

DISCUSSION TOPICS

Franchise Tax Board Interested Parties Meeting - Intercompany Transactions, Regulation Section 25106.5-1 April 21, 2010

1. BACKGROUND

During 1999, the Franchise Tax Board promulgated California Code of Regulations, title 18, section 25106.5-1, which addresses the treatment of intercompany transactions in a combined report context occurring on or after January 1, 2001. Regulation section 25106.5-1 generally follows the federal consolidated intercompany regulations (Treasury Regulation 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(e) – Simplifying Rules Issue

For income tax purposes, gain or loss from intercompany transactions is ordinarily deferred until there is a triggering event, such as the sale of the deferred item outside the group to a third party. Notwithstanding this general principle, both the California and federal intercompany regulations allow taxpayers in specified circumstances to elect to account for their income or loss from intercompany transactions on a "separate entity" basis. This election allows current recognition of income or loss from intercompany transactions. The election is governed by Regulation section 25106.5-1, subsection (e), for California tax purposes and Treasury Regulation section 1.1501-13, subsection (e)(3), for federal tax purposes.

Both the California and federal regulations include "simplifying rules" provisions. This election is included within those "simplifying rules." Regulation section 25106.5-1, subsection (e), authorizes federal "separate entity" elections to be effective for California tax purposes. Even in situations in which the taxpayer has not made a federal "separate entity" election, taxpayers can elect to recognize intercompany income or loss on a separate entity basis as long as they have "properly reported" the intercompany income or loss on a separate entity basis for federal or foreign national tax purposes.

Questions have arisen regarding the proper sales factor treatment of intercompany transactions that are recognized on a separate entity basis due to the above described election. Some taxpayers have suggested that because the election results in current income recognition from intercompany transactions, as opposed to the normal scheme of deferral, that the sales factor for the year of election should contain the gross receipts related to the income recognized currently due to the election, which results in a higher sales factor denominator and reduced California apportioned income. Staff believes that it is prudent to clarify that a Regulation section 25106.5-1, subsection (e), election does not allow taxpayers to include intercompany transaction receipts in their sales factor denominator in the year of election. Instead, receipts are only included in the sales factor when the intercompany items are sold to third parties, giving rise to economic gain or loss to group as a whole. If intercompany receipts were to be recognized currently due to the election, the receipts that arise when the items are eventually sold outside the group would result in a double count of the actual economic activity in the sales factor. Furthermore,

inclusion in the sales factor in the current year due to a subsection (e) election is inconsistent with Regulation section 25106.5(a)(5)(A) and (a)(5)(B).

Deferred Intercompany Stock Accounts

Regulation section 25106.5-1, subsection (f)(1)(B), addresses the situation where a distributee corporation that is a member of the combined reporting group receives a non-dividend distribution that is in excess of its basis in the stock of the distributor corporation, who is also a member of the combined reporting group. These are referred to as the Deferred Intercompany Stock Account (DISA) provisions. Recently, taxpayers have sought guidance regarding the interplay of the DISA provisions with respect to mergers, subsequent capital contributions and tiered distributions.

The FTB seeks to obtain input with respect to the following:

- (1) Should a merger trigger the recognition of a DISA?
- (2) Should a subsequent capital contribution reduce a DISA?
- (3) If the same distribution is effectively made through various tiers of stock ownership, should more than one DISA be created?

Conformity to Federal Law

Finally, Regulation section 25106.5-1, subsection (a)(2), states that California's intercompany transaction regulations conform to the version of Treasury Regulation section 1.1502-13 that was in effect as of March 17, 1997. The most recent version of Treasury Regulation section 1.1502-13 is in effect as of April 1, 2009. The current version of California's intercompany transaction regulations should be updated to reflect the current version of Treasury Regulation section 1.1502-13.

2. STAFF'S EXPECTATIONS FOR THE MEETING

The FTB seeks to allow the public an opportunity to discuss possible amendments to Regulation section 25106.5-1. Staff believes that the following core principles provide an objective basis upon which to evaluate the suggested amendments.

Among these principles are:

- (1) Equity: Are all similarly situated taxpayers being treated in a similar manner?
- (2) Administration: Is a rule as clear and simple as possible? Can taxpayers and the FTB apply a rule?
- (3) Elimination of potential disputes: Does a rule raise new concerns that could lead to new disputes?
- (4) Recordkeeping: Does a rule use existing records as much as possible to minimize the burdens of recordkeeping on taxpayers?

With respect to any proposed amendments to bring Regulation section 25106.5-1 into conformance with the most recent version of Treasury Regulation section 1.1502-13, this principle is:

- (1) Is conformance with the most recent version of Treasury Regulation section 1.1502-13 necessary?

The following regulatory changes should be considered:

- (1) Amend Regulation section 25106.5-1, subsection (e), to add specific references stating that it is only an election to recognize intercompany "income or loss" on a separate entity basis.
- (2) Amend Regulation section 25106.5-1, subsection (a)(5)(A), to add a new subsection (a)(5)(A) 4 that indicates that sales factor sourcing located at subsections (a)(5)(A) 1 through 3 applies even if a subsection (e)(2) election has been made.
- (3) Amend Regulation section 25106.5-1, subsection (b)(6), to add a reference to subsection (a)(5) as follows, "Treatment as a separate entity means treatment without application of the rules of this regulation (other than the rules in subsections (a)(4) and (5))..."
- (4) Amend Regulation section 25106.5-1, subsection (f)(1)(B), to address mergers, subsequent capital contributions and tiered distributions.
- (5) Amend Regulation section 25106.5-1 to bring it into conformity with the most recent version of Treasury Regulation section 1.1502-13.

3. POSSIBLE SOLUTIONS

The intercompany transaction regulation could be amended to incorporate the above amendments. This would allow the FTB to ensure that taxpayers are reporting consistent with the principles underlying the subsection (e) election. Furthermore, this would provide taxpayers with guidance regarding the interplay between the DISA provisions and mergers, subsequent capital contributions and tiered distributions. Finally, conforming to the most recent version of Treasury Regulation section 1.1502-13 may eliminate many material inconsistencies.

The FTB anticipates hosting an open discussion to address concerns that may be presented by taxpayers and representatives. Interested parties should discuss alternatives for amending Regulation section 25106.5-1.