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Chief Counsel Ruling 2012-02

Subject: Chief Counsel Ruling Request for *******************.

Dear Mr. *******:

This is in response to your Chief Counsel Ruling Request of May 8, 2012 wherein you seek guidance as to whether the gain from the sale of a partnership interest by a member of a combined reporting group to a unitary partnership will be deferred as a result of the intercompany transaction combined reporting regulations contained in California Code of Regulations, title 18, (CCR) section 25106.5-1.

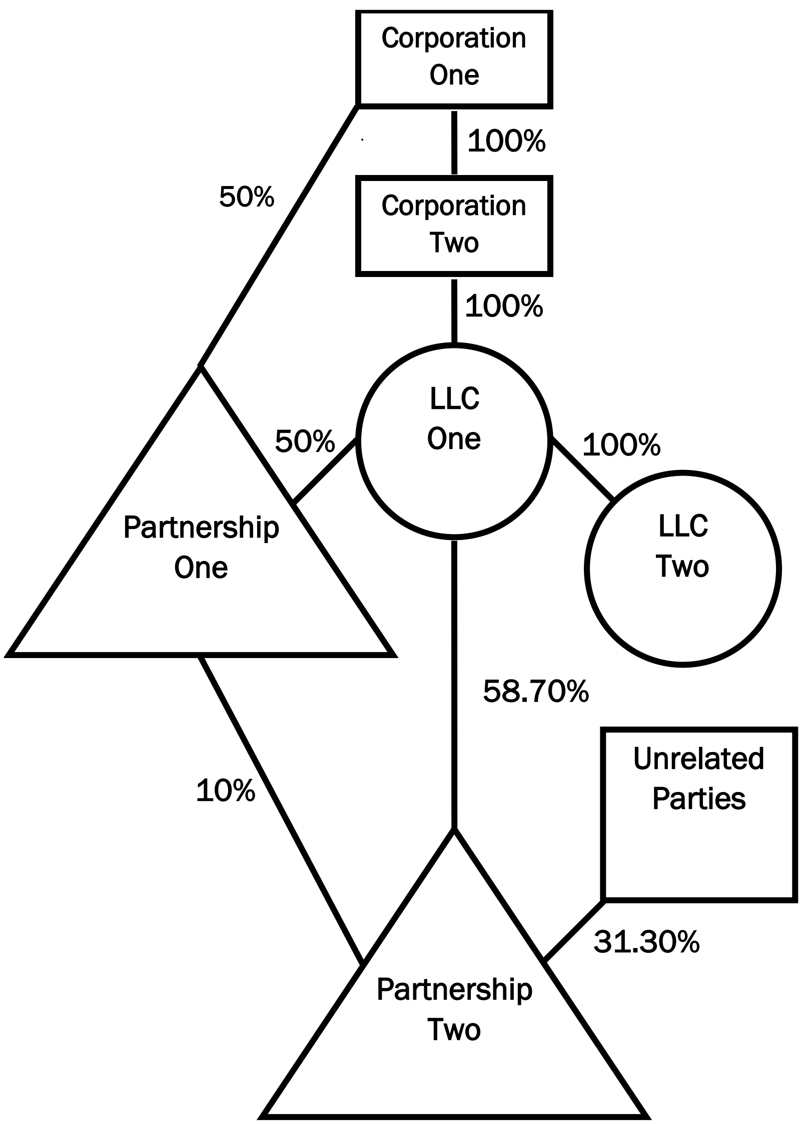
FACTS

*****************, (hereinafter Corporation One), is the common parent company of a group of affiliated corporations that are included in a federal consolidated return and are also included in a combined report for California franchise tax purposes. Corporation One owns all of the stock of ************, (hereinafter Corporation Two). Corporation Two is a member of ************* federal consolidated return group and combined reporting group.

Corporation Two owns all of the membership interests of ************. (Hereinafter LLC One.) LLC One is treated as a disregarded entity for federal and California tax purposes. Therefore, pursuant to CCR section 23038(b)-2(a), LLC One is treated as a division of Corporation Two. LLC One owns all of the membership interests of **************, LLC. (Hereinafter LLC Two.) Prior to the restructuring outlined below, LLC Two was also treated as a disregarded entity for federal and California tax purposes. Therefore, pursuant to CCR section 23038(b)-2(a), LLC Two was treated as a division of LLC One, which in turn is treated as a division of Corporation Two. In essence, even though LLC Two is owned by LLC One, for tax purposes, prior to the restructuring outlined below, it was ultimately collapsed into Corporation Two.

Corporation One and LLC One each own 50% of the partnership interests in ********** *********** (Hereinafter Partnership One.) LLC One owns 58.70% of the partnership interests in ***************. (Hereinafter Partnership Two.) Partnership One, the managing general partner of Partnership Two, owns 10% of the partnership interests in Partnership Two. The remaining 31.30% partnership interest in Partnership Two is owned by unrelated parties. (Other than the 10% partnership interests that Partnership One owns in Partnership Two, all other percentages of interests in Partnership Two are approximate.) The relationships between Partnership One and Partnership Two and Corporation One and Corporation Two, which includes LLC One and LLC Two as disregarded entities, are such that if Partnership One and Partnership Two were corporations, they would be included in Corporation One's and Corporation Two's combined reporting group. In other words, all of the entities are unitary with one another.

The ownership structure can be represented by the following diagram:



For reasons other than for California franchise tax purposes, the ownership structure outlined above will be restructured. The restructuring will involve a number of steps, each of which is set forth as follows.

- In accordance with Treasury Regulation section 301.7701-3(c), LLC Two will change its classification from a disregarded entity to an association that is taxable as a corporation. Pursuant to CCR section 23038(b)-3(c)(1), LLC Two's federal classification will be its classification for California tax purposes. As an association that is taxable as a corporation, LLC Two will be a member of Corporation One and Corporation Two's federal consolidated return group and their combined reporting group. LLC Two does not possess any tax attributes attributable to the period prior to it being classified as an association taxable as a corporation.

- LLC One will contribute its 50% partnership interest in Partnership One and 40.29% of its 58.70% partnership interest in Partnership Two to LLC Two.

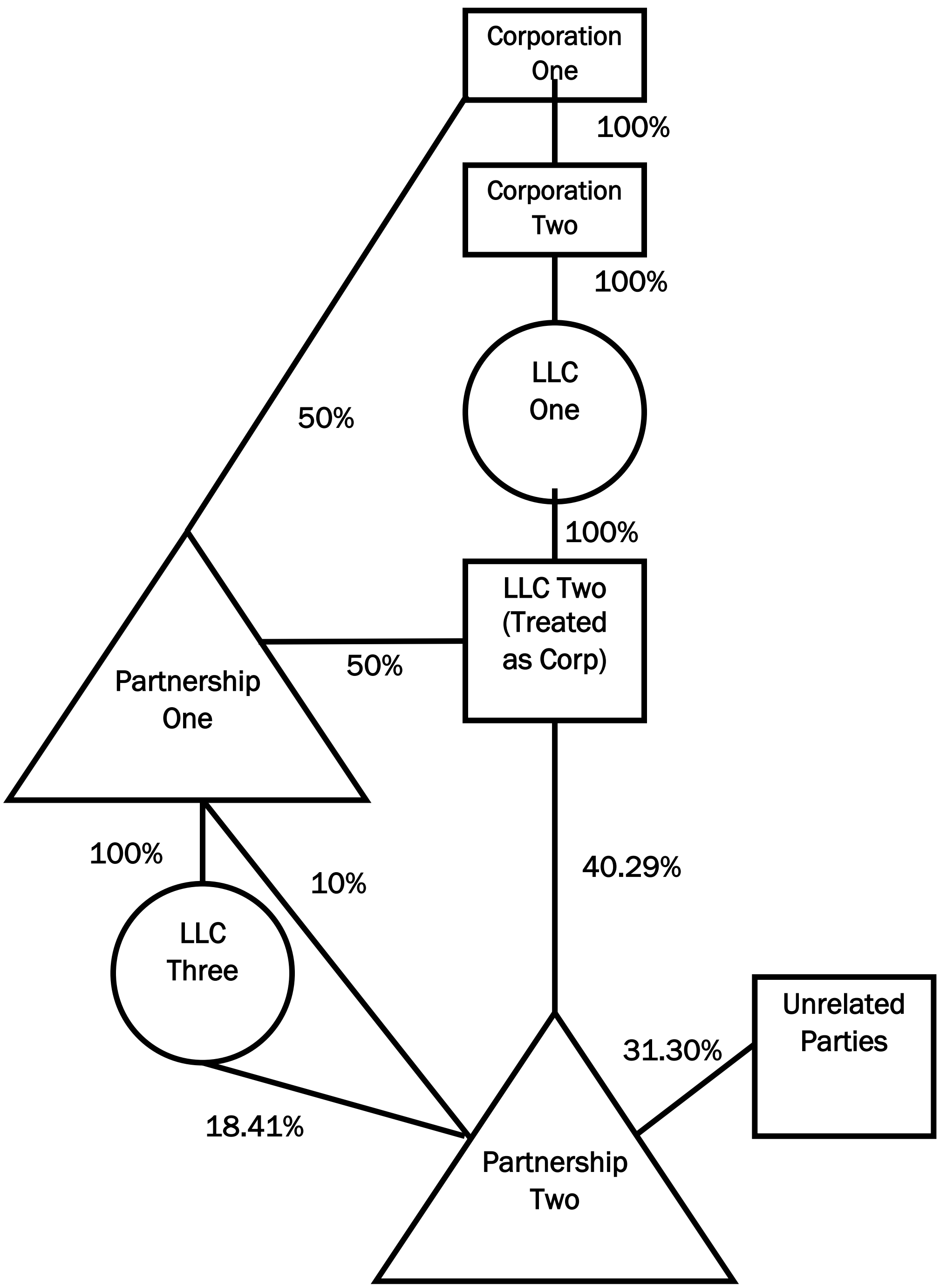
- Partnership One will form a new LLC, LLC Three. LLC Three will be disregarded for federal and California tax purposes. As such, pursuant to CCR section 23038(b)-2(a), LLC Three will be treated as a division of Partnership One.

- LLC One will sell its remaining 18.41% partnership interest in Partnership Two to LLC Three. In exchange for the 18.41% partnership interest in Partnership Two, LLC One will receive a note receivable from LLC Three in the amount of the fair market value of the 18.41% partnership interest in Partnership Two. As a disregarded entity for federal and California tax purposes, LLC One's sale of the 18.41% interest in Partnership Two to Partnership One will be treated as if LLC One's owner, Corporation Two, had sold the 18.41% interest in Partnership Two directly to Partnership One.

As mentioned above, if Partnership Two were a corporation it would have been included in Corporation Two's combined reporting group. Accordingly, pursuant to California Revenue and Taxation Code (CRTC) section 25120(a), Corporation's Two's partnership interest in Partnership Two would constitute intangible property that is an integral part of Corporation Two's regular trade or business operations. Consequently, its sale, if taken into account for combined reporting purposes, would generate apportionable business income. (See *Jim Beam Brands Co. v. FTB* (2005) 133 Cal. App. 4th 514,).

After the restructuring steps have occurred, Corporation One and LLC Two will each own 50% of the interest in Partnership One. Partnership One will own 10% of the partnership interests in Partnership Two, LLC Three will own 18.41% of the partnership interests in Partnership Two, LLC Two will own 40.29% of the partnership interests in Partnership Two and the remaining 31.30% of the partnership interests in Partnership Two will continue to be owned by unrelated parties.

The resulting ownership structure can be represented by the following diagram:



ISSUE

Should the sale of the 18.41% interest in Partnership Two be treated as a sale between members of a combined reporting group and subject to the rules contained in CCR section 25106.5-1 et seq., otherwise known as the combined report intercompany transaction regulations?

HOLDING

The sale of the 18.41% interest in Partnership Two should not be treated as a sale between members of a combined reporting group and is not subject to the deferral of gain rules contained in CCR section 25106.5-1 et seq. Instead, the sale should be currently recognized and reflected in Corporation One's combined reporting group income for the year of sale.

DISCUSSION

CCR section 25106.5-1 et seq., contains the rules for California tax purposes relating to intercompany transactions between members of a combined reporting group. As explicitly stated in CCR section 25106.5-1(a)(1), gains and losses resulting from intercompany transactions between members of a combined reporting group are generally deferred. However, as set forth in CCR section 25106.5-1(b)(1)(A), by definition an "intercompany transaction" only occurs between *corporations* which are members of the same combined reporting group immediately after the transaction in question. (Emphasis added.) In this case, the transaction in question involves the sale of the 18.41% interest in Partnership Two by LLC One to LLC Three. As a disregarded entity for California tax purposes, LLC One is treated as a division of its owner, Corporation Two. Corporation Two is a member of a combined reporting group with Corporation One. However, even though it is owned by Partnership One, which is in turn owned by Corporation One and LLC Two, (as an association taxable as a corporation), which would be members of Corporation Two's combined reporting group, in and of itself, LLC Three, as a division of a partnership, is not itself a member of Corporation Two's combined reporting group. Consequently, since the transaction is not between corporations that are members of the same combined reporting group after the transaction occurred, the combined reporting intercompany transaction rules contained in CCR section 25106.5-1 et seq., do not apply. In other words, any gain resulting from LLC One's sale of the 18.41% interest in Partnership Two to LLC Three will not be deferred pursuant to CCR section 25106.5-1(a)(1).

Since the rules contained in CCR section 25106.5-1 et seq., are inapplicable with respect to the subject transaction, other statutory provisions will control its treatment. CRTC section 24271 incorporates by references Internal Revenue Code (IRC) section 61. IRC section 61(a)(3) provides that gross income includes gains from dealing in properties. CRTC section 24901 provides that the gain from the disposition of property shall be the difference between the amount realized less the basis in the property disposed, as determined by

CRTC section 24911. Accordingly, due to the application of CRTC sections 24271, 24901 and 24911, Corporation Two, through LLC One, will currently recognize a gain to the extent the fair market value of the note receivable it receives from LLC Three exceeds its basis in the 18.41% interest in Partnership Two. As mentioned above, the gain will be treated as apportionable business income.[1]

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,

Craig Swieso
Tax Counsel IV

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[1] Pursuant to regulation section 25137(c)(1)(A)1 as well as regulation 25137-1, the proceeds from the transaction at question, even though includable in apportionable business income, should not be included in the sales factor of the apportionment formula.