

Summary of California Law on Intercompany Transactions Between Members of a Unitary Group

I. History of California practice.

A. The original general practice with respect to intercompany transactions was the same as the old federal practice, i.e. elimination of gain from the transaction and transfer of the basis to the transferee. See Appeal of Pacific Telephone, Cal. St. Bd. of Equal., May 4, 1978 (involving income years 1961 and 1963).

B. In Chase Brass v. Franchise Tax Board (1977) 70 Cal.App. 3d 457, 472 (involving income years 1954, 1955, and 1956) the taxpayer asserted that intercompany sales should be reflected in the sales factor. The court held that the Franchise Tax Board (FTB) did not err by excluding such sales, stating, "These contentions ignore the fact that while gross sales are used to compute the sales factor, only net income is subject to the franchise tax. Since no net income was produced by the internal sales, it was not required that they be included in the computation.

C. In 1978, the FTB sent a letter to the "tax services" which, after describing the federal regulations and the federal election to treat income from intercompany transactions as current income, stated "In order to minimize differences as to the amounts of income subject to tax for state and federal purposes, the federal provisions regarding the period for which income from intercompany transactions is reportable will be accepted for state corporation franchise and income tax purposes when a consolidated group determines income on the basis of a combined report which includes the same members unless the transactions appear to have been adopted for the purpose of avoiding state franchise or income taxes (emphasis added)."

*This outline was prepared by Michael Brownell, Sr. Counsel, Franchise Tax Board for the 1991 California Tax Policy Conference.

D. In 1979, in a response to a question from the California Society of CPAs, the FTB stated that "It has been the general rule of this department that the gain or loss on the intercompany sale of business assets between members of a combined report shall be deferred." The response indicated that deferred gain would be restored when the asset was sold to outsiders, or when either the purchaser or seller left the combined group.

E. In September 1981, the FTB issued its form 1061, Instructions for Corporations Filing a Combined Report, which provided rules for intercompany transactions. These rules apply only with respect to transactions between members of a unitary group. Thus, transactions which are deferred under federal consolidated return treatment will not necessarily be deferred for state purposes. Transactions deferred for state purposes will not necessarily be deferred for federal purposes (e.g. more than 50% of the voting stock held, but less than 80%).

1. Inventories.

(a) In computing cost of goods sold intercompany profits are eliminated from beginning and ending inventories.

(b) The value of inventory for property factor purposes is adjusted to eliminate intercompany gains.

2. Fixed Assets and Capitalized Items.

(a) Gain or loss on intercompany sales of business fixed assets or capitalized charges or expenditures is deferred.

(b) An election for federal purposes to report income currently will be allowed for state purposes.

(c) If the seller or purchaser are no longer a member of the combined report, the deferred gain is restored.

(d) Deferred gain is restored if both the seller and purchaser remain in the combined report but the asset is sold to outsiders.

(e) The amount of the gain recognized is generally the same amount as reportable under federal consolidated reporting.

(f) The property factor for the property sold intercompany shall be the seller's cost.

3. Property and Sales Factors. Generally, there is no reflection of intercompany sales in either the sales factor or in the value of the property for property factor purposes.

4. Issues not addressed in Form 1061.

(a) Treatment of intangibles; definition of fixed assets. Consider effect of prior treatment of "business assets" in the 1979 notice.

(b) Apportionment of previously deferred gain on restoration (including gain restored from the depreciation add-back).

(c) Defining the combined group, where group during deferral is different than the group at the time of restoration.

(d) Effects of deferred treatment on members of the group other than purchaser and seller, and the effects of those members entering or leaving the group.

(e) Effects of members of the group entering and leaving the tax jurisdiction of the State.

(d) Apportioned gains or losses are to be included in income on a pro rata basis for the first five income years to which the original election applies.

(e) The FTB Notice did not define the deferred transactions subject to the treatment prescribed for water's-edge. Presumably a reference to the Form 1061.

(f) Form 1061 would imply elimination treatment with respect to inventory. Major issue presented by water's-edge election where there were substantial outstanding inventory transactions between electing and excluded entities.

G. In 1987 AB 129 (Stats. 1987, Ch. 918) added Section 25106.5:

1. Section 25106.5: "The Franchise Tax Board may adopt regulations necessary to ensure that the tax liability or net income of any taxpayer whose income derived from or attributable to sources within this state which is required to be determined by a combined report pursuant to Section 25101 or 25110 of this chapter, and of each entity included in the combined report, both during and after the period of inclusion in the combined report is properly reported, determined, computed, assessed, collected or adjusted."

2. Broad authority similar to Section 1502, IRC, authorizing the Commissioner to regulate with respect to federal consolidated returns.