Summary of Symposium
Discussion Draft Regulation Section 25106.5-1: Treatment of Intercompany Transactions in a Combined Report

June 8, 1999
Franchise Tax Board
Sacramento, California

The Symposium was held at 9:30 a.m. on June 8, 1999 at the Franchise Tax Board offices at 9645 Butterfield Way, Sacramento California. The facilitator was Tommy Leung, Tax Counsel for the Franchise Tax Board.

The facilitator opened the symposium by summarizing the history of the regulation project and explaining that the discussion draft regulation was part of a series of combined reporting regulations under the auspices of Section 25106.5. The discussion draft regulation conforms in large part to Treasury Regulation §1.1502-13, which is the federal regulation that addresses the treatment of intercompany transactions in a consolidated return. Modifications are made for state-only issues such as apportionment, unity, nexus considerations, etc. The discussion draft regulation does not, however, conform to other consolidated return provisions such as the investment basis adjustments.

Subsection (a) of the discussion draft regulation provides an overview and general sourcing rules. Under the draft regulation, intercompany transactions will not be reflected in the sales factor of the seller. If the buyer resells the asset outside the unitary group, the buyer's sales factor will reflect that third party transaction. An asset that was the subject of an intercompany transaction will be reflected in the buyer's property factor at the original cost to the combined reporting group (the seller's cost). However, if the intercompany gain is recognized under the acceleration rule of Subsection (d), then the value in the property factor will be adjusted to reflect the buyer's cost.

At this point, a member of the audience commented that Treasury Regulation §1.1502-13 is a very voluminous, complex regulation, and very few state practitioners have very good knowledge of that regulation. The state regulation is also quite voluminous and complex. As one example, Subsection (j)(2) deals with taxpayers that have had intercompany transactions before coming into the state. Once they enter the state, the draft regulation would require such taxpayers to identify such transactions and determine whether the buyer and seller were unitary at the time of the transaction. This unitary determination may have to be made for a year in which the taxpayer was not required to determine unity for any other reason. This is a difficult requirement to comply with. The commentator asked that the FTB consider other alternatives. In particular, the FTB should consider the elimination system used by the IRS prior to 1966. The commentator suggested that FTB draft an elimination version of the regulation so that the business community could compare the two systems with full knowledge of how each system would work.

With respect to the issue of taxpayers entering the state, a representative of FTB commented that the majority of intercompany transactions will already have been deferred for federal purposes in the consolidated return. In most cases, taxpayers will be in compliance with the draft regulation simply by taking the intercompany transaction into account in the same manner as on the federal consolidated return. If the taxpayer makes a state adjustment to back out the federal intercompany gain, that is when they should be prepared to demonstrate why the gain should not be taken into account for California purposes. Furthermore, the treatment is consistent with the fact that the draft regulation does not trigger intercompany gains when taxpayers leave the state. If the regulation is revised to alleviate complexity for incoming taxpayers, the trade-off would be additional complexity at the back end for outgoing taxpayers. A member of the audience commented that there may be members of a combined reporting group that are not included in a federal consolidated return, so taxpayers will not just be able to follow federal treatment in all cases. It was suggested that rules similar to those for installment sales or construction contractors be applied: Taxpayers should go back to the historical apportionment factors from the year of the transaction to determine whether or not the intercompany gain will be taken into account for California purposes.

The FTB representatives explained that the elimination method was considered as an alternative to the federal deferral method, but the decision was made to follow federal treatment so that taxpayers would not be subject to two entirely different intercompany regimes. If California were to use an elimination method, major federal/state differences would arise not only with respect to basis and the amount of gain or loss, but also with respect to the timing of intercompany gain or loss. When the issue of intercompany transactions was studied several years ago, taxpayers expressed their desire that California should conform as closely as possible to the federal timing. A member of the audience responded that taxpayers must already track the unitary group's original basis for property factor purposes. Furthermore, following the federal deferral system would still result in timing differences when the members of the combined reporting group are different from the members of the consolidated return and as a result of the 60/40 rule in Subsection (j). Another problem with the elimination method that was mentioned was the fact that the elimination method taxes the wrong entity. The comment was made that some taxpayers are currently disputing the use of the elimination method in cases before the Board of Equalization.

A member of the audience requested that Subsection (a)(5)(A) be clarified to make it more clear that gross receipts from B's corresponding item are included in the sales factor in the year in which the corresponding items are taken into account in income.

Subsection (b) is a definitional section that tracks the federal regulation. The definition that is unique to California is the definition of the DISA (deferred intercompany stock account). There were no questions or comments from the audience regarding the definitional section.

Subsection (c) explains the matching rule. Simply stated, the matching rule is designed to produce the same effect on taxable income as if the intercompany seller and buyer were divisions of a single corporation. The seller's intercompany gain is deferred, and it is taken into account to the extent that there is a difference between the buyer's corresponding item (determined on a separate entity basis) and the buyer's recomputed corresponding item (determined as if the seller and buyer were divisions of a single entity). The matching rule conforms to federal treatment, and the examples in the draft regulation which illustrate the application of the matching rule track the examples in the federal regulation. There were no questions or comments from the audience regarding the matching rule.

Subsection (d) explains the acceleration rule. Intercompany items are taken into account under the acceleration rule to the extent that it is no longer possible to produce the effect of treating the intercompany seller and buyer as divisions of a single entity. This rule also conforms to federal treatment with the addition of two acceleration events that are unique to California. The first of those acceleration events is the conversion of the asset to nonbusiness use, because at that time the asset is removed from the unitary business. The second California-only acceleration event is a substantial change in the composition of the combined reporting group, which will be discussed in more detail in Subsection (j). At this point in the discussion there were no questions or comments from the audience regarding the acceleration rule.

Subsection (e) conforms to the federal simplification rules, and provides for an election to report intercompany transactions on a separate entity basis. If a taxpayer makes a federal election to treat intercompany transactions on a separate entity basis, then it will be treated as having made the same election for California purposes unless it "elects out." A taxpayer that is qualified to request a federal election may not elect separate entity treatment for California purposes unless it also follows such treatment for federal purposes. However the taxpayer may make a California-only election to the extent that it reports transactions on a separate entity basis for federal or foreign national tax purposes and the federal election is not applicable for those transactions. There were no questions or comments from the audience regarding Subsection (e).

Subsection (f) pertains to transactions relating to distributions between members of a combined reporting group. The general rule is that the matching and acceleration rules will apply to a distributing corporation's IRC § 311(b) gain (the gain that a corporation recognizes upon a distribution of appreciated property). The recipient of a § 301(a) dividend distribution will recognize current income under IRC § 301 unless such distribution satisfies the requirements for elimination or deduction under § 25106 or § 24402.

Under IRC § 301(c)(3), a corporation has gain to the extent that it receives a distribution that exceeds the payor's earnings & profits and its basis in the payor's stock. For federal purposes, such gains are placed in an excess loss account (ELA) and are triggered when the parent disposes of the subsidiary's stock. However, the ELA collects not only § 301(c)(3) gains, but also investment adjustments. Because California is not conforming to the stock basis adjustments, the draft regulation does not adopt the ELA, but instead introduces the concept of the DISA as the deferral mechanism for IRC § 301(c)(3) gains. The DISA is triggered when either the distributing corporation or the recipient corporation leaves the combined reporting group. Discussion ensued regarding whether the DISA should be treated as negative basis. The federal ELA is treated as negative basis and a previous version of the discussion draft regulation had

EXHIBIT H
PAGE 3 OF 6

conformed to that treatment. In the current version of the draft regulation, Subsection (f) was revised to provide that the DISA is a deferral account rather than negative basis. The effect of this difference is that a federal ELA will disappear if the subsidiary liquidates into the parent in an IRC § 332 liquidation, but a liquidation will trigger the DISA for California purposes. A member of the audience commented that there did not appear to be any differences between the federal consolidated return and the California combined report that would warrant non-conformity in this area. Non-conformity increases complexity, and could be a trap for the unwary because a taxpayer that is familiar with the federal rules will know that a § 332 liquidation will cause an ELA to disappear and will expect the same treatment for California. IRC § 332 causes a subsidiary's basis to disappear, so it does not seem fair to require a taxpayer to recognize income related to negative basis or to a DISA. The commentator also suggested that the DISA should be eliminated if the parent later makes a capital contribution to the stock of the subsidiary.

In response to those comments, FTB representatives indicated that a § 301(c)(3) distribution is Code income. R&TC § 25106.5 is a delegation of authority from the Legislature that has the power to overcome court decisions that have interpreted the statute, but does not have the power to be contrary to the statute itself. A delegated power has to stay within the confines of the Code. A legislative regulation cannot undo the acts of the Legislature.

A member of the audience pointed out that the Legislature has a general policy of conformity to federal provisions. FTB's response was that the Legislature exercised selective conformity, and the fact that they conform to many federal provisions does not necessarily mean that they intended to conform to all federal provisions. An FTB representative explained that the overall goal was to conform as closely as possible to the federal intercompany treatment, but still preserve unitary theory. Unitary theory supports the deferral of Code income until the point in time when there is an economic effect to the group as a whole, but unitary theory should not trump the statute by completely eliminating Code income. Income may be deferred until it is no longer possible to achieve the deferral (such as when a dividend distributor is liquidated), and then it must be taken into account. Members of the audience expressed their belief that elimination of the DISA after a § 332 liquidation is appropriate because the assets are just being moved from one pocket of the unitary group to another. It was pointed out, however, that there are instances even within the federal rules where the ELA is recognized even though assets are just moving between pockets.

Subsection (g) deals with intercompany obligations and Subsection (h) contains the anti-avoidance rules. Those subsections follow the federal treatment. There were no questions or comments from the audience regarding Subsections (g) or (h).

Subsection (j) contains the miscellaneous operating rules. The first set of rules is called the "60/40" rule. It provides that a substantial change to the combined reporting group will be an acceleration event. Even though the seller, buyer and asset remain together, a substantial change will occur if the "tested group" of the seller and buyer immediately after the change accounts for less than 60% of the average property, payroll and sales of the combined reporting group immediately prior to the change. The 60/40 rule only applies to dispositions and situations where the original group is split-up; it does not apply to acquisitions.

For federal purposes, the concept of "leaving the group" in a consolidated return context is tied to the presence of a common parent corporation. If the parent disposes of its subsidiaries, all intercompany transactions between those subsidiaries and other members of the original consolidated return group are accelerated, even if the subsidiary members themselves remain affiliated with each other and even if they immediately enter a new consolidated return group.

In contrast, in a California combined report, the unitary group is not tied to a common parent. Many unitary groups do not even contain a common parent corporation. Thus, there is no convenient way to define "leaving the group" because there is no common reference point for that purpose. The 60% rule is premised on the notion that if the size of the original combined reporting group is reduced by more than 40%, it is so substantial a change that it is appropriate to treat the change as a disbanding of the old combined reporting group. That is, the original "group" with respect to the intercompany transaction does not substantially exist as it did when the intercompany transaction originally occurred. Thus, the 60% rule is an analogy to the federal acceleration treatment that occurs when the parent is severed from part of its original group, despite the fact that subsidiaries actually involved in the intercompany transaction still remain affiliated with each other.

Members of the audience suggested that the rule be revised to provide that intercompany gain is not accelerated as long as the seller, buyer and asset remained together. It would be a much simpler rule and would avoid the complexities of the 60/40 analysis. Furthermore, the business community was concerned that the interim period information necessary for the 60/40 analysis is not data that taxpayers normally track. There could be both winners and losers with respect to a buyer/seller/asset rule. Anti-avoidance rules may also be necessary. Members of the audience expressed their opinion that the operating realities of business would usually preclude structuring transactions solely to manipulate acceleration of intercompany items.

The next set of rules in Subsection (j) provides that if a triggering event occurs at a time when a member of the group is a California taxpayer, the gain will be triggered even though the original intercompany transaction occurred prior to any member of the group entering the state. The playing field is leveled by the fact that intercompany items will not be triggered when taxpayers leave the state.

Subsection (j)(3) explains how the intercompany rules apply to entities that are partially included in a water's-edge combined report. The treatment will depend upon whether an entity is partially included under § 25110(a)(4) or (a)(6). Entities described in § 25110(a)(4) are included in a combined reporting group to the extent of their U.S. activities or U.S. source income. An example would be a foreign bank with a U.S. branch. If a transaction takes place between a domestic member of the combined report and the U.S. branch of the foreign affiliate, it is an intercompany transaction. Conversely, if the transaction is with the excluded foreign activity, it is not an intercompany transaction.

Controlled foreign corporations (CFCs) described in § 25110(a)(6) are not included in a water's-edge combined report with respect to any specific activity. Instead, the income and factors of CFCs are included based on the ratio of the CFC's subpart F income over its current earnings and profits. If transactions occur between a partially included CFC and a domestic member of the combined report, the same inclusion ratio is applied to determine what percentage of the transaction is considered to be intercompany. A CFC's inclusion ratio can fluctuate from year to year. Rather than requiring incremental triggering of intercompany items every time the inclusion ratio fluctuates, the draft regulation provides that decreases in the inclusion ratio will not accelerate intercompany items unless there is a substantial decrease of 50% or more. Such a substantial decrease will accelerate all intercompany items involving that CFC unless the taxpayer elects to take into account only a proportionate share of the intercompany items. Nothwithstanding such an election, all remaining intercompany items will be triggered if the CFC's inclusion ratio falls below 10%.