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08.04.11

## **FTB NOTICE 2011-04**

**Subject:** Abusive Tax Shelters – California Listed Transactions – Circular Cash Flow

### **BACKGROUND**

FTB Notice 2011-03, relating to the identification of certain circular cash flow transactions as "listed transactions" within the meaning of subparagraph (A) of paragraph (4) of subdivision (a) of section 18407 of the Revenue and Taxation Code, was issued on April 22, 2011. The department has determined that the facts identified in that Notice did not clearly identify the abusive nature of the transactions that the department intended to identify as a "listed transaction" under that Notice.

As a result, this Notice is being issued to supersede FTB Notice 2011-03, which is hereby withdrawn.

### **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 parent corporations ("Parent") that artificially increase their basis in the stock of their subsidiaries ("Subsidiary"), without any outlay of cash or property, prior to the Parent selling the stock of Subsidiary to an unrelated third party. 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 R&TC section 18407. 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 a Parent that is planning to sell its wholly-owned Subsidiary. Parent takes steps to minimize taxable gain on the sale by increasing Parent's stock basis in Subsidiary artificially through the contribution of a promissory note or other instrument and a subsequent circular flow of cash from Parent to Subsidiary and from Subsidiary back to Parent. In the first step, Parent contributes a promissory note or other instrument to Subsidiary in a transaction that Parent treats as a contribution to capital under Internal Revenue Code (IRC) section 351, which is applicable for California purposes pursuant to R&TC section 24451. Parent's contribution to Subsidiary's capital is temporary and transitory in nature, and is intended to remain with Subsidiary for a short period of time.

Subsequent to the contribution from Parent, Subsidiary takes steps to generate what Subsidiary alleges are earnings and profits through the sale or transfer of intangible property to a related entity in a manner that avoids the application of the intercompany transaction rules in California Code of Regulations, title 18, section 25106.5-1.

Shortly before or after Subsidiary has purportedly generated earnings and profits, Parent pays off the promissory note (or other instrument) issued to Subsidiary either in one lump sum payment or in installments. Subsidiary then distributes the amount of cash received in payment of the promissory note (or other instrument) or a substantially equivalent amount of property back to the Parent. Because Subsidiary purports to have earnings and profits (which may have been artificially created), Parent claims that the cash distribution from Subsidiary is a dividend and thus deductible or excludable from net income pursuant to the appropriate dividend or exclusion section of the R&TC, and as a purported dividend, Parent further claims that it does not have to reduce its basis in Subsidiary pursuant to R&TC section 24451, which conforms to IRC section 301(c)(2). The end result is that Parent claims an increased basis in Subsidiary for its contribution of a promissory note (or other instrument) that never remained with Subsidiary.

## DISCUSSION

The transactions described in this Notice are designed for the purpose of and/or utilized in a manner that exploits and abuses California's nonconformity to a substantial portion of the federal consolidated return regulations provided under IRC section 1502. Specifically, with respect to earnings and profits and stock basis, California has no provisions similar to the investment adjustments allowed for federal purposes under Treasury Regulation sections 1.1502-32 and -33. Instead, under California law the earnings and profits of each entity in the combined report are calculated on a separate accounting basis and do not reflect the earnings of any lower tier subsidiaries. (See *Appeal of Young's Market Company*, Cal. St. Bd. of Equal., Nov. 19, 1986.) Likewise, the cost basis of a unitary subsidiary's stock is not adjusted to reflect the earnings of that subsidiary. (See *Appeal of Rapid American Corp.*, Cal. St. Bd. of Equal., Oct. 10, 1996.) Unlike the stock basis investment adjustments for federal purposes, when Subsidiary actually or purportedly generates earnings and profits, Parent's stock basis in Subsidiary is not increased under California law. The end result of the exploitation and abuse in these transactions is that Parent artificially inflates its basis in its stock in Subsidiary without any actual out-of-pocket cost to Parent.

The Franchise Tax Board intends to challenge the purported tax benefits from these transactions based on the application of various theories, including judicial doctrines such as substance over form, sham transaction, and step transaction. Pursuant to the authority in Revenue Ruling 78-397 (1978-2 C.B. 150) and *Andantech L.L.C. v. Commissioner* (TC Memo 2002-97), the Franchise Tax Board may argue that the circular cash flow should be wholly disregarded for tax purposes. Under appropriate facts and circumstances, the Franchise Tax Board also may argue that the transactions lack economic substance and/or lack valid non-tax business purposes. Finally, the Franchise Tax Board may argue that the contribution to capital did not meet the requirements under R&TC section 24451, which conforms to IRC section 351, because it was illusory and remained in Subsidiary for a temporary period of time.

Note that the manner in which Subsidiary generates its alleged earnings and profits is not determinative of whether this Notice applies to a particular transaction. Additionally, the Franchise Tax Board does not concede that earnings and profits are actually being created in any permutation of these transactions.

Persons participating in transactions substantially similar to these transactions are deemed to be participating in these transactions for purposes of R&TC section 18407.

Persons participating in these transactions have reporting requirements under R&TC section 18407. Persons failing to comply with the reporting requirements are subject to penalties under R&TC section 19772. Persons that participated 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, persons that participated in such transactions may also be subject to the fraud penalty (R&TC section 19164, subdivision (c)).

Material advisors, as defined in IRC section 6111(b), have reporting and list maintenance requirements under R&TC sections 18628 and 18648. Material advisors failing to properly comply with 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.

#### **DRAFTING INFORMATION**

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