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STEVE WESTLY
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September 13, 2004
 Chief Counsel Ruling CCR2004-001

RE: *****

Dear *****:

Your letter dated *****, requesting a Chief Counsel Ruling, has been referred to me for a response.

FACTS

You provided the following facts:

*****, a national bank, is a California-based commercial bank, which provides a wide range of banking and financial services to consumers, small businesses, middle-market companies and major corporations, primarily in California, Oregon, and Washington. ***** is wholly owned by a bank holding company, *****.

Through its ***** also operates as a bank securities dealer that trades and sells fixed income securities. ***** , an unincorporated division of ***** , consists of a ***-person trading desk and a *****-person institutional sales desk.

*****, a California corporation and a subsidiary of ***** , is a registered broker/dealer that offers a full line of investment products to individual and institutional clients. ***** , and has since been actively engaged in the conduct of its business as a registered broker/dealer.

The Office of the Comptroller of the Currency regulates ***** and most of its subsidiaries. ***** and its subsidiaries are also subject to extensive regulation, supervision and examination by various other federal and state regulatory agencies. In addition, ***** and its subsidiaries are subject to certain restrictions under the Federal Reserve Act, including restrictions on affiliate transactions.

Under the Securities Exchange Act of 1934, broker/dealers are required to register with the Securities Exchange Commission. Prior to enactment of the Gramm-Leach-Bliley Act in 1999, banks enjoyed a blanket exemption from such broker/dealer registration requirements. The Gramm-Leach-Bliley Act repealed this blanket exemption and replaced it with individual exemptions for certain types of products and activities. Despite the enactment of the Gramm-Leach-Bliley Act, the Securities Exchange Commission has continued the blanket exemption from registration for banks until the Securities Exchange Commission's implementing regulations become final. The Securities Exchange Commission has adopted final regulations for broker activities effective as of September 30, 2003, but has not yet adopted final regulations for dealer activities.

Most, but not all, of the products and activities currently offered by ***** are exempt under the Gramm-Leach-Bliley Act and do not require broker/dealer registration. The main limitation under the Gramm-Leach-Bliley Act that affects the ***** involves corporate debt securities. ***** has increased in recent years its offering of corporate debt securities, mainly to retail clients. With the enactment of the Gramm-Leach-Bliley Act, ***** , through ***** , will only be able to transact in corporate debt securities on a limited basis.

Due to the limitations under the Gramm-Leach-Bliley Act, the management of ***** and the management of ***** have proposed to separate the ***** from ***** , which will be effected through the following steps (collectively, the "Proposed Transaction"):

1. The formation by ***** of a wholly owned limited liability company ***** which will be disregarded as an entity separate from ***** for federal income and California corporation franchise and income tax purposes (the "Formation");
2. The merger of ***** with and into ***** being the surviving entity (the "Merger"); and
3. The contribution of ***** (the "Combination").

Further, it is your position that:¹

For federal income tax purposes, no gain or loss is recognized on the liquidation of a wholly owned corporate subsidiary, pursuant to section 332 of the Internal Revenue Code ("IRC").² In addition, the merger of a corporation into a disregarded entity is treated as the merger of such corporation with and into the disregarded entity's sole member. Thus, a merger of a corporate subsidiary into a disregarded entity wholly owned by the corporate subsidiary's parent should be treated as an IRC section 332 liquidation of the subsidiary. California conforms to IRC sections 332 and 368 and the Treasury Regulations thereunder. Therefore the merger of ***** , an entity disregarded as separate from ***** , should be regarded as the liquidation of ***** for federal income and California income and franchise tax purposes.

The contribution of the ***** ***** will have no effect for federal income and California income and franchise tax purposes, because ***** is disregarded as an entity separate from *****

After the completion of the Proposed Transaction (i.e., the Formation, Merger and Contribution), neither ***** will exist as separate entities from *****. Thus, immediately following the Proposed Transaction, ***** should be disregarded as an entity separate from ***** for California income and franchise tax purposes, including for purposes of determining whether ***** is "bank or financial corporation" within the meaning of Sections 23181 to 23183.

All of the trading activity previously conducted by ***** (through its *****) and broker/dealer activities conducted by ***** . will be consolidated under, and carried out by ***** . The management of ***** and the management of ***** . have determined that the Proposed Transaction will enable their operations to be better served in light of the restrictions imposed by the Gramm-Leach-Bliley Act.

ISSUES

Issue 1. You ask if immediately following the Proposed Transaction, ***** will be disregarded as an entity separate from ***** for purposes of

¹ Your request for Chief Counsel Ruling dated ***** , beginning with the second paragraph, page 4, and ending on page 5.

² These are the facts presented in the request for this Chief Counsel Ruling. This ruling does not address the tax aspects of the "Merger", "Combination" or "liquidation" and is not to be considered as providing or implying any comments or opinions on these federal income tax or California franchise tax issues.

determining whether ***** is a "bank or financial corporation" within the meaning of Revenue and Taxation Code sections 23181 and 23183.

Issue 2. Assuming that ***** is a bank or financial corporation immediately following the Proposed Transaction under ruling 1 above, you ask if California Code of Regulations, title 18, section 25137-4.2 will apply to *****
*****.

HOLDING

Issue 1. If ***** elects for federal income tax purposes to be taxed as a disregarded entity, it is deemed to make the same election for California franchise tax purposes, and immediately following the Proposed Transaction ***** will be disregarded as an entity separate from ***** for purposes of determining whether ***** is a "bank or financial corporation" within the meaning of Revenue and Taxation Code sections 23181 and 23183.

Issue 2. Immediately following the Proposed Transaction with ***** , California Code of Regulations, title 18, section 25137-4.2 will apply to ***** unless such application will not fairly represent the extent of the taxpayer's business activity in this state under Revenue and Taxation Code section 25137. The party who seeks not to have California Code of Regulations, title 18, section 25137-4.2 apply has the burden of proving that its application would lead to unfair representation of the extent of the taxpayer's business activity in California.³

The tax issues associated with ***** "merger" of a subsidiary, ****
***** , into a limited liability company and the tax issues associated with
***** "contribution" of a division, the
***** into a limited liability company are governed
by federal tax law to which California conforms.⁴ Accordingly, this ruling does not
address the tax aspects of the merger or the contribution and is not to be considered as
providing or implying any comments or opinions on the federal income or California
franchise tax issues associated with ***** "merger" of a subsidiary,
***** , into a limited liability company and the tax issues associated
with ***** "contribution" of a division, the *****
***** , into a limited liability company.

DISCUSSION

Issue 1.

³ See *Appeal of Fluor Corporation*, 95-SBE-016, Dec. 12, 1995.

⁴ California Revenue and Taxation Code § 24451 conforms to the federal law in this area, Subchapter C, of Chapter 1, of Subtitle A, of the Internal Revenue Code.

California Corporations Code section 17002 provides:

Authorized activities of limited liability company –

Subject to any limitations contained in the articles of organization and to compliance with any other applicable laws, a limited liability company may engage in any lawful business activity, except the banking business, the business of issuing policies of insurance and assuming insurance risks, or the trust company business.⁵

A limited liability company may engage in any lawful business activity, except the banking business, the business of issuing policies of insurance and assuming insurance risks, or the trust company business. ***** will act as a securities dealer that trades and sells fixed income securities and as a registered broker/dealer that offers a full line of investment products to individual and institutional clients. Based on your representations, ***** will not engage in the banking business.

Both the Internal Revenue Service and the Franchise Tax Board have regulations regarding the classification of business entities. U.S. Treasury Regulations sections 301.7701-1, -2, and -3⁶, and California Code of Regulations, title 18, sections 23038(b)-1, -2, and -3⁷, are effective for taxable years commencing on or after January 1, 1997. Generally, the California regulations conform to the applicable federal regulations. Further, California Code of Regulations, title 18, section 23038(b)-3 requires the California election of a business entity for tax purposes to be the same as the federal election. A limited liability company with a single owner may choose to be taxed as a disregarded entity.

Based on your representations that ***** will not engage in the business of banking, it will be compliant with Corporations Code section 17002. As a limited liability company owned by a single member, ***** may elect to be subject to income tax and franchise tax as a disregarded entity for both federal and state purposes. The federal and state election must be the same. A business entity that has a single member and is not a corporation under California Code of Regulations, title 18, section 23038(b)-2, subsection (b), is disregarded as an entity separate from its owner for purposes of the Corporation Tax Law, Part 11, California Revenue and Taxation Code.⁸ As such, the single member, ***** , will report the items of income, deductions, and credits of ***** for California franchise tax purposes.

⁵ For purposes of this ruling it is assumed that the securities activity formerly done by ***** is an allowable activity for *****; however, this determination is considered to be within the jurisdiction of the Secretary of State, the Department of Corporations, and the Office of the Comptroller of the Currency.

⁶ These Treasury Regulations were amended by T.D. 8767, March 23, 1998, T.D. 8827 (corrected October 29, 1999) July 9, 1999, T.D. 8844, November 26, 1999, T.D. 8970, December 14, 2001, and T.D. 9012, July 31, 2002.

⁷ The California regulations have not yet been modified to conform to the changes to Treas. Regs. §§ 301.7701-1, -2, and -3, but a regulation project is in process to consider adopting these modifications.

⁸ Cal. Code of Regs., title 18, § 23038(b)-(2)(b).

Revenue and Taxation Code section 23181 imposes an annual tax upon every bank doing business within the State of California and Revenue and Taxation Code section 23183 imposes an annual tax upon every financial corporation doing business within the State of California. Revenue and Taxation Code section 23039 states that "bank" includes a national banking association. California Financial Code section 140.3 defines a national bank as a national banking association organized under the National Bank Act.⁹ ***** , a national bank, is regulated by the Office of the Comptroller of the Currency, and is subject to certain restrictions under the Federal Reserve Act. As long as ***** remains a national bank, as that term is used in Chapter 2, National Banks, Title 12, Banks and Banking, United States Code, ***** will be subject to the tax imposed by Revenue and Taxation Code section 23181, inclusive of the activities conducted by *****.

Issue 2.

California Code of Regulations, title 18, section 25137-4.2, provides rules for the allocation and apportionment of income for banks and financial corporations. As long as ***** remains a national bank, as that term is used in Chapter 2, National Banks, Title 12, Banks and Banking, United States Code, ***** will be subject to California Code of Regulations, title 18, section 25137-4.2. For apportionment purposes, the activities of ***** will be treated as if conducted by the bank itself. However, in the event the application of the allocation and apportionment provisions of California Code of Regulations, title 18, section 25137-4.2, do not fairly represent the extent of the taxpayer's business activity in this state, the regulation may not be applicable.¹⁰

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to ***** , and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they 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 section 21012 of the Revenue and Taxation Code. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

⁹ 12 U.S.C. A. § 38.

¹⁰ Rev. & Tax. Code § 25137.

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Very truly yours,

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