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Investment management tax alert
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California FTB says RIC business trusts do not owe minimum franchise tax

OVERVIEW

The California Franchise Tax Board (FTB) recently issued two Chief Counsel Rulings addressing whether regulated investment companies (RICs) organized as business trusts are subject to the minimum franchise tax imposed under California Revenue & Taxation Code (CRTC) Section 23153 (Minimum Franchise Tax).[1] Specifically, the issue turned on whether the definition of "corporation" under CRTC Section 23038(a) included business trusts for purposes of the Minimum Franchise Tax. Chief Counsel Ruling 2016-01 held that a RIC organized as a Massachusetts Business Trust was not a "corporation" under CRTC Section 23038(a) for purposes of the Minimum Franchise Tax and thus was not subject to this tax. Similarly, Chief Counsel Ruling 2016-02 held that a RIC organized as a Delaware Business Trust was not a "corporation" under CRTC Section 23038(a) for purposes of the Minimum Franchise Tax and thus was not subject to this tax.

This Tax Alert summarizes these Chief Counsel Rulings, and provides taxpayer considerations concerning their potential implications.

RULINGS CLARIFY APPLICATION OF MINIMUM FRANCHISE TAX TO RICs FORMED AS BUSINESS TRUSTS

Generally, corporations are subject to one of two taxes in California: corporations "doing business" in California are subject to the Corporation Franchise Tax (Chapter 2 of Part 11 of the CRTC);[2] corporations not doing business in California but deriving income from California sources are subject to the Corporation Income Tax (Chapter 3 of Part 11 of the CRTC).[3] There is an $800 minimum Corporation Franchise Tax, but no minimum Corporation Income Tax. Both Chapter 2 Corporation Franchise Tax and Chapter 3 Corporation Income Tax use the definition of "corporation" found under CRTC Section 23038(a). CRTC Section 23038(a) defines the term "corporation" to include "every corporation except corporations expressly exempt from the tax by this part or the Constitution of this state." Chief Counsel Rulings 2016-01 and 2016-02 clarify that the term "corporation" as used in CRTC Section 23038(a) includes "Massachusetts or [other state] business trusts," but only for purposes of the Corporation Income Tax and not the Corporation Franchise Tax.[4] Based on this reasoning, the FTB concluded that a RIC organized as a Massachusetts or Delaware Business Trust "is not a 'corporation' as that term is used in CRTC Section 23153 and, accordingly, a RIC organized as a business trust is not liable for the minimum tax imposed under that section."[5]

CONSIDERATIONS

Chief Counsel Rulings 2016-01 and 2016-02 may create opportunities for filing refund claims for years not barred by California's statute of limitations for RICs organized as Massachusetts and Delaware Business

[1] Chief Counsel Rulings 2016-01, available here, and 2016-02, available here.
[2] CRTC § 23151.
[3] CRTC § 23501.
[4] The inclusion of such business trusts in the definition of a "corporation" is consistent with the federal treatment of business trusts as corporations.
[5] Chief Counsel Rulings 2016-01, p. 1; 2016-02, p. 1.

Trusts that have paid the $800 Minimum Franchise Tax. However, the associated costs of preparing a refund claim and responding to potential follow-up questions from the FTB may potentially outweigh any refund benefits. Nonetheless, with respect to 2015 tax year returns and future years, RICs formed as Massachusetts Business Trusts and Delaware Business Trusts now arguably have guidance that they are exempt from the Minimum Franchise Tax. Additionally, although not explicitly stated, the FTB's use of general language in Chief Counsel Rulings 2016-01 and 2016-02 may suggest that these principles are not limited to RICs formed as business trusts in only Massachusetts and Delaware, but that RICs formed as business trusts in other states may also be exempt from the Minimum Franchise Tax.[6] Further, the reasoning in Chief Counsel Rulings 2016-01 and 2016-02 may not be limited only to RICs and may suggest that all business trusts are exempt from the Minimum Franchise Tax. Lastly, it should be noted that taxpayers following the guidance in Chief Counsel Rulings 2016-01 and 2016-02 and not reporting the $800 Minimum Franchise Tax may want to consider attaching a statement to their respective tax returns, explaining the statutory basis for their non-reporting and referencing these two Chief Counsel Rulings as additional support to possibly help discourage issuance of FTB notices related to this issue.

CONTACTS

If you have questions regarding Chief Counsel Ruling 2016-01, Chief Counsel Ruling 2016-02, or other California tax matters, please contact any of the following Deloitte Tax LLP professionals.

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[6] The FTB's reasoning in the rulings also suggest that RICs formed as Massachusetts or Delaware Business Trusts are subject to the Corporation Income Tax on any California source income remaining after the dividends paid deduction allowed to RICs, but are not subject to the Corporation Franchise Tax in general.