

AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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► SUBJECT

RECENT CALIFORNIA INCOME TAX DEVELOPMENTS MAY AFFECT TAXPAYERS

► SUMMARY

Over the past several months, many income tax developments have occurred in California, including the adoption of new and amended regulations, the release of several Chief Counsel Rulings and the Los Angeles Superior Court's March 6, 2014, bench ruling in *In ComCon Prod. Servs. I Inc. v. Cal. Franchise Tax Bd.*, No. BC489779 (Cal. Super. Ct.), *bench ruling* ("Comcast"). These developments address some of the more important state income tax matters such as business vs. nonbusiness income, unitary relationships, apportionment, and sourcing of sales and could affect taxpayers across many industries and in various stages of the business life cycle.

► DETAILS

The following are brief summaries of some of California's most recently adopted income tax regulations and issued Chief Counsel Rulings as well the *Comcast* bench ruling.

Recently Adopted Regulations

The Franchise Tax Board Issued an Amended Combined Reporting Regulation which Makes Taxpayer-Favorable Changes to the Deferred Intercompany Stock Account ("DISA") Provisions. On January 8, 2014, the Franchise Tax Board approved amendments California Code of Regulations ("CCR") title 18, section 25106.5-1, and with it some taxpayer-favorable changes. These changes became effective April 1, 2014, but apply to transactions occurring on or after January 1, 2001. Most notably, under the regulation as amended: (1) a parent corporation

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may decrease and even eliminate a DISA via a capital contribution or transfer of the stock to another member that possesses stock of the subsidiary with a positive basis; (2) a merger among members of a combined group, the majority of which are owned by other members of the combined group, is a now non-recognition event for DISA purposes; and (3) the potential to create multiple DISAs in the event of a tiered distribution is eliminated.

The Franchise Tax Board Adopted a New Regulation which Addresses the Calculation and Assignment of Income for Purposes of the Limited Liability Company ("LLC") Fee. On May 14, 2014, the Franchise Tax Board adopted a new regulation, CCR title 18, section 17942, which addresses the calculation and assignment of income for purposes of the LLC fee. Most notably, the newly adopted regulation requires: (1) an adjustment to income from other pass-through entities not subject to the LLC fee to include costs of goods sold; (2) assignment of income derived from the passive holding of intangible personal property to the location from which the intangible personal property is managed by the LLC; and (3) assignment of income from other pass-through entities to the state where assigned on the Schedule K-1 (Form 1065) provided to the LLC. In addition, the newly adopted regulation provides an alternative method of calculating the income of a multistate LLC assigned to California which is based on the LLC's sales factor numerator. The new regulation is effective July 1, 2014, and applies to taxable years beginning on or after January 1, 2012.

Recently Issued Chief Counsel Rulings

Chief Counsel Ruling 2013-01 - The Taxpayer Must Include Gross Receipts from Films Released in California Theaters in the Sales Factor Numerator. The Chief Counsel ruled that the taxpayer, an out-of-state motion picture entertainment company that digitally encodes film for showing in theaters, met the definition of "producer." As such, pursuant to CCR title 18, section 25137-8.2(c)(3)(A)(i), the taxpayer was required to include gross receipts derived from films released in theaters located in California in the numerator of its corporation franchise/income tax sales factor.

Chief Counsel Ruling 2013-02 - The Nonresident Taxpayer Must Source Income from a Restricted Stock Unit Plan Using a Reasonable Allocation Method. The Chief Counsel ruled that a nonresident taxpayer who was a California resident on the date he was granted restricted stock units was required to use a reasonable allocation method to allocate the income therefrom because the taxpayer was a California resident for part of the vesting period. The Chief Counsel further ruled that the most reasonable method for allocating the income appeared to be multiplying the income by a ratio of California working days from the grant date to the vesting date over the total working days during the same period.

Chief Counsel Ruling 2013-03 - Sales Shipped to a Temporary Storage Facility in California but With an Ultimate Destination Outside the State Do Not Constitute California Sales. The Chief Counsel ruled that the taxpayer should not treat products sold and shipped to a third-party distributor for temporary storage in California and distribution outside the state as California sales. The Chief Counsel reasoned that the activities of the distributor were no more substantive than temporary storage in California and the non-California ultimate destination and billing address were designated by the taxpayer at the time of the initial order.

Chief Counsel Ruling 2013-04 - A Nonresident Partner's Income from an LLC that Conducted All of its Business in California Is 100% Allocable to the State. The Chief Counsel ruled that a nonresident partner in an LLC that conducts all of its business in California, and for which the nonresident partner performs services in California only, must allocate 100 percent of his income from the LLC to California. The Chief Counsel reasoned that the LLC did not meet the definition of a "qualified investment partnership" under CCR title 18, section 17955(c), and therefore, the nonresident was required to allocate income according to the rules under CCR title 18, section 17951-4(a), which source income from a nonresident's business to California when the business is wholly conducted in the state.

Comcast Decision

In *Comcast*, Los Angeles Superior Court Judge Abraham Khan ruled from the bench and held that Comcast's receipt of a \$1.5 billion contract termination fee arising from MediaOne's cancellation of a merger agreement was apportionable business income for corporate income tax purposes and that Comcast was not unitary with its 57-percent owned subsidiary, QVC. With respect to the contract termination fee issue, the court agreed with the Franchise Tax Board and found that the transactional and functional tests were satisfied. With respect to the unitary issue, the court found that the evidence

presented at trial demonstrated that Comcast and QVC did not meet any of the unitary relationship tests - the *Mobil*¹ three factor test, the three unities test, or the contribution and dependency test.

► BDO INSIGHTS

- Now that a DISA may be eliminated via a capital contribution or a merger, a taxpayer may plan in order to avoid or defer DISA recognition. For example, instead of liquidating a subsidiary that has a DISA, an upstream merger may be used instead. Or, to avoid the annual reporting requirement or DISA recognition upon the sale of subsidiary stock, a capital contribution may be made to reduce the DISA or to eliminate potential DISA recognition.
- The amended DISA provisions may even eliminate a present reporting requirement or, under the right circumstances, create a refund opportunity for open taxable years. This may occur because the amendments will be effective April 1, 2014, but they apply to transactions that occurred on or after January 1, 2001. This suggests that a taxpayer may look to pre-April 1, 2014, capital contributions, stock transfers, mergers, and tiered distributions to assess whether, under the provisions in the amended regulation, a DISA existed in the first place or income recognition triggered.
- Chief Counsel Ruling 2013-03 illustrates that sourcing sales of tangible personal property is not always as straightforward as is commonly thought and emphasizes the importance of understanding a taxpayer's business operations and arrangements for purposes of arriving at the proper assignment of sales - especially in light of the present trend toward a single or more heavily-weighted sales factor. For example, had the distributor not designated the ultimate destination at the time of order or if the distributor had the warehouse operator modify the goods slightly before shipment outside California, the outcome in Chief Counsel Ruling 2013-03 could very well have been to source the sales of tangible personal property with a non-California ultimate destination to California. Inbound companies that deliver to logistics centers outside of California should also assess the location of the ultimate shipping destination.
- Comcast is an unusual case in that the court held in favor of the taxpayer on the unitary issue. It was not surprising, however, that the court held in favor of the state on the business income-contract termination fee issue because, for example, the Franchise Tax Board was able to establish that Comcast's acquisition activity was an integral part of its regular business due to the fact that Comcast made seven acquisitions in the same year as the failed MediaOne merger and Comcast used the proceeds to pay down its business obligations.

¹ See *Mobil Oil Corp. v. Comm'r*, 445 U.S. 425 (1980).

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