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California FTB issues new notice of listed transaction: "Circular Cash Flow"

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The California Franchise Tax Board (FTB) on April 22 issued [Notice 2011-03](#), describing a new listed transaction for California income and franchise tax purposes: transactions involving parent corporations that artificially increase their basis in the stock of subsidiaries without any outlay of cash or property, prior to selling the stock of the subsidiary to an unrelated third party. California listed transactions and substantially similar transactions are subject to disclosure and reporting requirements and penalties under the state's [abusive tax shelter](#) regime.

"Circular Cash Flow" Transactions

Under the Notice, the new listed transaction involves a parent corporation that is seeking to minimize gain on the sale of its subsidiary by increasing its stock basis in the subsidiary prior to the sale. The parent contributes a promissory note or other instrument to the subsidiary in a transaction intended to qualify as a contribution to capital under Internal Revenue Code section 351. The subsidiary then takes steps to generate what arguably are earnings and profits, allowing distributions to the parent to be treated as dividends that are either deductible or excludable from the parent's income. Further, because the distribution is treated as a dividend, the parent claims that it does not have to reduce its basis in the subsidiary pursuant to California's conformity to Internal Revenue Code section 301(c)(2). Ultimately, the parent does not receive additional consideration from the sale of the subsidiary to a third party, even though it has purportedly increased the subsidiary's value as a result of the



contribution to capital of the subsidiary. The Notice states that these transactions are designed to exploit and abuse California's lack of conformity with federal consolidated return regulations under IRC section 1502 related to earnings, profits, and stock basis. California has no provisions similar to the investment adjustments allowed for federal purposes under Treasury Regulation sections 1.1502-32 and -33.

The Notice provides a description of how this transaction might be implemented to create a circular flow of cash as a means to artificially inflate basis and reduce gain. It is our understanding that the FTB is substantially modifying its description of the transaction to more accurately describe how the California benefit is created.

However, it is important to note that the Notice, as currently written, provides that the manner in which the subsidiary generates "its alleged earning and profits" is not determinative of whether the Notice applies to a particular transaction.

Reporting Requirements

Taxpayers that first entered into the new listed transaction or a substantially similar transaction on or after August 3, 2007, or filed a return reflecting the tax treatment of such a transaction during this period, must disclose their participation for all such years **by July 21, 2011**, by filing Form 8886, Reportable Transaction Disclosure Statement with the FTB. Taxpayers that entered into the new listed transaction or a substantially similar transaction on or after September 2, 2003, and before August 3, 2007, or filed a return reflecting the tax treatment of such transaction during this period, must disclose their participation for all such years by filing Form 8886 **by the earlier of** the first California return filed after April 22, 2011, or July 21, 2011. If the initial disclosure is made with a return, the taxpayer must also send a copy of the Form 8886 to the FTB's "Tax Shelter Fling" address by the same date. Going forward, each filed return reflecting the new listed transaction or a substantially similar transaction must include the Form 8886 disclosure for the return year.

The statute of limitations (SOL) for the FTB to assess taxes for a listed transaction was increased from eight years to 12 years by recently-enacted S.B. 86, effective for notices mailed on or after August 2, 2011, for taxable years that have not been closed by a statute of limitations as of that date. Once the FTB obtains material advisor lists or the Form 8886s, it will likely contact affected taxpayers to determine if the transactions were in use prior to September 2, 2003, for those years still open under the applicable SOL or due to a federal or California waiver.

What Should You Do?

Taxpayers should evaluate their previously-filed returns for the use of the "circular cash flow" arrangement described in the Notice. This includes an examination of returns filed by acquired corporations that were subsequently included in the taxpayer's California combined report. While the Notice outlines specific transactions and fact patterns, the Notice makes clear that the FTB will examine transactions that are substantially similar to those described, and particularly how the earnings and profits of the subsidiary are generated "in any permutation of these arrangements."

Once a transaction is determined to be a listed or substantially similar transaction covered by the Notice, taxpayers should determine their exposure for disallowance of

the transaction and imposition of penalties, including the ASC 740-10 impact, additional tax shelter interest penalties, the noneconomic substance transaction penalty, and the large corporate understatement penalty. Partial penalty relief may be available under "Voluntary Compliance Initiative Two," which runs from August 1, 2011 through October 31, 2011. [Click here](#) for more.

Taxpayers should keep in mind that regardless of whether the transaction ultimately withstands FTB scrutiny, the failure to disclose a listed or substantially similar transaction may result in the imposition of a strict liability disclosure penalty.

For more information, please do not hesitate to contact:

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