# INTERCOMPANY TRANSACTIONS IN A COMBINED REPORT

# PREVIEW OF UPCOMING DRAFT REGULATIONS

**Presented by**

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# INTERCOMPANY TRANSACTIONS IN A COMBINED REPORT

## *PREVIEW OF UPCOMING DRAFT REGULATIONS*

This 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.[1]

A. ***Considerations that FTB took into account in developing a comprehensive approach.***

1. ***The tension between separate taxpayer vs. single entity treatment***

The concept of the combined report originated as a means of ensuring that the income of a unitary business conducted partly within and partly without the state would be computed and apportioned in the same manner whether the business is conducted by a single corporation or by multiple controlled corporations.[2] The notion that gain or loss should not be taken into account until there has been an economic effect to the unitary group as a whole is therefore consistent with the combined reporting concept.

Notwithstanding the combined reporting ideal of treating unitary corporations as a single economic unit, the fact remains that unitary affiliates are treated as separate taxpayers for many other purposes of the California Revenue & Taxation Code. Unitary entities are only combined for purposes of sourcing income. Once combined income is apportioned to California, each taxpayer in a combined report determines its share of that income, and is then subject to its own tax liability, NOL carryovers and tax credits.

The necessity for preserving separate taxpayer status for some purposes under the California Rev. & Tax. Code creates issues concerning the extent to which single-entity treatment is desirable. Should single entity treatment be reflected only in the timing of intercompany items, or should it determine the sourcing and attributes of those items? In new regulations which became final on July 12, 1995, the IRS has attempted to balance this problem in a manner that treats consolidated entities as separate entities for some purposes but as divisions of a

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[1] The views expressed herein do not necessarily reflect those of the Franchise Tax Board.

[2] See Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 Journal of Taxation 106 (1975).

single entity for other purposes. FTB plans to generally follow the federal approach, but with certain exceptions which are necessary in order to address apportionment and jurisdictional problems. In general, 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.

2. *Apportioning intercompany items using the apportionment factors from the time of the intercompany transaction vs. the time when the items are reflected in income*

Under the pre-95 federal methodology for treating intercompany transactions, intercompany gain or loss was considered to be realized and recognized at the time of the transaction. The source of the gain or loss was also considered to be fixed at that time. Restoration of deferred intercompany gain or loss using the historical apportionment factors from the time of the intercompany transactions was consistent with the theory behind the pre-95 federal approach. On the other hand, such "historical apportionment" would be quite difficult to administer and comply with. Theoretically, it would require identification of transactions on a worldwide, year-by-year, entity-by-entity basis. For example, assume that a member of a combined report sells one of its facilities. Included in the sale are various pieces of equipment which had been acquired through different intercompany transactions in each of ten preceding years. Ten separate apportionment calculations would be necessary in order to apportion each deferred gain in accordance with the factors from the year(s) of the intercompany transaction.

Furthermore, use of pure historical apportionment factors would require that a share of the gain be apportioned to each taxpayer who was a member of the group at the time of the intercompany transaction. In order to accomplish this, recognition of deferred gain would have to be accelerated for any taxpayer who left the combined report or withdrew from California, even if that taxpayer was not an immediate party to the intercompany transaction. This would require each taxpayer to keep track of its intrastate apportioned share of each year's intercompany transactions occurring between combined affiliates on a worldwide basis.

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. Multiple apportionment computations will not be required because the restored income will simply be included in the combined business income of the group in existence at the time of the restoration. If either the buyer or seller from an intercompany transaction leaves the combined report, the entire gain



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from that transaction will be restored. On the other hand, there will be no effect on restoration (i.e., no need to restore income on a piecemeal basis) as members who were not immediate parties to the intercompany transaction leave the combined report or withdraw from the state. Therefore, there will be no need for taxpayers to spread deferred items among the entities on a year-by-year basis.

It is clear that the use of current factors for apportioning intercompany items is more desirable from an administrative and compliance standpoint. 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. Except in unusual situations (which are discussed below in Item C.3), there is no longer any theoretical advantage to the use of historical factors.

### 3. *Administrability and ease of compliance*

Any method of eliminating or deferring the effect of intercompany transactions requires detailed recordkeeping and tracking of transactions. In developing a system for accounting for such transactions, FTB strived to take advantage of recordkeeping that taxpayers already have for book, federal tax, or foreign national tax purposes. It is impossible to totally eliminate California-only recordkeeping requirements for intercompany transactions because the California combined report is often made up of different entities then the federal consolidated return or the consolidated financial statements, but enough flexibility has been built in to the proposed system to keep such recordkeeping to a minimum.

Generally, the methodology of the proposed system is modeled after the federal deferral system, so much of the required deferral and restoration will be the same for California purposes as for federal. As explained in Item C of this paper however, exceptions to this rule will provide taxpayers with alternatives in cases where deferral is not done for federal purposes.

## B. *FTB's Approach, In General*

The methodology of the proposed system is modeled after the current federal deferral system. Intercompany items will generally be deferred and taken into account in

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accordance with the rules described in the Treasury Regulation §1.1502-13 (as amended 7/12/95). In the year in which intercompany items are taken into account, they are apportioned using the current apportionment factors for that restoration year. If intercompany items are taken into account as a result of a water's-edge election or an event which causes a short period (such as a disaffiliation), then the items will be taken into account immediately before that event occurs, and the apportionment factors for that immediately preceding period will be used.

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.[3]

For example, assume that a product is sold for $100 by a manufacturer to its unitary distributor in an intercompany transaction. Assume that the distributor then resells the product to its unrelated customer for $120. 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.

As another example, assume that S and B are members of a combined report. S owns a building which it rents to B for use in the unitary business as a retail outlet. S's cost of the building is already represented in the property factor as owned property used in the trade or business. If B then includes the rent expense that it pays to S in the property factor (capitalized by eight), then the value of the building will have been double-counted. Consequently, the intercompany rent expense should not be reflected in the property factor, and only the original cost should be included.

When an asset is transferred in an intercompany sale under the deferral system, the buyer's basis in the asset for most purposes will be its own cost basis (the amount that the buyer paid). For purposes of the property factor however, the intercompany sale will not be reflected, and the asset will still be reflected at the original cost to the unitary group (the seller's cost). Since the asset was used in the unitary business both before and after the intercompany sale, to permit the property factor valuation to be stepped-up as a result of the intercompany sale would create a lack of parity with other assets which also continue to be used in the business and which are still reflected at original cost. Such a step-up in the valuation would create differing apportionment based upon the form in which the entities operate, and would provide opportunities for manipulation of the property factor.

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3 Elimination of intercompany sales from the sales factor was approved in *Chase Brass & Copper Co. vs. Franchise Tax Board*, (1977) 70 Cal.App. 3d 457.

Examples to illustrate the operation of FTB's general approach are attached at the end of this paper.

## C. *Exceptions to the general rules*

### 1. ***Subject to certain restrictions, foreign entities will be permitted to treat intercompany items in the same manner as for consolidated financial statement purposes.***

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. 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. Adjustments may be permitted or required, however, for any transaction for which the financial reporting method does not produce a reasonable result.

*Example:* Corporation P is a domestic parent which files a combined report with its foreign subsidiaries X and Y. X and Y are involved in numerous intercompany transactions. One of these transactions involved X's sale of a patent with a basis of 10x to Y for 50x. For financial reporting purposes, X eliminated the intercompany gain, and the patent continued to be reported on the consolidated balance sheet at a basis of 10x. Subsequent to the intercompany sale, all of the stock of Y was sold to an unrelated party. If the deferral method had been used, Y's departure from the combined report would trigger recognition of $40 deferred gain. Under the financial accounting method used by the taxpayer however, the intercompany gain will not be triggered, and will thus never be taken into account in the combined report. Recognition of the gain is material to the computation of the California tax. In this situation, an adjustment would be required to take the gain into account immediately before the sale of Y stock in order to approximate the results that would have been obtained from use of a deferral method. If Y's other intercompany transactions were not material to the computation of California tax, either individually or in aggregate, then no adjustments would be required with respect to those transactions.

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2. ***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.[4] 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.

3. ***FTB is evaluating whether, and under what circumstances, a taxpayer would be permitted or required to apportion intercompany items using historical apportionment factors.***

As a general rule, deferred items will be apportioned using the current apportionment factors from the year in which the items are included in income (current year apportionment). In most cases, 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. The department is evaluating whether exceptions to current year apportionment should be allowed (or required) under certain conditions, such as where there is a large increase or decrease in the California apportionment factors between the year of the intercompany transaction and the year in which the intercompany item is included in income, or where necessary to prevent manipulation.

**D.** *Intercompany Distributions*

1. ***No change is anticipated to the current application of Section 25106.***

Under California Revenue & Taxation Code Section 25106, dividend distributions between members of a combined report are eliminated to the extent that they are paid from earnings of the unitary business. Dividends paid from earnings and profits that were earned prior to the dividend payor becoming a

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[4] Treas. Reg. §1.1502-13(e)(3), as amended 7/12/95.

member of the combined report are not eligible for elimination.[5] The Section 25106 elimination of intercompany dividends is generally similar to the federal consolidated return treatment, except that the federal rules do not require that the earnings and profits of the dividend payor be earned during the period of consolidation.[6]

The provisions of Section 25106 are statutory, technically narrow, and long established. No changes in the application of those provisions is expected.

2. *Non-dividend distributions in excess of stock basis.*

If a distribution exceeds the earnings and profits and stock basis of the payor, Internal Revenue Code Section 301(c)(3)[7] provides that the excess is treated as income from the sale of property. Under FTB's proposed approach, the excess distributions would not be included in income in the year of the distribution, but would go into a Deferred Intercompany Stock Account which would generally operate as a negative basis account. The balance of the Deferred Intercompany Stock Account would be restored into income when stock of the distributor is sold or when either the distributor or distributee otherwise leaves the combined report. In this limited respect, the Deferred Intercompany Stock Account would operate in the same manner as the federal excess loss account (ELA)[8].

When the Deferred Intercompany Stock Account is recaptured into income, it will generally be apportioned using the current apportionment factors for that year. As discussed in Item C.3, the department is evaluating whether exceptions to the use of current apportionment factors should apply under certain circumstances.

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5 *Willamette Industries, Inc. vs. Franchise Tax Board*, (1995) 34 Cal.App.4th 1242.

6 Prior to July 12, 1995, Treas. Reg. §1.1502-14(a)(1) provided for the federal consolidated return treatment of dividend distributions. As of 7/12/95, the rules for intercompany dividend distributions were combined with rules for intercompany distributions in general in Treas. Reg. §1.1502-13(f)(2).

7 Revenue & Taxation Code Section 24451 conforms to this provision.

8 Treas. Reg. §1.1502-13(f)(2); -19, -32.

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## *EXAMPLE 1: Proposed California Treatment of Intercompany Sale in a Combined Report*

- S and B are members of a combined report.
- S holds land with a basis of $70.
- In Year 1, S sells the land to B for $100.
- In Year 3, B sells the land to an unrelated party for $110.

The average apportionment factors for the S-B group are:

Year 1: 33%
Year 2: 35%
Year 3: 30%

On a separate basis:

⇒ S has intercompany gain of $30 in Year 1 ($100 sale price - $70 basis).

⇒ B has corresponding gain of $10 in Year 3 ($110 sale price - $100 basis).

Treated as divisions of a single entity, there would be a $40 gain in Year 3 ($110 sale price - $70 basis from transfer between divisions.

To achieve the effect of treating S & B as divisions of a single entity, S's $30 gain will be taken into account in Year 3 (S's $30 gain + B's $10 gain = $40).

Furthermore, if S and B were divisions of a single entity, then the entire $40 gain would be apportioned to California based on the apportionment factors in Year 3. Therefore, both S's $30 gain and B's $10 gain are apportioned to California using the 30% average apportionment factor for Year 3. The net amount of gain included in California income will be $12 [($30 + $10) X 30%].

The effect of this transaction on the apportionment factors is as follows:

- Sales factor: The intercompany transaction will not be reflected in the sales factor in Year 1. In Year 3, the $110 gross receipts from B's sale of the land will be included in the sales factor.
- Property factor: The land will continue to be reflected in the property factor at it's $70 original basis until it is sold outside the combined report in Year 3.

If the effect of treating S & B as divisions of a single entity can't be achieved, then S's intercompany gain will be accelerated. For example, assume that 60% of the stock of B is sold so that B is no longer included in the combined report on January 1 of Year 3. S's $30 gain will be taken into account as of December 31 of year 2, and will be apportioned to California using the year 2 apportionment factor of 35%.

## *EXAMPLE 2:* ***Proposed California Treatment of Intercompany Sale of Depreciable Property***

- S and B are members of a combined report.
- On January 1 of year 1, S buys property for $100, and depreciates it using the straightline method over a 10-year life. (Annual depreciation deduction = $10.)
- On January 1 of year 3, S sells the property to B for its $130 fair market value. At that time, S had an adjusted basis in the property of $80. S's intercompany gain is $50.
- B determines that the remaining useful life of the property is 10 years, and elects to depreciate the property using the straightline method. (Annual depreciation deduction = $13.)
- The average apportionment factors for the S-B group are:

| | |
|---|---|
| Year 1: | 8% |
| Year 2: | 10% |
| Year 3: | 10% |
| Year 4 | 12% |
| Year 5 | 15% |

If S and B were divisions of a single entity, then $10 depreciation would be deducted in each of Years 3 through 10. In order to achieve this result, S will take into account $3 of its intercompany gain each year (the net result of B's $13 depreciation deduction and S's $3 intercompany gain equals $10).

In Years 11 and 12, the property would have been fully depreciated if S and B had been divisions of a single entity. In order to achieve this result, S will take into account $13 of its remaining intercompany gain in each of those years so that the $13 depreciation deductions still being reported by B will be fully offset.

**Apportionment of intercompany gain:** The portion of the intercompany gain taken into account in Year 3 will be apportioned along with the rest of that year's unitary business income using the Year 3 apportionment factor of 10%; the portion of the intercompany gain taken into account in Year 4 will be apportioned using the Year 4 apportionment factor of 12%, and so forth.

**Effect on factors:**
Sales factor: The intercompany transaction will not be reflected in the sales factor in Year 3.

Property factor: The property will continue to be reflected in the property factor at its $100 original cost basis.

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## *EXAMPLE 3: Proposed California Treatment of Section 351 Transaction Between Members of a Combined Report*

- S holds land with a basis of $70 and a fair market value of $100. The land is subject to liabilities of $80.
- On January 1 of Year 1, S transfers the land to B in exchange for all of the stock of B and B's assumption of the $80 liability. Section 351 applies to the transaction
- In Year 3, B sells the land to an unrelated party for $100.
- The average apportionment factors for the S-B group are :

  Year 1: 33%
  Year 3: 30%

On a separate basis:

- The excess of the assumed liabilities over S's adjusted basis in the land are considered boot, and result in a $10 intercompany gain to S in Year 1.
- B's basis in the land is $80 (S's $70 basis + $10 gain). B has a corresponding gain of $20 in Year 3.

Assume that S and B are instantly unitary. Treated as divisions of a single entity, there would be a $30 gain in Year 3 ($100 sale price - $70 basis.

To achieve the effect of treating S and B as divisions of a single entity, S's $10 gain will be taken into account in Year 3 (S's $10 gain + B's $20 gain + $30). Both S's and B's gains will be apportioned using the 30% average apportionment factor for Year 3.

Effect on apportionment factors:

Sales factor: The transaction is not reflected in the sales factor in Year 1. In Year 3, the sales factor will include the $100 gross receipts from B's sale of the land.

Property factor: For property factor purposes, the land will continue to be valued at its $70 original cost basis until it is disposed of outside the combined report.

*EXAMPLE 4:* ***Proposed California Treatment of Services Performed Between Members of a Combined Report***

S is in the business of drilling water wells, B operates a cattle ranch, and requires water to maintain its cattle. B pays S $100 to drill a water well on B's ranch. S incurs $80 of expenses in connection with that drilling project.

On a separate basis:

- S takes its intercompany income and expenses into account in Year 1, and has $20 intercompany profit.
- B depreciates the cost of the well over its 10 year useful life, and deducts $10 of depreciation in each of Years 2 through 11.

Treated as divisions of a single entity, the cost of $80 would be capitalized and depreciated over 10 years, for depreciation deductions of $8 in each of Years 2 through 11.

In Year 1, $80 of S's income and the $80 expenses will be taken into account. The remaining $20 of intercompany income will be taken into account over 10 years ($2 per year) in order to achieve the same effect as if S and B were divisions of a single entity ($10 depreciation - $2 income = $8 net deduction).

Effect on factors:

- Sales factor: This transaction will not be reflected in the sales factor in any year.
- Property factor: The $80 capitalized cost will be included in the property factor.