



chair John Chiang
member Betty T. Yee
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State of California
Franchise Tax Board

02.20.2009

CHIEF COUNSEL RULING 2009-1

Subject: *****

Dear *****:

In your correspondence dated August 22, 2008, *****, a Delaware corporation ("Parent or "Taxpayer"), on behalf of itself, its affiliates, including *****, a Delaware corporation ("Controlled"), requested advice from the California Franchise Tax Board (the "FTB") in the form of a Chief Counsel Ruling regarding the distribution of the stock of Controlled held by *****, a Delaware corporation ("Distributing 1") to its majority shareholder, *****, a Delaware corporation ("Distributing 2"), in a transaction intended to qualify for nonrecognition treatment under section 355 of the Internal Revenue Code¹ (the "Proposed Distribution").

FACTS²

A. Procedural History

The Proposed Distribution is one of a series of related transactions consummated by Parent and its subsidiaries (collectively referred to as the "Restructuring Transactions"). Your request for a Chief Counsel Ruling from the FTB ("FTB CCR Request")³ dated August 22, 2008, included a copy of your request for guidance from the Internal Revenue Service ("IRS" or "Service") regarding the Restructuring Transactions made in an IRS private letter ruling request dated July 31, 2008* ("IRS PLR Request").⁴

¹ All references to the "Code" or "IRC" are to the Internal Revenue Code of 1986, as amended.

² These facts were provided by the Taxpayer in a "DECLARATION OF FACTS AND REPRESENTATIONS," dated February 20, 2009, attached hereto as EXHIBIT F.

³ Exhibit A attached hereto.

⁴ Exhibit B attached hereto.

After submitting your FTB CCR Request on August 22, 2008,⁵ you sent the IRS several supplemental submissions regarding the Restructuring Transactions in connection with your IRS PLR Request (collectively referred to as the "IRS Supplemental Submissions").⁶

On February 13, 2009, you updated your FTB CCR Request to include the IRS Supplemental Submissions. In so doing, you represented that "there have been no relevant factual changes since the time of the August 22, 2008 Request."⁷

On February 12, 2009, Parent received from IRS a favorable private letter ruling ("IRS PLR") with respect to the Restructuring Transactions, including the Proposed Distribution. In the IRS PLR, the Service ruled, among other things, that the Proposed Distribution qualifies for nonrecognition treatment under 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").⁸ A copy of this IRS PLR was provided to the FTB in connection with the FTB CCR Request.⁹ As of the date of this FTB CCR Request, 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.¹⁰

B. Relevant Corporate Structure

Parent

Parent, a holding company, is the common parent of an affiliated group of corporations (including Distributing 2, Distributing 1, and Controlled, as defined below) that files a consolidated federal income tax return.

Distributing 2

Distributing 2, a holding company, is a wholly owned subsidiary of Parent, which owns stock in several Parent subsidiaries.

⁵ All correspondence sent to the FTB regarding the Proposed Transaction was sent by Taxpayer's representative, *****.

⁶ Exhibit C attached hereto. The dates of the IRS Supplemental Submissions are November 14, 2008, December 29, 2008, January 23, 2009, January 29, 2009, and February 5, 2009.

⁷ Exhibit D attached hereto.

⁸ Section 355(b)(3) was enacted on May 17, 2006, and is applicable to distributions made after that date of enactment.

⁹ Exhibit E attached hereto.

¹⁰ As such, except where otherwise indicated, references to IRC section 355 and the California conformity thereto are to IRC section 355 prior to its amendment by TIPRA.

Distributing 1

Distributing 1, a holding company, owns stock in several Parent subsidiaries. Distributing 1 has approximately **** shares of common stock outstanding (the "Distributing 1 Common Stock") and approximately **** shares of series A common stock outstanding (the "Distributing 1 Series A Common Stock").¹¹ At the time of the Proposed Distribution, **** % of the Distributing 1 Common Stock and all of the Distributing 1 Series A Common Stock will be owned by Distributing 2.

Controlled

Controlled is a "controlled" subsidiary of Distributing 1. As of *****, 2008, Distributing 1 owned approximately *** million of the *** million shares (**** percent) of the Controlled Class A common stock issued and outstanding,¹² and all of the *** million shares (*** percent) of the Controlled Class B common stock issued and outstanding

Active Partnership

***** is a ***** general partnership ("Active Partnership"). **** percent of the profits interest in Active Partnership is held by one of its two general partners, Distributing 1, and the remaining **** percent is owned by *****, a **** corporation, a wholly owned subsidiary of Distributing 1 ("Related Corporate Partner").

Active Partnership was formed more than 5 years prior to the Proposed Distribution, and Distributing 1 and Related Corporate Partner have owned their respective interests in Active Partnership for more than 5 years prior to the Proposed Distribution. Within the 5 year period immediately preceding the Proposed Distribution, Distributing 1 has not acquired any portion of its interest in Active Partnership in any transaction in which gain or loss is required to be recognized for federal income tax purposes.

Active Partnership has been operating the same business for more than five years prior to the time of the Proposed Distribution, and this business, if conducted directly by Distributing 1, would satisfy the requirements of IRC section 355(b), as currently adopted in the CR&TC for California franchise tax purposes.

The Proposed Distribution

As stated above, the Proposed Distribution is one of a series of related transactions, collectively referred to as the Restructuring Transactions. In the Proposed Distribution, Distributing 1 will distribute its entire interest in Controlled¹³ to Distributing 2 in exchange for Distributing 1 Series A Common Stock and Distributing 1 Common Stock, of approximately equal value, owned by Distributing 2. The IRS ruled in the IRS PLR that this

¹¹ The Distributing 1 Common Stock carries *** vote per share and the Distributing 1 Series A Common Stock carries ***** votes per share.

¹² Approximately **** million shares of Controlled Class A Common Stock are traded on the New York Stock Exchange under the symbol "*****".

¹³ **** Percent of Controlled Class A Common Stock and **** percent of the Controlled Class B Common Stock.

Proposed Distribution will qualify for nonrecognition of gain or loss to Distributing 2 and Distributing 1 under IRC sections 355(a) and (c), respectively.

Parent's FTB CCR Request and the issue addressed herein arise from the lack of conformity between the California income and franchise tax laws and recent federal legislation amending IRC section 355(b). Immediately prior to the Proposed Distribution, Distributing 1 will not itself be directly engaged in the active conduct of a trade or business, and it is not clear that it would satisfy the "holding company" test of IRC section 355(b)(2)(A) as in effect prior to TIPRA (as currently still in effect for purposes of the CR&TC due to the lack of conformity to IRC section 355(b)(3)). However, Distributing 1 is a *** percent general partner in Active Partnership, which is itself engaged in the conduct of an active trade or business within the meaning of IRC section 355(b). If Distributing 1 is considered to be actively engaged in the trade or business of Active Partnership, Distributing 1 will satisfy the IRC section 355(b) requirements in effect prior to TIPRA and currently adopted by the CR&TC.

ISSUE

Will the FTB apply Rev. Rul. 2007-42, 2007-28 I.R.B. 44, to view Distributing 1 as satisfying the requirements of IRC section 355(b) for California franchise tax purposes by reason of its *** percent general partnership interest in Active Partnership?

HOLDING

Based on the accuracy and completeness of the facts and representations provided by Parent to the FTB for purposes of receiving this CCR,¹⁴ including but not limited to all of the exhibits attached hereto and any other information provided to the IRS in connection with the IRS PLR Request, the FTB will apply Rev. Rul. 2007-42 for the sole purpose of attributing the business activities conducted by Active Partnership in the five years preceding the Proposed Distribution to Distributing 1, and thereby viewing Distributing 1 as having been directly engaged in the business activities of Active Partnership for purposes of IRC section 355(b).¹⁵

REPRESENTATIONS¹⁶

1. Parent asserts that the identical issues in this CCR are not in a prior California franchise tax return of Parent or an affiliate for a previous year, and are not the subject of an existing California audit, protest, appeal, or litigation concerning Parent or an affiliated group member.

¹⁴ Which, as provided below, are subject to examination and verification by the Service and/or FTB.

¹⁵ As provided below in the section entitled "SCOPE OF RULING," this holding is subject to several limitations and conditions.

¹⁶ These representations were provided by the Taxpayer in a "DECLARATION OF FACTS AND REPRESENTATIONS," dated February 20, 2009, attached hereto as EXHIBIT F.

2. All of the facts and representations regarding the Restructuring Transactions provided to the IRS for purposes of receiving the IRS PLR as provided in IRS PLR Request, the IRS Supplemental Submissions, and the IRS PLR, attached hereto as Exhibit B, Exhibit C, and Exhibit E, respectively, are incorporated by reference and thereby represented to the FTB for purposes of obtaining this FTB CCR.
3. Immediately before the Proposed Distribution, Distributing 1 and Controlled will be members of the same California combined reporting group. In addition, immediately before the Proposed Distribution, the income and apportionment factors of Active Partnership are included in the combined reporting group that included Distributing 1 and Controlled. Controlled will no longer be a member of Distributing 1's California combined reporting group as a result of Parent's proposed distribution of the Controlled shares to its shareholders (the "External Distribution").
4. Immediately before the External 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 1's excess loss account, if any, with respect to Controlled common stock or the excess loss account that Distributing 1 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 External Distribution.¹⁷
5. Immediately before the External 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 25106.5-1(f)).¹⁸
6. Active Partnership was formed more than 5 years prior to the Proposed Distribution, and Distributing 1 and Related Corporate Partner have owned their respective interests in Active Partnership for more than 5 years prior to the Proposed Distribution.
7. Active Partnership has been operating the same business for more than five years prior to the time of the Proposed Distribution, and this business, if conducted directly by Distributing 1, would satisfy the requirements of IRC section 355(b), as currently adopted in the CR&TC for California franchise tax purposes.

¹⁷ The FTB reserves the right to require such items to be taken into account based on any recast of the Proposed Transaction or other transactions included in the Restructuring Transactions (including any recast identified by the IRS or described in any of the Supplemental Submissions), regardless of the fact that the IRS did not adopt such recast in the IRS PLR.

¹⁸ Id.

8. Distributing 1 has not recognized gain or loss with respect to any acquisition or disposition of any interest in Active Partnership within the 5 years prior to the Proposed Distribution.
9. Following the Proposed Distribution, Active Partnership will continue the active conduct of its trade or business independently with its separate employees. There is no plan or intent to significantly alter the trade or business activities of Active Partnership and/or sell, transfer, exchange, or otherwise dispose of any significant portion of Active Partnership's business assets that are being relied upon to satisfy the requirements of IRC section 355(b) at any time following the Proposed Distribution. Nor is there any plan or intent on the part of Distributing I to significantly alter, sell, transfer, exchange, or otherwise dispose of its equity investment in Active Partnership at any time following the Proposed Distribution.
10. Parent, Distributing 1, and Active Partnership agree that upon request made by any employee of the FTB under CR&TC section 19504 or otherwise, Active Partnership or its successor will promptly provide the FTB with financial statements and any other financial information requested for purposes of verifying the facts and information contained in this CCR, including but not limited to verification that Active Partnership was engaged in the conduct of an active trade or business for the five years immediately preceding the Proposed Distribution.
11. None of the Restructuring Transactions, including but not limited to the Proposed Distribution, is being undertaken for a significant purpose of reducing, directly or indirectly, the California franchise or income tax liability of Parent, Distributing 2, Distributing 1, Controlled, and/or Active Partnership.
12. Parent has fully disclosed all relevant facts in receiving the IRS PLR and in the submission of this FTB CCR Request. Parent will promptly notify the FTB in the event that the facts relating to this FTB CCR change, including but not limited to a revocation of the IRS PLR or the submission of a supplemental or additional IRS PLR Request relating to the Proposed Distribution or the IRS PLR.

DISCUSSION

A. Relevant IRC Subchapter C Provisions – California Adoption of Federal Law

The IRS PLR received by Parent provides that the Proposed Distribution qualifies for nonrecognition treatment under IRC section 355. Pursuant to CR&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 CR&TC section 23051.5, subdivision (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.

B. IRC Section 355(b) -- Active Trade or 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.¹⁹ 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;²⁰ (B) such trade or business has been actively conducted throughout the five (5) year period ending on the date of the distribution ("Relevant Period");²¹ (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");²² 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").²³

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."

As stated above, Parent received a favorable IRS PLR in which the IRS ruled that the Proposed Distribution qualified for nonrecognition treatment under IRC sections 355 and 368(a)(1)(D). Implicit in this IRS PLR is the conclusion that Distributing 1 will satisfy the "active trade or business" requirement of IRC section 355(b), as amended by TIPRA.

D. Lack of Conformity to IRC Section 355(b)(3) Requires Distributing 1 to Satisfy IRC Section 355(b) by Reason of Rev. Rul. 2007-42 for Purposes of the CR&TC.

¹⁹ IRC section 355(b)(1)(A).

²⁰ 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."

²¹ IRC section 355(b)(2)(B).

²² IRC section 355(b)(2)(C).

²³ IRC section 355(b)(2)(D).

As of the date of this CCR, California has not adopted the amendments to IRC section 355(b) made by section 202 of TIPRA. 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).

Prior to TIPRA, a corporation was considered to be engaged in the active conduct of a trade or business only if (1) the corporation was directly engaged in the active conduct of a trade or business, or (2) the corporation was not directly engaged in an active business, but substantially all its assets consisted of stock and securities of one or more corporations that it controlled that were engaged in the active conduct of a trade or business. Accordingly, for California purposes, in order to satisfy the IRC section 355 active trade or business test, Distributing 1 either must be engaged in an active trade or business or substantially all of its assets must consist of stock in controlled subsidiaries engaged in the active conduct of a trade or business.

Distributing 1 does not itself actively engage in the conduct of a trade or business, and it is not clear that it would meet the holding company test for active trade or business under pre-TIPRA IRC section 355(b). Therefore, Distributing 1 is required to look to the businesses it conducts indirectly through Active Partnership if it is to satisfy IRC section 355(b) for California purposes.

Immediately prior to the Proposed Distribution, Distributing 1 will own a ** percent general partner interest in Active Partnership, which has been directly engaged in the conduct of an active trade or business within the meaning of pre-TIPRA IRC section 355(b). Thus, if the activities of Active Partnership are attributed to its ** percent general partner, Distributing 1 will be treated as satisfying the active trade or business test under pre-TIPRA IRC section 355(b).

Rev. Rul. 2007-42, 2007-28 I.R.B. 44, considers whether a corporate partner is engaged in the active conduct of a trade or business within the meaning of IRC section 355(b) where the partner has a significant interest in, *but does not itself* actively participate in the management of, such partnership. In Rev. Rul. 2007-42, a corporation owned a 33 percent membership interest in a limited liability company (LLC) classified as a partnership for federal tax purposes. The LLC owned commercial buildings leased to unrelated parties and provided day-to-day upkeep and maintenance services for the buildings; however, the corporate partner was not itself involved in the management or operations of the LLC's business. Rev. Rul. 2007-42 concludes that the corporate partner was engaged in the active conduct of the LLC's rental business under IRC section 355(b) because it owned a *significant interest* in the LLC and the LLC performed the required activities that constituted an active trade or business.²⁴

²⁴ The conclusion reached in Rev. Rul. 2007-42 (i.e., the partnership-to-corporate-partner attribution of active trade or business assets and activities where the partner owns a significant interest in the partnership) is based in large part on the partnership-to-corporate-partner attribution rules under Treas. Reg. § 1.368-1(d)(4)(iii)(B), regarding continuity of business enterprise ("COBE") requirements applicable to corporate reorganizations. That regulation indicates that a corporation that owns a "significant" interest in a partnership, but

Rev. Rul. 2007-42 expressly modifies Rev. Rul. 92-17, 1992-1 C.B. 142, which considered whether D, a corporate general partner in a limited partnership, was engaged in the active conduct of a trade or business within the meaning of IRC section 355(b). For more than five years, D owned a 20 percent interest in LP, a limited partnership that owned several commercial office buildings leased to unrelated third parties. D's officers *performed active and substantial management functions* with respect to LP, including the significant business decision-making of the partnership, and regularly participated in the overall supervision, direction, and control of LP's employees in operating LP's rental business. Rev. Rul. 92-17 concluded that D was engaged in the active conduct of a trade or business within the meaning of IRC section 355(b).

Based on the application of Rev. Rul. 2007-42 to the facts at hand, the FTB views Distributing 1, the ** percent general partner of Active Partnership, as satisfying 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 Request for Chief Counsel Ruling.

SCOPE OF RULING

The scope of this CCR is confined to the narrow issue of whether the FTB will apply the attribution aspect of Rev. Rul. 2007-42 for purposes of IRC section 355(b). No other issues have been considered in or are addressed in this CCR, and the consequences of the FTB's ruling are solely confined to the attribution of business activities of a partnership under Rev. Rul. 2007-42 to its partners for purposes of satisfying the active trade or business requirements of IRC section 355(b), as discussed herein.

Please be advised that the California franchise tax consequences expressed in this CCR are applicable only to the Taxpayers addressed in the "HOLDINGS" 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 F). 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

does not perform active and substantial management functions for the business of the partnership is nevertheless treated as conducting the business of the partnership. For purposes of these provisions, a one-third interest in the partnership represents a significant interest in the partnership business. The COBE regulations under Treas. Reg. § 1.368-1(d)(4)(iii)(B) were issued on April 6, 1998, and apply to transactions occurring after Jan. 28, 1998. (T.D. 8760; see also Treas. Reg. § 1.368-1(d)(4), Ex. 10.)

the distribution of the earnings and profits of Distributing 1 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 1 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/or 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 CR&TC section 21012. Please attach a copy of the FTB CCR Request and the CCR to the appropriate returns when filed or in response to any notices or inquiries that might be issued by the FTB.

Very truly yours,

Geoffrey S. Way
Chief Counsel

Michael C. Hamersley
Tax Specialist III

Attachments: EXHIBIT A through EXHIBIT F