STATE OF CALIFORNIA
FRANCHISE TAX BOARD
Legal Division MS A260
PO Box 1720
Rancho Cordova, CA 95741-1720
tel: 916.845.5244 fax: 916.843.6080
ftb.ca.gov

Date: 06.28.18

Technical Advice Memorandum: 2018 - 02

Requested By: National Business Audit – Audit Division
Requested Date: 12.15.17
TAM Author: Craig Swieso
Phone Number: 916.845.5244
Fax Number: 916.843.6080

SUBJECT: Apportionment of Excess Inclusion (EI) amongst Non-Economic Residual Interest Holders (NERI) that are Taxpayer Members in a Combined Reporting Group

QUESTION PRESENTED

How is EI properly apportioned amongst multiple NERIs that are taxpayer members of the same combined reporting group?

CONCLUSION

The EI pertaining to all the NERIs in the combined reporting group is aggregated and thereafter apportioned to each NERI that is a taxpayer member of the combined reporting group with reference to the taxpayer member NERI's California apportionment factor percentage.

ANALYSIS AND DISCUSSION

On January 26, 2009, the Franchise Tax Board (FTB) issued Legal Ruling 2009-01, setting forth the rules pertaining to a NERI reporting EI from its interest in a Real Estate Mortgage Investment Conduit (REMIC). On June 23, 2009, the FTB issued Information Letter 2009-01, which addressed the application of the EI rules to taxpayer members of a combined reporting group that are not NERIs. For purposes of this TAM, it is not necessary to reiterate the discussion set forth in Legal Ruling 2009-01 and Information Letter 2009-01; rather, this TAM will analyze an issue not addressed in Legal Ruling 2009-01 and Information Letter 2009-01. Nevertheless, for purposes of this TAM, it is helpful to reiterate the definition of a NERI and EI. A NERI is a residual interest holder in a REMIC that does not receive distributions from the REMIC; EI is the minimal amount of income that a NERI must annually report for income or franchise tax purposes.

As discussed in Legal Ruling 2009-01, only NERIs are required to report the minimum amount represented by EI. As a result, non-NERIs are not subject to the EI rules. This means that EI cannot be attributed to a non-NERI. Accordingly, non-NERIs are not the focus of this TAM. Rather, as indicated by the question presented above, guidance is sought as to the appropriate methodology for attributing EI when there are multiple NERIs that are taxpayer members in a combined reporting group.

Insight can be gained into the appropriate methodology for attributing EI when there are multiple NERIs that are taxpayer members in a combined reporting group by considering the proper treatment if the combined reporting group consisted entirely of NERIs subject to the EI rule. In this scenario, every member of the combined reporting group would be required to report a minimum amount of income (i.e., EI). In this instance, the entirety of the unitary operations of the combined reporting group would exclusively relate to the collective status of each of its members as NERIs. In this regard, attributing the EI relating to each of the NERIs on a separate company basis, as opposed to aggregating it, would not reflect the unitary contributions that each of the NERIs provides to the other NERIs. Moreover, this would isolate each NERI's function on a geographic separate accounting basis, which is not consistent with the purpose of unitary apportionment. Accordingly, in this instance, it follows that the EI from each of the NERIs that is a member of the combined reporting group should necessarily be aggregated to be consistent with unitary principles. Thereafter, the aggregate EI should be assigned to each taxpayer member NERI of the combined reporting group by referencing the taxpayer member NERI's California apportionment factor percentage.

This same approach is also warranted in situations where the combined reporting group also contains members that are not NERIs. The same principle is present, in that the unitary contributions that each of the NERIs provides to the other NERIs supports aggregating the EI from each of the NERIs and appropriately assigning it with reference to the taxpayer member NERI"s California apportionment factor percentage.

This treatment can be illustrated by the following example:

> Assume that a combined reporting group consists of five members, two of which are non-NERIs and three of which are NERIs. The facts pertaining to each entity are set forth below.
>
> 1. NERI One has a loss of $100, EI of $20, and a California apportionment factor percentage of 10 percent.
>
> 2. NERI Two has a loss of $200, EI of $50, and a California apportionment factor percentage of zero.
>
> 3. NERI Three has a loss of $100, EI of $10, and a California apportionment factor percentage of 25 percent.
>
> 4. Corporation A has income of $50 and a California apportionment factor percentage of 40 percent.

5. Corporation B has loss of $130 and a California apportionment factor percentage of zero.

Based on these assumptions, the amount of California-sourced income or loss is calculated as follows:

	NERI One	NERI Two	NERI Three	Corp. A.	Corp. B.	Total
Income/(Loss)	($100)	($200)	($100)	$50	($130)	($480)
EI	$20	$50	$10	N/A	N/A	$80
Apportionment Factor Percentage	10%	0%	25%	40%	0%	---
California-Sourced Income/(Loss)- before application of EI Provision	($48)	$0	($120)	($192)	$0	($360)
California-Sourced EI (minimum California taxable income)	$8	$0	$20	$0	$0	$28
California-Sourced Loss Eligible for Carryover (California-Sourced Loss minus California-Sourced EI)	($56)	$0	($140)	($192)	$0	($388)

Craig Swieso
Assistant Chief Counsel