

Legal Ruling 95-8, California Franchise Tax Board., November 29, 1995

When a parent company owns the majority of stock of an intermediate passive holding company that in turn owns a majority of stock of one or more operating company subsidiaries that are unitary with the holding company's parent, the holding company is unitary with and includible in a combined report with the parent and subsidiary or subsidiaries. In such a case, the holding company functions primarily as a conduit for effectuating contributions and/or dependencies between the parent and the subsidiary or subsidiaries. It dedicates all or virtually all of its activity, however small, to the parent and subsidiary or subsidiaries. Separating the holding company from the unitary group for combined reporting purposes would place too much emphasis on the form of corporate structure, when the underlying economic reality is that the holding company is an integral part of the unitary business. See ¶12-500

COMBINATION OF INTERMEDIATE PASSIVE HOLDING COMPANY WITH UNITARY OPERATING COMPANY PARENT AND SUBSIDIARIES

ISSUE

If a parent corporation owns the majority of stock of an intermediate passive holding company which in turn owns the majority of stock of one or more other corporations which are unitary with the parent, is the intermediate holding company unitary with the parent and the other corporations?

FACTS

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

Situation 2. Corporation P and Corporations S-1 and S-2 are unitary operating companies required to file a combined report. Corporation P is the majority shareholder of Corporation H. 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.

As used in this ruling, Corporation H is a "intermediate passive 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:

[T]he 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.

In addition, it is well established that there does not need to be a direct unitary relationship between each corporation included in a combined report. It is sufficient if the relationship is indirect. State Board of Equalization decisions, beginning with Appeals of Monsanto Co., Cal. St. Bd. of Equal., Nov. 6, 1970, have consistently so held; e.g., Appeal of Texaco, Inc., Cal. St. Bd. of Equal., Jan. 11, 1978. As stated in Appeal of Aimor Corp., Cal. St. Bd. of Equal., Oct. 26, 1983:

Appellant argues that because there is no direct contribution or dependency between appellant's operations within California and AEC's business in Japan, the two companies cannot be engaged in a unitary business. We cannot agree since it is not necessary for each part of a unitary business to be directly related to each other part. (Grolier Society, Inc., Cal. St. Bd. of Equal., Aug. 19, 1975; Appeals of Monsanto Co., Cal. St. Bd. of Equal., Nov. 6, 1970.) The taxpayer in Appeals of Monsanto Co., supra, argued that its subsidiary, Chemstrand Corporation, was not a part of the parent's unitary business because it did not contribute to or depend on the California operation and because it had no direct dealings with the California operation. In rejecting this argument, we stated:

The argument misconceives the unitary business concept. All that need be shown is that during the critical period Chemstrand formed an inseparable part of appellant's unitary business wherever conducted. By attempting to establish a dichotomy between appellant's California operations and Chemstrand, appellant would have us ignore other parts of appellant's business which cannot justifiably be separated from either Chemstrand or the California operations.

AEC contributes to and depends upon AEW and therefore is unitary with AEW. Because appellant is also unitary with AEW, AEC and appellant are both parts of the parent's unitary business.

Further, in *Barclays Bank v. Franchise Tax Board*, (1994) 512 U.S. --, fn.10, [129 L.Ed.2d 244, 258, 114 S.Ct. 2268], the U.S. Supreme Court rejected the suggestion that, absent meaningful contact between California and the activities of Barclays group members operating exclusively outside the United States, California could not reference the income of those members for purposes of formulary apportionment. The court stated:

...the theory underlying unitary taxation is that “certain intangible `flows of value' within the unitary group serve to link the various members together as if they were essentially a single entity.” (Citation omitted.)

When an intermediate passive holding company owns one or more operating company subsidiaries which are unitary with the holding company's parent, the holding company's primary function is as a conduit which effectuates contributions and/or dependencies between the parent and operating company subsidiary or subsidiaries. The holding company performs a unitary function for the group by holding the stock of the lower tier operating company subsidiary or subsidiaries which would be a unitary business asset of the parent corporation if it were held by the parent directly. It dedicates all or

virtually all of its activity, however small, to the parent and subsidiary or subsidiaries. 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.) To separate the holding company 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 parent and subsidiaries are engaged in but one unitary business. The underlying economic reality is that there is but one unitary business.

HOLDING

An intermediate passive holding company which dedicates all or virtually all of its activity to its operating company parent and subsidiary or subsidiaries, which are unitary with each other, is unitary with the parent and subsidiary or subsidiaries and includable in a combined report with them.

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

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

DRAFTING INFORMATION

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