PUBLIC HEARING OF JULY 14, 2000:
SUMMARY OF PUBLIC COMMENTS, STAFF'S COMMENTS, STAFF'S RESPONSE, AND STAFF'S RECOMMENDATIONS

The following is a summary of the testimony given at the public hearing and staff's comments and recommendations with respect thereto.

I. Use of the elimination/basis transfer method. (General)

Comment: It was suggested that staff draft an elimination basis transfer regulation so that the public can compare the two regulations side by side, and/or allow taxpayers to elect to use the elimination method. [Pillsbury, Madison & Sutro]

Recommendation: Staff has studied the concept of an intercompany transaction regulation and compared the use of current taxation, deferral, and elimination methods. Based on this analysis, staff recommends a deferral system patterned after the federal system.

Response: After considering the relative advantages and disadvantages of the elimination method, staff chose the federal deferral method as a model for state purposes. The IRS rejected use of the elimination/basis transfer system and changed to a deferral system in the mid-1960s because of the problems inherent in the elimination/basis transfer system. " It is generally acknowledged that greater single entity treatment reduces anomalies and planning opportunities, and better reflects the economic unity of a consolidated group." (59 Fed. Reg. 18,048, 18,050 (April 15, 1994).) Unlike the elimination of income/transfer of basis method, the proposed regulation uses the single entity approach.

As a practical matter, most, if not all, corporations file state tax returns consistent with the federal consolidated return computation of income. Accordingly, most, if not all, corporations are currently filing state returns using a deferral system. Adoption of a state only elimination/basis transfer system would result in additional compliance burdens for the taxpayer and the department (e.g., keeping track of basis differences between the federal method and a California-only method).

Staff identified the following points in favor of and against the use of the elimination/basis transfer method:

(1) Rationale in favor of use:

(a) Consistency with financial reporting. Elimination and basis transfer treatment is generally consistent with financial accounting treatment and the unitary method, and has been approved by the courts. For worldwide combined reporting, elimination and basis transfer will avoid having to conform international accounting practice to federal consolidated reporting methods. <u>However, financial accounting treatment does not often reflect a transfer of basis (see discussion below).</u>

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(b) Consistency with current state law. Elimination and basis transfer treatment is generally consistent with treatment of intercompany sales under *Chase Brass & Copper Co., Inc. v. Franchise Tax Board*, 70 Cal.App.3d 457 [138 Cal.Rptr. 901] (1977) (which dealt with the sales factor treatment of intercompany sales). Under that theory, a unitary group represents an economic whole, and income should not be taken into account until the economic benefit of the transaction is realized outside of the group. The method is also consistent with treatment of transfers of assets between divisions of a single corporation. (Also, see Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947); Appeals of Pacific Telephone and Telegraph Co., Cal. St. Bd. Of Equal., May 4, 1978.)

(2) Rationale against use:

(a) Disappearing income from distributions in excess of basis. When a subsidiary makes a distribution to its parent which exceeds earnings and profits and the parent's basis in the subsidiary's stock, that distribution will normally be treated as a capital gain. The elimination/basis transfer method will eliminate that capital gain, but no further reductions can be made to the basis of that subsidiary's stock because the parent's basis in the stock is already zero. Therefore, there is no mechanism under the elimination/basis transfer method for recapturing that gain. (See *Henry C. Beck Builders, Inc. v. Commissioner*, 41 T.C. 616 (1964).)

(b) Wrong entity. The purchasing entity must pick up gain after disaffiliation using the seller's basis. However, the purchaser's unitary group must report gain on a transaction for which it paid full value. This concern was raised by taxpayers in two recent Board of Equalization appeals (*Appeal of Pentel of America Ltd.*, Appeal No. 98A-0014, and *Appeal of Yamaha Motor Corp. U.S.A.*, Appeal No. 99A-0226).

(c) Compliance difficulties. Some administrative problems exist with assuring that basis is properly adjusted to the transferor's basis. Financial accounting, particularly some worldwide accounting methods, does not clearly reconcile either the year-to-year effects of such transactions, or the effects of disaffiliation. In 1994, prior to amending its intercompany transactions regulation, the IRS considered going back to the elimination of income/carryover of basis method. The IRS decided to retain the deferral method, concluding:

> The current deferred sale system was adopted in 1966 because of the many problems with the prior

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carryover basis system. The prior system permitted intercompany items to be recognized by the wrong member and at the wrong time, to be characterized improperly, and sometimes to be eliminated completely. See, e.g., Beck Builders, Inc. v. Commissioner, 41 T.C. 616 (1964), appeal dismissed (10th Cir. 1965) (intercompany income from the performance of services was eliminated without any corporate or shareholder level tax).

The problems with the alternatives to a deferred sale system have increased with the increasing complexity of the Code since 1966. Any system that allocates to one member the entire gain or loss from assets transferred in an intercompany transaction must compensate with numerous adjustments to accommodate each Code or regulatory provision that relies on location. For example, a carryover basis system might permit appreciated assets of S to be sold outside the group without gain recognition, by forming B with a cash contribution, selling S's asset to B for the cash, and then selling the B stock or S stock without recognizing the asset gain. This would be contrary to "mirror subsidiary" legislation. See, e.g., H.R. Rep. No. 391, 100th Cong., 1st Sess. 1081-84 (1987).

Although many of the problems could be addressed through supplemental adjustments to conform the outside stock basis of a member to changes in its inside asset basis, these adjustments would not eliminate all of the problems and would introduce new problems. See "Stock of members," discussed in this notice of hearing at B.5. Because each of the necessary adjustments would vary greatly as to its purpose and scope, the rules would be complex in the aggregate. By contrast, the deferred sale system under the proposed regulations will result in less complexity because it is based on separate return accounting and the rules required for single entity treatment have a common purpose that is more easily understood.

(59 Fed. Reg. 18,048, 18,050 (April 15, 1994.)

(d) Non-conformity with current federal practice. The 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. Furthermore, severe timing differences between the federal deferral system and an elimination/basis transfer system will occur – the latter method can cause low-basis assets to be retained indefinitely.

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

Another illustration of manipulation is the following: Assume that P owns stock of S. P has a basis of $10 in S but S now has a value of $100. P would like to sell S to an unrelated buyer, X. P forms a new subsidiary, T, and contributes $100 cash to that subsidiary in an amount equal to the value of S. T, at the direction of P, then purchases S from P for $100. T becomes an intermediate holding company between P and S. In an elimination system, P recognizes no gain, and T has a basis in S stock of $10 (P's original basis). P then sells the stock of T to new buyer X for $100. Because P's basis in T stock is equal to the amount of cash contributed ($100), no gain or loss is recognized by P on the sale of T. P has essentially exported its built-in gain in S to the X group. However, as long as X keeps the T and S relationship intact, X will continue to avoid taxation of that income. If X wants to dispose of S later, and X has no taxpayer members in the State, the gain on the sale of S will not be subject to California taxation. Even if X has a member subject to tax in California, it can alternatively sell the stock of T (whose principal asset still is its stock in S), thus causing permanent deferral of the income in the form of low basis to the next buyer. The T stock represents a permanent cocoon around the low basis S stock. At the end of the day, P has enjoyed the economic benefit of an indirect disposition of S without either it or its buyer X paying tax on the transaction.

This device could be used for any number of intercompany transactions in anticipation of a sale to outsiders.

II. Federal Conformity - Clarity. (a)

A. Comment: Public testimony suggests that the proposed regulation is unclear, particularly subsection (a)(2), because it does not specifically incorporate the applicable portions of Treasury Regulation section 1.1502-13. Furthermore, the reference to the 1997 version of Treasury Regulation section 1.1502-13 will create ambiguity and confusion for taxpayers because that version of the Treasury regulation will be difficult to locate in the future. In addition, subsection (a)(2) does not specify the state modifications to the incorporated provisions of the Internal Revenue Code (IRC). Finally, subsection (a)(4) is unclear because of subsection (a)(2). [Arthur Andersen, Pillsbury, Madison & Sutro]

Response and Recommendation: Staff proposes changing the language of the second sentence in subsection (a)(2) from: "This regulation does not restate all the provisions of the federal regulation in full, but the methodology of the federal regulation shall generally apply." To " This regulation does not restate all the provisions of the federal regulation in full (a copy of which can be obtained by going to the department's website at www.ftb.ca.gov or by mailing the request to the following address: California Franchise Tax Board, Legal Branch, Attn : Chief Counsel, P.O. Box 1720, Rancho Cordova, CA 95741-1720), but the methodology of the federal regulation shall apply except as otherwise provided in this regulation." Deleting the word "generally" in appropriate places, inserting additional language at the end of this sentence to tighten it up, and providing resource locations as to where to obtain the pertinent federal regulation should eliminate the clarity problem.

B. Comment: The phrase "original cost" as used in subsection (a)(5)(B)4 is not clear and a cross-reference to the property factor might help. [Arthur Andersen]

Response: Subsection (a)(5)(B)4. is contained within subsection (a)(5)(B), which addresses the property factor; thus, no cross reference is required. Subsection (a)(5)(B)4. specifically refers to B's original cost, and example 1 in subsection (d)(3) shows how this particular subsection works.

Recommendation: Staff will add some clarifying language to address the commentator's concerns.

III. Definitions (b)

A. Comment: The definition of a combined reporting group contained in subsection (b)(2)(B) is unclear because it does not take into account pass-through entities such as partnerships. [Arthur Andersen]

Response: This definition refers to the definition contained in Regulation section 25106.5 which, having passed OAL review, already meets the clarity standard.

As it stands, the proposed regulation does not deal with the treatment of intercompany transactions between and with pass-through entities. Staff recommends that this topic be addressed in a future project. It is further noted that subsection (j)(6) has been reserved for pass-through entities.

Recommendation: Staff recommends that no change be made to this definition.

B. Comment: The last phrase of the first sentence in subsection (b)(6) concerning the application of other combined report regulations is unclear. [Arthur Andersen]

Response and Recommendation: Staff will add a parenthetical at the end of this sentence to read "as promulgated under the authority of section 25106.5".

IV. Matching and Acceleration Rules (c) & (d)

A. Comment: Subsections (c) and (d) are unclear because of the reference to subsection (a)(2) and Treasury Regulation section 1.1502-13. [Arthur Andersen]

Response and Recommendation: The language in subsection (a)(2) will be modified to eliminate this concern. See II above.

B. Comment: The three acceleration events in subsection (d) should be placed in a list for clarity. [Arthur Andersen]

Response: The main paragraph in subsection (d) sets forth the general rule, and subsection (d)(1) sets forth additional acceleration events which are unique to California. Staff believes this structure provides a clearer description to the reader than what the commentator proposes.

Recommendation: No change is necessary.

V. Elections (e)

A. **Comment:** Application of subsection (e) is unclear when there are multiple entities. "For example if there are five foreign subsidiaries and two report on a separate entity basis and two report on an intercompany transaction basis, what is the result? In addition whose return controls if a single group return is not filed?" [Arthur Andersen]

Response: This comment is itself unclear. The commentator does not define "report on an intercompany basis." Moreover, subsection (e)(2)(B) allows taxpayers to make an election with respect to a class of transactions. Thus, if two out of five taxpayers can properly file on a separate entity basis in a foreign country, then separate entity treatment can be elected for those two taxpayers for California purposes. In addition, the combined report regulations provide that separate elections may be made with respect to the separate income of each member. The only limitation is that all combined reports which include that member's income must reflect that member's income consistently. (See Regulation section 25106.5-3(a).)

Recommendation: No change is necessary.

B. Comment: Subsection (e)(2)(B) is a trap for the unwary because it requires a state election when no federal election is needed. [Arthur Andersen]

Response: The premise for this comment is wrong – subsection (e)(2)(B) addresses circumstances when the federal election is not available, not circumstances when "no federal election is required." Subsection (e)(2)(A) covers those situations where a federal election is available; subsection (e)(2)(B) applies to circumstances where no federal election can be made (e.g., P only owns 70% of the stock of S and B, thereby disqualifying P, S, and B from filing a federal consolidated return). Therefore, in the 70%-ownership example, the taxpayer is required to report intercompany transactions on a separate entity (or current recognition) basis for federal purposes, while it defers recognition under these proposed regulations, unless the taxpayer makes a subsection (e)(2)(B) election to use the separate entity method. In other words, this subsection gives the taxpayer a state election to opt out of a generally beneficial, default filing position of deferring income recognition. This should not be characterized as a trap for the unwary.

Recommendation: No change is necessary.

VI. Use of the Deferred Intercompany Stock Account (DISA) versus the federal Excess Loss Account (ELA). (f)

A. Comment: California should treat the DISA as a negative basis account, as it is in the federal consolidated return regulations. It was suggested that the proposed regulation adopt the federal ELA methodology and provide for the disappearance of the DISA upon liquidation of the subsidiary into the parent or in a downstream merger. One commentator stated that ~~if the FTB~~ did not have authority under section 25106.5 to avoid IRC section 301(c)(3) and determine that such distributions are not taxable, then it is questionable whether the FTB has authority to promulgate this proposed regulation. [PWCoopers, Pillsbury, Madison & Sutro, Doerr (tr. at p. 11)]

Response: Subsection (f) provides that the DISA is a method by which deferred income arising from intercompany distributions with respect to stock are tracked, and is not a negative basis account. The negative basis rule in the federal consolidated return scheme is part of a general goal of those regulations to prevent double taxation among the members of the consolidated group. For that reason, intercompany dividends are eliminated in full, and investment adjustments are made to the parent's interest in the stock of the subsidiary. Distributions in excess of basis would create a negative basis account called the ELA. A capital contribution to the subsidiary may reduce or eliminate the ELA. The ELA disappears upon the liquidation of the subsidiary into the parent.

Staff believes the DISA is a method for tracking deferred income and not a negative basis account. Unitary theory is not the same as consolidated return theory. (See *Appeal of Rapid-American Corp.*, 97-SBE-019-A, May 8, 1997.)

For example, the California Supreme Court has held that intercompany dividends are taxable income. (See *Safeway Stores, Inc. v. Franchise Tax Board*, 3 Cal.3d 745 [91 Cal.Rptr. 616] (1970).) Section 25106 of the Revenue and Taxation Code eliminates some, but not all, intercompany dividends. Under unitary theory it would be proper to defer income (as defined by the Revenue and Taxation Code) until some event inconsistent with the premise for the original deferral occurs, such as disaffiliation, the asset leaving the group, or a conversion of the asset to nonbusiness use, which does not justify continued deferral. The role of the unitary business principle (reflected in section 25101) is to source, through apportionment, a taxpayer's "net income" as defined under the Revenue and Taxation Code. Unitary theory does not provide a justification to eliminate income which is subject to tax under the Revenue and Taxation Code.

In addition, adoption of the federal negative basis rule produces an incongruous result for less than 80 percent held entities in a combined reporting group. Because these entities will not be able to file a federal consolidated return, they must necessarily report intercompany transactions on a separate entity basis for federal purposes; under such circumstances, use of either a negative basis approach or the DISA would result in federal/state differences. The examples provided by the public do not indicate what the result would be for a 70%-owned subsidiary. Clearly, the federal ELA rules would not apply, but if the State adopted the federal ELA approach, a federal/state difference would exist, which makes the commentator's conformity argument questionable. Moreover, these examples and public comments do not point out the disparity in treatment between 80% and less-than-80% owned corporations –the former entities qualify for a tax-free liquidation under IRC 332, while the latter entities do not qualify for such favorable treatment. Furthermore, the examples do not describe how the federal stock basis adjustment rules and California's nonconformity thereto would affect their outcomes.

While section 25106.5 permits the department to promulgate legislative regulations, it does not permit an administrative agency to contradict the law (i.e., section 24451) and usurp the province of the Legislature. (See Gov't Code sections 11342.2, 11342.1, 11349.1; also, see *Yamaha Corp. of America v. State Board of Equalization*, 19 Cal.4th 1 [960 P.2d 1031] (1998) (J. Mosk, concurring and citing *Morris v. Williams*, 67 Cal.2d 733 [433 P.2d 697] (1967).) Although section 25106.5 authorizes the department to adopt regulations regarding the ***proper*** reporting of income on a combined report, it does not authorize the department to promulgate rules which are inconsistent with present statutory provisions. (See Gov't Code section 11349.1.)

Although the *Safeway Stores* case dealt with pre-UDITPA California law, that fact does not detract from the underpinnings of the California Supreme Court's holding – the California combined report is not the same as the federal consolidated return. Some of those differences are highlighted in subsection (a) of the proposed regulation. These fundamental differences have been reaffirmed in recent decisions, including the *Willamette* (*Willamette Industries, Inc. v. Franchise Tax Board*, 33 Cal.App.4th 1242 [39 Cal.Rptr.2d 757] (1995)) and

Rapid-American (*Appeal of Rapid-American Corp.*, 97-SBE-019-A, May 8, 1997) cases. Furthermore, the commentator's suggestion that the department need not adopt much of the federal stock basis adjustment rules is contradicted by his numerous citations to Treasury Regulation section 1.1502-19, which is intertwined with Treasury Regulation section 1.1502-32, to support his assertions.

In summary, after studying the federal regulations on the treatment of investment accounts, staff recommends use of the DISA solely for the purpose of tracking deferred items arising from intercompany distributions. The federal rules for investment accounts are contained in Treasury Regulation sections 1.1502-19 and 1.1502-32, while intercompany transaction rules are contained in Treasury Regulation section 1.1502-13. Although intercompany distributions are intercompany transactions, the investment account adjustments are not intercompany transactions. Thus, staff recommends using one small element of the investment accounting scheme because the results for such distributions, in most cases, are consistent with the results expected under the intercompany transaction rules.

As noted above, the federal negative basis scheme is part of the general federal consolidated return approach of making intercompany adjustments to avoid multiple entity taxation. If the department were to decide to treat a distribution in excess of basis as negative basis, a study of whether the state should conform to the general philosophy of the entire federal investment account scheme will be required; such an approach would constitute a reversal of the Board of Equalization's decisions in the *Rapid-American* and *Safeway Stores* (*Appeals of Safeway Stores, Inc.*, Cal. St. Bd. Of Equal., March 2, 1962) appeals. Because of the philosophy in the consolidated return rules of elimination of multiple entity taxation, the federal consolidated return approach will inevitably result in lost revenue. Accordingly, if such a study were to be undertaken it should probably be initiated by the three-member Board. However, even if it is appropriate to be undertaken, such a study would be a future project and outside the scope of the intercompany transactions regulation.

Recommendation: The federal ELA or negative basis methodology should not be adopted.

B. Comment: Subsection (f)(1)(B) is unclear because B apparently means the distributee, and not the buyer. Additionally, this subsection should indicate which taxpayer holds the DISA. [Arthur Andersen]

Response and Recommendation: Staff agrees, and will change B to P, the parent of S, and will indicate which taxpayer holds the DISA.

C. Comment: Subsection (f)(1)(B)4. seems to indicate a DISA already exists (although it is a creation of this regulation), and the existence of a closing agreement should create a DISA for the distributing member. In addition, it is unclear how subsections (f)(1)(B)4. and (f)(1)(B)5. apply. [Arthur Andersen]

Response: The DISA is a creature of this proposed regulation. During the regulatory process, certain taxpayers requested closing agreements from the department to defer income from distributions in excess of basis, which are subject to current taxation. This subsection incorporates the substance of those closing agreements into the DISA provisions of this regulation. Since distributees are subject to tax on distributions in excess of basis, the DISA is created for the distributee. Subsections (f)(1)(B)4. and (f)(1)(B)5. essentially extend the closing agreement provisions of FTB Notice 97-2 (copy attached).

Recommendation: No change is necessary.

D. **Comment:** Example 2 in subsection (f)(2) makes a presumption that the distribution is business income, but such a determination should be made under section 25120. [PWCoopers, Pillsbury, Madison & Sutro]

Response: If the distribution produces nonbusiness income, then the distribution is not an intercompany transaction, as defined in subsection (b)(1)(B). In other words, if the transaction does not involve business income, then this proposed regulation is not applicable.

Recommendation: No change is necessary.

E. **Comment:** The DISA creates burdensome record-keeping requirements for taxpayers which would not exist if the federal ELA method was adopted. In addition, a cross-reference to the record-keeping requirements should be added. [Doerr (tr. At pp. 11-12)]

Response: Whichever method is used, taxpayers will have a record-keeping requirement. Even if this proposed regulation adopts the federal ELA approach, taxpayers will still be required to maintain separate records for state purposes because California does not conform to the federal stock basis adjustment rules contained in Treasury Regulation section 1.1502-32. Moreover, as noted above, the ELA only works for federal purposes if the taxpayers can qualify to file a federal consolidated return, and if the 80% ownership threshold is not satisfied, the ELA cannot be used. Thus, for example, if P owns 70% of S and they are engaged in a single unitary business, P and S cannot file a federal consolidated return and use the ELA; even if California adopted the ELA, P and S would still have a record-keeping requirement because P and S must file as separate entities for federal tax purposes. In addition, since taxpayers must disclose their DISA balances each year (see subsection (b)(8)), the annual updating of such balances should not be overly burdensome. Ironically, while this particular departure from the federal rules may raise compliance and record-keeping concerns for some taxpayers,some of the members of the public who have urged adoption of the negative basis approach because of federal/state conformity concerns are the same parties who suggest that the department adopt an elimination of income/transfer of basis method, a scheme which is ***completely*** different from the federal methodology and would require taxpayers to maintain a ***totally*** separate set of books and records for California purposes (see discussion in section I(A)(2) above); these parties have expressed no such qualms about the far more extreme federal/state compliance burdens associated with an elimination and basis transfer system. Finally, because subsection (f) contains an extensive discussion of the mechanics of the DISA, a cross-reference to record-keeping requirements would probably get lost in there.

Recommendation: No change is necessary.

F. **Comment:** There should be no revenue impact if the federal ELA is adopted. Moreover, having a federal/state difference will create a trap for the unwary. [Doerr (tr. At p. 12), PWCoopers]

Response: Staff disagrees. As noted above, adoption of the federal ELA for state purposes would be inconsistent with the Revenue and Taxation Code as it creates tax-free transactions in areas not provided for by state law. Since these types of transactions are already subject to tax in California, maintaining this departure from federal practice does not create a trap for the unwary.

Recommendation: No change is required.

VII. Sub-Groups (j)(1)(C)

Comment: Subsection (j)(1)(C) is mislabelled. [Arthur Andersen]

Response and Recommendation: Staff agrees; language from another subsection was transposed, which will be deleted, and a new caption will be added.

VIII. Entering/Leaving the State (j)(2)()B)

Comment: The language in (j)(2)(B) and example 2 are not entirely clear in the case where a parent could have made an election to treat items on a separate entity basis but in fact did not prior to a member becoming a taxpayer in California. In the case where a parent could elect separate entity basis but in fact did not what is the intended result? [Arthur Andersen]

Response: Example 2 refers to a retroactive election. If an election for separate entity treatment could have been made for California purposes in the year of the intercompany transaction but for the fact that no member of the unitary group was a California taxpayer, then subsection (j)(2)(B) permits a retroactive election, and the taxpayer files its California return(s) as if an election for separate entity treatment was made.

Recommendation: No change is required.

IX. Foreign Country Operations (j)(5)

Comment: "Subsection (j)(5) does not make sense in that it seems to state that if a foreign country operation is not subject to federal intercompany transaction rules, then they can use the rules for the financial statements, but then the last sentence basically says that if the financial reporting method does not produce a result which reasonably approximates the result that would have been obtained under this regulation, you can't use it. That phrase is going to apply to almost any situation. Either the separate entity method will apply or the deferral method will apply unless you are considering situations where an elimination method is being applied. If the Franchise Tax Board believes that an elimination is acceptable for foreign country operations it should specifically so state. Otherwise I see no need for the final sentence in the regulation because either the transactions are going to be reported currently or they are going to be deferred." In addition, if it is permissible for foreign entities to use the elimination method, then it should be permissible for domestic entities to use the elimination method. [PWCoopers, Pillsbury, Madison & Sutro, Arthur Andersen]

Response: The last sentence in subsection (j)(5) is intended to handle situations where a method of reporting does not approximate the results of the proposed regulation. While the commentator could not anticipate what such a method could be, such a situation can materialize. For instance, certain taxpayers have recently argued that the elimination method results in a step up in basis, a method which is violative of the traditional elimination system (as described by one of the commentators).

In addition, differences between the elimination and deferral methods of reporting will arise when either the seller or buyer leave the combined reporting group (i.e., no recognition event under the elimination method, but a recognition event under the deferral method). For example, assume S sells an asset with a basis of $60 to B for $80, and then B sells the same asset to an outsider, X, for $110. Under an elimination system, B will reflect income of $50 (the difference between the sales price to X and its $60 transferred basis from S). In a deferred system, S will have $20 of deferred income from its sale to B, and B will have a basis of $80. When B sells the asset to an outsider, B will have income of $30, the recomputed income is $50, and S will have income of $20. Because both items of income are business income, the total amount of business income taken into account is the same -- $50. In that case, the accounting method of the taxpayer produces the same income (and the same timing of that income) as a deferral system. However, if B leaves the combined reporting group, this symmetry between the deferral and elimination systems with respect to the timing and total amount of business income to be reported when the asset is sold to X for $110 will be broken. If S and B break up before the asset is sold to X, then, under the elimination system, there is no recognition event; however, under the deferral system, the break-up is an acceleration event requiring the restoration of income.

In fact, the principal difference between a deferral system and an elimination system will be when an acceleration event occurs. In that case, this subsection will restore foreign intercompany transaction income as if under a deferral system to account for the entities properly chargeable with that income and to account for the effect of the timing of that income.

Furthermore, as indicated above, conformity with the federal deferral method reduces federal/state differences and promotes ease of compliance. Clearly, such benefits are

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diminished when a foreign country does not use or permit use of the deferral method but, nevertheless, this subsection makes reasonable allowances for those situations.

Recommendation: No change is necessary.

X. Effective Date (k)

Comment: Because of the State's change from its current, accepted practice of elimination of income/transfer of basis to the complex deferral method, the effective date of the regulation should not be January 1, 2000, but some later date, like January 1, 2001. In addition, what does the effective date apply to – would an intercompany transaction which transpired prior to the effective date with a triggering event after the effective date be subject to the proposed regulation? [Pillsbury, Madison & Sutro]

Response: Staff agrees with the first point. The proposed regulation would apply to "intercompany transactions" which occur on or after the effective date. "Intercompany transactions" are defined under subsection (b)(1)(A), and the proposed regulation applies only to income triggered from such transactions which occur after the effective date.

Recommendation: Subsection (k) will be changed to reflect a January 1, 2001, effective date.

XI. Miscellaneous (General)

Comment: The proposed regulation should be considered by the Franchise Tax Board. [Doerr (tr. At p. 12)]

Response: Staff agrees.

Recommendation: The proposed regulation will be presented to the Board.