

Legal Ruling 95-7, California Franchise Tax Board., November 29, 1995

A passive holding company that owns the majority of stock of one or more operating company subsidiaries engaged in a single unitary business is unitary with and includible in a combined report with the subsidiary or subsidiaries. In such a case, the holding company primarily functions as a conduit between shareholders and the single unitary business that the shareholders indirectly own. In addition, the holding company represents the unitary group in relationships with government agencies and lenders and in the preparation of audited financial statements. It dedicates all or virtually all of its activity, however small, to the unitary operating company subsidiary or subsidiaries. Separating the holding company from the unitary group for combined reporting purposes would emphasize form over substance.

However, an operating company that is engaged in a separate and distinct business from the unitary group and that owns a majority of the holding company's stock as a nonbusiness asset is not includible in a combined report with the holding company and the holding company's unitary subsidiary or subsidiaries. If the holding company serves no essential purpose other than to act as a holder of stock of subsidiaries that are not unitary with the holding company's parent, the holding company merely furthers the investment objective of its parent, and does not create a unitary business relationship between the parent and the holding company's subsidiaries.

See ¶12-500

COMBINATION OF PASSIVE PARENT HOLDING COMPANY WITH UNITARY OPERATING COMPANY SUBSIDIARIES

ISSUE

If a passive parent holding company owns the majority of stock of one or more corporations which constitute a single unitary business, is the holding company unitary with the other corporations?

FACTS

Situation 1. Corporation H is the majority shareholder of Corporation S-1. Corporation S-1 is an operating company engaged in a single unitary business. Corporation H has no compensated employees and conducts no management activities or other business operations of its own.

Situation 2. Corporation S-1 and Corporation S-2 are operating companies engaged in a single unitary business and required to file a combined report. Corporation H is the majority shareholder of Corporations S-1 and S-2. Corporation H has no compensated employees and conducts no management activities or other business operations of its own.

Situation 3. Situation 2 is modified in the following respect: Corporation P, an operating company engaged in a trade or business which is separate and distinct from Corporations

H, S-1 and S-2, owns a majority of the stock of H as a nonbusiness asset. The stock of S-1 and S-2 would be nonbusiness assets if held directly by P.

As used in this ruling, Corporation H is a “passive parent holding company.”

LAW AND ANALYSIS

Revenue and Taxation Code (RTC) §25101 states in pertinent part:

When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120).

Title 18, California Code of Regulations (CCR) §25101 states in pertinent part:

Apportionment and Allocation of Income in General. When a taxpayer has income from sources within the state as well as income from sources outside this state, the division of income and the resulting determination of the portion of the taxpayer's entire net income which has its source in this state shall be determined pursuant to the allocation and apportionment provisions set forth in sections 25120 to 25129, inclusive.

Title 18, CCR §25120(b) states in pertinent part:

Two or More Businesses of a Single Taxpayer. A taxpayer may have more than one “trade or business.” In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business is then apportioned by an apportionment formula which takes into consideration the instate and outstate factors which relate to the trade or business the income of which is being apportioned.

The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole (Emphasis added.)

Edison California Stores v. McColgan (1947) 30 Cal.2d 472, 480--481 states:

[T]he separate accounting method is appropriate to determine the true income of a separate business; but ... when the business is not separate, and is an integral part of a larger and unitary system, the separate accounting system is inadequate and unsatisfactory in ascertaining the true result of the activities and values attributable to that business. If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise if there is no such dependency, the business within the state may be considered to be separate.

In Appeals of PBS Building Systems, Inc. and PKH Building Systems, Inc., 94-SBE-008, Nov. 17, 1994, the State Board of Equalization stated that in a unitary determination involving a holding company, the standard tests, including the contribution and/or dependency test, apply. However, in concluding that the corporations in issue were unitary, the Board recognized that where corporations, as in this case, are neither horizontally nor vertically integrated, the typical characteristics of unity may not exist. The Board stated:

The holding company context requires us to focus on the economic realities of the particular corporate structure in determining whether a holding company and its operating subsidiaries are unitary: (Emphasis added.)

“...[W]here there is no horizontal or vertical integration, some of the most significant unitary factors, such as intercompany product flow, often will not exist. Therefore, factors which might be considered relatively insignificant in a case of horizontal or vertical integration take on added importance because they are the only factors present to consider.”

(Hollywood Film Enterprises, supra, at 665.) [Cal. St. Bd. of Equal., March 31, 1982.]

Thus, where pure or passive holding companies are involved, it is relevant to carefully inquire into the nature of the benefits accruing to both the holding company and the operating subsidiaries as a result of their corporate structure. For example, even in the most extreme circumstance, where a pure holding company lacks even acquisition debt, an operating company it holds may gain significant advantages, such as insulation from liability. Consequently, in the typical case where a group of corporations conduct only one unitary business, it would be expected that the requisite contribution or dependency would exist between the “ultimate parent” holding company and its operating subsidiary or subsidiaries.

In Mobil Oil Corp. v. Commissioner of Taxes (1980) 445 U.S. 425, 440 [63 L.Ed.2d 510, 100 S.Ct. 1223], the U.S. Supreme Court stated:

It remains to be considered whether the form in which the income was received serves to drive a wedge between Mobil's foreign enterprise and its activities in Vermont. In support of the contention that dividend income ought to be excluded from apportionment, Mobil has attempted to characterize its ownership and management of subsidiaries and affiliates as a business distinct from its sale of petroleum products in this country....

Nor do we find particularly persuasive Mobil's attempt to identify a separate business in its holding company function. So long as dividends from subsidiaries and affiliates reflect profits from a functionally integrated enterprise, those dividends are income to the parent earned in a unitary business. One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability. (Emphasis added.)

Superficially, intercorporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of [the] business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those

divisions would meet due process requirements for apportionability. Cf. *General Motors Corp. v. Washington*, 377 U.S. 436, 441, 12 L.Ed.2d 430, 84 S.Ct. 1564 (1964). Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives. (Emphasis added.)

In a related context, in *Appeal of Fibreboard Corporation*, Cal. St. Bd. of Equal., Jan. 6, 1987, the State Board of Equalization held that a parent operating company's gain on the stock of an intermediate holding company which, in turn, held an operating company, was not apportionable business income. Noting the lack of evidence that the appellant parent company's "own operations and those of Pabco (the operating company whose relationship with appellant is the one really at issue here) were integrated," the Board concluded that the appellant had failed to show that the gain was business income under the "functional" test. Thus, the Board looked through the holding company in determining the business/nonbusiness character of income from the sale of holding company stock.

When a passive parent holding company holds one or more operating company subsidiaries engaged in a single unitary business, the holding company's primary function is as a conduit between the shareholders and the single unitary business that the shareholders indirectly own. The unitary business is what gives the holding company value to the shareholders. The holding company represents the unitary business and the shareholders in relationships with each other. In addition, the holding company is the focal point for the unitary group and third parties, representing it in relationships with government (e.g., the Securities and Exchange Commission and other regulatory agencies) and lenders and in the preparation of audited financial statements. It dedicates all or virtually all of its activity, however small, to the unitary operating company or group. In such circumstances, the holding company "is an integral part of a larger and unitary system," the parts of which contribute to and/or depend upon each other. (*Edison California Stores v. McColgan*, supra.) Separating the holding company from the unitary operating company or group for combined reporting purposes places too much emphasis on the form of corporate structure, when the substance is that the holding company and its operating company subsidiaries are engaged in but one unitary business. That underlying economic reality is not altered when an operating company engaged in a separate and distinct business owns a majority of the holding company's stock as a nonbusiness asset.

With respect to Situation 3 as noted above, the State Board of Equalization has held that gain on the sale of the stock of a holding company, which in turn held another corporation, was determined to be business or nonbusiness income by reference to the relationship between the seller and the ultimate corporation held. (*Appeal of Fibreboard Corporation*, supra.) In other words, if the seller and ultimate corporation held would not have satisfied the functional or transactional business income tests if the ultimate corporation were held directly, the gain or loss on the sale was properly characterized as nonbusiness income. The unitary analysis is similar. If the holding company serves essentially no purpose other than to act as a holder of a nonunitary subsidiary, the holding company only furthers the investment objective of its parent, and does not create a unitary business relationship. For purposes of unitary analysis, as the Fibreboard, the investment attribute which would apply with respect to the parent corporation and the ultimate subsidiary also attaches to the holding company which holds that subsidiary.

HOLDING

A passive parent holding company which is the majority shareholder of one or more operating company subsidiaries engaged in a single unitary business, which dedicates all or virtually all of its activity, however small, to the unitary operating company subsidiary or subsidiaries, is unitary and includable in a combined report with the subsidiary or subsidiaries.

In Situation 1 above, Corporation H is unitary with and includable in a combined report with Corporation S-1. In Situation 2 and 3 above, Corporation H is unitary with and includable in a combined report with Corporations S-1 and S-2.

In Situation 3, Corporation P, a separate and distinct business, is not includable in a combined report with Corporations H, S-1 and S-2.

No inference should be drawn from this ruling as to the unitary status of a passive parent holding company which holds an operating company subsidiary or group of operating company subsidiaries engaged in two or more nonunitary businesses.

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