NOTE: This paper is intended only for purposes of facilitation of discussion at the Interested Parties Meeting (IPM) scheduled for June 12, 2018.

EXPLANATION AND BACKGROUND OF PROPOSED REGULATION 23663-6

California Revenue and Taxation Code ("RTC") section 23663 permits the assignment of credits among affiliated members of the same combined reporting group. RTC section 23663 was added by Section 10 of AB 1452 (Stats. 2008, ch. 763), is specifically operative for assignments made in taxable years beginning on or after July 1, 2008, and first permits assigned credits to be claimed against the tax of the assignee in taxable years beginning on or after January 1, 2010. The statute specifies that credits may only be assigned to an eligible assignee, which is generally defined in RTC section 23663(b)(3) as an affiliated corporation that is a member of the same combined group as the assignor in both the taxable year the credits were earned and the taxable year the credits are assigned to the assignee.

However, taxpayers may have uncertainty regarding whether assignments would be permissible in certain situations that may result from corporate reorganizations and other corporate restructurings. For example, as a result of a corporate merger, the assignor may not be the entity that originally earned the credit, and so, taxpayers may have uncertainty regarding which combined reporting group (i.e., the assignor's combined reporting group or the combined reporting group of the taxpayer that originally earned the credits) is relevant in applying the eligible assignee requirements in RTC section 23663(b)(3).

Additionally, when the assignor and its subsidiaries have been acquired by an unrelated combined reporting group in the intervening time between the year in which the credits were earned and the year of the planned assignment, taxpayers may have uncertainty as to which group members are eligible assignees. Alternatively, the assignor (or a potential eligible assignee) may have participated in a corporate merger or reorganization, such as a reorganization under Internal Revenue Code ("IRC") section 368(a)(2)(F), and so, taxpayers may have uncertainty as to whether the assignor (or potential eligible assignee) will be considered to have existed when the credits were earned. Due to these situations and others resulting from similar corporate events, taxpayers may have uncertainty regarding which entities are eligible to receive assigned credits under the statute.

BENEFITS ANTICIPATED FROM REGULATORY ACTION

The proposed regulation will benefit taxpayers, tax practitioners, and the State of California by providing clarity that does not currently exist through guidance to identify entities that are eligible assignees for purposes of the assignment of credits pursuant to RTC section 23663. The proposed regulation will clarify which taxpayers are eligible assignees in situations resulting from corporate reorganizations and other corporate restructurings. The clarity from the proposed regulations will reduce uncertainty for taxpayers and tax practitioners, and will facilitate tax administration for the State of California by providing rules and examples relating to proper elections to assign credits. These benefits are the result of goals developed by the Franchise Tax Board ("FTB") with input from interested parties and based on broad statutory authority.

DISCUSSION OF NECESSITY AND SPECIFIC PURPOSE OF THE PROPOSED REGULATION

The purpose of this proposed regulation under RTC section 23663 is to give taxpayers certainty by providing guidance as to which entities are eligible assignees when members of the combined reporting group have been affected by corporate reorganizations and other corporate restructurings. The regulation will also effectuate the purpose of the statute, which was to allow credits to be utilized within the combined report, while balancing the explicit limitations of the credit assignment statute, including that the assignor and assignee be in the "same combined group" at the time the credit was earned and also at the time the credit was assigned. The proposed regulation achieves the statute's purpose by providing clear rules in the case of reorganizations and other corporate restructurings. The proposed regulation also contains numerous examples that provide additional clarity as to the identity of "eligible assignees" in specific scenarios.

Under RTC section 23663(e)(4), the FTB is specifically authorized to issue quasi-legislative regulations to implement the purposes of the statute, including any regulations "necessary to specify the treatment of any assignment that does not comply with the requirements of this section (including, for example, where the taxpayer and eligible assignee are not properly treated as members of the same combined reporting group on any of the dates specified in paragraph (3) of subdivision (b) [of RTC section 23663])."

The proposed regulation in subsection (b) first clarifies that eligible credit, as defined in RTC section 23663(b)(2), includes credits that a taxpayer acquired as a result of a reorganization or other corporate restructuring. The proposed regulation gives taxpayers certainty that such credits are eligible credits for purposes of credit assignments under this statute.

The proposed regulation in subsection (c) next clarifies the requirements of an eligible assignee found in RTC section 23663(b)(3). Specifically, the proposed regulation clarifies that the assignee must have been in the same combined reporting group as the taxpayer that originally earned the credit to be an eligible assignee.

The proposed regulation in subsection (d) then clarifies RTC sections 23663(b)(3)(A)(i) and (b)(3)(B)(i), which requires entities to have been in the assignor's combined reporting group when the assignor originally earned the credit. When the assignor did not originally earn the credit, but instead, received it as a result of a corporate reorganization, taxpayers are left with uncertainty as to whether they meet this requirement. The proposed regulation clarifies that eligible assignees must have been in the combined reporting group of the taxpayer that originally earned the credit at the relevant statutory date and provides a rule to make that determination.

The proposed regulation next contains two provisions, found in subsections (e) and (f), that address two specific situations. First, in subsection (e), the proposed regulation allows a member that undertook a reorganization under Internal Revenue Code (IRC) section 368(a)(2)(F) to be an eligible assignee. And second, in subsection (f), when a member of the assignor's combined reporting group who had little to no assets or business activity is the surviving entity in an acquisition of an active business, the proposed regulation clarifies that the member is not an eligible assignee. The surviving entity is, in substance, a newly acquired business in the combined reporting group, and so, substantively was not a member of the combined reporting group of the taxpayer that earned the credits.

Proposed Regulation 23663-6 – Corporate Reorganizations and Other Corporate Restructurings

1. Subsection (a) sets forth the purpose of the regulation and provides an overview of what the regulation covers. This subsection states that this regulation gives guidance to taxpayers regarding credit assignments following reorganizations and other corporate restructurings. This subsection is necessary to provide users of Regulation 23663-6 guidance regarding its scope, so that users can identify the applicability of this regulation to their specific issues.

2. Subsection (b) clarifies the definition of eligible credit set forth in RTC section 23663(b)(2). An eligible credit is defined in the statute as "[a]ny credit earned by the taxpayer" on or after July 1, 2008 or earned before July 1, 2008 that can be carried forward to the taxpayer's first taxable year beginning on or after July 1, 2008. The purpose of this section is to clarify that eligible credits (credits that can be assigned) includes credits allowed to a taxpayer through corporate events, such as reorganizations and other corporate restructurings. In these situations, the taxpayer did not originally earn or generate the credits; however, such credits may be allowed to a taxpayer for reasons other than the taxpayer earned or generated the credits, and it is necessary to clarify that those credits are included in the definition of eligible credit to effectuate the purpose of the statute. Also, consistent with RTC section 23663, the proposed language clarifies that eligible credit does not include credits that a taxpayer received by assignment or sale.

3. Subsection (c) clarifies that an eligible assignee generally must have been in the same combined reporting group as the entity that earned the credit when the credit was originally earned.

This subsection is necessary to effect the purpose of the statute in the case of corporate reorganizations and other corporate restructurings. Without this subsection, users of the credit assignment statute will be left with uncertainty regarding who is an eligible assignee when there has been corporate reorganizations and other corporate restructurings.

The statute specifies that an eligible assignee had to have been in the assignor's combined reporting group when the assignor originally earned the credit. However, if the assignor was not the entity that originally earned the credit, but instead, held the credit because, for example, it merged with the entity that earned the credit, taxpayers have uncertainty as to which entity's combined reporting group satisfies the requirement – the assignor's combined reporting group when the credit was originally earned or the combined reporting group of the taxpayer that originally earned the credit. Thus, the regulation clarifies that the relevant combined reporting group for purposes of the requirement in RTC section 23663(b)(3) is that of the taxpayer that originally earned the credit when the credit was originally earned.

This subsection contains four illustrative examples. In Example 1, B is the assignor in 2013. To determine the "eligible assignees," the regulation looks to the members of B's combined reporting group in 2010 when B earned the credits. According to this snapshot, A and C are the only potential eligible assignees. Second, the regulation looks to the members of B's combined reporting group in 2013, the year of assignment. In 2013, X, Y, Z and C are potential eligible assignees. However, C is the only potential eligible assignee in both the year the credit was earned and the year the credit is assigned. As such, C is the only eligible assignee.

Examples 2, 3 and 4 address IRC section 355 transactions – spin-offs, split-offs and split-ups. These transactions generally involve the creation of a new entity that is a continuation of a part of the prior company's business. However, the new entity is not considered an eligible assignee. The new entity does not meet the requirements of the statute because it was not a member of the assignor's combined reporting group when the assignor earned the credits.

4. Subsection (d) of the regulation addresses situations in which the assignor is not the taxpayer who originally generated the credits, but instead received the credits as a result of a corporate reorganization or other corporate restructuring. Taxpayers may have uncertainty regarding the identity of the eligible assignees when the assignor is not the taxpayer that originally earned the credits because, for purposes of the requirements found in RTC sections 23663(b)(3)(A)(i) and (b)(3)(B)(i), it is not clear which combined reporting group satisfies the requirements – the assignor's combined reporting group or the combined reporting group of the taxpayer that originally earned the credits. Thus, the regulation clarifies that the statutory requirements of RTC sections 23663(b)(3)(A)(i) and (b)(3)(B)(i) are based on the combined reporting group of the taxpayer that originally earned the credits. In this regard, the regulation clarifies that the taxpayer that earned the credits is treated as the assignor to determine which entities are eligible assignees. As such, when the assignor is not the taxpayer who originally earned the credits, but assigns credits under RTC section 23663, an eligible assignee must meet the requirements of Regulation section 23663-6 and RTC sections 23663(b)(3)(A)(i) and (b)(3)(B)(i) in relation to the taxpayer that originally

earned the credits. This result is consistent with the statute because it does not allow the assignment of credits to entities that were not members of the combined reporting group of the entity that originally earned the credits.

This subsection is necessary to provide clarity and guidance to taxpayers for purposes of determining the identity of eligible assignees when the assignor was not the taxpayer that earned the credits. The statute does not clearly address these situations, and so, without this subsection, taxpayers are left with uncertainty regarding the entities that are eligible to receive credits under the statute.

There are two examples that illustrate the rules in this subsection. In Example 5, after the corporate reorganization, B no longer exists in the year of assignment because it merged into Y, and Y wants to assign B's historical credits. In this situation, Y is the assignor, but was not the entity that earned B's historical credits. As such, the statute leaves taxpayers with uncertainty as to which entities are "eligible assignees" because it is not clear which entity is treated as the assignor for purposes of analyzing the requirements found in RTC section 23663(b)(3)(B)(i) and proposed Regulation 23663-6(c). In this situation, as the examples demonstrate, the proposed regulation determines the eligible assignees for B's historical credits by looking to B's combined reporting group in the year B earned the credits. At that time, A and C were in B's combined reporting group, and so, A and C are potential eligible assignees. In the year of assignment, of the two potential eligible assignees, only C meets the requirement found in RTC section 23663(b)(3)(B)(ii). Thus, C is the only eligible assignee, assuming C meets all other applicable requirements.

Example 6 is the reverse situation of the situation in Example 5. In Example 6, C has no eligible assignees because C did not earn the credits, and A and B were not in Z's combined reporting group when Z earned the credits. Again, the statute leaves taxpayers with uncertainty as to which entities are "eligible assignees" because the assignor (the entity C in Example 6) did not earn the credits. However, the proposed regulation clarifies this ambiguity. Since A and B were not part of Z's combined reporting group when Z earned the credits, there are no eligible assignees.

5. Subsection (e) of the regulation sets forth a rule that a potential eligible assignee that would have been an eligible assignee but for a reorganization under IRC section 368(a)(1)(F) ("F reorganization"), will be treated as an eligible assignee for purposes of this subsection. This rule would treat the resulting corporation from an F reorganization the same as the original corporation that disappeared in the F reorganization for purposes of this regulation.

An F reorganization is unique in that the new corporation is treated for tax purposes as a continuation of the old corporation. Indeed, secondary authorities note that the old and new corporations of an F reorganization are characterized as "functional equivalents in the context of the larger transaction and with respect to related transactions or events."[1] Thus,

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[1] Bittker and Eustace, Federal Income Taxation of Corporations and Shareholders (Thomson Reuters/Tax & Accounting, 7th ed. 2000 & Supp. 2017-3) (accessed on Checkpoint (www.checkpoint.riag.com) [February 2, 2018]) section 12.28.

this subsection is necessary, and is consistent with the purpose of the credit assignment statute, to allow corporations affected by F reorganizations to be eligible assignees, assuming the corporations have met all other requirements of the statute.

Example 7 illustrates the narrow rule found in subsection (e) of the regulation.

6. Subsection (f) imposes a business assets test to determine the eligibility of a potential eligible assignee. This subsection prevents instances where a corporation with a relatively low level of business activity and assets is combined with a corporation outside of the group which has much higher business activity and assets. The result is that the relatively much smaller corporation now houses the relatively much larger corporation that was acquired. While the relatively small corporation was part of the assignor's combined reporting group when the credits were earned and in the year of assignment, the relatively larger corporation would not have been an eligible assignee, but for the merger with the relatively smaller corporation.

This result affords consistency with the same combined reporting group requirement under RTC section 23663(b)(3) and denies positive treatment in situations that would be contrary to the purpose of the statute which requires that an assignee be in the same combined reporting group when credits are both earned and assigned. In enacting the requirement that the assignor and assignee be members of the same combined reporting group both when the credit was originally earned and when the credit was assigned, the Legislature demonstrated that its purpose was to allow utilization of credits within the assignor's combined reporting group, but only so long as the limitation rule for the year the credits were originally earned and assigned was satisfied. The fact pattern set forth above creates uncertainty for taxpayers as to whether the post-merger corporation would be an eligible assignee. However, the post-merger corporation is fundamentally almost entirely comprised of the out-of-group corporation after the merger.

Thus, this subsection disallows credit assignments to entities that engaged in a reorganization or other corporation restructuring such that the amount of business assets after the merger are more than 80% of the amount of business assets of the surviving entity before the merger. This subsection is necessary to effectuate the purpose of the statute, which was to allow the assignment of credits subject to the same combined group limitation. The Legislature's purpose was to limit the assignment of credits to members of the same combined reporting group as the taxpayer that originally earned the credit and the assignor, and so, this subsection enforces that limitation by preventing the assignment of credits to an entity that in substance was not in the same combined reporting group as the taxpayer that earned the credits.

Example 8 illustrates the exception to the "eligible assignee" requirements found in subsection (f) of the regulation. C was a relatively small corporation with minimal assets, but was a member of B's combined reporting group when B earned its credits. B acquired Z and merged Z into C, with C being the surviving entity. Thus, C is now over 80% comprised of Z's business assets. However, to allow C to be an eligible assignee would be inconsistent with the purpose of the statute, and so, this regulation disqualifies C as an eligible assignee because C's business assets were less than 20% than the surviving entity's assets after the merger.

7. Subsection (g) states that limitations on the allowance of credits against the assignor's tax will also apply to the allowance of the credits to the assignee's tax. If the assignor's use of the credits against its tax was subject to limitations or would have been subject to limitations but for the assignment, then the same limitations apply to the assignee's ability to use the credits against its tax.

While the Legislature made it clear that a limitation attaches to a credit permanently unless a statute specifically removes the limitation, this subsection is necessary to avoid any uncertainty regarding the impact of a corporate reorganization or other corporate restructuring on the limitations that attach to credits.

Example 9 illustrates these limitations in the context of Enterprise Zone ("EZ") credits. If B had EZ credits subject to the limitations found in RTC section 23662.7(j) and assigned those credits to C, C's ability to use the credits against its tax would be subject to the same limitations that applied when B held the credits. Accordingly, the limitations on B's use of the credits do not extinguish on assignment, but instead, apply consistently to the use of the credits before and after the assignment.