State of California
Franchise Tax Board

1999 Guidelines for Corporations Filing A Combined Report

See California Code of Regulations Section 25106.5-0 through Section 25106.5-11 for combined reporting definitions and procedures adopted under Section 25106.5 of the Revenue and Taxation Code.

FTB Pub. 1061 1999

EXHIBIT: C
PAGE 1 OF 3

California has no provisions similar to the investment adjustments allowed for federal purposes under Treas. Reg. Sections 1.1502-32 and -33. The E&P of each entity in the combined report are calculated on a separate accounting basis and do not reflect the earnings of any lower tier subsidaries (see *Appeal of Young's Market Company*, Cal. St. Bd. of Equal., 11/19/86). Likewise, the cost basis of a unitary subsidiary's stock is not adjusted to reflect the earnings of that subsidiary (see *Appeal of Safeway Stores*, Cal. St. Bd. of Equal., 3/2/62 and *Appeal of Rapid American Corp*. Cal. St. Bd. of Equal., 10/10/96).

S Corporations

If an S corporation holds 100% of the stock of a subsidiary, and elects to treat that subsidiary as a qualified subchapter S subsidiary (QSub), then a combined return is not filed. Instead, the QSub is disregarded, and the activities, assets, liabilities, income, deductions, and credits of the QSub are treated as activities, assets, liabilities, income, deductions, and credits of the S corporation parent. If the QSub is not unitary with the S corporation, then it is treated as a separate division and separate computations must be made to compute business income and apportionment factors for the QSub and the S corporation, and to apportion to California the business income of each.

Corporations With Different Accounting Periods

Common Accounting Period Necessary

When filing a combined report, each member must align its income and apportionment data from its own accounting period to the accounting period of the "principal member." Where there is a parent-subsidiary relationship in the combined reporting group, the Parent Corporation will generally be the principal member. If there is no corporation in the combined reporting group which is a parent corporation to all the other members, the principal member will be the member that is expected to have, on a recurring basis, the largest value of real and tangible personal property in California as determined for property factor purposes. However, the taxpayer members of a combined reporting group may elect to treat any other member of the combined reporting group as the "principal member." But, unless the election is made in the first year that a combined report is required, the principal member may only be changed with the consent of the FTB.

Income Calculation

Each member of the group should generally use the actual figures taken from its books of account to determine the proper income and related computations corresponding to the accounting period of the principal member. This will usually require an interim closing of the books for members whose normal accounting period differs from the accounting period of the principal member. Alternatively, a pro-rata method of converting income to the principal member's accounting period will be accepted as long as the results do not produce a material misstatement of income apportioned to the state.

Pro-Rata Method

Under the pro-rata method, income of a member of the group is converted to the accounting period of the principal member on the basis of the number of months falling within the applicable income year. For example, if a parent corporation operates on a calendar year basis and a subsidiary includable in a combined report operates on a September 30 income year, it is necessary to assign 9/12 of the subsidiary's unitary income of one income year and 3/12 of the unitary income of the succeeding income year to arrive at a full twelve months' income to be included in the combined report. Where this procedure results in using the income of a corporation whose income year has not yet closed, it may be necessary to make an estimate based on available information and amend the return at a later date.

Apportionment of Combined Unitary Income Using a Common Accounting Period

The factors of the combined formula should be computed on the basis of the same accounting period as was used to compute the unitary income. If an interim closing of the books was done to determine income attributable to the accounting period of the principal member, then the actual figures from the interim closing should be used to determine the apportionment factors as well. If the pro-rata method is used to convert income, then a pro-rata method should also be used to convert the factors of a member of the group to the accounting period of the principal member.

Once income and apportionment factors have been placed on a common accounting period, combined unitary business income is apportioned to California and to each of the taxpayer member corporations filing returns in California. For each California reporting corporation with a normal accounting period which differs from the accounting period of the principal member, the California income apportioned to that corporation is then converted back to the corporation's normal accounting period. This conversion is made on the basis of the number of months falling within the common income year of the group.

The computations necessary to determine the combined income under the pro-rata method, when members of the group are on different accounting periods, are illustrated in the example beginning on page 9 of this publication.

Part-Year Members

A part-year member is a corporation that either becomes a member or ceases to be a member of the unitary group after the beginning of the income year. If the part-year member is required to file two short period returns for the income year, then the income for the period in which the member was unitary with the group must be determined on a combined basis. The income for the remaining short period will be determined on a separate basis (or on a combined basis with a different group if the taxpayer had a unitary relationship with one or more corporations in that short period).

If the part-year member is **not** required to file short period returns, then it must file a single return for the entire year. The income reported on that return would be determined by combined reporting procedures for any period in which the part-year member was part of a unitary group, and by separate accounting for any period it was not part of a unitary group. Use the actual income and apportionment data from the common unitary period to apportion income for that period. See the interim closing discussion under "Apportionment of Combined Unitary Income Using a Common Accounting Period." However, the comprehensive example beginning on page 9 contains an acceptable alternative method for this computation, if that method does not cause income apportioned to this state to be materially misstated.

Note: R&TC Section 24632 provides that the income year of a taxpayer may not be different than the taxable year used for purposes of the IRC, unless initiated or approved by the FTB. Whenever a taxpayer is required to file a federal return for a period of less than 12 months, a California return for that period is also required. Federal due dates for these short period returns also apply for California.

Adjustments for Intercompany Transactions

The following guidelines reflect the FTB's current policy regarding adjustments necessary to properly reflect intercompany transactions among unitary affiliates included in the combined report.

Note: The FTB is presently reviewing the treatment of intercompany transactions between members of a combined group with the intention of promulgating regulations to provide more specific guidance. The following guidelines are subject to change and may be superseded by regulation.

Inventories

Income from intercompany sales of inventory is eliminated from unitary business income. The seller's basis in the inventory will carry over to the buyer in the intercompany sale. Intercompany profits in inventory shall be eliminated for property factor purposes.

Intangible Assets

Gain or loss from intercompany sales of intangible assets shall be eliminated from unitary business income. The seller's basis in the intangible assets will carry over to the buyer in the intercompany sale.

Fixed Assets and Capitalized Items

The gain or loss on intercompany sales of business fixed assets or capitalized intercompany charges and expenditures between members of a combined group are generally deferred. The exception to this rule occurs when an affiliated group that files a consolidated federal return elects not to defer gain or loss on intercompany transfers. In that case, the federal election will be allowed for the combined report.

Under the general rule, the gain or loss remains deferred as long as both the seller and the purchaser remain in the combined group and the asset is not sold to outsiders. When either the seller or purchaser is no longer a member of the combined group, or the group for any reason terminates combined reporting, the gain or loss is reportable by the seller at a time immediately preceding the date either corporation ceases to

EXHIBIT: C
PAGE 2 OF 3

be a member of the group. If the asset is sold to third parties, the deferred gain or loss is reportable by the combined group in the year of sale. A water's-edge election is also a restoration event which will cause previously deferred intercompany gains and losses to be included in income on a pro-rata basis over five years (refer to FTB Notice 89-601 for further details of this computation). The amount of gain recognized upon the occurrence of a restoration event is generally the same amount that would be reportable for federal purposes under similar circumstances in a consolidated return.

Where intercompany gain or loss is deferred, the basis of the asset for property factor purposes shall be the seller's cost.

Other Factor Adjustments

For factor purposes, intercompany sales and other intercompany revenue items are eliminated in computing the numerator and denominator of the sales factor. Intercompany rent charges are also eliminated from the property factor computation.

Dividends

To the extent that intercompany dividends are paid out of E&P derived from unitary business income, they are eliminated in computing the California measure of tax (R&TC Section 25106). In determining whether a dividend is paid out of unitary E&P, distributions are deemed to be paid first out of current E&P and then out of prior years' accumulation in reverse order of accumulation. Distributions paid out of nonbusiness E&P or distributions from E&P accumulated prior to the time the payer corporation became a member of the combined group are not eliminated from the income of the recipient corporation (although such dividends may be subject to deduction under R&TC Section 24402 or Section 24411).

An intercompany distribution which exceeds the payer's E&P and stock basis (described by IRC Section 301(c)(3)), is not treated as income from an intercompany sale of an asset, and is not subject to the treatment of income from intercompany sales between members of a unitary group described above. It is instead characterized as income from a distribution, and is generally subject to tax under *Safeway Stores v. Franchise Tax Board (1970) 3 Cal. 3d. 745*, even if both distributor and distributee are members of a unitary group. However, the taxpayer members of the unitary group may request a closing agreement with the FTB which would allow income from such distributions to be deferred. After February 18, 1998, the request to enter into a closing agreement must be received by the extended due date of the applicable return for the income year of the distribution. For further information, get FTB Notice 97-2.

Unitary Partnerships

When a corporation is a partner in a partnership and the partnership's activities are unitary with the corporation's activities (disregarding ownership requirements), then the corporation's share of the partnership's trade or business is combined with the corporation's trade or business (see 18 Cal. Code Regs. Section 25137-1). For example, assume that Corporation A has a 20% partnership interest in Partnership P and that the activities of Corporation A and Partnership P are unitary. The apportionment factors for A and P are as follows:

Apportionment Factor of a Corporation and a Unitary Partnership

	EVERYWHERE		CALIFORNIA	
	Corporation A	Partnership P	Corporation A	Partnership P
Property	400,000	250,000	300,000	75,000
Payroll	100,000	50,000	50,000	25,000
Sales	500,000	300,000	400,000	100,000

Corporation A's 20% share of Partnership P's property, payroll, and sales is included in the combined apportionment factor:

		EVERYWHERE	CALIFORNIA	FACTOR
Combined Property:	Corporation A	400,000	300,000	
	Partnership P (20%)	50,000	15,000	
	Combined	**450,000**	**315,000**	**70%**
Combined Payroll:	Corporation A	100,000	50,000	
	Partnership P (20%)	10,000	5,000	
	Combined	**110,000**	**55,000**	**50%**
Combined Sales:	Corporation A	500,000	400,000	
	Partnership P (20%)	60,000	20,000	
	Combined	**560,000**	**420,000**	**75%**
	Combined x 2			**150%**
Average Apportionment Factor				**67.5%**

Net business income for Corporation A and Partnership P was $300,000 and $100,000 respectively. Assuming that Corporation A's distributive share of Partnership P's profits and losses was also 20%, Corporation A's net income apportioned to California would be:

Corporation A net business income	$300,000
Corporation A's distributive share of Partnership P's net business income ($100,000 x 20%)	20,000
	320,000
Multiplied by combined apportionment factor	x 67.5%
Corporation A's net income apportioned to California	$216,000

EXHIBIT: C
PAGE 3 OF 3