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CA FTB notice applies IRC § 367 regulations to transactions with insurers

California law generally provides for recognition of gain on certain transfers of appreciated property from a combined reporting taxpayer member to an insurance company (excluded from the combined report) and an E&P inclusion rule for certain liquidations of an insurer into a combined reporting taxpayer member.[1] New California Franchise Tax Board (FTB) Notice 2019-1,[2] dated February 25, 2019, states FTB's intention to apply "the principles of the regulations promulgated under IRC section 367, which is generally applied in the context of foreign corporations … to [Cal. Rev. & Tax. Code] section 24465 in the context of the transfer of appreciated property to an insurance company…." These regulations will be applied "[i]n the absence of regulations promulgated by the FTB" and "to the extent those … regulations address similar substantive transactions to those described under [Cal. Rev. & Tax. Code] section 24465."

The notice describes the underlying purpose of section 24465 as "to protect California's corporate franchise and income tax base by preventing the tax-free export of appreciated property from the corporate franchise and income tax base to an insurance company subject to the gross premiums tax in a tax-free transaction where the insurance company's subsequent sale of the appreciated property escapes taxation" under the Corporation Franchise Tax laws.

FTB Notice 2019-1 describes the statutory regime concerning gain recognition requirement for transfers of appreciated property from a taxpayer to an insurer, gain deferral provisions for transfers of appreciated property to an insurer for active use in the insurance business, and an "end of deferred gain treatment for transferring appreciated property to an entity that does not pay the otherwise applicable income tax." In describing how section 24465 "overrides IRC section 332" treating a liquidating distribution of an insurer as a dividend under section 24410, the notice states "[t]reating the liquidating distribution as a dividend prevents overcapitalized ("stuffed") insurance companies from moving assets back in the [income/franchise] tax base without a toll charge."

The notice states FTB's intention "to eventually open a new regulation project to address any outstanding issues concerning use of the IRC section 367 regulations in administering" the California law.

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[1] Cal. Rev. & Tax. Code § 24465. A full discussion of this section and its related provisions (Cal. Rev. & Tax. Code §§ 24425 (expense disallowance provisions), 24455 (deemed dividends for investment income), and 24410 (rules for determining dividends received deduction for distributions of insurance company E&P)) is outside the scope of this Alert.
[2] Cal. FTB Notice 2019-1 (Feb. 25, 2019), located here.