B. 467.
[17] Subsequently, the brand X business was distributed in a transaction intended to qualify under IRC section 355. At issue in this ruling was whether the acquisition of the brand Y business, which had been acquired within the Relevant Period, violated the active trade or business test. The Service ruled that the active business requirements of IRC section 355(b) were not met because the brand Y business retained by the corporation had not been actively conducted by the corporation for five-years. *See also*, Rev. Rul. 2002-49, 2002-32 I.R.B. 288.
[18] Treas. Reg. section. 1.355-3(b)(3)(ii).

an indirect acquisition of assets through a stock acquisition, the Regulations do not specifically prohibit expansion through stock acquisitions.

Initially, the IRS took a very conservative approach in its interpretation of the reference to an acquired "trade or business" to mean a direct acquisition of the assets of a trade or business and viewed an expansion as occurring only if the assets of the newly acquired business were brought into direct contact with Distributing's existing business assets. However, over time, the IRS gradually expanded its narrow view of acceptable methods of expansion and permitted variances of the direct asset acquisition including indirect asset acquisitions through a stock acquisition.

In PLR 199937014,[19] in the context of a spin-off under IRC section 355, Distributing 1, a wholly owned subsidiary of Distributing 2, created two new subsidiaries, Subsidiary and Controlled. Distributing 2 paid cash for the assets of Target and Target Sub, which were immediately transferred to Subsidiary and Controlled. Arguably, the assets acquired by Distributing 2 were brought into contact, albeit very briefly, with Distributing 1's existing business assets. The IRS ruled that the active trade or business requirement of IRC section 355(b) was not violated by such an acquisition despite the momentary holding of the acquired assets and immediate contribution to Controlled. This ruling is an example of a cause-to-be-directed transfer in which a corporation is entitled to receive acquired assets, but requests that such assets be transferred directly to a subsidiary.

The Tax Court also embraced indirect expansion in *Athanasios v Comm'r*.,[20] where it found an expansion had occurred despite Distributing's acquisition of an active trade or business through the use of a newly formed subsidiary. The Tax Court held that the Business Expansion Doctrine applied, notwithstanding the fact that the business assets acquired never came into direct contact with the business being expanded.

Following *Athanasios*, *supra*, the Service appears to have embraced the notion that the application of the business expansion doctrine renders moot the asset acquisition requirement of section 355(b)(2)(C). For example, in Rev. Rul. 2002-49[21], the Service ruled that notwithstanding D's taxable acquisition of the remaining interests in the LLC within the Relevant Period, the transaction satisfied the "active business" requirement within the meaning of section 355(b). In reaching this conclusion, the IRS ruled that because D was engaged in the trade or business of LLC prior to the taxable acquisition, and therefore, the subsequent acquisition of the remaining interests in the LLC constituted a mere expansion of D's existing business. Note that the Service held the acquisition was an acceptable method of expansion despite the fact that the assets never came into direct contact with Distributing. While not expressly stated, this ruling also held, similar to the Tax Court in *Athanasios*, supra, that the application of the business expansion doctrine renders the asset acquisition requirement under section 355(b)(2)(C) moot.

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[19] June 15, 1999. Private letter rulings ("PLR's") may not be used or cited as precedent under IRC section 6110(k)(3). Nevertheless, these documents may provide insight regarding the IRS' position with respect to a particular issue.
[20] T.C. Memo. 1995-72.
[21] 2002-32 I.R.B. 288.

The authorities discussed above strongly support a conclusion that indirect acquisitions of business assets are, in substance, no different from a direct acquisition of the stock of a corporation conducting such business for purposes of the business expansion exception to IRC section 355(b). A stock acquisition is likewise an indirect acquisition of the underlying assets of the business and creates no greater separation between the existing business and newly acquired business than other indirect asset acquisitions discussed above. A stock acquisition is not materially different than a "cause-to-be-directed" transfer and virtually indistinguishable from the expansion approved in *Athanasios*, supra. The broadening use of the Business Expansion Doctrine to include direct and indirect types of asset acquisitions, suggests that the expansion doctrine should apply equally to stock expansions.

The language in Treas. Reg. section 1.355-3(b)(4)(i) read in conjunction with Treas. Reg. section 1.355-3(b)(3)(ii) serves as further support that the expansion doctrine was intended to apply equally to both asset expansions and stock expansions. Treas. Reg. section 1.355-3(b)(4)(i) provides generally that IRC sections 355(b)(2)(C) and 355(b)(2)(D) prohibit the acquisition of a trade or business that results in the recognition of gain or loss from satisfying the "active business" test of IRC section 355(b). Notably, the Regulation concludes with the following sentence "[a] trade or business acquired, directly or indirectly, within the five-year period ending on the date of the distribution in a transaction in which the basis of the assets acquired was not determined in whole or in part by reference to the transferor's basis does not qualify under section 355(b)(2)."[22] The placement of the phrase "a trade or business acquired, directly or indirectly" immediately following the discussion of section 355(b)(2)(C) and (D), relating to taxable asset acquisitions and taxable stock acquisitions, strongly suggests that the phrase was intended to cover both a direct acquisition of a trade or business and an indirect acquisition of a trade or business by acquiring either the assets or stock of the corporation holding such trade or business. Consequently, the use of the same phrase, "[a] corporation engaged in . . . one trade or business . . . acquired another trade or business,"[23] in the immediately preceding regulation, relating to the expansion doctrine, should likewise be interpreted to cover both asset and stock acquisitions.

On May 8, 2007, the Treasury issued proposed regulations (REG-123365-03) under section 355(b)(3), addressing the impact of the SAG rule on IRC sections 355(b)(2)(C) and (D). Although the R&TC does not incorporate proposed regulations, and it has not incorporated IRC section 355(b)(3),[24] the proposed regulations promulgated under IRC section 355(b)(3) strongly suggest that the IRS and Treasury believe IRC sections 355(b)(2)(C) and (D) had the same "common [anti-abuse] purpose during the pre-TIPRA era."[25]

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[22] Treas. Reg. section 1.355-3(b)(4)(i).
[23] Treas. Reg. section 1.355-3(b)(3)(ii).
[24] Only regulations promulgated in final form or issued as temporary regulations by the Secretary are applicable as regulations under the R&TC. See R&TC sections 17024.5(d0 and 23051.5(d).
[25] Which is "to prevent distributing from using assets -- instead of its stock or stock of a corporation in control of distributing -- to acquire a new trade or business in anticipation of distributing that trade or business (or facilitating the distribution of another trade or business) to its shareholders in a tax-free distribution."

Although the SAG rule is a new concept as a result of the addition of IRC section 355(b)(3), the concept of stock expansion (now specifically addressed in the proposed regulations) is not new. In recent private letter rulings, the Service has entertained the use of the Business Expansion Doctrine through a stock acquisition and has ruled favorably that such acquisitions did not disqualify the distribution from non-recognition treatment under IRC section 355. See, e.g., PLR 200351005,[26] permitting an expansion of an existing trade or business through a stock acquisition. Similarly, in PLR 200545001,[27] the Service ruled that each of Distributing and Controlled met the "active business" test, notwithstanding the fact that Parent's indirect acquisition of Distributing's stock in a taxable acquisition within the five-year period. To come to this conclusion, the Service also permitted an indirect asset expansion through a stock acquisition.

Based upon the foregoing, it is clear that Treasury, the IRS and the courts, in the Pre-TIPRA era, viewed the Business Expansion Doctrine as being applicable to both asset and stock acquisitions Pre-TIPRA, and that IRC section 355(b)(2)(D) should not impose any greater barrier to a non-taxable distribution under IRC section 355 than that of section 355(b)(2)(C). Drawing upon the rationale of the Tax Court in *Athanasios*, supra, since an acceptable direct acquisition of a trade or business qualifying for expansion "must necessarily satisfy IRC section 355(b)(2)(C)," an acceptable indirect acquisition of a trade or business qualifying for expansion should also satisfy IRC section 355(b)(2)(D). Accordingly, since the Service ruled in the IRS PLR that the Acquisition of Controlled was an expansion of Distributing's existing five-year active trade or business, and that it comported with IRC section 355(b)(2)(C), the Acquisition of Controlled will similarly be viewed for California franchise tax purposes as a valid expansion that comports with IRC section 355(b)(2)(D).

F. <u>Noneconomic Substance Transactions (NEST) Under R&TC Section 19774</u>

For tax years beginning on or after January 1, 2005, pursuant to R&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 generally 40 percent of the understatement of tax.

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. 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.

The Taxpayer has represented that the Proposed Distribution is motivated, in whole or in substantial part, by one or more of the valid non-tax corporate business purposes described above. In addition, the Taxpayer has represented that the Proposed Distribution shall not be undertaken to reduce the California franchise tax liability of Distributing and its subsidiaries, except to the extent that the Proposed Distribution shall enable the distribution to qualify for

[26] July 8, 2003.
[27] August 12, 2005.

nonrecognition treatment for California franchise tax purposes. Based on these representations by Taxpayer, the Proposed Distribution will not be treated as lacking economic substance for purposes of R&TC section 19774. Moreover, the form of the Proposed Distribution as reflected in the IRS PLR will be respected and the Proposed Distribution will not be disregarded or recharacterized as a "sham," because Taxpayer has represented that the Proposed Distribution has a valid non-tax California business purpose.

SCOPE OF RULING

Please be advised that the California franchise tax consequences expressed in this CCR are applicable only to the Taxpayers addressed in the "Rulings" above. The rulings contained in this letter are based on facts and representations submitted by Taxpayer and accompanied by declaration made under penalty of perjury ("Declaration of Facts and Representations," attached hereto as Exhibit B). The FTB has not verified any of the materials submitted by Taxpayer in support of the request for this CCR. Verification of the facts, representations, and other relevant information and data may be required as part of the FTB audit process. In addition, the FTB is relying upon the IRS PLR issued by the Service regarding the Proposed Distribution.

The IRS PLR relied solely upon Taxpayer representations and provided no ruling or opinion with respect to whether the Proposed Distribution (1) has a valid business purpose as required by Treas. Reg. section 1.355-2(b); (2) is not being used principally as a device for the distribution of the earnings and profits of the Distribution or Controlled or both; or (3) is not a part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50 percent or greater interest in Distributing or Controlled and thus comports with the requirements of IRC section 355(e).
In the event of a revocation of the IRS PLR, 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 CCR is based, the CCR 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 CCR is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of R&TC section 21012. Please attach a copy of the CCR and your CCR request to the appropriate returns when filed or in response to any notices or inquiries that might be issued by the FTB.

Very truly yours,

Debra S. Petersen
Tax Counsel IV

Michael C. Hamersley
Tax Specialist III

Attachments: *******************;
EXHIBIT B (DECLARATION OF FACTS AND REPRESENTATIONS)