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 Member

August 25, 2005

Chief Counsel Ruling 2005-0007

Re: *****

Dear *****,

In your correspondence dated *****, you requested advice concerning the propriety of including a ***** (*****) in a combined report with its unitary taxable ***** (*****).

You presented the following facts:

***** is a publicly held mortgage ***** (*****), the common stock of which is traded on the New York Stock Exchange. ***** (*****) is a wholly owned subsidiary of *** that originates mortgage loans and sells those loans to **. ** then holds those loans in a portfolio. ***** are unitary under Chapter 17 (commencing with Section 25101) of the Revenue and Taxation Code.¹

The issue you raised is whether ***, a publicly traded *****, must file a California combined report with ***, its ***.

From the facts you have provided, *****, must file a California combined report with ***, its ***, since the standard unity tests have been met and *** and *** are considered "taxpayers" under Revenue and Taxation Code section 23037.

Combined Report

When a taxpayer has income both from within California and outside of California, the taxpayer must pay franchise or income taxes based on the portion of the taxpayer's income that is sourced to California. The amount of a taxpayer's total income attributed

¹ All further references to code sections are the California Revenue and Taxation Code, and will be referred to as "Section," unless otherwise indicated.

to California is determined by the allocation and apportionment provisions in Sections 25120 to 25139.² Under the unitary apportionment method, the business income from all elements of a single trade or business is combined into one report.³ Then, the combined business income is apportioned to California by applying the apportionment formula.⁴

"Taxpayer" is defined as "any person subject to the tax imposed under Chapter 2 (commencing with Section 23101), Chapter 2.5 (commencing with Section 23400), or Chapter 3 (commencing with Section 23501.)"⁵ "Person" includes "any association, corporation, business trust, or organization of any kind."⁶ Entities are required to file a combined report if they are subject to either the corporation franchise tax (Chapter 2) or the corporation income tax (Chapter 3) and conduct a unitary business both inside and outside of California.

***** is an entity created by the Internal Revenue Code which functions like a mutual fund except that it owns mostly real estate related assets as opposed to securities. If the Internal Revenue Code requirements are met, then the income of the **** is effectively untaxed since it is paid out to the shareholders in the form of a dividend and the **** receives an equivalent dividends-paid deduction.⁷ In general, a **** is allowed to deduct all dividends paid to its shareholders out of gross income; however, the deduction for dividends paid is only available if 90 to 95 percent of the **** taxable income is paid out in dividends.⁸ **** shareholders treat dividends received as they would any other corporate distribution.⁹ ***** can be a corporation, an association, or a trust, but it cannot be a financial institution or an insurance company.¹⁰ ***** are subject to both the California corporation franchise and income tax.¹¹

The federal tax base for a **** is its "*****"¹² which is the ***** taxable income. This is computed as though the **** were a general

² § 25101.

³ §§ 25101, 25120.

⁴ § 25128.

⁵ § 23037.

⁶ Cal. Code Regs., tit. 18, § 23037. All further references to regulations are to the California Code of Regulations, title 18, and will be referred to as "Regulation."

⁷ IRC § 856 et seq.; see § 857 (requirements to qualify as a ****). A qualifying **** must make a proper election that is not terminated or revoked. (IRC § 856(c)(1).) In addition, a **** must meet the minimum dividend distribution requirements to shareholders. (IRC § 857(a)(1).)

⁸ IRC § 857(a)(1); § 24872.

⁹ IRC § 301(c); Treas. Reg § 1.857-6(a).

¹⁰ IRC §§ 856(a), (a)(4).

¹¹ § 24872(b)(2).

¹² IRC § 857(b)(1).

corporation, with some adjustments.¹³ The most significant adjustment is the deduction for **** dividends paid to shareholders.¹⁴ California has adopted the **** federal statutes, with some exceptions. Instead of the federal tax rate imposed on a ****, California imposes standard corporation taxes on a ***** net income, referred to as *****¹⁵ for California is equivalent to the federal ***** with some modifications not relevant here.¹⁶ In addition, there are federal taxes on **** that California does not impose.¹⁷

***** can own a subsidiary. **** is a corporation that is directly or indirectly owned by a ****. To be a ***, both the **** and the proposed *** must elect such *** treatment.

**** Election

***** are governed by the California Revenue and Taxation Code at Chapter 14.5, commencing with Section 24870. Under Chapter 14.5, portions of the Internal Revenue Code (26 U.S.C. §§ 851 to 860L)¹⁸ are adopted as the California law relating to ****. Specifically, Section 24872.6 provides that a corporate election to be a **** for federal purposes is treated as a **** election for California in the same taxable year, and no alternate election under Section 23051.5(e)(3) is allowed. *** elected to be a **** for federal purposes and hence is also considered a **** for California purposes.

Section 24872(b)(2) states that all **** are subject to the corporation franchise tax (Chapter 2) and the corporation income tax (Chapter 3). Accordingly, *** is subject to the Chapter 2 and Chapter 3 taxes. If *** is operating a unitary business, then as a "person" considered a "taxpayer," it is eligible to be included in a combined report.

*** Election

The **** Modernization Act ("RMA"), included in the Ticket to Work and Work Incentives Improvement Act of 1999 (Public Law 106-170) and effective for tax years that begin after December 31, 2000, enables a **** to own a ***. The RMA allows a **** to perform activities indirectly through a *** that would otherwise result in impermissible income if performed by the **** directly. ***** is taxable as a corporation for federal income tax purposes. Internal Revenue Code section 856(l) allows a **** and a corporation (other than a ****) to jointly elect *** treatment for the corporation. In order to be eligible for *** treatment, the **** must directly or indirectly own stock in the corporation, and the **** and the corporation must jointly elect *** treatment.

¹³ IRC § 857(b)(2).

¹⁴ IRC §§ 561, 857(b)(2)(B).

¹⁵ § 24872(b), (c); see IRC § 857(b)(2).

¹⁶ § 24872(c).

¹⁷ §§ 24872(d), (e), (g), (i); IRC §§ 857(b)(3); (b)(4)(A); (b)(6)(A); (c); 856(c)(7), (g).

¹⁸ All further references to the Internal Revenue Code will be identified as "IRC."

California Revenue and Taxation Code section 24870 generally adopts IRC sections 851 to 860L, relating to ****. Within these adopted sections is IRC section 856(l), which specifically provides for the *** election. Pursuant to section 24872(h)(1), IRC section 856(l) is applicable for California purposes.

***** made the federal election for *** to be treated as a ***; pursuant to section 23051.5(e), that election is operative for California purposes. Consequently, *** is a *** for California purposes and, like other corporations, is subject to California franchise and income taxes.

***** are corporations that qualify as "person[s]" under Regulation section 23037 and are hence considered "taxpayer[s]" under Section 23037.

*** is required to be included in a California combined report with *** provided that the standard unity tests are met because a **** and a *** are considered "taxpayers" under Revenue and Taxation Code section 23037. Combination does not alter the treatment of *****.

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer 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.

Very truly yours,

Laurie J. McElhatton
Tax Counsel III