CA CCR 2017-03: Divestment of Subsidiaries Deemed Substantial and Occasional

Overview

The California Franchise Tax Board ("FTB") recently released Chief Counsel Ruling 2017-03 ("Ruling 2017-03"), which concluded that a non-U.S. multinational company's divestment of indirectly owned U.S. subsidiaries was substantial and occasional pursuant to California Code of Regulations ("CCR") section 25137(c)(1)(A) where the non-U.S. multinational company's U.S. subsidiaries' normal course of business did not involve selling subsidiaries and the divestitures occurred infrequently.[1] As a result, the gross receipts from the divestments were excluded from the California sales factor.

This Tax Alert summarizes Ruling 2017-03 and provides some taxpayer considerations.

Factual background

A non-U.S. multinational company owned and operated a renewable energy business.[2] At the time, the multinational company operated in the U.S. through two holding companies.[3] Due to common ownership and unitary ties through a non-U.S. parent company, the U.S. holding companies (hereinafter "Taxpayer") filed on a combined, water's-edge reporting basis for California corporation franchise tax purposes.[4]

Subsequently, the non-U.S. multinational company engaged in efforts to sell its U.S. renewable energy businesses in order to monetize their value, pay down debt, and focus future investments in other aspects of its business, consistent with its strategic initiative.[5] The non-U.S. multinational company hired investment bankers and arranged a competitive bidding process.[6] The Taxpayer ultimately divested these businesses through three separate transactions, which generated almost all of Taxpayer's gross receipts in the subject tax year. After those sales, the non-U.S. multinational company ceased to operate in the U.S.[7]

Summary of the FTB's analysis in Ruling 2017-03

For California apportionment purposes, the sales factor is a fraction, the numerator of which is the taxpayer's total sales in this state during the taxable year and the denominator of which is the taxpayer's total sales everywhere during the taxable year.[8] For taxable years on or after January 1, 2011, "sales" means all gross receipts of the taxpayer not allocated under California Revenue and Taxation Code ("CRTC") Sections 25123 to 25127.[9] Gross receipts means the gross amounts realized on the sale or exchange of property, the performance of services, or the use of property or capital in a transaction that produces business income.[10]

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[1] Chief Counsel Ruling 2017-03 at 6, available here.
[2] *Id.* at 1, 3.
[3] *Id.* at 2.
[4] *Id.* at 1.
[5] *Id.* at 3.
[6] *Id.*
[7] *Id.*
[8] *Id.* at 4; Cal. Rev. & Tax. Code § 25134.
[9] Chief Counsel Ruling 2017-03 at 4; Cal. Rev. & Tax Code § 25120(f)(1). CRTC Section 25123 through 25127 contains California's rules used to allocate non-business income.
[10] Chief Counsel Ruling 2017-03 at 4; Cal. Rev. & Tax Code § 25120(f)(2).

However, CCR Section 25137(c)(1)(A) provides a special rule that excludes certain receipts from the sales factor when those receipts are substantial and arise from an occasional sale of assets used in the taxpayer's trade or business.[11] CCR Section 25137(c)(1)(A) provides in relevant part:

> Where substantial amounts of gross receipts arise from an occasional sale of fixed assets or other property held or used in the regular course of the taxpayer's trade or business, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory, patent, or affiliate's stock will be excluded if substantial. For purposes of this subsection, sales of assets to the same purchaser in a single year will be aggregated to determine if the combined gross receipts are substantial.
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> 1. For purposes of this subsection, a sale is substantial if its exclusion results in a five percent or greater decrease in the sales factor denominator of the taxpayer or, if the taxpayer is part of a combined reporting group, a five percent or greater decrease in the sales factor denominator of the group as a whole.
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> 2. For purposes of this subsection, a sale is occasional if the transaction is outside of the taxpayer's normal course of business and occurs infrequently.[12]

Therefore, the sale must be (1) "substantial" and (2) "occasional."[13] Where both of these elements are met, the gross receipts derived from the transaction are excluded from both the sales factor numerator and denominator.[14]

The Taxpayer's U.S. divestments were substantial under CRTC Section 25137(c)(1)(A) 1: As to the first element, the FTB reasoned that excluding the gross receipts from the denominator of the sales factor for each of the U.S. divestments (evaluated separately) reduced the Taxpayer's sales factor denominator by more than the five percent threshold set forth in the regulation and thus, these sales were considered "substantial."[15]

The Taxpayer's U.S. divestments were occasional under CRTC Section 25137(c)(1)(A) 2: As to the second element, to be "occasional," the FTB stated that a sale must be outside of the Taxpayer's normal course of business and occur infrequently. In analyzing whether the sale was outside of the Taxpayer's normal course of business, the FTB stated that the analysis is similar to the test to determine whether income constitutes "business income" under the "transactional test" and that, in *Hoechst Celanese*,[16] the California Supreme Court held that the "controlling factor" for determining whether a transaction occurred outside the regular course of a taxpayer's business activity under the transactional test is the "nature of the particular transaction" generating the income.[17] The FTB reasoned that, Taxpayer's day-to-day business did not involve building and developing the subject facilities for sale at a profit, and it did not regularly or normally sell such facilities.[18] Although the Taxpayer had a plan in place to strategically sell this business, its ongoing and normal business model did not contemplate regular, recurring, and ongoing divestitures of its business.[19] This was not Taxpayer's normal course of business, and it received regular and recurring revenues from other sources.[20] Therefore, the FTB concluded that, because the disposition of the Taxpayer's entire U.S. businesses was an extraordinary corporate occurrence, the U.S. divestment was outside of the Taxpayer's normal course of business.[21]

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[11] Chief Counsel Ruling 2017-03 at 4; California Code of Regs., tit. 18, § 25137(c)(1)(A).
[12] Chief Counseling Ruling 2017-03 at 4; California Code of Regs., tit. 18, § 25137(c)(1)(A).
[13] Chief Counsel Ruling 2017-03 at 5.
[14] *Id.*
[15] *Id.* at 5.
[16] *Hoechst Celanese v. Franchise Tax Bd.,* 25 Cal. 4th 508 (2001).
[17] *Id.*
[18] *Id.* at 6.
[19] *Id.* at 5.
[20] *Id.*
[21] *Id. at* 5-6.

As to whether the U.S. divestments were "infrequent," the FTB reasoned that, although case law considering whether income is "business income" under the "transactional test" is useful, it is not controlling on whether a sale is "occasional" under CCR Section 25137(c)(1)(A).[22] Relying on various California State Board of Equalization cases,[23] the FTB reasoned that because the multinational company made only four prior divestitures over the eight year period, and the Taxpayer only had a single prior divestiture in a prior year, the U.S. divestments were infrequent.[24]

Considerations

Chief Counsel Rulings are taxpayer-specific rulings that may only be relied upon by the taxpayer named in the ruling. However, they serve as guidance on how the FTB may potentially interpret the respective provisions in cases involving substantially similar facts. Ruling 2017-03 appears to support the position that, where the sale of a business is not the core business activity of a taxpayer and those sales occur infrequently, such sales may potentially be excluded from the taxpayer's California sales factor, provided the decrease in the taxpayer's sales factor denominator exceeds the required five percent threshold. Taxpayers engaging in or planning to engage in divestments should consult their tax advisors to determine whether gross receipts may potentially be excluded from their sales factor under CCR Section 25137(c)(1)(A) as it may significantly impact their overall California tax liability.

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[22] *Id.* at 6.
[23] *Appeal of New York Football Giants, Inc.*, 77-SBE-014, Feb. 3, 1977 and 77-SBE-015, June, 28, 1979 (holding that a professional sports team playing one game in California in a taxable year was occasional); *Appeal of the Learner Company, et. al.*, 80-SBE-103, Sept. 30, 1980 (holding that trips made by the taxpayer's officers once or twice a year were infrequent and occasional); *Appeal of Triangle Publications, Inc.*, 84-SBE-096, June 27, 1984 (holding that the sales of two corporate divisions and a building during a four-year period were "occasional" under CCR Section 25137(c)(1)(A)).
[24] Chief Counsel Ruling 2017-03 at 6.

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