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05.01.19 Chief Counsel Ruling 2019 - 01

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*** ******* **** **** ****
********** ** *****

RE: Request for Chief Counsel Ruling for * ****** ***** and Subsidiaries**
FEIN: ********
California Corporation Number: *****

Dear *** **********:

This Chief Counsel Ruling is issued in response to a request for a legal opinion authored by yourself, dated ******** *** ****. Your request asks for an opinion as to the applicability of Revenue and Taxation Code Section 25106[1] to eliminate dividends paid to *** ****** ***** * ******** corporation ("Parent" or "taxpayer") after a series of mergers described below. The Chief Counsel concludes that, subject to audit verification of the factual representations made in this request, the dividends will qualify for elimination from income under Section 25106, as provided in more detail below.

The Taxpayer has reviewed the facts set forth below and represents that the facts are true and correct and that all material facts have been disclosed. The taxpayer represents that the issues in this ruling request have not been subject to an existing audit, protest, appeal, or litigation concerning the taxpayer or affiliate.

FACTS

The taxpayer represents the following facts are true:

*** ("Parent") is a financial holding company headquartered in *** **** with significant management operations in *** ******. Parent provides commercial financing, ******** *** ******** ******** ** ***** *** ************ ********** *** *** ************* ****** through a number of U.S. and foreign subsidiaries.

[1] All subsequent references to section numbers refer to the California Revenue and Taxation Code unless otherwise indicated.

*** ****, formed under **** law in **** (“Original Sub”), was a wholly-owned ********** **** subsidiary of Parent. Original Sub also provided lending *** ******* ** ***** *** ************* ********** *** ********* ** *** ************** ******* *** ******* * ******* ** ******* *** ******* ******* ** ****** ********** ****** ** *** *** **** ******** ****** ** ** *****. Prior to the merger transactions described below, Parent filed a combined report for California corporation franchise and income tax purposes with Original Sub and other affiliated corporations with which it was engaged in a unitary business (the “Acquirer Unitary Group”). During that period, Original Sub generated taxable income and earnings and profits (the “Pre-Merger Original Sub E&P”).

Prior to the merger transactions described below, *** ****** ***[2] (“Target Parent”), was the holding company parent of ******* ***** ****. (“New Sub”), a *************** ******, and other subsidiaries (the “Target Group”). *** ****** ***** ******** ******* ** * **** ***** ** ****** ****** (all of New Sub’s branches were located in California) *** ******** ******** *** ********* ********* ******** ******* ************ ******* ********* **** **** ****** *****. The Target Group engaged in a unitary business and filed a combined report for California corporation franchise and income tax purposes (the “Target Unitary Group”). During that period, New Sub generated taxable income and earnings and profits (the “Pre-Merger New Sub E&P”).

During ****, Parent, Target Parent, and ****** ****** *** *** (“Holding Company”), a newly-created, wholly-owned subsidiary of Parent, entered into an Agreement and Plan of Merger (the “Agreement”). As a single member limited liability company, Holding Company did not elect to be treated as a corporation for federal income tax purposes, and, therefore, was treated as an entity disregarded from its owner for federal income and California corporation franchise and income tax purposes.[3] Pursuant to the terms of the Agreement, on ****** ** ****, Target Parent merged with and into Holding Company with Holding Company remaining in existence (the “Holding Company Merger”). The Holding Company Merger was treated as a tax-free reorganization under the Internal Revenue Code of 1986, as amended (“IRC”), sections 361 and 368(a)(1)(A), and, as Holding Company was a disregarded entity, was treated as if Target Parent merged directly into Parent (with Parent surviving).[4] Pursuant to IRC section 381(c)(2), the earnings and profits attributable to Target Parent are transferred to Parent as a result of the acquisition.[5] After the Holding Company Merger, Holding Company merged into Parent. As Holding Company already was a disregarded entity, this transaction had no federal income or California corporation franchise and income tax consequences. The Holding Company Merger is illustrated below.

Simultaneous with the Holding Company Merger, Original Sub merged with and into New Sub (the “**** Merger”). Both Original Sub and New Sub were taxed as corporations for federal income and California corporation franchise and income tax purposes, with the **** Merger being effectuated as a state law merger and treated as a tax-free reorganization under IRC Sections 361 and 368(a)(1)(A). Pursuant to IRC section 381(c)(2) the earnings and profits attributable to Original Sub are transferred to New Sub as a result of the merger

[2] Target Parent was treated as a C corporation for federal income and California corporation franchise and income tax purposes.

[3] *See* U.S. Treasury Regulation (“Treas. Reg.”), 26 C.F.R. section 301.7701-3(b)(1)(ii).

[4] *See* Treas. Reg. section 1.368-2(b)(1)(iii), Example 2.

[5] Pursuant to Section 24451, California conforms to IRC section 381.

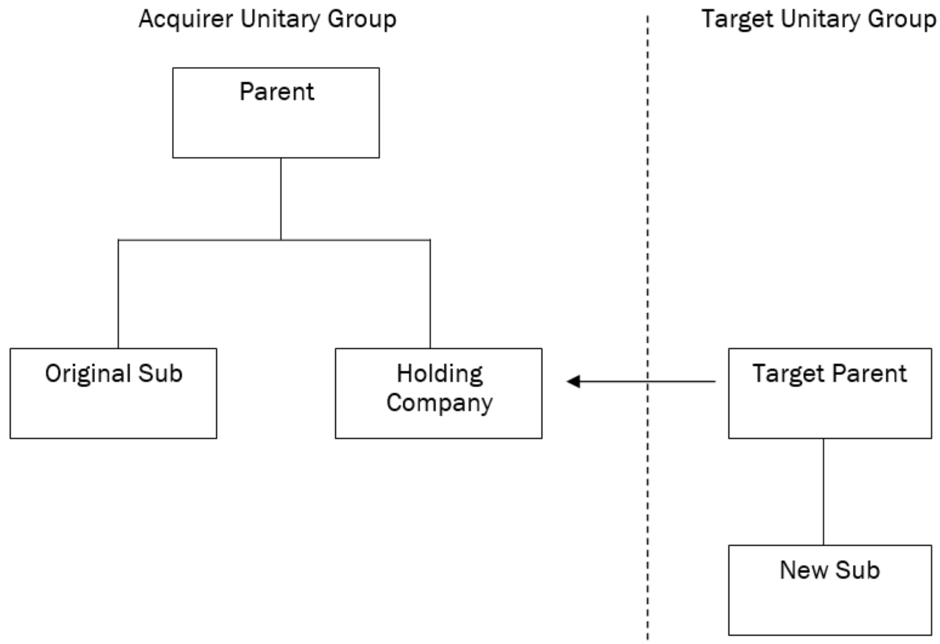
transaction. New Sub survived as a wholly-owned subsidiary of Parent. The **** Merger is illustrated below.

Subsequent to the Holding Company Merger and the **** Merger, Parent, New Sub, and their respective subsidiaries engaged in a unitary business relationship and filed combined reports for California corporation franchise and income tax purposes (the "Post-Merger Unitary Group"). Since that time, New Sub has generated additional taxable income and earnings and profits (the "Post-Merger New Sub E&P"), none of which included any nonbusiness income.

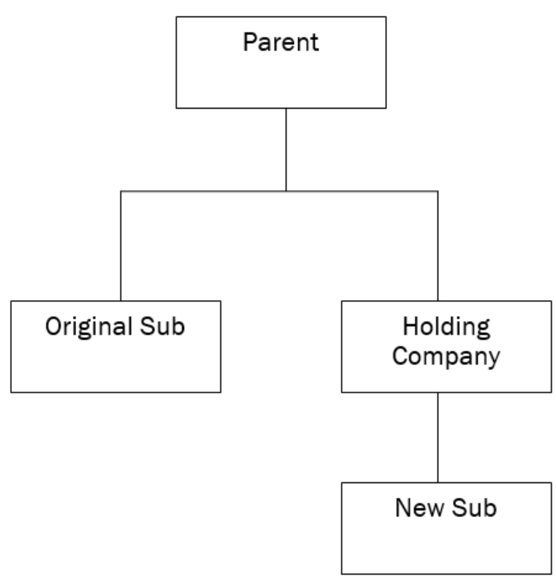
Recently, New Sub distributed earnings and profits to Parent. The amount of the distribution exceeded the Post-Merger New Sub E&P. Accordingly, the distribution was partially out of the Pre-Merger Original Sub E&P and the Pre-Merger New Sub E&P.

Holding Company Merger

<u>Before</u>

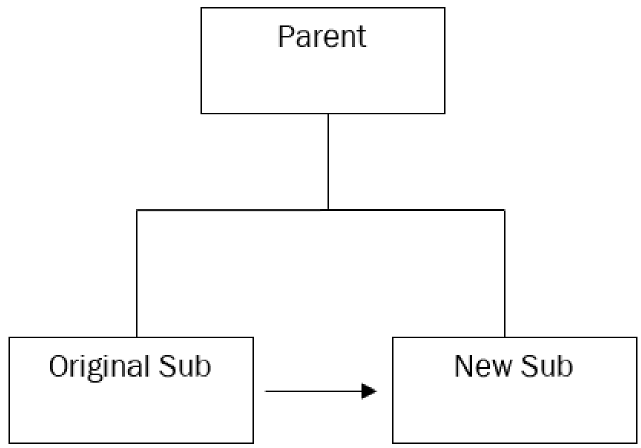


<u>After</u>

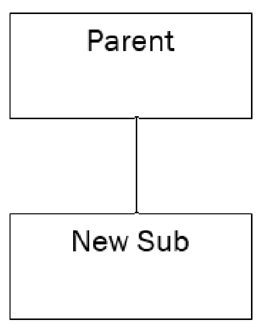


**** Merger

<u>Before</u>



<u>After</u>



RULING REQUESTED

The taxpayer requests a ruling to confirm that the dividend out of Pre-Merger Original Sub E&P and the Pre-Merger New Sub E&P will create "unitary income" to Parent within the meaning of Section 25106 so that the dividends will qualify for elimination from income under Section 25106.

HOLDING

The dividend out of Pre-Merger Original Sub E&P and the Pre-Merger New Sub E&P will constitute "unitary income" within the meaning of Section 25106 for Parent qualifying for elimination from income under Section 25106 (i.e., "paid out of the income of the unitary business").

LAW AND ANALYSIS

Pursuant to Section 24451, California specifically adopts by reference Subchapter C of Chapter 1 of Subtitle A of the IRC, as it is amended through January 1, 2015,[6] without any modifications that are relevant to the legal analysis herein, except as provided below.[7]

Section 25106(a)(1) provides:

> 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, except for purposes of applying Section 24345, shall not be taken into account under Section 24344 or in any other manner in determining the tax of any member of the unitary group.

To qualify for elimination from income 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.[8] IRC Section 316 defines a dividend as a distribution by a corporation out of earnings and profits.

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 under IRC Section 312.[9] 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.[10] 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.

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.[11] This rule applies even if the amount of income

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[6] Section 23051.5(a).

[7] Section 24451.

[8] *Id.*; *Willamette Industries, Inc. v. Franchise Tax Bd*. (1995) 33 Cal.App.4th 1242.

[9] *See* B. Bittker and J. Eustice, Federal Income Taxation of Corporations and Shareholders, 7th Ed. ¶8.04[1].

[10] Id. at ¶8.04[2]. *See* IRC section 312 (containing a number of required adjustments for calculating earnings and profits).

[11] *Appeal of Young's Market Co.,* No. 86-SBE-198 (Cal. State Bd. Equal. Nov. 19, 1986).

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.[12]

Under Section 24451, California incorporates IRC Section 316. IRC Section 316 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.[13] If dividends are drawn from earnings and profits of a specific year, but are insufficient to consume all of the earnings and profits for that year, earnings and profits are drawn on a pro rata basis from all classes of earnings and profits earned during the year, without regard to the specific date on which an income item giving rise to earnings and profits was realized.[14]

Here, because the amount of the dividend from New Sub exceeds the Post-Merger New Sub E&P, the excess is out of Pre-Merger Original Sub E&P and the Pre-Merger New Sub E&P. To be eligible for elimination from income under Section 25106, a dividend must be considered "paid out of the income previously described of the unitary business."

If the **** Merger and the Holding Company Merger qualify as reorganizations under IRC Section 368(a)(1)(A), then IRC Section 381 would apply and attribute carryover of earnings and profits would be applicable for the **** Merger and the Holding Company Merger. As such, the Pre-Merger Original Sub E&P, as well as Original Sub's past and present unitary relationship with Parent, would carry over to New Sub. Likewise, the past and present unitary relationship between New Sub and Target Parent would carry over to Parent.

With respect to the portion of the dividend paid out of the Pre-Merger Original Sub E&P (the "Pre-Merger Original Sub Dividend"), the dividend to be received from New Sub would have been apportionable business income to the Acquirer Unitary Group. As a result, the Pre-Merger Original Sub Dividend should properly be considered paid from "income" determined by reference to the apportionment factors of the Post-Merger Unitary Group and thus will constitute "income previously described of the unitary business" when that amount is paid as a dividend to Parent. As such, the Pre-Merger Original Sub Dividend will qualify for elimination from income pursuant to Section 25106.

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[12] See generally, *Safeway Stores, Inc. v. Franchise Tax Bd.* (1970) 3 Cal.3d 745 (the court authorized a special rule [often described as the "Safeway formula"] in the application of Section 24402 to deal with that eventuality).

[13] See generally, Treas. Reg., Section 1.316-2(b) and (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).

[14] See *Safeway Stores*, 3 Cal.3d 745 at 753; See also, Treas. Reg., Section 1.245-1, subdivision (c)(4) (applying the last-in, first-out principle), and subdivision (d), Example (3) (illustrating application of the ratio principle, without regard to the specific date in a given year that an item of U.S. source income is earned).

With respect to the portion of the dividend paid out of the Pre-Merger New Sub E&P (the "Pre-Merger New Sub Dividend"), the dividend to be received from New Sub would have been apportionable business income to the Target Unitary Group. As a result, the Pre-Merger New Sub Dividend should properly be considered paid from "income" determined by reference to the apportionment factors of the Post-Merger Unitary Group and thus will constitute "income previously described of the unitary business" when that amount is paid as a dividend to Parent. As such, the Pre-Merger New Sub Dividend will qualify for elimination from income pursuant to Section 25106.

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. All representations of fact, including representations of unitary relationships, are subject to verification by audit examination. 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 inquires which might be issued.

Very truly yours,

Maria Huseinbhai
Tax Counsel