State Tax Treatment of Intercompany Transactions Between Members of a Unitary Group

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from earnings and profits deficits incurred by the subsidiary after the stock basis is reduced to zero.

b. Restoration of income from an ELA. Income from an excess loss account is restored in accordance with the rules of Treas. Reg. §1.1502-32, and Reg. §1.1502-19. Generally, the ELA is restored to income to the extent the holder of the stock of the subsidiary is considered to have disposed of its stock. Disposition occurs to the extent that the shares are actually transferred or redeemed. In addition, disposition is deemed to have occurred as to all shares when either distributor or distributee leaves the group, or the group ceases to file a consolidated return.

IV. CALIFORNIA PRACTICE REGARDING TREATMENT OF INTERCOMPANY TRANSACTIONS BETWEEN MEMBERS OF A UNITARY GROUP.

A. History of California practice.

1. 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 basis to the transferee. See Appeal of Pacific Telephone, Cal. St. Bd. of Equal., May 4, 1978 (involving income years 1961 and 1963).

2. In Chase Brass v. Franchise Tax Board (II) (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 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." The view that no income was produced by intercompany sales is consistent with elimination and basis transfer methodology.

3. In 1978, the Franchise Tax Board 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)." While the scope of the letter may not have been as broad as this language would indicate, the

portion quoted above arguably suggested a permissive use of consolidated reporting methodology.

4. In 1979, in a response to a question from the California Society of CPAs, the Franchise Tax Board 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.

B. Current California Practice. In September 1981, the FTB issued its Form 1061, Instructions for Corporations Filing a Combined Report. Now Publication 1061, this form provides 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 eliminated or deferred for state purposes. Transactions deferred or eliminated 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. In computing cost of goods sold intercompany profits are eliminated from beginning and ending inventories. The value of inventory for property factor purposes is adjusted to eliminate intercompany gains.

2. Fixed Assets and Capitalized Items. Gain or loss on intercompany sales of business fixed assets or capitalized charges or expenditures is deferred. Deferred gain is restored if either the seller or the purchaser leave the unitary group or the asset is sold to outsiders. Generally the gain is to be restored as in federal consolidated practice. If the members of a consolidated return group have an election to report income currently will be allowed for state purposes.

3. Effects on Apportionment factors. Generally, the property factor for the property sold in an intercompany transaction is not generally affected by the sale, and the purchaser must use the seller's original cost in its property factor. In addition, intercompany sales are not reflected in the sales factor.

C. Issues not addressed in Publication 1061.

1. Intangibles. The Publ. 1061 is silent as to the appropriate treatment of intangibles. It is unclear whether elimination and basis transfer principles apply, as in the case of inventory, or whether deferred treatment applies, as

in the case of fixed assets, or whether current taxation is appropriate.

2. Apportionment of deferred income. There are no rules regarding the apportionment of previously deferred gain from the sale of fixed assets on restoration events (including gain restored from the depreciation add-back). Should the apportionment percentage at the time of the intercompany sale apply, or should the apportionment percentage at the time of the restoration event govern?

3. Effects of changes in the group. Publ. 1061 provides no guidance for defining the combined report group, and the effects that occur where group during deferral is different than the group at the time of restoration.

4. Effects on other members. The Publ. 1061 does not describe the 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.

5. Effects of leaving tax jurisdiction. There are no rules in the Publ. 1061 which deal with the effects of members of the group entering and leaving the tax jurisdiction of the state.

D. Water's edge elections. Under Section 25111, corporations doing business in California are permitted to file as if certain affiliated foreign corporations were not members of their unitary group. If those foreign corporations were formerly in a unitary relationship with the electing corporation, those corporations may have had intercompany transactions in prior year. The termination of the unitary relationship by a water's edge election raises the question as to the proper treatment of those transactions on deemed termination of the unitary relationship as a result of the election.

1. FTB Notice 89-601. In FTB Notice 89-601, the Franchise Tax Board indicated that a water's edge election would cause deferred intercompany gains or losses to be taken into account. Under that notice:

a. Deferred gains or losses are to be subject to apportionment using the apportionment factor for the income year immediately preceding the income year of the election.

b. Taxpayer, at its election, is permitted to use the factors of the income year the original deferred intercompany transaction took place.

c. FTB may require use of factors of the income year in which the deferred intercompany transaction took place only if the apportionment percentage of the preceding year varied by more than 10% from the apportionment percentage of the year of the transaction, and the total additional income apportioned to California exceeds $100,000. Apportioned gains or losses are to be included in income on a-prorata basis for the first five income years to which the original election applies.

2. Issues not addressed in the notice. The FTB Notice did not define the deferred transactions subject to the treatment prescribed for water's edge. Presumably, the Notice refers to the transactions described in the Publ. 1061. As noted above, that would imply elimination and basis transfer treatment with respect to inventory. Thus, a very significant issue is presented by water's edge election where there were substantial outstanding inventory transactions between electing and excluded entities.

a. If elimination and basis transfer applies, prior to the water's edge election, after the sale by a foreign corporation to a domestic affiliate, the purchaser takes the seller's basis. After the election, income from the later sale of inventory is apportioned using the water's edge group's apportionment percentage (primarily U.S.).

b. On the other hand if, prior to the water's edge election, there is a sale of inventory by a domestic corporation to a foreign affiliate, the foreign affiliate takes the seller's basis. After the election, income from the later sale of the inventory by the purchaser is not subject to taxation if the purchaser is not in the water's edge group.

V. CALIFORNIA REGULATION OF INTERCOMPANY TRANSACTIONS. The California Franchise Tax Board is currently being challenged in its use of combined reporting on a worldwide basis. While it has been successful in defending that practice in the California courts (Barclay's Bank v. Franchise Tax Board (1992) 2 Cal.4th 708) examination of the use of a worldwide combined report may be soon undertaken by the U.S. Supreme Court. If the court were to invalidate the use of the unitary method on a prospective basis, there will be some point in time where the use of worldwide combined reporting will be acceptable and thereafter would not. If so, at the point in time where combination is no longer appropriate, there will be significant effects with respect to outstanding intercompany transactions will then become significant. Because the effects of prospective decombination, both in a constitutional challenge and with a water's edge election, are substantial, and because of the uncertainty surrounding the appropriate treatment of such transactions under current law, the Franchise Tax Board was received statutory authority in Section 25106.5, Cal. Rev. and Tax Code (AB 129 (Stats. 1987, Ch. 918)) to promulgate regulations regarding the mechanics of the combined report:

A. Section 25106.5, Rev. and Tax. Code: "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 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."

B. Similarity to consolidated regulatory authority. The authority in Section 25106.5 is broad regulatory authority similar to Section 1502, IRC, which authorizes the Commissioner to regulate with respect to federal consolidated returns. Given the broad grant of authority in Section 25106.5, the Franchise Tax Board could expand the scope of its regulatory endeavors beyond the issue of intercompany transactions.

C. Models Under Consideration. Regulations have not been issued under Section 25106.5. Drafts have been prepared, but are being held for further review and/or revision. General public input has been sought and obtained. Potential models for treatment of intercompany transactions between unitary corporations include: 1) Current taxation, 2) Elimination and basis transfer, 3) Deferred taxation, apportioning restored income using the apportionment percentage at the time of the original intercompany transaction, 4) Deferred taxation, apportioning restored income using the apportionment percentage at the time of the restoration event.

1. Current taxation of intercompany transactions. There is some support in the California case law for treating income from intercompany transactions between members of a unitary group as currently taxable under the California law. In Safeway Stores v. Franchise Tax Board (1970) 3 Cal.3d 745, the California Supreme Court held that an intercompany dividend paid between unitary taxpayers was currently taxable to the recipient, despite that both payor and payee of the dividend were members of a unitary group. (This holding has been reversed by statutory amendment, see Section 25106, Rev. and Tax Code.) While the case is somewhat qualified by the fact that dividends were generally characterized as nonbusiness income at the time, the case does provide some authority for current taxation.

a. Rationale in favor of current taxation. Notwithstanding the use of the unitary method, the members of a unitary group are separate corporate entities, transactions between them are realized and recognized and should be reported currently. In addition, administrative problems of accounting for intercompany transactions, such as tracing and apportionment, are at a minimum, although financial accounting data, which may reflect elimination of such income, will require adjustment.

b. <u>Rationale against current taxation</u>.

(1) Income from intercompany sales should not be taken into account until the income produces an economic benefit to the unitary group as a whole, a rationale supported by the holding in <u>Chase Brass v. Franchise Tax Board</u>, supra. Transfers between divisions of a single corporation are not taxed on a current basis. Current taxation would place a premium on a taxpayer's choice to operate in corporate form.

(2) 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?

(3) The current reporting of such income is inconsistent with consolidated financial accounting principles which eliminate such income.

(4) Current reporting of such income would result in a substantial variation between federal and state treatment, where the trend is toward such conformity. Under both current and historical treatment of such transactions in the federal consolidated return regulation, such income was not taken into account currently, except by election.

(5) Members of a unitary group could control the timing of intercompany sales to absorb losses otherwise forced into net operating loss treatment. California law generally allows a carryforward of only 50% of a taxpayer's net operating losses, and at the present time such losses are suspended and not available as a deduction.

2. <u>Elimination and basis transfer</u>. This method would follow the historical treatment in the federal consolidated return regulations: Income from intercompany transactions is eliminated and the basis in the asset is transferred to the transferor.

a. <u>Rationale in favor of use</u>:

(1) Elimination and basis transfer treatment is generally consistent with financial accounting treatment. For world-wide combined reporting, elimination and basis transfer would avoid having to conform international accounting practice to federal consolidated reporting methods. The method is consistent with treatment of transfers of assets between divisions of a single corporation.

(2) Elimination and basis transfer treatment is consistent with <u>Chase Brass</u> treatment of intercompany sales. Income is not taken into account until the economic benefit of the transaction is realized outside of the group.

b. Rationale against use:

(1) Raises the same problems with zero basis, "disappearing income," etc. that were present in the federal consolidated return regulations prior to 1966. There is no clear statutory means of preventing "lost income" on distributions in excess of basis, if such income is eliminated.

(2) The wrong entities pick up gain after disaffiliation. Purchaser (or purchaser's unitary group) must report gain on a transaction for which it paid full value.

(3) Some administrative problems exist with assuring that basis is properly adjusted to the transferor's basis. Financial accounting does not clearly reconcile year-to-year effects of such transactions, particularly world wide accounting methods.

(4) Elimination and basis transfer methodology produces a significant variation from the present federal rules for taxpayers filing consolidated returns. This could cause considerable federal-state tax accounting problems, particularly with respect to inventory (e.g. LIFO accounting) and depreciable assets.

(5) Opportunities for taxpayer manipulation are substantial. For example, assume that one corporation sells intangibles or movables to related unitary entity with no independent California tax nexus in anticipation of sale of that entity to third party, or in anticipation of a water's edge election. As neither sale of the entity nor the water's edge election is traditionally a realization event to the seller with regard to the assets held by the purchaser, the state may lose any opportunity to tax the income.

3. Deferred treatment, restoration using historical apportionment factors. Under this method, gain or loss on intercompany transactions is deferred. Gain or loss is restored if the purchaser or seller leaves the group, if there is a termination of unitary relationship, or if the asset is sold to an outsider, as in federal consolidated reporting. Income from intercompany transactions is restored using apportionment factors at the time of the original intercompany transaction.

a. Rationale in favor of use.

(1) This method is consistent with federal treatment, including retention of historical source and character. Apportionment is a sourcing principle (see Section 25101, Cal. Rev. and Tax. Code) so using apportionment factors at the time of transaction is consistent with federal source theory.

(2) The use of historical apportionment percentages is consistent with realization and recognition principles. Because the federal consolidated reporting is based on realization and recognition, but deferral, historical apportionment of later restored deferred income is consistent with full recognition of income, treating intercompany transactions as closed transactions. Restoration of previously deferred income is merely reversal of a deferral privilege on the happening of an event inconsistent with unitary reporting.

(3) Deferred transaction accounting cures the zero basis and "wrong entity" problems, and prevents manipulation.

b. <u>Rationale against use.</u>

(1) Historical apportionment of restored income from an intercompany transaction is administratively quite difficult. It requires identification of transactions, on a worldwide, year-by-year, entity-by-entity basis. Because this method treats the intercompany sale as a closed transaction, California unitary theory requires that income realized and recognized to the group be apportioned to each entity for purposes of the assessment of tax, Legal Ruling 246 ,Oct. 27, 1959, Cal.CCH ¶201-418. Thus, each entity must account for income from all intercompany transactions which occur throughout a worldwide unitary group. This would require annual examination of assets previously subject to an intercompany sale, and an examination of the entities, world-wide, which leave the group, for possible restoration events.

(2) Historical apportionment of restored income raises serious problems with respect to definition of the group. Unlike federal regulations, which define the group with respect to a common parent, the unitary group is defined by ownership and the quality of corporate business relationships. This relationship can change from year to year, even though the entities remain affiliated. Is the group defined by reference only to purchaser and seller and the intercompany asset? Does this mean that there are several subgroups in a given year, with respect to each seller, purchaser, and asset?

> Example. A, B, C, and D are members of a unitary group. A sells asset X to B in year 1. If, in year 2, C and D are sold to a third party, is a portion of the gain with respect to asset X restored with respect to C and D, under Legal Ruling 234, but not A and B?

(3) Historical apportionment of restored income also raises a problem with the income restoration as a result of the depreciation offset rule. Depreciation is a current expense; restored income is a historical income item. This results in an arguable mismatching of historical income restoration and current depreciation expense. Would a rule of deemed matching of source, similar to deemed matching of character (i.e.,

restoration of income as ordinary to match ordinary expense of depreciation) under the federal regulations, do violence to the concept of historical apportionment?

(4) The use of historical apportionment also raises a problem with respect to a member of the group which remains a member but which leaves the jurisdiction of the state. Should a state-specific restoration rule apply?

(5) The use of any deferred transaction system would be extremely difficult to apply in a worldwide combined reporting environment, particularly for predominantly foreign groups. Deferred accounting is unnecessary for any context other than consolidated reporting; requiring that method for state purposes only for corporations not otherwise subject to consolidated reporting could be seen as burdensome and/or impractical.

4. Deferred Treatment with Current Apportionment of Restored gain or loss. Under this method, gain or loss from intercompany transactions is deferred, as in federal consolidated reporting. Gain or loss is realized and recognized, but deferred in the separate account of the seller, and restored on purchaser or seller leaving the group, termination of unitary relationship, or sale of asset to outsider. Restored gain or loss is apportioned using current apportionment factors, and reflecting the entities, in existence immediately prior to triggering event.

a. Rationale in favor of use.

(1) The use of deferred intercompany transaction methodology, apportioning restored income on a current basis, is generally consistent with federal treatment, with the notable exception of historical source and character.

(2) Deferred methodology cures the zero basis problem and partially cures "wrong entity" problems (some "wrong entity problems remain, if the group changes the composition of its members).

(3) Current factor apportionment is administratively easier than historical sourcing: There is no requirement for spreading income to entities on a year-by-year basis. Apportionment of restored income is not required until the restoration event. Depreciation restoration offset matches on equivalent source basis. Departure of entities from the group, or the jurisdiction of the state, does not have effect except as to the selling and purchasing members, and the members in the group at the time of the restoration event.

b. Rationale against use.

(1) Practical problems. Current apportionment of restored income which was previously deferred still presents some administrative difficulty. It requires accounting for intercompany transactions worldwide, and a worldwide determination of whether a trigger event has occurred. For foreign groups this requires the use of consolidated reporting methods for no other use than state taxation.

(2) Theoretical problems. Original realization and recognition, and deferral of the recognized income, is the justification for the restoration of income on a later event which is traditionally a nonrealization event, such as departure from the group, or discontinuance of the unitary relationship. This implies a closed transaction, and original sourcing, as is done in installment sales reporting in California. Is it theoretically inconsistent to use current apportionment factors to report income from a previously realized and recognized transaction? Is there adequate theoretical support to treat the sale as realized and recognized only as to the seller and not a closed transaction as to the group as a whole?

(3) Current factor apportionment is inconsistent with treatment that would obtain with respect to the same income if taxpayer had election in place to tax deferred transactions currently in the year of the original intercompany sale.

(4) How is the group to be defined? Is the group defined with respect to the purchaser, seller and asset? Does this imply subgroups in any given year?

> Example 1: Corporations A, B, C, and D are members of a unitary group. A sells asset X to B in year 1, C sells asset Y to D in year 1. If, in year 2, C and D are sold to a third party, and if A and B, respectively, and C and D, respectively, remain unitary entities with respect to each other, does gain with respect to assets X and Y remain deferred in their respective smaller groups?

> Example 2: Assume the same facts as the example above, except that entities A and D are sold and remain unitary with one another. Neither the seller C, nor the asset X is in the A-D group. Is gain restored as to both assets?

(5) Is it appropriate to tax income from a previous deferred intercompany transaction, when at the time of sale no member of the unitary group was doing business in the state?

> Example: A sells an asset to unitary subsidiary B in an intercompany transaction when A and B were not doing business in this state, resulting in $1 million gain. A acquires new entity C, which is doing business in California. Because of relative size, C has 50% of the apportionment factors of the larger group. If A sells

the stock of B to an outsider in a later year, can the $1 million of deferred gain which is restored be apportioned 50% to California, reflecting current apportionment?

(6) Manipulation problems. Does the use of current apportionment factors provide an opportunity for manipulation?

Example. Assume that Corporation A is doing business in California and is unitary with corporation B which is not doing business in the state. There is an outstanding deferred intercompany transaction resulting from the sale of an asset by A to B. Corporation A wishes to discontinue doing business in California. Can (or should) California cause restoration of an apportioned amount of the gain on such discontinuance? If so, can B delay ceasing to do business until a later year, when its apportionment factor in California is de minimis, resulting in only minimal income to be apportioned to California on the restoration?

D. <u>Election of methods.</u> Is there a partial solution to administrative and theoretical problems noted above? For example, should taxpayers be allowed to elect to apportion restored income on a current basis, as a method of accounting, reserving to the Franchise Tax Board the power to require historical methods for taxpayer relief or limitation of taxpayer manipulation? Should taxpayers, particularly foreign controlled, be allowed elect to use elimination and basis transfer methods, as a method of accounting, subject to Franchise Tax Board anti-abuse powers? Should hybrid deferral/elimination methods of accounting for mixed foreign and domestic groups be allowed? Should taxpayers be allowed to treat income from intercompany transactions as taxable in the year of the original transaction, or should such treatment be limited to taxpayers who report income currently for federal purposes? Based on public input received to date, there is considerable support for such elective methods of accounting.

E. <u>Other issues</u>.

1. <u>Retention of Character</u>. If either an elimination and basis transfer method or a deferred method with current factor apportionment of restored income is used, should some effort be undertaken to preserve the character of deferred gain (e.g. capital, Section 1231, etc.) of the original transaction?

2. <u>Conversion to nonbusiness use</u>. If corporation sells an asset which is a nonbusiness asset in the hands of the seller for business use of the unitary purchaser, should the seller's nonbusiness income be taxed currently? Should sale of a business asset for the nonbusiness use of a member of a unitary group be treated as if a sales to an outsider? Should deferred income from the sale of a business asset be

restored if the asset is converted by the purchaser to nonbusiness use?

3. Section 267. What effects does Section 267, IRC, have on apportionment of income in an intercompany transaction? Generally, transfers of assets between members of a controlled group (defined in Section 267, IRC) which result in a loss, are deferred in a manner similar to the rules prescribed under Treas. Reg. §1.1502-13 (See Treas. Reg. §1.267(f)-1T and 2T). A controlled group is a more broadly defined group under Section 267 than an affiliated group under Section 1504, IRC. The rules of Section 267 generally supersede the rules of Treas. Reg. §1.1502-13. Thus, loss may continued to be deferred under Section 267, notwithstanding the fact that the rules of §1.1502-13 might otherwise call for a restoration of loss.

If California applies the elimination and basis transfer approach, either by rule or election, there will be difficulties integrating such rules with the provisions of Section 267. Applying Section 267 on a worldwide basis raises the many of the same compliance problems as use of deferred intercompany transaction methodology on a worldwide basis. This may require California-specific Section 267 regulations for elimination and basis transfer situations, or integration of the Section 267 rules directly into the rules for intercompany transactions under Section 25106.5, Rev. and Tax Code.

4. Section 367. What effects does Section 367, IRC, have on apportionment of income in an intercompany transaction? Section 367 provides that a transfer of certain assets to a foreign corporation in a transaction otherwise governed by Sections 332, 351, 354, 356, or 361 will, in some circumstances, be treated as a transfer to a noncorporate entity. Thus, to the extent stock is received for property, the transfer is treated as a taxable transaction. Section 367(a)(6) allows the Secretary to waive the application of Section 367, as prescribed by regulation. In some cases, the Secretary may, by agreement, treat the transfer as a taxable event, but defer the taxability of the effects of the transfer so long as prescribed circumstances are present.

California conforms to Section 367. Assume that a corporation transfers an asset to a foreign corporation which is also a member of a unitary group, and Section 367 applies. The use of an elimination and basis transfer method for intercompany transactions may have the effect of converting the taxable event of Section 367 to a stock basis reduction. This would provide substantially the same economic effect as the nonrecognition provisions described above. Even deferred intercompany transaction treatment could treat the transfer as realized and recognized income, but deferred.

Thus, some integration of Section 367 provisions with the provisions in any intercompany transaction regulations under Section 25106.5 will be necessary.