State of California
Franchise Tax Board

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12.06.12

CHIEF COUNSEL RULING 2012-08

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Dear M*. ********,

You requested a Chief Counsel Ruling regarding the application of California Revenue and Taxation Code section 25106(a)(2)(A) to dividends paid by COMPANY 1 ("CO1") to COMPANY 2 ("CO2").

FACTS

COMPANY 1 ("CO1") is a *************************company and the ultimate parent for all other subsidiaries pertinent to this ruling. The company's management and board of directors concluded that it was in the company's best interests to create a new public company holding company to acquire all of the outstanding stock of CO1 and all of the stock of another company, COMPANY 3 ("CO3"). This Chief Counsel Ruling deals solely with the relationship between COMPANY 1 ("CO1") and the new holding company, COMPANY 2 ("CO2").

On DATE 1, 2011, a plan of merger was entered into by CO1, CO3, CO2, COMPANY 4 ("CO4"), and COMPANY 5 ("CO5"), collectively henceforth referred to as the "Mergers" or the "plan of Mergers."

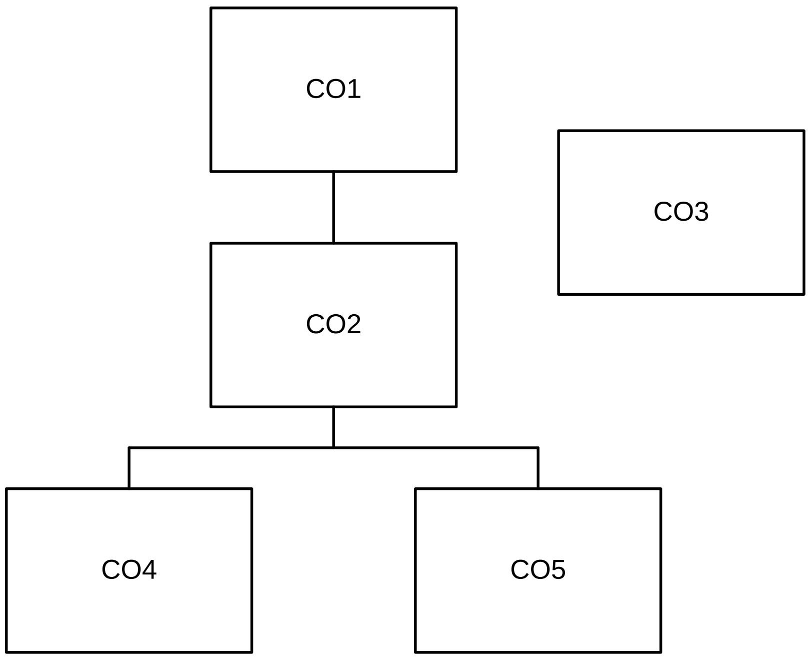
A number of steps were employed to put the new structure into effect.

On DATE 2, 2011:

- CO1 formed CO2 as a direct, wholly owned subsidiary.
- CO1 caused CO2 to form CO4 as its wholly owned subsidiary.
- CO1 caused CO2 to form CO5 as a second wholly owned subsidiary.

From DATE 2, 2011 until the plan of merger was actually carried out, these companies conducted all transactions necessary to effectuate the plan, such as their capitalization and the borrowing activities necessary to execute the plan. Each of the entities has interlocking boards of directors and officers with each of the others, all activities carried out by each of the entities was for the benefit of the unitary enterprise, and all entities (including CO2 and CO1) were included in a combined report for the year ending December 31, 2011. All income generated by each of the entities and relevant for purposes of this Chief Counsel Ruling was business income.

Relevant Organizational Chart as of DATE 2, 2011 (and through DATE 3, 2012)[1]



On DATE 3, 2012, CO2 purchased all of the outstanding stock of CO3 for $*** cash (totaling $*** billion) and *** shares of CO2 per share. The plan of Merger between CO1, CO2, CO3, CO4, and CO5 was also executed on DATE 3, 2012.

The plan of Merger was executed via the following steps:

Step 1: CO4 merged with CO1. CO4 ceased to exist. CO1 is the surviving corporation and operates as a wholly owned subsidiary of CO2.

Step 2: CO5 merged with and into CO3. CO5 ceased to exist. CO3 is the surviving corporation and operates as a wholly owned subsidiary of CO2.

Step 3: CO2 changed its name under Delaware law to COMPANY 6 (CO6).

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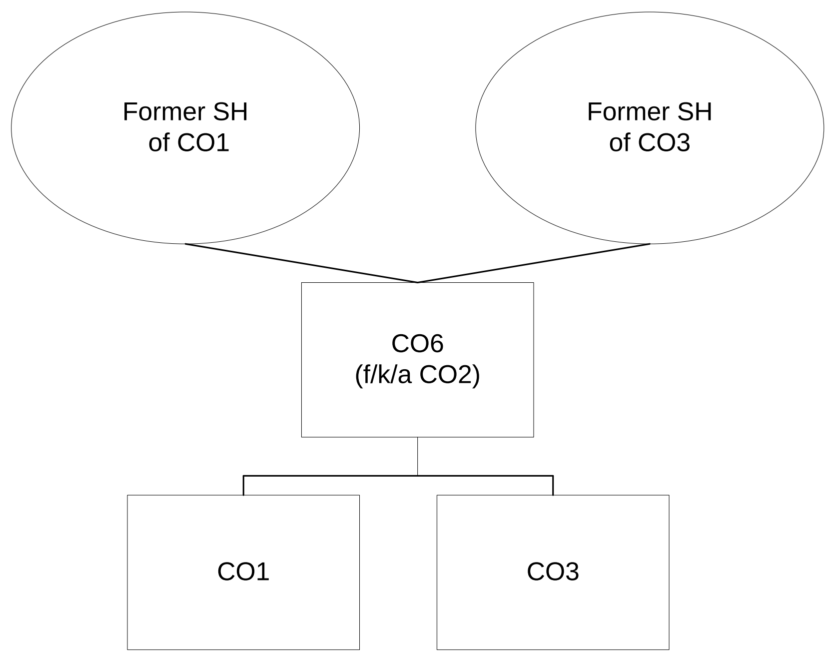
[1] Both CO1 and CO3 had numerous operating subsidiaries that are not relevant to this Chief Counsel Ruling request.

Step 4: All outstanding shares of CO1 were cancelled and each share was replaced with one share of CO6.

Step 5: CO1 common stock was delisted from STOCK EXCHANGE 1 and the CO3 common stock was delisted from STOCK EXCHANGE 2. Trading of CO1 and CO3 stock was halted on DATE 3, 2012. CO6 common stock now trades on STOCK EXCHANGE 1 under the symbol "****."

Current and Final Structure of Relevant Entities—Post-Merger



The taxpayer plans to pay a dividend from CO1 to CO6 from income of its unitary business determined by reference to the income and apportionment factors of both the dividend payor and the dividend recipient.

ISSUE

Whether, under California Revenue and Taxation Code section 25106(a)(2)(A), dividends paid by CO1 to CO6 should be eliminated from the income of CO6 and not taken into account for purposes of determining the tax of CO1 or CO6.

HOLDING

The elimination from income of the intercompany dividends to be paid by CO1 to CO6 here regardless of the temporal proximity of the time of payment to the precise moment of CO6's formation effectuates the statutory purpose of California Revenue and Taxation Code section 25106 in this case, which is to prevent the taxation of dividends received by a member of a unitary group where those dividends were paid from the income previously described of the unitary business by another member of the same unitary group. Thus, subject to possible audit verification of the factual representations made in the request for ruling and as more fully described below, a dividend paid from CO1 to CO6 should be eliminated from taxable income of CO6 and should not be considered when determining the taxable income of CO1 or CO6.

DISCUSSION

California Revenue and Taxation Code section 25106(a)(1) provides in pertinent part as follows:

> In any case in which the income of a corporation is or has been determined under this chapter with reference to the income and apportionment factors of one or more other corporations with which it is doing or has done a unitary business, all dividends paid by one to another of any of those corporations shall, to the extent those dividends are paid out of the income previously described of the unitary business, be eliminated from the income of the recipient and . . . shall not be taken into account . . . in determining the tax of any member of the unitary group.

Effective January 1, 2009 and applicable to taxable years beginning on or after January 1, 2009, the dividend elimination provided by Revenue and Taxation Code section 25106(a)(1) above also includes dividends paid out of the income of the unitary business by a member of the unitary group to a corporation formed subsequent to the accrual of the income as long as the recipient corporation was part of the unitary group during the period from its formation to its receipt of those dividends.[2] The expressed statutory purpose for section 25106, including this amendment, "is to prevent taxation of dividends received by a member of a unitary group where those dividends were paid from the income previously described of the unitary business by another member of the same unitary group."[3]

To qualify for elimination under Section 25106, a dividend must be paid from "income" of a unitary business, and that "income" must have been determined by reference to the income and apportionment factors of both the dividend payor and the dividend recipient.[4] However, Internal Revenue Code section 316, incorporated into the Revenue and Taxation Code by reference under Section 24451, defines a dividend as a distribution by a corporation out of

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[2] Rev. & Tax. Code § 25106(a)(2), as amended by Ch. 305 (A.B. 3078), Laws 2008.
[3] Rev. & Tax. Code § 25106(b).
[4] Rev. & Tax. Code § 25106(a)(1); *Willamette Industries, Inc. v. Franchise Tax Bd*. (1995) 33 Cal.App.4th 1242.

its earnings and profits. This requires an analysis of both the concept of "earnings and profits" and the term "income" as it is used in Section 25106.

Although "earnings and profits" is not precisely defined by statute, the meaning of the term has generally evolved by administrative practice of the Internal Revenue Service, by regulations, case law, and as prescribed by adjustments required under IRC section 312, also incorporated by reference into the Revenue and Taxation Code by Section 24451.[5] In practice, earnings and profits are determined by using taxable income as a starting point, and by making a series of positive and negative adjustments thereto.[6] For the most part, by incorporation of IRC sections 312 and 316, California follows the federal adjustments to arrive at earnings and profits. However, California does not adopt the adjustments to earnings and profits prescribed by the federal consolidated return regulations adopted under IRC section 1501.[7]

Under California law, for purposes of determining the amount of earnings and profits of a corporation, unitary attributes of a corporation are disregarded, and earnings and profits are determined on a separate entity basis.[8] This rule applies even if the amount of income apportioned to a taxpayer member of a unitary group under Chapter 17 of the Corporation Tax law exceeds the separate entity earnings and profits of that member.[9]

Under Section 24452, California incorporates IRC section 316. That section provides that every distribution is made out of earnings and profits, to the extent thereof, and from the most recently accumulated earnings and profits. Thus, earnings and profits are drawn first from current earnings and profits, and then from each year's layer of earnings and profits in reverse order of accumulation (i.e., on a last-in, first-out basis). This principle is a general rule of dividend distributions, and applies to all earnings and profits regardless of character or source.[10]

As previously described, CO1 formed CO6 (f/k/a CO2) as a direct, wholly owned subsidiary of CO1 on DATE 2, 2011, solely for the purpose of making it the public holding company and effecting the Merger. The plan of Merger was executed on DATE 3, 2012, thus establishing the post-Merger structure described above. During this intervening period, CO6's sole purpose continued to be completion of the necessary steps for execution of the Merger. Specifically, CO1 and CO6 obtained financing to fund the Merger. Cash was received from third party financial institutions by CO6 in ***** 2011, ***** 2012, and ***** 2012 to

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[5] See Bitker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, 6th Ed. ¶8.03[2].
[6] *Id*.
[7] In a similar context, see *Appeal of Rapid American*, 96-SBE-19, Oct. 10, 1996, pet. for reh. den. 96-SBE-19A, May 8, 1997, in which the State Board of Equalization held that the consolidated return investment stock basis adjustments required under Treasury Regulation section 1.1502-32 do not apply for combined report purposes.
[8] *Appeal of Young's Market Co.,* 86-SBE-199, Nov. 19, 1986.
[9] *See generally Safeway Stores, Inc. v. Franchise Tax Bd.* (1970) 3 Cal.3d 745.
[10] *See generally* Treas. Reg. § 1.316-2(b), (c) (treating current earnings and profits as evenly earned throughout the year, without regard to the possibility that the specific date that an item of current earnings and profits is earned occurs after the date of a mid-year distribution in that current year).

be used for this purpose. The funds were maintained in an CO1 cash management account, and all loan proceeds and any interest earned during this period were used to acquire CO3 stock from its shareholders and execute the Merger. CO1 and CO6 had completely overlapping boards of directors and officers, and all activities undertaken by each of them were for the benefit of the unitary group.[11]

Without Revenue and Taxation Code section 25106(a)(2)(A), income of a unitary business could conceivably be included twice if a dividend were to be paid to a newly formed corporation.[12] This result would obtain when the dividends distributed to a newly formed corporation were paid out of the earnings and profits previously included in the unitary business' income. In that case, the income would be included again upon distribution, as the newly formed corporation was not a member of the combined unitary business in the prior year.[13] Such a result would be contrary to the express legislative intent underlying the statutory elimination, which was "to prevent including the same income twice in determining the tax base of the unitary group."[14]

Affording elimination from income to qualifying intercompany dividends paid to CO6, which was formed with the intent that it become the new parent holding company of CO1's historical unitary group, regardless of temporal proximity to the actual moment of formation effectuates the statutory purpose of California Revenue and Taxation Code section 25106(a)(2)(A) in this case. Thus, a dividend paid from CO1 to CO6, provided it satisfies the rules regarding characterization of income and layered earnings and profits, as well as the requirement that the dividend be paid from the income previously described of the unitary business by another member of the same unitary group, should be eliminated from the taxable income of CO2 and should not be considered when determining the taxable income of CO1 or CO6.

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

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[11] *Cf.* Legal Ruling 95-7, Combination of Passive Parent Holding Company with Unitary Operating Company Subsidiaries (holding a passive parent holding company which is the majority shareholder of one or more operating company subsidiaries engaged in a single unitary business, which dedicates all or virtually all of its activity, however small, to the unitary operating company subsidiary or subsidiaries, is unitary and includable in a combined report with the subsidiary or subsidiaries), *and* Legal Ruling 95-8, Combination of Intermediate Passive Holding Company with Unitary Operating Company Parent and Subsidiaries (holding an intermediate passive holding company which dedicates all or virtually all of its activity to its operating company parent and subsidiary or subsidiaries, which are unitary with each other, is unitary with the parent and subsidiary or subsidiaries and includable in a combined report with them).

[12] FTB Assembly Revenue & Taxation Committee Bill Analysis, Bill No. 3078, Aug. 28, 2008 Provision 6, *available at* https://www.ftb.ca.gov/law/legis/07_08bills/ab3078_FINAL.pdf (last visited November 20, 2012).

[13] *Id.*

[14] *Id.*

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,

Frederick W. Campbell-Craven
Tax Counsel IV