# SUPPLEMENTAL REVISED INITIAL STATEMENT OF REASONS FOR PROPOSED REGULATION SECTION 24465-3, RELATING TO TRANSFER OF APPRECIATED PROPERTY TO INSURER

## PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENTS, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS

The proposed regulation is designed to implement subdivision (c) of Revenue and Taxation Code (RTC) section 24465, pertaining to the annual reporting requirement for those corporations that transfer appreciated property to an insurer and claim the gain deferral provided under subdivision (b) of RTC section 24465 (transferred property used in the active conduct of a trade or business of the insurer).

## SPECIFIC PURPOSE OF THE REGULATION

Subsection (a) of the regulation refers to the annual statement authorized under RTC section 24465, subdivision (c), and provides a non-exhaustive list of data to be provided on the annual statement:

Subsection (a)(1) requires the name, California corporation number, and federal employer identification number of the transferor of the property where the transferor is claiming it is entitled to rely upon the "active trade or business" exception to having to recognize gain in the taxable year of the transfer. This provision is necessary to properly identify the subject transaction.

Subsection (a)(2) requires the name, California corporation number, and federal employer identification number of the insurance company transferee of the property where the transferor is claiming it is entitled to rely upon the "active trade or business" exception to having to recognize gain in the taxable year of the transfer. This provision is necessary to properly identify the subject transaction.

Subsection (a)(3) requires the taxable year and the actual date the transfer of the property occurred from the transferor to the insurance company transferee of the property where the transferor is claiming it is entitled to rely upon the "active trade or business" exception to having to recognize gain in the taxable year of the transfer. This provision is necessary to properly identify the subject transaction.

Subsection (a)(4) requires the description and location of the property transferred by the transferor to the insurance company transferee where the transferor is claiming it is entitled to rely upon the "active trade or business" exception to having to recognize gain in the taxable year of the transfer. This provision is necessary to properly identify the subject transaction.

Subsection (a)(5) requires the fair market value and adjusted basis, as of the date of the transfer, of the property transferred by the transferor to the insurance company transferee where the transferor is claiming it is entitled to rely upon the "active trade or business" exception to having to recognize gain in the taxable year of the transfer.
This provision is necessary to properly identify the gain from the subject transaction.

Subsection (a)(6) requires the transferor to represent that the property transferred is being used in the active conduct of the insurance company transferee's trade or business where the transferor is claiming it is entitled to rely upon the "active trade or business" exception to having to recognize gain in the taxable year of the transfer.
This provision is necessary to properly defer gain from the subject transaction.

Subsection (a)(7) requires the transferor to disclose whether the insurance company transferee of the property transferred has disposed of the transferred property, in whole or in part, during the taxable year, since if that has occurred, then the "active trade or business" exception no longer applies to the portion of the property disposed of and the transferor is then required to recognize gain in the taxable year of the disposition.

Subsection (a)(8) requires the transferor to disclose whether the insurance company transferee of the property transferred has disposed of the transferred property to a member of the transferor's combined reporting group or to another insurance company in the transferor's commonly controlled group during the taxable year, since if that has occurred, then the "active trade or business" exception might still apply; if the exception still applies, the transferor is entitled to continue to defer the recognition of gain on its original transfer.

Subsection (a)(9) requires the transferor to disclose whether ownership of the holder of the property transferred (whether that be an insurance company or another member of the transferor's combined reporting group) has changed during the taxable year, since if that has occurred, then the "active trade or business" exception may no longer apply to the portion of the property disposed of and the transferor may then be required to recognize gain in the taxable year of the change of ownership.

Subsection (a)(10) requires the taxable year in which and the date on which any disposition of the transferred property by the insurer has occurred, since if that has occurred, then the "active trade or business" exception no longer applies to the portion of the property disposed of and the transferor is then required to recognize gain in the taxable year of the disposition.

Subsection (a)(11) requires the description of the property disposed of by the insurer, and percentage of the property disposed of where less than 100 percent is disposed of, and the location of where the property was disposed of, since if that has occurred, then the "active trade or business" exception might no longer apply to the portion of the property disposed of and the transferor is then required to recognize gain in the taxable year of the disposition, and this information is in turn necessary to compute the amount of gain to be recognized in the taxable year of such disposition.

Subsection (a)(12) requires a computation of the amount realized upon a taxable disposition and the adjusted basis of the property disposed of in order to compute the amount of gain to be recognized in the taxable year of such disposition.

Subsection (a)(13) requires, in situations where the property transferred to the insurance company transferee was shares of stock and there was a subsequent transfer or disposition of such stock or the insurance company transferee, the percentage of such stock or insurance company (measured by relative fair market value) that was subsequently transferred, since if that has occurred, then the "active trade or business" exception might no longer apply to the portion of the property (shares of stock) disposed of and the transferor may then be required to recognize gain in the taxable year of the change of ownership.

Subsection (a)(14) requires, in situations where the transferred entity or insurance company transferee issues additional shares of stock or cancels existing shares of stock during the taxable year, to provide detailed information indicating the number of shares of stock outstanding before and after such issuance or cancellation, since if that has occurred, then a dilution or concentration may have occurred which in turn may have the effect of representing a partial disposition of the transferred property, which in turn may cause the transferor to be required to recognize gain in the taxable year of the dilution or concentration event.

Subsection (a)(15) requires, in situations where the insurance company transferee issues an additional class of stock or another form of equity interest, the requested information since if that has occurred, then an event may have occurred which may have the effect of representing a partial disposition of the transferred property, which in turn may cause the transferor to be required to recognize gain in the taxable year of the event.

Subsection (a)(16) requires, in situations where the transferred property was shares of stock, and the equity interest in the transferred entity becomes worthless, a statement that the equity interest has become worthless, since if that has occurred, then a disposition of the transferred property is deemed to occur, which in turn may cause the transferor to be required to recognize gain in the taxable year of the disposition.

Subsection (a)(17) requires that both the transferor and the insurance company transferee sign the statement, which is filed under penalty of perjury. This provision is necessary to certify the truthfulness, correctness, and completeness of the information contained on the form.

Subsection (a)(18) requires any other pertinent information that is necessary to identify the property transferred and to be able to compute the amount of gain to be deferred and the amount of gain to be recognized be provided with the statement. This provision is necessary to properly identify the subject transaction and the amount of gain there from when additional information not furnished above is required.

Subsection (b) prescribes when and how the annual statement is to be filed, and requires that the statement be filed annually with the transferor's original tax return for each taxable year for which the gain continues to be deferred, on a form prescribed by the Franchise Tax Board containing the information specified in subsection (a). This provision is necessary as it prescribes when and how the annual statement shall be filed.

Subsection (c) sets forth a records retention requirement upon the transferor and any other person filing the annual statement required by this regulation until the statements are no longer required to be filed and the applicable statute of limitations upon assessment have expired, so that the relevant information will continue to be available to compute the amount of gain required to be recognized.

The proposed language for this regulation addresses –

- The type and amount of data that is required to be reported;
    - When and how the annual statement is to be filed; and
    - Records retention.

NECESSITY/PROBLEM THE REGULATION INTENDS TO ADDRESS

RTC section 24465 is an anti-abuse provision enacted in 2003 by the Legislature to proscribe the use of specified insurers as receptacles of appreciated assets transferred by affiliated corporations, effectively eroding the corporation tax base as those insurers are subject only to the gross premiums tax. Nevertheless, RTC section 24465 allows for a deferral of gain recognition if the transferred asset is used in the active conduct of the insurer's trade or business.

In order to provide the Franchise Tax Board with sufficient notice of the status of such transferred assets and subsequent trigger of the deferred gain, RTC section 24465, subdivision (c), provides that until that asset is subsequently disposed of and gain is fully recognized, the Franchise Tax Board may require, by regulation, that an annual statement must be filed with FTB. This regulation would prescribe the parameters for the contents of that annual statement.

BENEFITS OF THE REGULATION

The regulation as proposed provides appropriate guidance regarding the annual statement authorized under Revenue and Taxation Code section 24465, subdivision (c). Under Government Code section 11346.3, subdivision (d), the Franchise Tax Board finds that requiring the annual statement under the proposed regulation from businesses is necessary for the general welfare of the people of the State of California by ensuring businesses properly report certain deferred gains that are subject to taxation under the provisions of Revenue and Taxation Code section 24465 and saves the State of California resources by requiring that the Franchise Tax Board receive timely notifications from taxpayers rather than having to physically track property that was transferred and for which gain was deferred under the provisions of Revenue and Taxation Code section 24465, subdivision (b).

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS

In drafting the proposed regulation, the Franchise Tax Board primarily relied upon RTC section 24465, and existing Internal Revenue Code provisions (including Treasury Regulations promulgated there under) relating to corporate transactions. As a result, the Franchise Tax Board did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON PRIVATE PERSONS OR SMALL BUSINESS

In accordance with the requirement of Government Code section 11346.5, subdivision (a)(13), that the Franchise Tax Board consider alternatives to the proposed regulatory action, staff of the Franchise Tax Board conducted two interested parties meetings.

An Interested Parties Meeting was held on February 15, 2011, to elicit public input on a proposed regulation to implement RTC section 24465, subdivisions (c) and (f). The Discussion Topics from the February 15, 2011, Interested Parties Meeting provided a general background of the purpose behind the proposed regulation, and general principles upon which staff intended to base the proposed regulation language. After this first Interested Parties Meeting, language for the proposed regulation was drafted based upon the public comments received at that first Interested Parties Meeting.[1]

A second Interested Parties Meeting was held on March 29, 2012, during which a draft of the proposed language was discussed with the public. The language of the proposed regulation section was generally acceptable to the interested parties in attendance. A question was raised as to whether the proposed regulation could include a provision addressing an unintentional non-filing of the annual statement for the taxable year of the transfer, where the department has not been prejudiced and/or had yet to begin auditing the transferor/taxpayer, and whether such a non-filing could be excused. Staff took this comment into consideration when drafting the attached proposed regulation language, and determined that such an exception would conflict with the terms and tenor of the statute. In enacting RTC section 24465, the Legislature specifically inserted a "reasonable cause" exception only for post-transfer taxable years. Moreover, as RTC section 24465 is an anti-abuse provision, providing yet another exception to an existing exclusionary provision would tend to irreparably erode the statute's effectiveness. In addition, based on public input, staff added clarifying language and a record retention requirement.

As a result, the regulation as proposed provides appropriate guidance regarding the annual statement authorized under RTC section 24465, subdivision (c), and the Franchise Tax Board has determined that no alternative would lessen any adverse impact on private persons or small businesses. The proposed regulation would benefit taxpayers, tax practitioners, and the State by providing clarity about the information required on the annual statement.

[1] No public input was provided with respect to section 24465, subdivision (f) and, thus, staff decided not to proceed thereon.

ECONOMIC IMPACT ANALYSIS

RTC section 24465 is an anti-abuse provision enacted in 2003 by the Legislature to proscribe the use of specified insurers as receptacles of appreciated assets transferred by affiliated corporations, effectively eroding the corporation tax base as those insurers are subject only to the gross premiums tax. Nevertheless, RTC section 24465 allows for a deferral of gain recognition if the transferred asset is used in the active conduct of the insurer's trade or business.

In order to provide the Franchise Tax Board with sufficient notice of the status of such transferred assets and subsequent trigger of the deferred gain, RTC section 24465, subdivision (c), provides that until that asset is subsequently disposed of and gain is fully recognized, the Franchise Tax Board may require, by regulation, that an annual statement must be filed with FTB. This regulation would prescribe the parameters for the contents of that annual statement.

The regulation as proposed provides appropriate guidance regarding the annual statement prescribed in RTC section 24465, subdivision (c). The Franchise Tax Board will save resources by receiving timely notifications rather than having to physically track transferred property.

Pursuant to Government Code section 11346.3, subdivision (b), the Franchise Tax Board has made the following assessments regarding the proposed regulation:

Creation or Elimination of Jobs Within the State

Since RTC section 24465 is an anti-abuse provision and the proposed regulation only impacts certain entities that transfer appreciated property to insurers, there are no effects on the creation or elimination of jobs within the state.

Creation of New or Elimination of Existing Businesses Within the State

Since RTC section 24465 is an anti-abuse provision and the proposed regulation only impacts certain entities that transfer appreciated property to insurers, there will be no effect on the creation of new businesses or elimination of existing businesses within the state.

Expansion of Businesses or Elimination of Existing Businesses Within the State

Since RTC section 24465 is an anti-abuse provision and the proposed regulation only impacts certain entities that transfer appreciated property to insurers, there will be no effect on the expansion of businesses or the elimination of existing business within the state.

ADVERSE ECONOMIC IMPACT ON BUSINESS

Since RTC section 24465 is an anti-abuse provision and the proposed regulation only impacts certain entities that transfer appreciated property to insurers, the Franchise Tax Board has determined that there will be no adverse economic impact on business.