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State of California
Franchise Tax Board

01.06.11

FTB Notice 2011-01

Subject: Abusive Tax Shelters – California Listed Transactions – Abusive Sales Factor Manipulation

PURPOSE

This Notice constitutes a published position of the Franchise Tax Board within the meaning of subparagraph (A) of paragraph (4) of subdivision (a) of section 18407 of the California Revenue and Taxation Code (R&TC).

The Franchise Tax Board has become aware of transactions involving apportioning corporate taxpayers that use one or more partnerships¹ to improperly inflate the denominator of the California sales factor, thereby reducing the amount of business income apportioned to California for franchise or income tax purposes. This Notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and substantially similar transactions, as listed transactions for purposes of subparagraph (A) of paragraph (4) of subdivision (a) of section 18407 of the R&TC. This Notice also alerts parties involved with these transactions to certain responsibilities that may arise from their involvement with these transactions.

FACTS

The transactions described in this Notice involve the use of special sales factor rules in Regulation 25137-1(f)(3)² to include intercompany sales in the denominator of the sales factor even though the gain or loss generated by those sales is eliminated from the calculation of apportionable business income. Although there are many variations using different entities and structures, these transactions typically involve the following common facts:

- (a) A group of corporations³ engaged in a unitary business that file a California combined report (the "combined reporting group");

¹ For purposes of this Notice, the term "partnership" means any entity, including a limited liability company, that is classified as a partnership for California franchise or income tax purposes.

² All references to a Regulation in this Notice are to sections of title 18 of the California Code of Regulations.

³ As used in this Notice, the term "corporation" is as defined in R&TC § 23038.

- (b) At least one member of the combined reporting group (the partner-corporation) owns, forms, or otherwise acquires an interest in a partnership (the partnership);
- (c) At least one other member of the combined reporting group (the nonpartner-corporation) does not own an interest in the partnership;
- (d) The partnership's business activities are considered to be unitary with those of the combined reporting group, disregarding ownership requirements;
- (e) The partnership's business activities are activities that were, or could be, performed by a corporate member of the combined reporting group;
- (f) The partnership sells goods or services to the nonpartner-corporation, or vice-versa;⁴
- (g) The sales between the partnership and the nonpartner-corporation are included in the sales factor denominator, but none of those sales are assigned to California for purposes of the sales factor numerator.

Typically, these transactions involve a partnership that is newly formed, newly acquired, or previously dormant. Typically the partnership will be assigned to perform an existing function that had been performed by one or more members of the combined reporting group. However, the partnership often will have little or no assets or employees of its own, and thus be unable to perform its assigned function directly. In such instances the partnership will contract with another member of the combined reporting group (either a partner-corporation or a nonpartner-corporation) to perform the assigned function on the partnership's behalf. The partner-corporation may also be newly formed, newly acquired, or previously dormant, and may or may not conduct any business activity apart from holding an interest in the partnership.

DISCUSSION

The arrangement described in this Notice is designed to improperly inflate the sales factor denominator and thereby reduce a taxpayer's⁵ California apportionment percentage. Taxpayers take the position that the sales between the partnership and the nonpartner-corporation, which are excluded from the net business income of the combined reporting group, are nevertheless included in the sales factor denominator under their interpretation of Regulation 25137-1(f)(3)(B).

Where it is determined that a taxpayer has used the arrangement described in this Notice, the Franchise Tax Board intends to disallow any tax benefits claimed as a result of including the sales between the partnership and the nonpartner-corporation in the sales factor. Depending on the facts and circumstances of each particular

⁴ Note that the partnership may be making sales to, or purchases from, more than one nonpartner-corporation. The number of nonpartner-corporations involved is not dispositive of the application of this Notice. Similarly, the number of partnerships involved is not dispositive of the application of this Notice.

⁵ As used in this Notice, the term "taxpayer" is as defined in R&TC § 23037.

case, reasons for disallowance may include, but are not limited to, one or more of the following:

- 1) Regulation 25137-1(f)(3) does not include the sales between the partnership and the nonpartner-corporation in the sales factor because those sales do not "give rise to business income" in the combined report.
- 2) Regulation 25137-1(f)(3) excludes the sales between the partnership and the nonpartner-corporation from the sales factor because the term "taxpayer," as used in the regulation, refers to each corporation in the combined report.
- 3) Regulation 25106.5-1(a)(5)(A)1. excludes the sales between the partnership and the nonpartner-corporation from the sales factor because they are "sales attributable to intercompany items."
- 4) Including the sales between the partnership and the nonpartner-corporation in the sales factor creates a mismatch of income and apportionment factors and thereby leads to an unfair representation of business activity in this state.
- 5) R&TC section 25102 authorizes inclusion of the partnership in the taxpayer's combined report in order to properly reflect the taxpayer's income.
- 6) The partnership is disregarded for tax purposes because it lacks economic substance and has no valid business purpose beyond the reduction of the taxpayer's California tax liability.
- 7) Sales between the partnership and the nonpartner-corporation are disregarded for tax purposes because they lack economic substance and have no valid business purpose beyond the reduction of the taxpayer's California tax liability.
- 8) Regulation 25137-1 does not apply because the partnership is not a valid "partnership" for tax purposes under R&TC section 17008 and *Commissioner v. Tower* (1946) 327 U.S. 280.

Taxpayers engaging in transactions substantially similar to these transactions are deemed to be engaged in these transactions under R&TC section 18407.

Taxpayers engaging in these transactions have reporting requirements under R&TC section 18407. Taxpayers failing to comply with the reporting requirements are subject to penalties under R&TC section 19772. Taxpayers determined to be engaged in these transactions may be subject to penalties including, but not limited to, accuracy-related (R&TC section 19164, subdivision (a)), noneconomic substance transaction (R&TC section 19774), and 100% interest-based (R&TC section 19777).

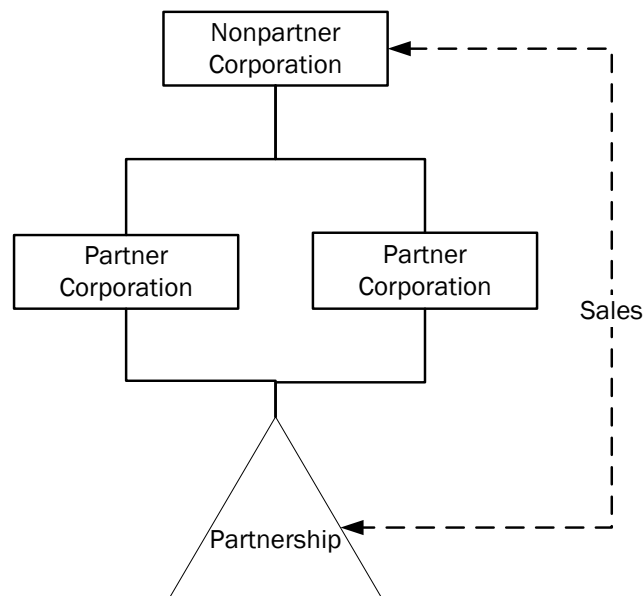
In certain circumstances, taxpayers engaging in such transactions may also be subject to the fraud penalty (R&TC section 19164, subdivision (c)).

Material advisors have reporting and list maintenance requirements under R&TC sections 18628 and 18648. Material advisors failing to properly meet these requirements are subject to penalties for failure to maintain and/or furnish investor information (R&TC section 19173) and failure to disclose reportable transactions (R&TC section 19182). Material advisors may also be subject to a penalty for promoting an abusive tax shelter under R&TC section 19177.

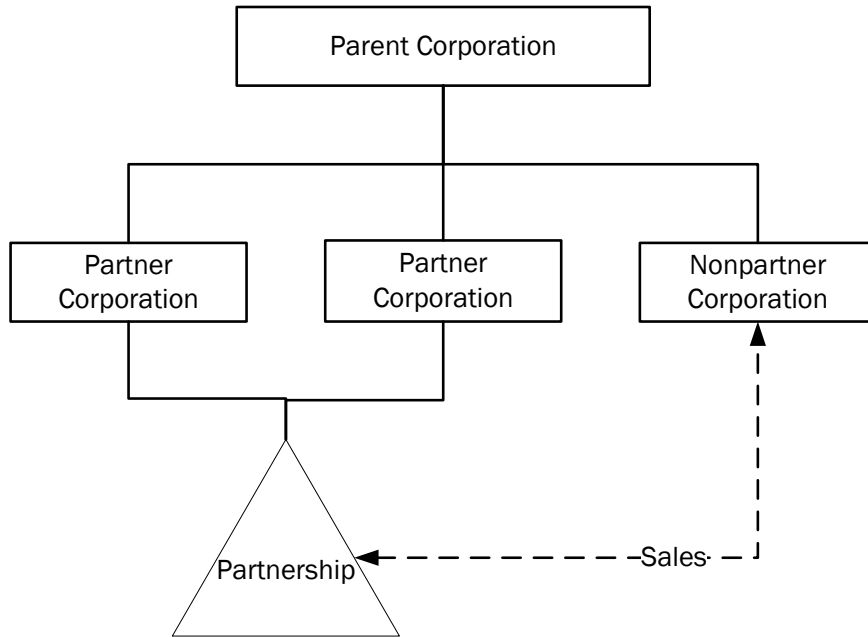
EXAMPLES

This section illustrates two common variations of the business structures used to facilitate the tax avoidance transaction described in this Notice. This section also lists examples of the types of factors the Franchise Tax Board will consider in determining whether to assess tax and/or penalties. Because the possible variations on business structures are too many to describe herein, the application of this Notice is not limited to arrangements that precisely match one of the variations described below. Similarly, the list of factors is illustrative rather than all-inclusive. In any case implicated by this Notice, the Franchise Tax Board will make a determination only after an inquiry into the taxpayer's business structure and the business purposes for such structure.

Example Structure A: In the following diagram, the Nonpartner Corporation and both Partner Corporations are engaged in a unitary business and file a California combined report. The Nonpartner Corporation is the direct or indirect owner of 100% of both Partner Corporations. The Partnership is engaged in the same unitary business.



Example Structure B: In the following diagram, the Parent Corporation, the Nonpartner Corporation and both Partner Corporations are engaged in a unitary business and file a California combined report. The Parent Corporation is the direct or indirect owner of 100% of the Nonpartner Corporation and both Partner Corporations. The Partnership is engaged in the same unitary business.



Example Factors: The Franchise Tax Board will consider the following factors in determining whether to assert one or more of the legal theories enumerated in the DISCUSSION section of this Notice, *supra*, and whether to assess tax and/or penalties:

- Whether the Partnership has sufficient employees to conduct its alleged business activity, including its alleged sales to or from the Nonpartner Corporation;
- Whether the Partnership has sufficient funds to support its alleged business activity, including its alleged sales to or from the Nonpartner Corporation;
- Whether the sales between the Partnership and the Nonpartner Corporation are fictitious or overvalued;
- Whether the sales between the Partnership and the Nonpartner Corporation serve a valid, nontax business purpose;
- Whether the Partnership's purported transactions with third parties are undertaken by the Partnership in substance, and not merely in form;
- Whether the Partnership performs activities other than acting as a mere conduit for sales between the Nonpartner Corporation and third parties;

- Whether the Partner Corporations were formed for any purpose other than facilitating the Partnership's existence;
- Whether the Partner Corporations conduct business activities apart from holding interests in the Partnership;
- Whether the taxpayer can demonstrate that it benefitted economically from assigning activities to the Partnership that previously had been performed by corporate members of the combined reporting group, apart from claimed favorable tax consequences;
- Whether the taxpayer can demonstrate that the creation of the Partnership meaningfully affected the taxpayer's (or the combined reporting group's) economic position, apart from claimed favorable tax consequences;
- Whether the Partnership and/or the Partner Corporations were created in response to promotional materials that highlighted favorable tax consequences.

DRAFTING INFORMATION

The principal author of this notice is Ian Foster of the Franchise Tax Board, Legal Division. For further information regarding this notice, contact Mr. Foster at the Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, CA 95741-1720.