

## EXHIBIT A

When the original Regulation section 25106.5-1 was adopted, there were 16 documents that were listed as relied upon in the rulemaking file. That list is attached at [Exhibit B](#). Comments were made at the first interested parties meeting that indications of intent of the original regulation should be reviewed and shared from the rulemaking file. This document contains the requested review. Pertinent portions of the reference documents and the documents from the regulation process are summarized below and attached as exhibits.

### 1) 1999 FTB Publication 1061:

At pages 2 and 3 of 3, this publication discusses "Adjustments for Intercompany Transactions" (see attached [Exhibit C](#)). This section states the pre-regulation (1999) FTB policy regarding adjustments to "properly reflect intercompany transactions among unitary affiliates included in the combined report." (*Id.* at p. 2 of 3.) At "Other Factor Adjustments" it states, "For factor purposes, intercompany sales and other intercompany revenue items are eliminated in computing the numerator and denominator of the sales factor." (*Id.* at p. 3 of 3, emphasis added.) There is a notation that the FTB is "presently reviewing the treatment of intercompany transactions ... with the intention of promulgating regulations to provide more specific guidance." It also states that the guidelines may be changed and superseded by regulation. Hence, this publication states that as of 1999 intercompany transactions were not included in the sales factor and gives warning that a regulation is coming.

### 2) 1999 Treasury Regulation section 1.1502-13 Intercompany transactions

The treasury regulation upon which the California simplifying rules were modeled was attached as a reference in the rulemaking file. Since there is no apportionment at the federal level, all language within this document cannot provide a basis for making a sales factor adjustment in California when a subsection (e) election is made. The California regulation itself states that "unless otherwise specified" that the treasury regulation, which includes no apportionment, applies.

### 3) Summary of California Law on intercompany Transactions Between Members of a Unitary Group, by Michael Brownell, FTB for 1991 Tax Policy Conference.

This summary is attached as [Exhibit D](#). At page 1 of 4, *Chase Brass v. Franchise Tax Bd.* (1977) 70 Cal.App. 3d 457, 472 is summarized as standing for the fact that since gross sales are used to compute the sales factor, but net income is subject to franchise tax, and no net income is produced from internal sales, that such sales are not included in the sales factor. The election at issue is discussed in the Summary at page 2 (emphasis added) where it states, "An election for federal purposes to report income currently will be allowed for state purposes." Hence, at that reference, specific mention of currently reporting income is made with no accompanying reference to sales factor inclusion. More specifically, at ¶ 3 on page 2 of 4, "Property

and Sales Factors," the Summary states, "Generally, there is no reflection of intercompany sales in either the sales factor or in the value of the property for property factor purposes." (Page 4 was missing in the original in the Rulemaking file and hence is not included in this excerpt.)

4) Intercompany Transactions in a Combined Report – Preview of Upcoming Draft Regulations, by Ligia Machado, FTB

The subject paper is attached at [Exhibit E](#). Ms. Machado was on the drafting committee for Regulation section 25106.5-1 and represents that the "paper presents an overview of the approach that the staff of the FTB is taking as it drafts regulations to provide clarification and guidance for the treatment of intercompany items in a combined report." ([Exhibit E](#), p. 2 of 12). Ms. Machado states, "...only the amount and location within the group of intercompany items will be determined on a separate entity basis. As is done for federal purposes, the timing and sourcing of intercompany items will be determined as if the entities in a combined report are divisions of a single enterprise." (*Id.* at p. 3 of 12, emphasis added). This is the stated general rule and at no time does Ms. Machado state there is an exception to this general rule.

At pages 3 through 4 of 12, the Preview explains what factors are used when intercompany income is recognized after deferral and discusses how attributes are determined as though the entities were divisions of a single enterprise.

Apportionment of deferred gain using the current factors for the year in which intercompany items are taken into account is a much more administrable system.... ¶ Current factor apportionment produces the same result as if the parties were divisions of a single entity, and thus harmonizes well with unitary theory. Furthermore, now that the new federal regulations determine attributes (including source) of intercompany items as if the parties to the transaction were divisions of a single enterprise, the use of current factors is conceptually consistent with the deferral methodology.

At page 4 of 12, Ms. Machado discusses that FTB was striving to "take advantage of recordkeeping that taxpayers already have for book, federal tax, or foreign national purposes" and to keep California-only recordkeeping to a minimum. To that effect, the Preview states, "Generally, the methodology of the proposed system is modeled after the federal deferral system..."

As discussed earlier, the federal system does not apportion, so a change from the general apportionment rules for Regulation section 25106.5-1, subsection (a)(5) would have to be found somewhere other than in subsections copied from the treasury regulation and would have been specifically discussed in documents such as this Preview.

The FTB approach is explained in the Preview starting at the bottom of page 4 of 12, (emphasis added),

Intercompany items will generally be deferred and taken into account in accordance with the rules described in Treasury Regulation §1.1502-13 (as amended 7/12/95). In the year in which the intercompany items are taken into account, they are apportioned using the current apportionment factors for that restoration year....

The excerpt then continues explaining what is to be done when there is a water's edge election or where there must be a short period due to a disaffiliation so that income is accelerated, and concludes that in those circumstances, "items will be taken into account immediately before that event occurs, and the apportionment factors for that immediately preceding period will be used." The next paragraph on page 5 of 12 states, (emphasis added),

Intercompany transactions will not be reflected in the apportionment factors. Elimination of intercompany transactions from the factors prevents duplication and is consistent with the concept of treating unitary entities as divisions of a single enterprise.

Hence, there is no indication that those "current apportionment factors" would ever take into account the intercompany sales receipts. Ms. Machado quite clearly states that intercompany transactions will not be included in apportionment factors. This is consistent with her statements at page 4 of 12, "Current factor apportionment produces the same result as if the parties were divisions of a single entity, and thus harmonizes well with unitary theory." Had there been an exception in the case of a subsection (e) election, it would have been mentioned in the Preview at some point, and it was not.

The first example given on page 5 of 12, (emphasis added), explains why receipts from intercompany transactions are not included in the sales factor and concludes, "Inclusion of both the \$100 receipts from the intercompany transaction and the \$120 receipts from the sale outside the combined report would result in duplication, and would not fairly represent the market for the unitary business. To avoid this result, the \$100 intercompany receipts should be eliminated and only the \$120 receipts from the outside sale should be included in the sales factor." (*Id.* at p. 5).

Ms. Machado explains exceptions to the general rules starting on page 6 of 12. The first exception is for foreign entities that are allowed to treat intercompany items in the same manner as for consolidated financial statement purposes. (*Id.* at p. 6). In the beginning, the Preview explains, "When combined reports include foreign corporations, it can be difficult for taxpayers to apply California- only rules in order to compute foreign net income, particularly when the California activities are minor in relation to the worldwide operations." (*Id.* at p. 6, emphasis added). Because of the stated problem, the Preview concludes,

In recognition of this problem, FTB proposes to allow taxpayers to report the intercompany transactions of foreign corporations under the method that they use for consolidated financial reporting purposes, so long as that method

reasonably reflects income and approximates the result that would be obtained from use of a deferral method.

(Id. at page 6 of 12, emphasis added). As repeatedly explained by Ms. Machado, under the deferral method, intercompany receipts are not included in the sales factor to avoid duplication. She states that taxpayers will be allowed to report their intercompany transactions as they do for federal purposes with the only requirements being that income is reasonably reflected and it leads to a result similar to that under deferral (a method that eliminates intercompany receipts from the sales factor.)

The Preview, at page 7 of 12, paragraph 2, specifically addresses the subsection (e) election in a section entitled, "Current year recognition of intercompany items may be elected to the extent that such treatment is used for federal or foreign national tax purposes."

Combined reports frequently include corporations which are not in the federal consolidated return. To the extent that consolidated corporations engage in transactions with such unconsolidated corporations, any income or loss related to the transactions will have been reported on a separate entity basis for federal purposes. In addition, taxpayers may make a federal election to report intercompany items on a separate entity basis (i.e. current year recognition) even though such items would otherwise qualify for deferral. Taxpayers wishing to avoid treating such transactions differently for California purposes may elect to take intercompany items into account on the basis of current year recognition. This election will only be available to the extent that intercompany items are reported on a separate entity basis for federal or foreign national tax purposes.

The above excerpt defines "report intercompany items on a separate entity basis" to mean "current year recognition" which clearly has nothing to do with the sales factor as recognition is an income term, not an apportionment term.

Also on page 7, paragraph 3, The Preview states that, "current year apportionment will be the least complex method to comply with and administer, and the results will most closely achieve the objective of sourcing intercompany items as if the transaction had occurred between divisions of a single enterprise." This statement indicates that apportionment factors in the year of recognition should be as though the entities were divisions of a single enterprise, and hence there would be no sales factor inclusion of the intercompany receipts at the time of recognition of intercompany income.

The above explanations are illustrated in Example 1 at page 9. Standard deferral and elimination of intercompany receipts is explained, and then in the last paragraph an example of acceleration of the intercompany gain is provided. This is relevant because a subsection (e) election is simply another way of accelerating recognition of intercompany income. The final paragraph details that the factors used in the year of

income recognition when there is acceleration are the existing factors for that year. No mention is made of including intercompany sales receipts in the sales factor for the year of recognition.

5) State Tax Treatment of Intercompany Transactions Between Members of a Unitary Group, 1993, Michael E. Brownell

The portions of this paper that pertain to California are attached at [Exhibit F](#). This paper explained the 1993 California practice as of the time of drafting on page 3 of 14. The final line of subsection B.3. states,

...intercompany sales are not reflected in the sales factor.

This paper from Mr. Brownell discusses "Current taxation of intercompany transactions" starting on page 10. Subsection (b) gives the rationale against current taxation of intercompany transactions and asks,

If current taxation of such income is appropriate, would this call for inclusion of intercompany transactions in the sales factor? If so, wouldn't this allow unitary groups to manipulate their sales factors by controlling the destination of intercompany sales?

Hence, concern regarding possible manipulation if intercompany transaction receipts were included in the sales factor for currently recognized intercompany income was predicted back in 1993 and attached as a reference relied upon during the regulation drafting process.

6) Explanation of the Discussion Draft of the Section 25106.5-1A Regulations

This two page document is attached at [Exhibit G](#) and was written to accompany the proposed regulations. It is significant to note that the general statements regarding apportionment of intercompany transactions do not allow for an exception in the case of subsection (e) elections. Instead, the following applies to all of Regulation section 25106.5-1,

Apportionment. Consistent with the approach that intercompany transactions are taken into account as if the seller and buyer are divisions of a single corporation, intercompany transactions are eliminated from the apportionment factors. Intercompany items are treated as current apportionable business income in the period in which they are taken into account.

([Exhibit G](#), p. 1 of 3, emphasis added). The drafters were aware that there was a subsection (e) election contained in the proposed regulations, yet no exception was made so that subsection (e) elections to currently recognize intercompany income would have anything other than the generally applied apportionment rules under Regulation section 25106.5-1, subsection (a)(5).

7) Summary of Symposium – Discussion Draft Regulation Section 25106.5-1:  
Treatment of Intercompany Transactions in a Combined Report

This Summary covered the interested parties meeting held on June 8, 1999 and is attached at [Exhibit H](#). The third paragraph explains apportionment for intercompany transactions which is included at subsection (a) of the regulation. It states, "Under the draft regulation, intercompany transactions will not be reflected in the sales factor of the seller. If the buyer resells the asset outside the unitary group, the buyer's sales factor will reflect that third party transaction." (Exhibit H, page 1 of 6, emphasis added).

The Regulation section 25106.5-1, subsection (e) election was discussed at page 3. As has been the case in all prior documents, no mention was made in this complete explanation of a subsection (e) election that any different sourcing would apply than that found at subsection (a)(5) which states that intercompany transactions are not included in the sales factor.

8) Public Hearing of July 24, 2000: Summary of Public comments, Staff's  
Comments, Staff's Response, and Staff's Recommendations

The Summary is attached at [Exhibit I](#). The Regulation section 25106.5-1, subsection (e) election is discussed on page 6 of 13. In response to a comment, FTB states at the end of the response, "...the combined report regulations provide that separate elections may be made with respect to the separate income of each member. The only limitation is that all combined reports which include that member's income must reflect that member's income consistently." (Exhibit I, p. 6 of 13, emphasis added). No mention is made of a different rule for sales factor assignment than the general rule at Regulation section 25106.5-1, subsection (a)(5), and only income is discussed indicating the intent of the Regulation section 25106.5-1, subsection (e) election was to address income recognition.