

TITLE 18. FRANCHISE TAX BOARD

As required by Section 11346.4 of the Government Code, this is notice that a public hearing has been scheduled at 1:00 p.m. on July 25, 2013, at offices of the Franchise Tax Board, 9646 Butterfield Way, Town Center, Golden State Room A/B, Sacramento, California, to amend California Code of Regulations ("CCR"), title 18, section 25106.5-1. The Board proposes to amend this regulation under authority granted in Revenue and Taxation Code ("RTC") sections 19503 and 25106.5, subsection (a). The Board proposes to revise Regulation section 25106.5-1 to bring it into conformity with the most recent version of Treasury Regulation section 1.1502-13. Additional revisions will provide further guidance regarding the proper apportionment treatment of intercompany transactions that are reported utilizing the simplifying rules of Regulation section 25106.5-1, subsection (e). Moreover, subsections (f)(1)(B), (j)(4), and (j)(7) are being revised to reflect additional guidance with respect to the treatment of a Deferred Intercompany Stock Account (DISA) in circumstances involving mergers, subsequent capital contributions, intercompany transfers of stock, tiered excess distributions, and DISA reporting requirements. Finally, subsection (j)(3) is being revised to reflect a nonsubstantive statutory renumbering referenced therein.

The proposed amendments to Regulation section 25106.5-1 would be retroactive in application. Under RTC section 19503, subdivision (a), at its discretion, the Franchise Tax Board may prescribe that a regulation applies retroactively, if the underlying regulation relates to a statute that was enacted prior to January 1, 1998. Revenue and Taxation Code section 25016.5, the statute underlying the revisions to the intercompany transaction regulations, was originally enacted prior to 1998. Accordingly, the Franchise Tax Board may prescribe that the revisions to the intercompany transaction regulations be applied retroactively.

WRITTEN COMMENT PERIOD

Written comments will be accepted until 5:00 p.m., July 25, 2013. All relevant matters presented will be considered before the proposed regulatory action is taken. Comments should be submitted to the agency officers named below:

AUTHORITY & REFERENCE

Revenue and Taxation Code section 19503 authorizes the Franchise Tax Board to prescribe regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.2 (commencing with section 18401), Part 10.7 (commencing with section 21001) and Part 11 (commencing with section 23001). Revenue and Taxation Code section 25106.5-1 requires amendments to interpret, implement and clarify RTC section 25106.5.

INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW

Taxpayers that have business activities within and without California are required to determine the amount of income properly attributed to activities in California. During 1999, the Franchise Tax Board promulgated Regulation section 25106.5-1, which addresses the treatment of intercompany transactions in a combined report context that occurred on or

after January 1, 2001. Regulation section 25106.5-1 generally follows the federal consolidated intercompany regulations (Treas. Reg. section 1.1502-13 et seq.) with respect to many of the issues in those regulations, but because income is not apportioned for federal purposes, Regulation section 25106.5-1 also provides applicable apportionment rules.

Regulation section 25106.5-1, subsection (a)(2) – Conformity

Subsection (a)(2) will be revised to state that it incorporates the version of Treasury Regulation section 1.1502-13 that was in effect as of April 1, 2012.

Regulation section 25106.5-1 subsection (e) – Simplifying Rules Issue

Subsection (a)(5) provides the apportionment rules for intercompany transactions. Subsection (a)(5)(A) sets forth the rules for assigning receipts for purposes of the California sales factor. A new subsection at Regulation section 25106.5-1, subsection (a)(5)(A)4 will make it clear that when a subsection (e) election is made to currently recognize income or loss from an intercompany transaction, the apportionment rules set forth at subsection (a)(5)(A) still apply so that receipts from the intercompany transaction are not included in the sales factor at the time of current recognition.

Subsection (b) provides definitions of terms used in the regulation. Subsection (b)(6) defines the term "treatment as a separate entity" to mean treatment without application of the rules of Regulation section 25106.5-1, except for subsection (a)(4), which states that other laws remain in full force. The amendment at subsection (b)(6) states that subsection (a)(5), in addition to subsection (a)(4), are excluded from the definition. This addition clarifies that when a subsection (e) election to currently recognize intercompany income or loss is made, the apportionment rules at subsection (a)(5) remain in effect.

Subsection (e) contains the simplifying rules and subsection (e)(2) contains the election "to treat intercompany transactions on a separate entity basis." Proposed amendments to subsection (e)(2) add the phrase "recognize income or loss from intercompany" transactions at subsections (e)(2)(A), (B), and (C). This makes it clear that the election only allows current recognition of income or losses from intercompany transactions.

Regulation section 25106.5-1, subsection (f)(1)(B) - Deferred Intercompany Stock Accounts

Subsection (f)(1)(B)2 is being revised to provide that a merger between combined reporting group members that are owned by other members of the combined reporting group will not result in a disposition requiring a DISA to be taken into income. It goes on to provide that the DISA attributable to the non-surviving member's stock will be included with any DISA attributable to the surviving members' stock and will be taken into income when the surviving member's stock is disposed of.

An additional revision to subsection (f)(1)(B)(2) pertains to subsequent capital contributions reducing an existing DISA. The revision allows P (the putative parent corporation) to make a contribution to S (the putative subsidiary) in order to reduce the DISA attributable to P's

stock in S. Without this proposed revision, taxpayers would always be required to recognize the tax implications for financial statement purposes whenever a DISA arises.

The current version of subsection (f)(1)(B)4 provides that if P (the putative parent corporation) transfers stock in S (the putative subsidiary) to another transferee member of the combined reporting group, any attributable DISA will continue to be deferred. A second sentence is being proposed to be added to subsection (f)(1)(B)4 to provide that if the transferee already possess shares in S that do not have a DISA attributed to it, the transferee's basis in its existing stock can reduce the DISA attributable to the shares of stock transferred from P.

Regulation section 25106.5-1, subsection (j)(3) – Partially Included Water's Edge Corporations

References to California Revenue and Taxation Code section 25110, subdivisions (a)(4) and (6) will be renumbered to subdivisions (a)(2)(A)(i) and (a)(2)(A)(ii), respectively.

Regulation section 25106.5-1, subsection (j)(4) – Earnings and Profits

The current version of Regulation 25106.5-1, subsection (j)(4), provides that intercompany items are not reflected in earnings and profits until those intercompany items are taken into account under the terms of the combined report intercompany transaction regulations. However, as stated previously, a DISA will result if the distribution exceeds the distributor's earnings and profits. As stated previously, if the same property or the same amount of money is distributed through multiple tiers of combined reporting group members, a DISA will result at every ownership level. On the other hand, if a DISA that results at the initial level also creates earnings and profits at that level, an additional DISA will not result when the same property or the same amount of money is distributed to another combined reporting group member. To alleviate this, a sentence is proposed to be added to subsection (j)(4) that will treat the DISA arising from the initial distribution as creating earnings and profits.

Regulation section 25106.5-1(j)(7) – Reporting DISAs

As previously stated, the proposed revision to subsection (f)(1)(B)2 will allow a DISA to be reduced by a subsequent capital contribution. The current version of subsection (j)(7) requires taxpayers to report on DISAs on their annual tax returns. It does not address reductions pertaining to subsequent capital contributions. Therefore, if the proposed revision to subsection (f)(1)(B)2 is adopted, the proposed revision to (j)(7) will require taxpayers to also annually report reductions to DISAs brought about by subsequent capital contributions.

The Franchise Tax Board has evaluated the proposed regulation changes and determined that the adoption of these changes to the existing regulation are not inconsistent or incompatible with existing state regulations. There are no other comparable existing state regulations.

Anticipated Benefits from the Proposed Regulation

Taxpayers and the Franchise Tax Board will benefit from being able to use the current version of Treasury Regulation section 1.1502-13, to which Regulation section 25106.5-1 conforms. Taxpayers will also benefit from the clarification made in situations where an election is made under Regulation section 25106.5-1, subsection (e), to currently recognize income from an intercompany transaction, will not result in the receipts from that transaction being included in the taxpayer's sales factor. Finally, taxpayers will benefit from the changes to the DISA rules dealing with certain mergers and tiered contributions and the reduction of DISAs through subsequent capital contributions and by the basis in transferred stock. There are no benefits of the regulation to the health and welfare of California residents, worker safety, and the state's environment.

DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION

Mandate on local agencies and school districts: None.

Cost or Savings to any state agencies: None.

Cost to any local agency or school district which must be reimbursed under Part 7, commencing with Government Code section 17500, of Division 4: None.

Other non-discretionary cost or savings imposed upon local agencies: None.

Cost or savings in federal funding to the state: None.

Significant statewide adverse economic impact directly affecting business including the ability of California businesses to compete with businesses in other states: None.

Cost to directly affected private persons/businesses potential: None.

Effect on small business: The department has made an initial determination that the adoption of the proposed amendments will not affect small businesses as generally multi-state corporations are not considered small businesses and this proposed regulation will apply to multi-state corporations. However, the Board invites public comments on the question of economic impact on small businesses.

Significant effect on housing costs: None.

RESULTS OF THE ECONOMIC IMPACT ANALYSIS

Pursuant to Government Code section 11346.3, subdivision (b), the Franchise Tax Board has determined in the economic impact analysis that there are no effects on the creation or elimination of jobs in the state, no effect on the creation of new businesses or elimination or expansion of existing business with the state and that the proposed revisions to Regulation section 25106.5-1 will benefit taxpayers by clarifying the separate entity treatment rules

and the DISA rules. In addition, the Franchise Tax Board will save resources by enhanced taxpayer self-compliance.

Benefits of the regulation to the health and welfare of California residents, worker safety, and the state's environment: None.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5, subdivision (a)(13), the Franchise Tax Board must determine that no reasonable alternative considered or that has otherwise been identified and brought to its attention would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons that the proposed regulatory action, or would be more cost-effective to affected private persons and equally effective in implementing the statutory policy or other provision of law.

COMPARABLE FEDERAL LAW

The simplifying rules at Regulation section 25106.5-1, subdivision (e), are comparable to Treasury Regulation section 1.1501-13, subsection (e)(3). The Deferred Intercompany Stock Account provisions at Regulation section 25106.5-1, subdivision (f), are not comparable to any federal law.

AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS

The Franchise Tax Board has prepared an initial statement of reasons for the proposed regulatory action. The express terms of the proposed regulatory action, the initial statement of reasons for the regulatory action, and all the information upon which the proposed regulatory action is based are available upon request from the agency officer named below. When the final statement of reasons is available, it can be obtained by contacting the agency officer named below, or by accessing the Franchise Tax Board's website at www.ftb.ca.gov.

CHANCE OR MODIFICATION OF ACTIONS

The regulations and amendments may also be adopted with modifications if the changes are nonsubstantive or the resulting regulations are sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulations as modified could result from that originally proposed. The text of the regulations as modified will be made available to the public at least 15 days prior to the date on which the regulations are adopted. Requests for copies of any modified regulations should be sent to the attention of the agency officer named below.

ADDITIONAL COMMENTS

The hearing room will be accessible to persons with physical disabilities. Any person who is in need of a language interpreter, including sign language, should contact the officer named

below at least two weeks prior to any scheduled hearing so that the services of an interpreter may be arranged.

CONTACT

All inquiries concerning this notice or the hearing should be directed to Colleen Berwick at Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Telephone: (916) 845-3306; Fax: (916) 845-3648; E-Mail: Colleen.Berwick@ftb.ca.gov. In addition, all questions on the simplifying rules of Regulation section 25106.5-1, subsection (e) election should be directed to Laurie McElhatton; Telephone: (916) 845-6916 or E-Mail: Laurie.McElhatton@ftb.ca.gov; and all questions regarding the Deferred Intercompany Stock Accounts (DISA) and conformity with the most recent version of Treasury Regulation section 1.1502-13 to Craig Swieso; Telephone: (916) 845-5244 or E-Mail: Craig.Swieso@ftb.ca.gov. This notice, the initial statement of reasons and express terms of the proposed regulation are also available at the Franchise Tax Board's website at www.ftb.ca.gov.