

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

Attached is a discussion draft of the Section 25106.5-A regulation. If adopted, this regulation would provide rules for the treatment of intercompany transactions between members of a combined reporting group.

For ease of administration and compliance, the draft regulation conforms to the extent possible to the federal rules for treating intercompany transactions contained in Treasury Regulation §1.1502-13. Modifications to the federal rules are provided when necessary to account for differences between federal and state law, such as combined reporting, apportionment, and water's-edge elections. Because the draft regulation incorporates and builds upon Treas. Regulation §1.1502-13, the structure and numbering generally follows the Treasury regulation in order to facilitate cross-referencing between the two regulations.

In conformity with federal treatment, the draft regulation requires intercompany transactions to be reported in accordance with a matching rule and an acceleration rule. Essentially, the matching rule provides that intercompany transactions shall be taken into account as if the seller and buyer were divisions of a single corporation. The acceleration rule operates to take intercompany items into account when the effect of treating the seller and buyer as divisions of a single corporation cannot be achieved, such as when either the seller or buyer leaves the combined reporting group. This methodology is consistent with unitary theory because it generally results in the deferral of items of income, gain, deduction and loss from intercompany transactions until such time as there is an economic effect to the unitary business as a whole.

The most significant modifications to the federal treatment of intercompany transactions are as follows:

- *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.
- *Acceleration rule triggered by conversion to nonbusiness use.* If an asset which was the object of an intercompany transaction is converted to a nonbusiness use, then it is no longer part of the unitary business operations. Therefore, any intercompany gains attributable to that asset will be taken into account under the acceleration rule immediately before the nonbusiness conversion.
- *Intercompany distributions.* Although the draft regulation generally applies the provisions of Treas. Regulation §1.1502-13(f) relating to stock of members, the federal rules will not be applied to intercompany dividend distributions. Intercompany dividend distributions are included in the income of the distributee member unless subject to elimination or deduction under other applicable sections of the Revenue and Taxation Code, including §25106 and §24402.
- California does not conform to Treas. Regulation §1.1502-32 relating to investment adjustments to the basis of the stock of a subsidiary, or to Treas. Regulation §1.1502-19 relating to excess loss accounts. However, the draft regulation provides for a "deferred intercompany stock account" which will operate in a manner similar to the federal excess loss account for the limited purpose of deferring gain from intercompany distributions which exceed the payor's earnings and profits and stock basis.
- *Change in the composition of the group.* For federal purposes, the acceleration rule operates to take intercompany items into account when the seller and buyer belong to a subgroup which becomes deconsolidated from the common parent corporation. Because the California combined report is based on unitary relationships rather than a common parent structure, the draft regulation applies the acceleration rule when there has been a substantial division of the combined reporting group rather than when there is a separation from the parent corporation. In essence, if the combined reporting group is

EXHIBIT: G

PAGE 1 OF 3 11/08/2000

divided, and the portion of the group to which the seller and buyer belong constitutes less than 60% of the former combined reporting group, the change to the group is considered so extreme that the acceleration rule is applied to take the intercompany items into account.

- *Entering or withdrawing from the state.* An objective of the draft regulation is to minimize state-only recordkeeping by conforming as closely as possible to the federal treatment, thus making it more likely that intercompany items will be taken into account in the same period for state purposes as for federal purposes. In furtherance of this objective, taxpayers which enter the state will bring deferred intercompany items with them as if this regulation had been applied in the year of the intercompany transaction. Likewise, taxpayers which withdraw from the state will take their intercompany items with them, and no acceleration will be applied to capture that income within the state. This is consistent with the divisional analogy of the matching rule.
- *Partially included water's-edge entities.* Rules are provided to clarify the application of this regulation to corporations which are partially included in a water's-edge combined reporting group under Revenue and Taxation Code Sections 25110(a)(4) and 25110(a)(6). These rules will supercede the rules currently stated in Cal. Code Regs. §25110(e) for eliminating intercompany accounts between entities included in a water's-edge combined reporting group. When this regulation under §25106.5 is adopted, Regulation §25110(e) will be repealed.
- *Foreign country operations.* Reasonable approximations will be permitted in order to minimize the compliance burden for foreign corporations which are not required to follow a similar deferral system for federal income tax or any other purposes. Such corporations may report intercompany transactions using the method used for consolidated financial reporting purposes as long as that method reasonably reflects income and approximates the result that would be obtained by using the rules in this regulation. Adjustments may be permitted or required for any material transaction or series of transactions if the financial reporting method does not produce a result which reasonably approximates the results under this regulation.

If adopted, this regulation will apply prospectively to intercompany transactions occurring on or after the effective date.

This discussion draft regulation is preliminary. It is offered to the public to provide interested parties with an opportunity to review and provide comment prior to formal public notice. If there is sufficient interest, the department will hold a public meeting or symposium on the draft regulation prior to commencing the formal notice process. Written comments should be addressed to Beverly Moore, Franchise Tax Board Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720; or faxed at (916) 845-3648. Please submit any comments by February 1, 1998.

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Last Modified: 10/17/98

EXHIBIT G
PAGE 2 OF 3

EXHIBIT: G
PAGE 3 OF 3