

AMENDED

FINAL STATEMENT OF REASONS PROPOSED AMENDMENTS TO SECTION 25106.5-1, RELATING TO INTERCOMPANY TRANSACTIONS IN A COMBINED REPORTING GROUP

The proposed amendments to the existing regulations do not impose any mandate on local agencies or school districts.

UPDATE OF INITIAL STATEMENT OF REASONS

In accordance with the requirement of Government Code section 11346.2, subdivision (b)(5), that the Franchise Tax Board consider alternatives to the proposed regulatory action, staff of the Franchise Tax Board conducted three interested parties meetings prior to commencing the formal regulatory process. A first interested parties meeting was held on April 22, 2010, to solicit input from the public. Staff did not provide language at that time, but rather provided discussion topics that sought to elicit input on the content of a potential regulation. The discussion centered on the separate entity treatment and deferred intercompany stock account (DISA) provisions of the existing regulations and how they needed to be clarified to assist the taxpayer and tax practitioner communities. Numerous participants contributed suggestions. Additionally, written comments were received after the April 22, 2010 interested parties meeting.

A second interested parties meeting was held on September 22, 2010. Staff provided proposed language pertaining to the separate entity treatment and DISA provisions. Comments about the separate entity treatment proposed provisions centered on the proposition that current recognition of income compels the use of the factors pertaining to the income, including the receipts factor. However, it was pointed out that allowing the intercompany receipts to be included in the receipts factor will lead to double counting when the subject of the intercompany transaction is sold to an independent party. Moreover, allowing intercompany receipts to be included the receipts factor would be contrary to the California Court of Appeal's holding in *Chase Brass & Copper, Inc. v. Franchise Tax Board* (1977) 70 Cal. App. 3d 457.

The comments about the DISA provisions centered on the brother/sister merger issue and the creation of earnings and profits as a result of an excess distribution to eliminate the possibility of multiple DISA resulting from the distribution of the same property or the same amount of money. An item was raised that was not addressed in the proposed DISA provisions regarding whether subsequent capital contributions should be allowed to reduce an existing DISA balance.

As a result of the discussion pertaining to the issue of subsequent capital contributions being allowed to reduce an existing DISA balance, a third interested parties meeting was held on August 16, 2011 to discuss proposed language pertaining to the matter. The comments indicated that the participants were in agreement with the proposed revisions pertaining to the matter.

The public notice required by Government Code section 11346.4 was mailed and published in the California Notice Register on April 26, 2013. The notice stated that a public hearing on the proposed regulation would be held on July 25, 2013. There were no comments made at the public hearing, but written comments were received. One commentator proffered four

suggestions, while another commentator suggested one. These five suggestions are outlined below, along with the Franchise Tax Board's response to them.

1. Create earnings and profits as a result of a subsequent distribution in excess of the initial distribution that originally created the DISA. In response to this suggestion, subsection (j)(4) was revised to so that the amount of the distribution was not referenced, thereby eliminating the concern as to whether a subsequent distribution in excess of the initial distribution would apply.
2. To further illustrate that earnings and profits would result as a due to a subsequent distribution in excess of the initial distribution that originally created the DISA, the accompanying example should be revised accordingly. However, it was determined that the revision to subsection (j)(4) was sufficient to indicate that that a subsequent distribution in excess of the initial distribution would apply. Therefore, there was no need to revise the accompanying example.
3. Create a time limit for when DISA balances that were eliminated due to a subsequent capital contribution needed to be reported. However, it was determined that this will be accomplished by means of revising the specific tax form used to report DISA balances. Therefore, there is no need to revise the regulation.
4. The amendments to the DISA provisions be allowed to be retroactively applied. In response to this suggestion, subsection (k) was revised to state that the revisions to the DISA provisions would apply retroactively, but taxpayers could also elect to have them apply prospectively.
5. Earnings and profits be created when appreciated property is distributed amongst members of the combined reporting group. It was determined that this issue did not relate to the proposed revisions to the DISA provision. Accordingly, this suggestion should be considered in a subsequent regulation project.

As the result of these written comments, the Department issued an initial fifteen-day notice on October 2, 2013 incorporating some of the suggestions.

The Initial Statement of Reasons indicated that subsection (j)(3) of the regulation would be revised to reflect renumbering to provisions of California Revenue and Taxation Code section 25110 that are referenced therein. However, the Franchise Tax Board decided not to do this.

The formal comment period for the initial fifteen-day notice expired on October 17, 2013 and no further comments were submitted. However, it was discovered that the initial fifteen-day notice did not identify a specific date when comments needed to be submitted. Therefore, a second fifteen-day notice was issued on October 24, 2013 identifying November 14, 2013 as the date when comments needed to be submitted. Other than including the date by when comments needed to be submitted, the second fifteen-day notice was virtually identical to the initial fifteen-

day notice. The formal comment period for the second fifteen-day notice expired on November 14, 2013 and no further comments were submitted.

ALTERNATIVES DETERMINED

The Franchise Tax Board has determined that no alternative to the proposed amendments to the regulation it considered would be more effective in carrying out the purpose of the proposed amendment to the regulation or would be as effective and less burdensome to affected private persons than the adopted amendments to the regulation, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provisions of the law, in accordance with Government Code section 11346.9, subdivision (a).