Chapter 17 Intercompany Transactions

Contents:

References:

RTC §§251O6, 251O6.5 & 2511O
CCR §2511O(e)
MATM 6032 (INTERCOMPANY DIVIDENDS)
MATM 526O (INTERCOMPANY ELIMINATIONS)
MATM 6070, 7121 & 7173 (INTERCOMPANY PROFIT IN ASSETS)
MATM 7518 (INTERCOMPANY RECEIPTS)
FTB 1O61 GUIDELINES FOR CORPORATIONS FILING A COMBINED REPORT
FTB NOTICE 89-6O1

Training Objectives:

At the conclusion of this section you will be able to do the following:

1. Describe the types of issues relating to intercompany transactions that could arise as a result of a water's edge election.
2. Explain how deferred gains or losses on intercompany transactions involving fixed assets and capitalized items are handled as a result of a water's edge election.
3. Explain how eliminated gains or losses on intercompany transactions involving inventories and intangible assets are handled as a result of a water's-edge election.
4. Explain the special issues that can arise in a water's-edge context with regard to the elimination of intercompany transactions in the computation of the apportionment factor.
5. Describe what sources are utilized in identifying the existence and amount of intercompany gains and losses.

a. Introduction

It is common for affiliates in a unitary business to engage in business transactions with each other. Although the individual members of the unitary group may realize a gain or loss on these transactions, there is no economic effect to the group as a whole. Because the combined report is based on the premise that the same apportionment result should be obtained whether the unitary business is conducted by several corporations or by only a single corporation, the question that arises is whether intercompany transactions should be treated any differently than intracompany transactions between divisions of the same corporate entity.[1]

Example 1:

EE=Related Party Transferee
OR=Related Party Transferor
UR=Unrelated Third Party
I/C Profit = Profit on intercompany transaction
U/R Profit = Profit on transaction with unrelated third party

	Year 1: OR sells inventory to EE	**Year 2: EE sells inventory to UR**	**Telescoped (combined unitary group) sale to UR in Year 2**
Sales Price	$100,000,000	$150,000,000	$150,000,000
Adjusted Basis	90,000,000	100,000,000	90,000,000
I/C Profit	10,000,000		10,000,000
U/R Profit		50,000,000	50,000,000
Total Profit			60,000,000

The questions that arise are:

- When should the Year 1 profit be taxed and which entity or entities should recognize the profit?
- When should the Year 2 profit be taxed and which entity or entities should recognize the profit?

- What effect should the intercompany transaction have on the computation of the apportionment factors?
- What apportionment factors should be used to apportion the profit?

b. Methods For Handling Intercompany Transactions

There are three basic methods for handling intercompany transactions: current recognition, elimination, and deferral.

1. Current Recognition Method

Under this method, income or loss from intercompany transactions is recognized in the year the transactions occur, just as if the transaction had occurred between unrelated parties. For federal consolidated return purposes, taxpayers may elect to use current recognition to account for intercompany transactions between members of the consolidated return group.[2] For federal purposes, income from transactions between a domestic corporation and its foreign affiliates is generally required to be currently recognized, because foreign affiliates are not (with limited exceptions[3]) included in a consolidated federal return.[4]

2. Elimination Method

This is a method similar to that called for by U.S. Generally Accepted Accounting Principles (GAAP), and by the GAAP of many foreign countries. All transactions between members of the consolidated financial statements are eliminated from both the income statement and the balance sheet. When assets are sold intercompany, the buyer takes the related seller's basis in the asset. Any appreciation in value that took place while the asset was held by the seller will therefore be recognized by the buyer as a result of a lower basis for depreciation and for computing gain or loss when the asset is sold to an unrelated party. The theory behind this treatment is that the corporations in a consolidated group form a single economic entity, and that profits can not be realized by that economic entity until the earning process is concluded by a sale to an unrelated party. The transactions are viewed as no more than intercompany transfers of property that create no net effect on the financial position of the business group as a whole.

Example 2:

Corporations S and B are included in the consolidated financial statements of an affiliated group. In 1992, S sells machinery with a basis of $60,000 to B for $90,000, thus recording a gross profit of $30,000 on its books. The machinery has a 10-year remaining useful life. B therefore records $9,000 in depreciation expense ($90,000 basis/10-year life). In order to properly account for these companies as a single economic entity, both the unrealized gain and the inflated depreciation must be eliminated. Therefore, an adjustment must be made to eliminate $30,000 from S's income and B's basis in the machinery. In addition, a $3,000 adjustment must be made to reduce B's depreciation expense ($9,000 - $6,000 ($60,000 carryover basis/10-year remaining life)).

Example 3:

Corporations S and B are included in the consolidated financial statements of an affiliated group. S sold inventory costing $500,000 to B for $750,000, thus recording a gross profit of $250,000 on its books. B resold all but $200,000 of this inventory to unrelated parties by the end of the year. In order to properly account for these companies as a single economic entity, all intercompany sales/purchases must be eliminated. Therefore, an adjustment must be made to eliminate $750,000 from S's sales and B's purchases. An adjustment also is required to eliminate the intercompany profit remaining in B's inventory account as of the end of the year.

From the viewpoint of the group as a whole, the intercompany profit on $550,000 ($750,000 - $200,000) of B's inventory has been realized by the subsequent sale to unrelated parties and no adjustment is required to B's inventory account. However, the intercompany profit recorded with respect to the $200,000 transfer remains as a cost factor in B's inventory account. Since the markup on the intercompany transfer was 33_% ($250,000 gross profit/$750,000 sales price), this $200,000 in inventory is being stated at a value of $66,667 above its original cost to the group ($200,000 x 33_%). The $66,667 unrealized profit must be eliminated from B's ending inventory for the year. In addition, because the unrealized profit still remains as an inventory cost within the separate financial records of B, the profit will carry through to the following year and create an overstatement in beginning inventory of the group. Thus, for consolidation purposes, an adjustment must be made to eliminate the unrealized profit from B's beginning inventory of the subsequent year. In effect, the intercompany profit must be eliminated twice: from the ending inventory in the year of sale with an equal amount being eliminated from the beginning inventory of the following year. To the extent any of these goods remain in B's inventory account as of the end of the following year, similar adjustments would be required to eliminate the intercompany profit from ending inventory of that year and the beginning inventory of the subsequent year, and so on for all succeeding years in which the intercompany profit remains as a factor in B's inventory account.

3. Deferral Method

For federal tax purposes, gains and losses from intercompany transactions are not truly eliminated from the seller's income, but instead are placed in a deferred status (unless an election is made to currently recognize intercompany gains and losses). The federal rules apply to any transaction between corporations that are members of the same consolidated group immediately after the transaction. Intercompany transactions include sales of property, performance of services, rental of property, loans, distributions with respect to stock, and any other type of transaction between members of a consolidated return group.

The federal deferral method generally treats the members of the consolidated group as a single entity for purposes of taking into account gains and losses from intercompany transactions. Specifically, the character, source, timing of income recognition, and other attributes (e.g. treatment of an item as excluded from gross income, treatment of an item as nondeductible, etc.) of intercompany income items are determined as if the members of the group were divisions of a single corporation (single entity treatment). However, the amount and location (i.e. which entity earned the income) of intercompany income items are determined as if separate returns were filed (separate entity treatment). In contrast to the elimination method where the seller's basis in the asset carries over to the related buyer, the buyer gets its own cost basis under the federal deferral method (i.e. its purchase price).

In general, intercompany items are taken into income to produce the same result on consolidated taxable income as if the seller and buyer were divisions of a single corporation. The timing of gain recognition is determined under either a "matching rule" or an "acceleration rule."[5]

NOTE*:* These rules and terminology (e.g. matching rule and acceleration rule) apply to income years beginning on or after July 12, 1995. However, the rules of the current regulations reflect the basic principles underlying the regulations that applied for income years beginning before July 12, 1995. Accordingly, the results of most common intercompany transactions are not changed under the current regulations, even though the analysis is changed.

Under the prior regulations, mechanical rules were set forth describing "restoration" events that would cause recognition of intercompany income or loss. A restoration event generally occurred at the point in time when the consolidated group realized the economic benefit of the seller's gain, such as when depreciation was deducted, when the buyer or the seller left the consolidated group, or when the asset that was the subject of the intercompany transaction was sold to an unrelated third party. The prior regulatory scheme treated the members of a consolidated group as *separate* entities for purposes of determining the amount, location, character, and source of intercompany items of income, but the timing of income recognition was determined more like the timing that would apply under single entity treatment. Thus, the *timing* of gain recognition will generally be the same under both the current and the prior federal regulations, but the character, source, and other attributes of the income items may differ.

You should be aware, however, that for less common types of transactions the matching and acceleration rules may cause recognition of intercompany income in situations where the prior regulations would not have "restored" income recognition.

A. MATCHING RULE

The "matching rule" is one of two principal rules used to determine the timing of intercompany income recognition. The matching rule focuses on the related buyer's intercompany items to determine the timing of income recognition for the seller. For each consolidated return year, the seller is required to recognize its intercompany income to the extent of the difference between the income, deduction, or loss the buyer recognizes on a separate entity basis and the items the buyer would have recognized if the seller and buyer were divisions of a single corporation.[6]

Example 4:

Corporations S and B are included in the consolidated federal return of an affiliated group. In 1996, S sells land with a $40 dollar basis to B for $100. Thus, S has a $60 intercompany gain from its sale to B. S's gain is not included in income at the time of the intercompany transaction, but B still gets a $100 basis in the land. In 1998, B resells the land to a nonmember for $90. At that time, S's intercompany gain is recognized to reflect the $60 difference between the $10 loss ($90 sales price - $100 cost basis) B recognizes on the sale to the nonmember on a separate entity basis and the $50 gain B would have recognized if B had succeeded to S's $40 basis in a transfer between divisions of a single corporation ($90 sales price - $40 cost basis).

Example 5:

Corporations S and B are included in the consolidated federal return of an affiliated group. S drills water wells. B operates a cattle ranch. During 1996, B pays S $100 to drill an artesian well on B's ranch. S incurred $80 of expenses drilling the well (e.g. for employees and equipment). Under its separate entity method of accounting, S would take the income and expenses into account in 1996. B capitalizes the $100 cost for the well. The well has a 10-year life and B deducts $10 in depreciation in years 1997 through 2006.

S's intercompany profit is included in income under the matching rule to reflect the difference between B's items to be taken into account on a separate entity basis (based on its $100 cost basis in the well) and B's items that would have been taken into account if S and B were divisions in a single corporation (based on the $80 basis B would have had if S and B were divisions). Thus, in 1996 S takes into account $80 of the intercompany sales price and the $80 of expenses. In each of the years 1997 through 2006, S takes $2 of the $20 of intercompany profit into account to reflect the annual $2 difference between B's $10 depreciation deduction on a separate entity basis and the $8 in depreciation B would have claimed if S and B were divisions of a single corporation ($80 basis/10-year life).[7]

B. ACCELERATION RULE

The federal provisions also contain an "acceleration" rule that requires intercompany income to be taken into account to the extent the matching rule cannot produce the effect of treating the related seller and buyer as divisions of a single corporation. The effect of treating the related seller and buyer as divisions cannot be produced if the matching rule will not fully account for the intercompany items in consolidated taxable income (e.g. if the buyer or seller becomes a nonmember) or if the intercompany transaction will be reflected by a nonmember (e.g. if the buyer subsequently transfers the property to a nonmember in a transaction where gain is not recognized by the buyer and the nonmember succeeds to the buyer's cost basis, such as a §351 transfer to a corporation or a §721 transfer to a partnership). Under the acceleration rule, the intercompany items are taken into income immediately before it first becomes impossible to produce the single corporation effect.[8]

Example 6:

Corporations S and B are included in the consolidated federal return of an affiliated group. On January 1, 1992, S sells land with a basis of $70 to B for $100, thus realizing a profit of $30. On July 1, 1995, parent corporation P sells 60% of S's stock to an unrelated party and, as a result, S becomes a nonmember of the consolidated group. Under the acceleration rule, S's $30 intercompany gain is included in consolidated income immediately before the effect of treating S and B as divisions of a single corporation cannot be produced. Because the effect cannot be produced once S becomes a nonmember, S includes the $30 in income in 1995 immediately before becoming a nonmember of the group.[9]

c. Overview Of California Treatment Of Intercompany Transactions

As discussed above, specific and detailed systems are in place under both GAAP and the federal consolidated return regulations to deal with intercompany transactions. The treatment for California purposes is not as well defined.

In 1967, §25106 was enacted to provide that to the extent intercompany dividends are paid out of earnings and profits derived from combined business income, they are eliminated from the income of the recipient. Additionally, CCR §25110(e) provides guidance for handling intercompany transactions in the computation of the apportionment factor for water's-edge combined report purposes. Other than these two provisions, neither the statute nor the regulations specifically address how to deal with intercompany transactions in a combined report.

The FTB has, however, provided guidance to taxpayers on the subject of the treatment of intercompany transactions through the FTB Publication 1061, *Guidelines For Corporations Filing a Combined Report*, and through FTB Notice 89-601.

1. FTB Publication 1061

The Publication 1061 states that intercompany transactions between members of a combined report should be treated as follows:

INVENTORIES: Intercompany profits are eliminated from beginning and ending inventories to compute cost of goods sold and the property factor. (Note: this treatment reflects the elimination and basis transfer method discussed above. The following court and SBE decisions have supported a method based on elimination, or have at least reflected FTB's long-standing practice of using elimination and basis transfer.[10]) Gain or loss is therefore recognized in the year the purchaser sells the inventory outside the combined group, and is apportioned using the factors for the year in which the gain is recognized.

FIXED ASSETS AND CAPITALIZED ITEMS: The following rules apply to intercompany sales or exchanges of business fixed assets, such as equipment and land, and to intercompany expenditures where the amount of the expenditure is capitalized. Gain or loss on intercompany transactions involving these items is generally deferred in a manner similar to the federal methodology (although if the taxpayer elects not to defer for federal purposes, the federal election will be allowed for California). The timing of gain or loss recognition is generally the same as for federal purposes under similar circumstances in a consolidated return. For example, if either the buyer or seller leave the combined report group for any reason, the deferred gain or loss will be recognized at the time immediately preceding that event. Gain or loss will also be recognized if the asset that was the subject of the intercompany sale is disposed of or sold outside the combined group.

Deferred gain or loss will generally be apportioned using the factors for the year in which the gain is recognized. However, as long as records are provided to substantiate their computations, taxpayers will also be allowed to use the historical apportionment percentage from the income year in which the intercompany transaction occurred. The department may also require the use of the historical apportionment percentage if that percentage varies materially from the apportionment percentage for the year in which the gain or loss is reported, and if use of the historical percentage results in a material difference in the amount of income apportioned to California.

INTANGIBLES:Gain or loss from intercompany transactions involving intangible assets is eliminated from income and the seller's basis in the asset is carried over to the transferee.

APPORTIONMENT FACTORS:Intercompany transactions are eliminated from the computation of the apportionment factor. Thus, for example, intercompany profit included in the cost of property acquired in an intercompany transaction must be eliminated from the property factor (i.e. the asset must be reflected in the property factor at the related seller's original cost). Intercompany rent charges are also eliminated from the property factor computation. Intercompany receipts are eliminated in computing the sales factor.

2. FTB Notice 89-601

An important issue which arises in the water's-edge context is whether a water's-edge election, which generally results in the exclusion of foreign affiliates from the combined report, is an event which will cause previously deferred gains and losses to be recognized.

FTB Notice 89-6O1 was issued on September 20, 1989, to provide interim guidance on this issue, pending the issuance of the proposed regulations under 25106.5. The interim water's-edge treatment can be summarized as follows:

A. A water's-edge election will cause recognition of any previously deferred gains or losses on transactions between entities included in worldwide combined report. This applies only to transactions where either the transferee, the transferor, or both, are to be excluded from a combined report by reason of the water's-edge election. It does not apply if both the transferor and the transferee are included in the water's-edge combination.
B. Generally, such gains or losses will be apportioned using the apportionment factor of the income year immediately preceding the income year of the water's-edge election, unless either the taxpayer or the FTB determines that the gains or losses should be subject to the apportionment factor applicable for the year in which the deferred intercompany transaction took place. The FTB will not require use of the historical percentage unless (1) the historical apportionment percentage varies by more than 1O% from the apportionment percentage for the income year immediately preceding the election, and (2) use of the historical percentage results in additional income apportioned to California of more than $100,000.
C. The apportioned gains or losses will be included in income on a pro-rata basis over the first five years of the election.

As discussed above, Publication 1061 provides that for California purposes the deferral method only applies to intercompany transactions involving fixed assets and capitalized items. Income from other types of transactions, such as from sales of inventory, are to be eliminated rather than deferred. Because Notice 89-601 applies only to gains or losses which were *deferred* in prior year combined reports, the Notice by its terms applies only to intercompany gain or loss on fixed assets and capitalized it.

d. Effects Of Intercompany Transactions On Net Income For Water's-Edge Electors

Except for transactions involving fixed assets and capitalized items, intercompany gains and losses are generally eliminated from the combined report and the buyer takes the seller's basis in the asset. As long as the members of the combined report group remain intact, the tax effect will generally be the same whether intercompany gains and losses are eliminated or deferred. Under certain circumstances, however, significant differences can result. For example, when the buyer or seller in an intercompany sale leaves the combined report group, deferred gain or loss will be recognized at that time under the deferral method. Thus, the deferral method causes intercompany income to be recognized by the group and included in the apportionable tax base at such time as an event inconsistent with combined reporting occurs.

On the other hand, under the elimination method the buyer has taken the seller's basis in the asset, and will only recognize gain or loss when the asset itself is disposed of. Therefore, if the buyer ceases for any reason to be a member of the combined report group, the intercompany gain will be recognized only by the buyer (and its new unitary group, if any) and only when the buyer disposes of the asset. Because the water's-edge election causes members of the group to leave the combined report, this difference in the tax effects of the deferral and elimination methods can give rise to significant water's-edge audit issues.

NOTE: Depending on how the worldwide combined report was compiled, income from intercompany transactions may have been currently recognized in the worldwide year in which the transaction occurred. For example, if the worldwide combined report was compiled by adding foreign affiliate separate company income (per the federal Form 5471 or separate company financial statements) to federal 1120 income, then intercompany income on sales between domestic and foreign affiliates was recognized in the year the intercompany sale occurred. This is because intercompany income from transactions involving foreign entities is neither deferred nor eliminated for federal purposes since foreign entities are not included in the consolidated federal return. We have generally accepted "current recognition" as long as this method of reporting has been used on a consistent basis. Therefore, if intercompany income was currently recognized for California purposes in the year intercompany transactions occurred there is generally no adjustment necessary for water's-edge purposes as long as current recognition was consistently used in the worldwide years, and was adopted for bona fide business reasons and not for the purposes of tax avoidance.[11]

1. Intercompany Inventory Issues

Fixed assets are not frequently transferred between foreign and domestic affiliates. The vast majority of intercompany transactions between foreign and domestic affiliates involve the sale of inventory. Therefore, the most common water's-edge issue will involve determining the tax effects when inventory purchased from a unitary affiliate in a worldwide combined report year is sold by the buyer to an unrelated third party during a water's-edge year. Since the deferral method does not apply to intercompany transactions involving inventory, FTB Notice 89-601 will not apply to determine the tax effects.

The workpapers to the consolidated financial statements should identify if material intercompany transactions occurred between foreign and domestic affiliates. The Schedule M, federal Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, and the Form 5472, *Information Return of a Foreign Owned Corporation*, will also contain information about intercompany transactions between affiliates, although the information on the forms may not be as reliable as the financial statement workpapers. Before pursuing a possible adjustment, remember to determine how the intercompany transactions were treated for California purposes in worldwide combined report years. If intercompany income was consistently recognized in the year the transaction occurred, there is generally no water's-edge issue.

A. Outbound Sales

A water's-edge election generally results in the exclusion of unitary foreign affiliates from the water's-edge combined report. If the elimination method was used during worldwide combined report years, intercompany profit on "outbound" sales of inventory from domestic affiliates to foreign affiliates would have been eliminated from combined income. The foreign affiliates would have a reduced basis in the inventory purchased (e.g. must use the seller's "transfer" basis for California purposes), and will recognize the intercompany gain as the inventory is sold. Because foreign affiliates are generally excluded from the water's-edge combined report, the intercompany profit embedded in the inventory that remained unsold on the date of the water's-edge election will excluded from water's-edge combined income. However, the transfer basis adjustment to reduce the foreign affiliate's inventory balances and COGS may be relevant for water's-edge purposes with respect to CFC's because the adjustment may affect the Subpart F "partial inclusion" percentage.

Example 7:

Assume that corporations X and Y are members of a unitary group which filed on a worldwide combined report basis for income years beginning before 1/1/94. During 1993, X sold inventory costing $1,500 to Y for $2,500, realizing an intercompany profit of $1,000. Y resold half ($1,250) of this inventory during 1993, leaving $1,250 in its inventory account as of 12/31/93. An adjustment was made to eliminate the intercompany transactions from the 1993 combined report. X made a water's-edge election effective for its income year beginning 1/1/94, and as a result Y is only required to be partially included in the combined report based on the ratio of its Subpart F income to its total E&P. During 1994, Y reported net income before taxes of $3,000, of which $500 qualified as Subpart F foreign base company sales income. Y's reported E&P for 1994 was $2,500. X therefore included 20% of Y's net income and apportionment factors in the water's-edge combined report ($500 Subpart F income/$2,500 E&P).

During the course of an audit of the 12/94 income year, the auditor determines that Y used the FIFO method for determining inventory balances (see the discussion of inventory accounting methods in part d.1.c below). Thus, the remaining $1,250 in inventory Y purchased from X was sold during 1994. The auditor also determines that the amount of Y's net income before taxes, Subpart F income, and E&P all tie to federal Form 5471. Because profit on intercompany transactions between X and Y is currently recognized for federal purposes, the auditor realizes that these amounts were determined using Y's actual purchase price of $1,250 for the inventory purchased from X in 1993 and remaining in Y's inventory account on 1/1/94. However, for California purposes Y should have used X's transfer basis, and its inventory is therefore overstated by $500 (e.g. the

$500 intercompany gain embedded in the $1,250 remaining in Y's inventory account as of 12/31/93. This amount was determined as follows: the markup on the transfer was 40% ($1,000 profit/$2,500 sales price), therefore the $1,250 in unsold inventory is stated at a value of $500 above cost to X ($1,250 x 40%)).

Upon further questioning regarding Y's business activities, it is determined that all inventory purchased from X was sold outside of Y's country of incorporation and therefore created Subpart F foreign base company sales income. For California purposes, an adjustment is made to increase net income before taxes to $3,500 and Subpart F income to $1,000 to reflect the $500 reduction to Y's inventory costs. As a result, X is required to include 40% of Y's net income and apportionment factors in the water's-edge combined report ($1,000/$2,500).

B. Inbound Sales

If the elimination method was used during worldwide combined report years, intercompany profit on "inbound" sales of inventory from foreign affiliates to domestic affiliates would have been eliminated from combined income and the domestic affiliates will have a reduced basis in the purchased inventory. After a water's-edge election, the intercompany profit will be recognized by the domestic affiliates when the inventory is sold. Since FTB Notice 89-601 does not apply, the gain is apportioned using the water's-edge factors for the year in which the domestic affiliate sells the inventory. There is no five-year spread of the gain as provided for by Notice 89-601. Nor is the taxpayer allowed to use the apportionment factor for the year immediately preceding the year of the water's-edge election.

Example 8:

A and B are wholly owned U.S. subsidiaries of FP, a foreign corporation. Effective for the 12/94 income year, A and B made a water's-edge election and excluded FP from the water's-edge combined report. For years prior to the 12/94 year, A and B filed on a worldwide combined report basis. FP's consolidated financial statements were used as the base to determine worldwide income (e.g. elimination adjustments were embedded in the financial statement income).

A and B purchased over 80% of their product line from FP. During 1993, FP sold inventory costing $50 million to A and B for $90 million. Because FP's consolidated financial statements were used as the base for determining worldwide income, the $40 million gain realized by FP was eliminated from 12/93 worldwide income. A and B resold $30 million of this inventory during 1993, leaving $60 million in their inventory accounts as of 12/31/93.

During the course of an audit of the 12/94 income year it is determined that A and B's net income reported on the California return ties to the federal 1120. The federal 1120 reflects A and B's purchases from FP at the $90 million purchase price because these inventory sales were not intercompany transactions for federal consolidated return purposes. However, for California purposes A and B should have used FP's transfer basis, and their inventory is therefore overstated by $26,664,000 (e.g. the $26,664,000 intercompany gain embedded in the $60 million remaining in A and B's inventory accounts on 1/1/94. This amount was determined as follows: the markup on the transfer was 44.44% ($40 million/$90 million), therefore the $60 million in unsold inventory is stated at a value of $26,664,000 above cost to FP ($60 million x 44.44%)).

A and B use the FIFO method to determine costs of inventory sold. Under the FIFO method, the remaining $60 million in inventory purchased from FP was considered sold by A and B during 1994. An audit adjustment is made to increase 1994 income by $26,664,000 to reflect the reduction to A and B's cost of sales for California purposes (the $26,664,000 intercompany profit in inventory should also be eliminated from the property factor. See discussion in Chapter 17(d), Water's-Edge Manual and MATM 7173). The intercompany gain is apportioned using the 1994 water's-edge apportionment factor.

Example 9:

Assume the same facts as in Example 8. However, assume that A and B use the dollar-value LIFO method of determining inventory balances instead of the FIFO method. A review of the taxpayer's inventory valuation workpapers indicates that A and B did not tap into the 1993 LIFO layer during 1994. The $60 million in purchases from FP that were reflected in A and B's 12/94 beginning inventory balances remains in their inventory as of 12/31/94 (see discussion of inventory accounting methods at SectionC.1.C. below). Although there is no income adjustment, the intercompany profit should be eliminated from the property factor computation, assuming the resulting tax effect is not immaterial.

C. Inventory Accounting Methods

As discussed above, under the elimination method intercompany profit in inventory is recognized by the related party buyer in the year it resells the inventory to unrelated third parties. In determining when inventory is resold, the buyer's inventory accounting method(s) needs to be taken into account. Because it is often impractical for taxpayers to keep track of which specific inventory items are sold and which remain on hand at year end, valuing ending inventory involves making assumptions about which purchase costs should be used to price the items on hand. The cost flow assumption used by the taxpayer is not required to be consistent with the actual physical flow of goods. In fact, the cost flow assumption can be quite different from the physical movement of goods. There are four basic inventory cost flow methods. Those methods are:

1. **Specific identification**. This method involves identifying each item sold and each item in ending inventory, and costing the items at the actual purchase price. Specific identification has limited application and is generally practical only where individual inventory items are significant and relatively expensive, such as jewelry, automobiles, and custom manufactured items.
2. **Average cost**. This method prices items in inventory on the basis of the average cost of all similar goods available during the period. It may be computed in several different ways, but typically involves using a weighted average of beginning inventory and purchases during the year. Another approach, the moving-average method, computes a new average unit cost each time a purchase is made.
3. **FIFO**. This method assumes that the first goods purchased or produced are the first goods sold. Under this method, the earliest costs are assigned to cost of goods sold and the most recent costs are retained in inventory. Ending inventory therefore represents the most recent purchase or production costs.
4. **LIFO**. This method assumes that the last goods purchased or produced are the first goods sold. Under this method, the most recent costs are assigned to cost of goods sold and the earliest costs are retained in inventory. Ending inventory therefore represents the earliest costs. (Note that LIFO inventories are required to be stated at cost for tax purposes. The lower of cost or market rule cannot be used with LIFO for tax purposes, although it can be used with LIFO for financial purposes.[12] See Section D below for a discussion of the lower of cost or market rules.)There are two basic

approaches to accounting for LIFO inventories: "unit method" and "dollar-value method." The major distinction between the two approaches is that the unit method measures inventory costs in terms of the physical quantity and price of specific goods, while dollar-value measures inventory costs by using a "base-year" cost (e.g. cost of inventory as of the beginning of the year of the LIFO election) expressed in terms of total dollar value rather than the quantity and price of specific goods. Most companies that use LIFO use the dollar-value method.[13] Under the dollar-value method, similar items of inventory are grouped into inventory pools. (Note that a "pooled" approach can be used under both unit and dollar-value LIFO. However, a much broader range of product lines may be included in a dollar-value LIFO pool. Most companies, particularly nonretailers, have only a few dollar-value pools.) Increases or decreases of items in the pool are reflected only in terms of a net increase or decrease for the pool as a whole. Thus, fluctuations may occur in quantities of various items in the pool, new items may be added to the pool, and old items may disappear from the pool, all without necessarily effecting a change in the dollar value of the pool as a whole. To determine if there has been an increase or a decrease to the dollar-value LIFO pool, the taxpayer compares the ending inventory for the pool expressed in terms of base-year cost to the beginning inventory for that pool expressed in terms of base-year cost.Because the same base-year cost is used year after year, any difference between ending inventory values and beginning inventory values are not regarded as being attributable to changes in prices; rather, they are regarded as resulting from changes in quantities only. Any increase in quantity so determined is then extended at current-year cost to arrive at the LIFO value of the increase for that year. These increases are referred to as inventory "layers". Thus, a dollar-value LIFO pool consists of inventory as of the beginning of the year of the LIFO election at base-year cost plus subsequent years inventory layers at costs for the year each layer was created. If for any year the comparison of beginning and ending inventory at base-year costs results in a decrease, the LIFO layers are removed from inventory in reverse chronological order (commonly referred to as "liquidating" the layer e.g. the layer, or a portion thereof, is removed from ending inventory and thereby included in cost of goods sold). The dollar-value LIFO method gives taxpayers greater flexibility in pooling their inventory items than the unit LIFO method. Because changes in quantities and product mix can be ignored, it is more difficult to erode or "liquidate" the LIFO layers using dollar-value LIFO than unit LIFO. Thus, dollar-value LIFO keeps old costs in inventory while charging the recent costs to costs of goods sold. Balance sheet inventories tend to retain costs at price levels extending back to the time the LIFO method was adopted.There are a number of complex computational methods that can be used under the dollar-value method to determine LIFO inventory values.[14] Therefore, if the related buyer uses dollar-value LIFO, a complex analysis will be needed to determine if inventory purchased from affiliates in worldwide years is reflected in the buyer's cost of goods sold. If this issue is pursued, you will obviously need to become familiar with the specific LIFO method used by the taxpayer.[15] Companies using the unit method for LIFO are much more likely to liquidate LIFO layers. This is because the items in a pool cannot be materially different from each other. Thus, if the materials used to manufacture an inventory item are changed, or if an item of inventory effectively becomes obsolete and is replaced by a "new and improved" product line, the new item may not be similar enough to be treated as part of the old pool. When this happens, the new items are grouped into a new LIFO pool, and the layer containing the old product line is liquidated. The issue of whether the buyer has properly used carryover basis for inventory purchased from an affiliate during worldwide years can be significant. In making this determination, the buyer's inventory accounting method(s) ***must*** be determined and that method(s) must be taken into account in determining when the buyer sold inventory purchased in worldwide years. For example, if FIFO was used, then all of the inventory acquired during worldwide years would most likely be sold to third parties in the first water's-edge year. Because the buyer's separate company books will have recorded the inventory at cost, rather than at the seller's carryover basis, a separate state adjustment will be required to properly report the intercompany gain for California purposes. If the taxpayer has not made such an adjustment and the items are material, then an audit adjustment will be necessary.If LIFO was used, especially dollar-value LIFO, then a much more complex analysis will be needed. The auditor will have to review the detailed workpapers computing the LIFO inventory values, and cost of goods sold workpapers, to determine if inventory purchased during a worldwide year was sold during the water's-edge year(s). If a LIFO layer from a worldwide year was tapped into during the audit years, the auditor will have to review the intercompany inventory transactions from prior years to determine what portion of each LIFO layer consists of inventory acquired from affiliates (assuming that not all of the inventory costs represent purchases from affiliates). In periods of increasing inventories, the inventory acquired through intercompany transactions during worldwide years may not turnover at all. If such is the case, there is no effect on the buyer's income, although if the buyer is included in the water's-edge combined report the carryover basis adjustment will effect the computation of the property factor. In periods of decreasing inventory levels, inventory acquired over several worldwide years may be deemed to be sold. Because of the complex and resource-intensive nature of a LIFO analysis, materiality will be a major consideration in deciding whether to pursue this issue, particularly if the buyer uses dollar-value LIFO. The notes to the financial statement should indicate the inventory accounting method being used. For domestic entities, the taxpayer's inventory valuation method will be shown on the Schedule A, *Cost of Goods Sold*, attached to the federal 1120, and the Schedule V, *Cost of Goods Sold*, attached to the California Form 100. Additionally, if the taxpayer is using LIFO, it must attach a statement to the return for the year LIFO was adopted that details the specific LIFO method being used (e.g. whether the unit or dollar-value method is being used, the method used to compute LIFO value dollar-value pools, etc.) The taxpayer can either file a Form 970, *Application to Use Lifo Inventory Method*, or may simply attach a statement to the return that gives the same information asked for on Form 970. The taxpayer should have retained a copy of this LIFO election information in its records.

D. Inventory Valuation Methods

The above discussion regarding the timing of recognition of gain on sales of intercompany inventory focused on the buyer's reselling the inventory. However, an issue can also arise if the buyer "writes-down" the inventory to reflect a loss in value because the future revenue-producing ability of specific items is no longer as great as their cost. This could occur, for example, because of obsolescence or market declines. Such losses can either be recognized when the goods are sold, or taxpayers can account for such losses by valuing their inventory at "lower of cost or market."[16]

For U.S. financial accounting purposes, the term "market" generally means current replacement cost, not to exceed "net realizable value" (i.e. estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal).[17] U.S. GAAP generally requires a departure from the cost basis of pricing inventory when the utility of the goods is no longer as great as their cost.[18] For tax purposes, market is generally defined as replacement cost (i.e. goods may not be written-down to "net realizable value" if that is less than replacement cost).[19] Further, for tax purposes each item must be separately valued to determine the lower of cost or market. In other words, a percentage write-down approach to the inventory as a whole is not allowed for tax purposes, even though this is an acceptable approach under U.S. GAAP.[20]

If the taxpayer uses lower of cost or market to value their inventory, any write-down of inventory acquired from an affiliate during worldwide years will be overstated for California purposes unless the taxpayer makes a state adjustment to reflect the inventory at the transfer basis. (Remember that for tax purposes, lower of cost or market cannot be used if the taxpayer is using LIFO). Therefore, the auditor will need to determine if the buyer is valuing inventory at lower of cost or market and whether they have written-down inventory that should have been carried at transfer basis for California purposes. The notes to the financial statement, the Schedule A, *Cost of Goods Sold*, attached to the federal 1120 and Schedule V, *Cost of Goods Sold*, attached to the California Form 100 should indicate if the taxpayer is using lower of cost or market.

Depending on how the taxpayer records a write-down to market, an overstated loss may be buried in cost of goods sold. Some taxpayers simply record the ending inventory at market (direct method), thereby increasing the costs of goods sold by the difference between cost and market and thus failing to report this loss separately. Alternatively, the taxpayer may first record ending inventory at cost (indirect or allowance method) in the adjusting or closing process and subsequently make a separate entry to reduce the inventory to market. Generally, the entry to reduce the inventory to market also establishes a separate allowance account (e.g. a contra asset account such as "Allowance to Reduce Inventory to Market") along with the loss account so that the effects of the write-down are clearly identified. In order to determine if the taxpayer has written-down its inventory, the auditor will need to determine how the taxpayer records the reduction of inventory values to market. A review of the workpapers detailing the inventory valuation and cost of goods sold should identify any write-downs involving inventory purchased from an affiliate during a worldwide year.

2. Fixed Assets And Capitalized Items

Although fixed assets and capitalized items are not frequently transferred between foreign and domestic affiliates, it does occur. FTB Notice 89-601 applies to these types of transactions. As discussed above in part d.2.c, Notice 89-601 provides that a water's-edge election will cause the "restoration" of any deferred gain or loss from intercompany transactions in worldwide years. Whether a taxpayer making a water's-edge election has properly handled previously deferred gains is an issue that should be addressed at audit. Before pursuing a possible adjustment, remember to determine how these intercompany transactions were handled for California purposes in worldwide combined report years. If intercompany gains were currently recognized in the year the transaction occurred, there is generally no water's-edge issue. Alternatively, if the taxpayer has consistently used elimination for these items instead of deferral, that method should be accepted (see discussion in part 2 of Chapter 17(c), Water's-Edge Manual). If the taxpayer used elimination for fixed assets and capitalized items, the types of issues discussed in part d.1.a & d.1.b, with respect to intercompany inventory sales, will also apply to intercompany sales of fixed assets and capitalized items.

Example 10:

FP, a foreign incorporated entity, and D, its wholly owned U.S. subsidiary, filed on a worldwide basis for income years prior to 12/94. During 1991, FP sold used manufacturing equipment with an adjusted basis of $2 million to D for $5 million, realizing an intercompany gain of $3 million. The equipment had a remaining useful life of 5 years at the time of sale to D and D deducted $1 million in depreciation in years 1991 through 1995. In preparing the 1991 worldwide combined report, an adjustment was made to defer the $3 million gain. In 1991 through 1993, as D claimed depreciation on the equipment, it "restored" $600,000 per year of the deferred gain ($3 million deferred gain x ($1 million annual depreciation/$5 million basis)).

D made a water's-edge election effective for its income year beginning 1/1/94, and excluded FP from the water's-edge combined report. In accordance with Notice 89-601, the remaining unrestored portion of the gain deferred in 1991 is restored to income as a result of the water's-edge election ($3 million gain less $1.8 million restored in 1991- 1993 = $1.2 million remaining unrestored gain). The gain is apportioned using the worldwide apportionment factor for the 1993 year, which is 5%. As a result, D includes $12,000 in income in each of the years 1994 through 1998 ($1.2 million unrestored gain x 5% = $60,000 included in income on a 5 year pro-rata basis).

Example 11:

Assume the same facts as Example 10, except that the taxpayer states that it did not use the deferral method to account for income. However, because FP's consolidated financial statements were used as the base to determine worldwide income, for purposes of the worldwide combined report an elimination adjustment was made for the $2 million gain and for inflated depreciation expense on the $2 million basis increase. Under the elimination method, D is required to use FP's transfer basis of $3 million. During the course of an audit of the 12/94 year it is determined that D's net income reported on the California return ties to the federal 1120. The federal 1120 reflects D's cost basis in the equipment at its purchase price of $5 million, and a depreciation deduction of $1 million ($5 million basis/5 year useful life). For California purposes, D is only entitled to a depreciation deduction of $600,000 ($3 million transfer basis/5 year useful life).

Thus, an adjustment is required for California purposes to reduce annual depreciation expense by $400,000.

If the taxpayer used the deferral method to account for intercompany transactions involving fixed assets and capitalized items the auditor will need to develop the following factual information:

- Amount of any deferred gain or loss previously excluded from worldwide net income.
- Date the intercompany transaction occurred.
- Apportionment factor percentage in the year the transfer occurred ("historical" apportionment factor).
- Apportionment factor percentage in the year immediately preceding the water's-edge election.

In most situations, the previously deferred income will be included in the water's-edge combined report on a pro-rata basis over the first five years of the election, and should be apportioned using the apportionment factor for the income year immediately preceding the income year of the election. However, the historical apportionment factor should be used if that factor varies from the last worldwide year's apportionment factor by more than 10%, and if use of the historical factor results in the apportionment of more than an additional $100,000 in income to California.

This issue may be difficult to identify. Since the department has been accepting the federal deferral method since at least 1979, the above information should be retrievable from the California returns filed for prior years. A review of the following information may also disclose material intercompany transactions during worldwide years for fixed assets: prior year's annual reports and SEC 10-Ks/20Fs; prior year's federal Forms 5471 and 5472; prior year's consolidating workpapers to the financial statement; current year consolidating workpapers to the financial statement (eliminations to balance sheet fixed asset accounts and to depreciation expense may indicate the existence of an intercompany transaction involving fixed assets in a prior year).

e. Effect Of Intercompany Transactions On The Apportionment Factor For Water's-Edge Electors

As discussed above, the department's long-standing policy has been that intercompany transactions are eliminated from the computation of the apportionment factors. The purpose of the elimination adjustments is to avoid taking an item into account more than once. Although neither the statute nor the regulations address this issue in the context of a worldwide combined report, the California Court of Appeals has upheld the department's exclusion from the sales factor computation of sales between members of the worldwide unitary group.[21] This policy of eliminating intercompany amounts from the factors applies to both worldwide and water's-edge combined reports. (For more information, see MATM 6070, MATM 7121, and MATM 7173.)

In order to determine whether intercompany transactions have been properly excluded from the apportionment factor, auditors should identify the source(s) used by the taxpayer to construct the factor. For example, the federal tax basis in property will include the step-up in basis that arises from intercompany sales. (This is because, with respect to transactions between domestic and foreign affiliates, for federal purposes such transactions are currently recognized. With respect to transactions between members of a consolidated federal return, the buyer uses step-up basis under the federal deferral method). If federal tax figures are used to compute the property factor, adjustments may be needed to reflect the seller's original cost in the factor. Even if there are no current water's-edge income effects from inbound intercompany inventory sales made during worldwide years because the buyer is using LIFO (and intercompany profit thus remains embedded in inventory balances), it may still be necessary to eliminate the intercompany profit from the property factor.

Similarly, for financial statement purposes, the eliminating entries for intercompany transactions are made on the workpapers to the consolidated financial statements. These entries *are not* posted to the separate books of the individual corporations. Therefore, if the taxpayer is computing the water's-edge apportionment factor using pre-consolidation or separate company book figures, adjustments may be necessary to eliminate step-ups in basis that resulted from intercompany sales.

As with all issues, auditors need to consider materiality before deciding to pursue these issues. In making this determination, consider that because of the effects of double weighting the sales factor (which lessens the significance of the property factor in the overall apportionment factor computation), even a seemingly large potential intercompany profit adjustment may produce only a negligible effect on the overall factor, particularly if there is an insignificant amount of property located in California.

1. Water's-Edge Factor Issues For Partially Included Entities

In addition to the "typical" apportionment factor intercompany elimination issues that exist for both worldwide and water's-edge purposes, the water's-edge "partial inclusion" of certain types of entities in the combined report creates unique problems with regard to intercompany eliminations from the computation of the apportionment factor.

Example 12:

D and F are affiliated unitary corporations. D is a domestic corporation and 100 percent of its income and factors are included in the water's-edge combined report. F is a foreign corporation with a ratio of Subpart F income to earnings and profits for the income year of 1/4. One-fourth of F's income and factors are therefore included in the combined report. Assume that 50 percent of D's sales are made to F. To what extent should such sales be eliminated from the sales factor? Should all of D's intercompany sales to F be eliminated? Should only a portion of the sales be eliminated since only a portion of F's income and factors are included in the combined report? If so, how should the partial elimination adjustment be computed?

CCR §25110(e) provides guidance on how various intercompany transactions are to be handled in the computation of the apportionment factor. In general, the regulations provide that a transaction with a partially included entity is to be treated as an intercompany transaction only to the extent the entity is subject to inclusion in the combined report. The regulations specifically do <u>not</u> address, however, the effects of intercompany transactions on the computation of net income.[22] For the effects of intercompany transactions on the computation of net income see Chapter 17(c), Water's-Edge Manual above and FTB Publication 1061.

Example 13:

D and F are affiliated unitary corporations. D is included 100% in the combined report and has net income of $500. F has net income of $300 and a ratio of Subpart F income to E&P for the income year of 1/3. D incurs $30 of interest expense to F. As discussed in greater detail below, only $10 ($30 x 1/3) of D's interest expense to F is regarded as intercompany and thereby eliminated for purposes of calculating the foreign investment interest offset.

The combined net income of D and F is determined as follows:

Net income of D	$500
Net income of F ($300 x 1/3)	$100
Combined net income before the interest offset	$600

Thus, even though $10 of D's interest expense is required to be eliminated from the offset computation, this elimination adjustment has no effect on the computation of net income subject to inclusion in the combined report.[23]

2. Intercompany Accounts Defined

CCR §25110(e)(3) defines intercompany accounts as including:

(i) Sales by one affiliated bank or corporation to another affiliated bank or corporation;

(ii) Loans, advances, receivables, and similar items due to one affiliated bank or corporation from another bank or corporation;

(iii) Stock or other equity of an affiliated bank or corporation which is owned or controlled by another affiliated bank or corporation;

(iv) Interest expense incurred or paid to one affiliated bank or corporation by another affiliated bank or corporation;
(v) Annual rent described in CCR §2513O(b)(3) paid by one affiliated bank or corporation to another affiliated bank or corporation;
(vi) Any other item of assets, liabilities, equities, income, cost, or expense whose elimination in whole or in part is necessary to properly reflect the combined income and apportionment factors in a combined report or the taxable income of any bank or corporation described in subdivision (a) of Section 2511O of the Revenue and Taxation Code.

Special rules apply to the intercompany accounts of entities which are only partially included in the combined report. Such accounts are treated as intercompany accounts only to the extent that the entity is subject to inclusion in the combined report.

Example 14:

D and F are affiliated corporations and are included in the water's-edge combined report under paragraphs (1) and (4)(formerly (5)), respectively, of R&TC §25110(a). F has total sales of $300, all of which are made to D. Pursuant to R&TC §25110(a)(4) only $100 of F's total sales are included in the combined report of D and F. Only the $100 is treated as an intercompany account of sales. The remaining $200 is not treated as an intercompany account of sales.[24]

3. Computation Of Intercompany Eliminations

Intercompany accounts between affiliated banks or corporations, both of which are included in their entirety in the water's-edge combined report, are eliminated from the factor computation in their entirety.[25]

Intercompany accounts between affiliated banks or corporations, one or both of which are only partially included in the water's-edge combined report, are eliminated with respect to one affiliated bank or corporation to the extent that the corresponding account of the other bank or corporation is taken into account in the combined report.[26]

Example 15:

D and F are affiliated corporations and are included in a water's-edge combined report under paragraphs (1) and (6)(formerly (7)), respectively, of R&TC §25110(a). F has net income of 1,000 and had total sales of $5,000, of which $3,000 were made to D. F has a ratio of Subpart F income to current year E&P of 1/3.

F has net income subject to inclusion in the combined report of $333 ($1,000 x 1/3) and sales potentially subject to inclusion in the sales factor of $1,667 ($5,000 x 1/3). Of the total sales subject to inclusion in the factor, $1,000 ($3,000 x 1/3) are considered an intercompany account of sales. Since the corresponding account of D with respect to such sales (D's purchases) is taken into account at 100 percent in the combined report, 100 percent of F's intercompany account of sales of $1,000 is eliminated for purposes of determining the sales factor.

Example 16:

F1 and F2 are affiliated corporations and are both partially included in a water's-edge combined report under R&TC §25110(a)(6)(formerly (7)). F2 has a ratio of Subpart F income to current year E&P of 1/3. F1 has a ratio of Subpart F income to current year E&P of 1/2. During the year, F1 made sales of $600 to F2. Under the provisions of (e), $300 ($600 x 1/2) are considered an intercompany account of sales. Since the corresponding account of F2 with respect to the sales of F1 (F2's purchases) is taken into account at 1/3 in the combined report, 1/3 of F1's intercompany account of sales of $300, or $100, is eliminated for purposes of determining the sales factor. The remaining $200 intercompany account of sales is not eliminated.

f. Suggested Audit Procedures

1. The first step that should always be taken is to review the manner in which the worldwide combined reports were compiled to determine how intercompany transactions were handled. If intercompany transactions between foreign and domestic affiliates were currently recognized on a consistent basis there will generally not be a water's-edge issue. Current recognition should only be denied when necessary to prevent manipulation, such as where a taxpayer has consistently used elimination, but then attempts to currently report intercompany gains in order to dump the profit into a loss year or a year with a lower apportionment factor.
2. If the taxpayer is compiling the water's-edge combined report by using the federal 1120 for domestic companies and separate company financial information for partially included foreign affiliates, and has not made a state adjustment to account for the state/federal differences for reporting intercompany transactions, you probably have an audit issue (at least in the first few years of the water's-edge election) if there were material intercompany transactions in worldwide years.
3. Assuming the taxpayer did not use current recognition during worldwide years, review the prior year's federal Forms 5471 and 5472 to determine if material intercompany transactions occurred during worldwide years. Intercompany sales of inventory will be easier to identify than sales of fixed assets because they are much more likely to occur every year. Other possible sources for identifying intercompany sales during worldwide years are the annual reports, workpapers to the consolidated financial statements, and prior year audit workpapers detailing intercompany eliminations from the sales factors.
4. With respect to inventory sales, if this issue is pursued you *must* determine the buyer's inventory accounting method. A review of the notes to the financial statement should indicate the methodology being used. If the buyer is using dollar-value LIFO and its inventories are increasing you are unlikely to have an income adjustment, although an adjustment to the property factor may still be necessary. If, however, the taxpayer is using any other method, including unit method LIFO, it is much more likely that inventory purchased during worldwide years is flowing into COGS and that the issue is worth pursuing.Because of the complex analysis required if the taxpayer is using dollar-value LIFO, the intercompany profit in inventory issue should only be pursued for taxpayers using this method if the issue is material. In evaluating

the materiality of the issue, you should consider the dollar amount of prior year intercompany inventory sales, the seller's mark-up, and the amount of inventory carried by the purchaser from worldwide years into the first water's-edge year (e.g. how material is the amount of intercompany profit embedded in the buyer's inventory accounts). Even if the taxpayer had hundreds of millions of dollars in purchases from related parties, if the seller's mark-up was small, or if the purchaser doesn't carry much inventory, the intercompany profit in inventory issue may not be material. For example, if the taxpayer had $100 million in purchases from related parties, but intercompany profit embedded in the purchaser's inventory is only $1 million, the issue may not be worth pursuing. Similarly, if the taxpayer had $100 million in purchases from related parties, but its beginning inventory in the first water's-edge year is only $1 million, the issue may not be worth pursuing.

5. The amount of intercompany profit in inventory should be detailed in the workpapers to the consolidated financial statements. If the taxpayer refuses to provide this information, or other documentation that will enable you to determine the seller's cost basis and/or the amount of intercompany profit in the buyer's inventory, it may be necessary to estimate the amount of the adjustment. Estimating the amount of the adjustment should be resorted to only if the taxpayer refuses to respond to demands for information regarding the seller's cost basis/inventory mark-up. Depending on the available information, there are any number of different ways to approach making an estimate. Because we are primarily concerned with a domestic company's transactions with its foreign affiliates (both inbound and outbound sales), information on the intercompany sales price should be obtainable from domestic company records. If separate company financial statements are available for the seller, the intercompany profit (e.g. the seller's mark-up) could be estimated by determining the seller's gross profit percentage, and applying that percentage to the intercompany sales price. (Note that such an estimate is not totally accurate because this mark-up represents an average of the various mark-ups the seller may have for different buyers and/or different products, but if you are unable to obtain the consolidating workpapers this may be the best estimate possible). For inbound sales, if separate company financial statements for the seller are not available, it may be possible to estimate the seller's mark-up by comparing the gross profit percentage per the consolidated financial statements to the domestic buyer's gross profit percentage. The difference between the two could be used as an

estimate of the seller's mark-up, although this would be a very rough estimate at best.

6. After determining the amount of intercompany profit in inventory, it will be necessary to determine when, and if, inventory purchased during worldwide years flows into COGS. A review of the buyer's workpapers detailing the valuation of the ending inventory, and the workpapers detailing COGS, should clearly identify the inventory flow. A review of these workpapers will be essential if the buyer if using dollar-value LIFO.
7. With respect to intercompany transactions involving fixed assets, the auditor should review the workpapers to the prior year combined reports to determine if the taxpayer used the deferral method to account for these transactions. If the taxpayer used the deferral method, they should have workpapers tracking by entity the amount of deferred gain or loss. If the taxpayer claims it did not use the deferral method, the auditor should fall back on the elimination method.
8. Any deferred gain that is restored as a result of the water's-edge election should generally be apportioned using the factor for the year immediately preceding the year of the water's-edge election. The gain is included in income on a 5-year pro-rata basis, beginning with the first year of the water's-edge election. For any material transactions, however, the auditor should review the return for the year the transaction occurred to determine if the historical factor varies from the factor for the year preceding the first water's-edge year by more than 10%. If the historical factor varies by more than 10%, and if use of the historical factor results in the apportionment of more than an additional $100,000 in income to California, the historical factor should be used to apportion the deferred gain to California.

g. Summary

1. The policy of the department has generally been to use the elimination and transfer basis method of accounting for intercompany sales of inventory. Under the elimination method, the intercompany profit is recognized by the buyer when it resells the inventory. In determining when the inventory is resold, the buyer's inventory accounting method must be taken into account. The income is apportioned using the apportionment factor for the year in which the buyer sells the inventory and recognizes the intercompany profit.
2. The policy of the department has generally been to allow the deferral of gains and losses on sales of fixed assets between members of a combined return, similar to the deferral method used for the purposes of the consolidated federal return. The deferred gain or loss is includible in net income when either the seller, the purchaser, or the asset leave the combined return.
3. When any deferred gain or loss is ultimately included in net income the apportionment factor percentage to be applied has also been the subject of much discussion. FTB Notice 89-6O1, generally provides that the deferred income is apportioned using the apportionment factor for the year preceding the year of the water's-edge election. However, the apportionment factor percentage in the year the transaction occurred must be considered. A variance of 1O% would provide a basis for utilizing the historical apportionment percentage rather than the current years percentage.
4. Before pursuing the intercompany transaction issue, the auditor should determine how the worldwide combined report was compiled. If intercompany income was currently recognized during the worldwide years, that method should generally be accepted.
5. The policy of the department has been to value transferred assets at the seller's cost for property factor purposes, regardless of whether the intercompany gain or loss has been eliminated or deferred.

As with all issues, materiality should be considered in deciding whether to pursue an intercompany transaction issue.

Footnotes

1. Edison California Stores, Inc. v. McColgan, (1947) 30 Cal.2d 472.
2. Treas. Reg. §1.1502-13(e)(3).
3. In certain limited cases, taxpayers can elect to include 100% owned Mexican and Canadian corporations in the consolidated federal return. IRC §1504(d) provides that if a domestic corporation directly or indirectly owns or controls 100% of the capital stock of corporation organized under the law of a contiguous foreign country and maintained as a foreign incorporated entity solely for the purpose of complying with the requirements of the foreign country as to title and operation of property within the country, the domestic entity can elect to treat the foreign subsidiary as a domestic corporation. As a result, if the election is made the foreign corporation can be included in the consolidated federal return.
4. See, however, IRC §267(f) and the regulations thereunder, which defer recognition of losses from the sale or exchange of property between members of the same controlled group until the property is transferred outside the group. California has conformed to this code section. See Chapter 19, Water's-Edge Manual for a discussion of IRC §267.
5. Treas. Reg. §1.1502-13.
6. Treas. Reg. §1.1502-13(c).
7. Treas. Reg. §1.1502-13(c)(7)(ii), Example 7.
8. Treas. Reg. §1.1502-13(d).
9. Treas. Reg. §1.1502-13(d)(3), Example 1.
10. Chase Brass v. Franchise Tax Board, (1977) 70 Cal. App. 3d 457, 472; Appeal of Pacific Telephone and Telegraph, Cal. St. Bd. Of Equal., 5/4/78; Appeal of Dohrman Commercial, Cal. St. Bd. of Equal., 2/29/56; Appeal of Jenkel-Davidson Optical Company, Cal. St. Bd. of Equal., 5/19/81; Appeal of Texaco, Inc., Cal. St. Bd. of Equal., 1/11/78.
11. See, for example, Rev. Rul. 60-289, 1960-2 C.B. 268, which allowed taxpayers to use current recognition to report intercompany transactions in years when the federal consolidated return regulations required the elimination method for intercompany transactions, as long as there was a business reason for current recognition and that method was consistently used.
12. IRC §472(b)(2).
13. Godbout, Herndon, Holt, and Tovig, 578 T.M., Inventories: General Principles; Lifo Method. at A-52; Kieso and Weygandt, Intermediate Accounting, Sixth Edition, 1989, John Wiley & Sons Inc. publisher, pgs.

363 and 368.
14. Treas. Reg. §1.472-8(e). The dollar-value methods authorized in the federal regulations are: (1) Double-extension method, (2) Index method, (3) Link-chain method, (4) Retail method, (5) Inventory price index computation method.
15. One detailed and very helpful reference source on LIFO accounting is Godbout, Herndon, Holt, and Tovig, 578 T.M., Inventories: General Principles; Lifo Method. See also Treas. Reg. §1.472-8, although it contains only a very basic discussion of the dollar-value LIFO method.
16. Treas. Reg. §1.471-2(c); ARB No. 43, Chapter 4, Statement 5 (AICPA, 1953).
17. ARB No. 43, Chapter 4, Statement 6 (AICPA, 1953).
18. ARB No. 43, Chapter 4, Statement 5 (AICPA, 1953).
19. Treas. Reg. §1.471-4.
20. Compare Treas. Reg. §1.471-4(c) to ARB No. 43, Chapter 4, Statement 7 (AICPA, 1953). See also Thor Power Tool Co. v. Comr., 439 U.S. 522 (179)), aff'm, 563 F.2d 861 (7th Cir. 1977), aff'm 64 T.C. 154 (1975).
21. Chase Brass & Copper Co., Inc. v. Franchise Tax Board (1977), 7O CA 3d 457, 138 CRptr 9O1.
22. CCR §25110(e)(2).
23. CCR 25110(e)(2)(A).
24. CCR 25110(e)(3), Example 1
25. CCR 25110(e)(4)
26. CCR 25110(e)(5)