Summary of Interested Parties Meeting
Regulation §25106.5-1
Intercompany Transaction Regulation

I. <u>Administration</u>: On April 21, 2010 at 1:00 p.m., members of the public attended an interested parties meeting at the Franchise Tax Board office in Sacramento. Parties attended in person and by telephone. Those physically present were asked to register at the entrance and those on the telephone were asked to fax a business card to Colleen Berwick for later correspondence. Phone participants introduced themselves. The session was to be tape recorded for reference but there would be no attribution of comments and no transcript. The Hearing Officers were Laurie McElhatton and Craig Swieso. Available handouts were: notice of the meeting, discussion topics, and a Deferred Intercompany Stock Account outline for discussion. Parties were told they had until May 3, 2010 to submit written comments. A summary of the interested parties meeting would be posted online. (Written comments may continue to be submitted after this deadline to assist with the drafting process.)

The purpose of the meeting was discussed as being a time for the public to discuss the possibility of amending the regulation to provide further guidance in two areas and to address conformity with federal laws.

II. <u>Discussion:</u> The discussion was organized topically, covering the following three areas:

- Discuss whether to provide further guidance regarding the proper apportionment treatment of intercompany transactions that are reported utilizing the simplifying rules of section Regulation section 25106.5-1, subsection (e).
- Discuss whether to amend Regulation section 25106.5-1, subsection (f)(1)(B), relating to Deferred Intercompany Stock Accounts, to provide further guidance addressing mergers, subsequent capital contributions and the effect of tiered distributions.
- Discuss whether to amend Regulation section 25106.5-1 to bring it into conformity with the most recent version of Treasury Regulation section 1. 1502-13.

A. <u>The Simplifying Rules of Regulation section 25106.5-1, subsection (e)</u>

<u>Statement:</u> The discussion was opened by Laurie McElhatton with a general statement regarding the simplifying rules located at subsection (e).

1. <u>Deferral:</u> For income tax purposes, gain or loss from intercompany transactions is ordinarily deferred until there is a triggering event, such as the sale of the deferred item outside the group to a third party.

2. <u>Exception to deferral:</u> Even though the general rule is deferral of intercompany income until a sale outside the group, both the California and federal intercompany regulations

allow taxpayers in specified circumstances to elect to account for their income or loss from intercompany transactions on a "separate entity" basis.

3. Election: This election allows current recognition of income or loss from intercompany transactions. The election is governed by Regulation 25106.5-1, subsection (e), for California tax purposes and Treasury Regulation section 1.1501-13, subsection (e)(3), for federal tax purposes.

4. Apportionment**:** While the subsection (e) election allows income or loss from intercompany transactions to be recognized in the year of the transaction, there was no intent to have taxpayers include intercompany receipts related to those transactions in their sales factors.

5. Proper sales factor treatment: The apportionment method that applies when there has been a subsection (e) election is set forth in Regulation section 25106.5-1 at subsection (a)(5) "Sourcing." It is this subsection (a)(5) that we want to be sure is given full effect. It states the following:

   > "(1) Sales attributable to intercompany items are not included in S's sales factor either in the year of the transaction or in the year(s) in which such intercompany items are taken into account."

6. Some taxpayers**:** have suggested that because the election results in current income recognition from intercompany transactions, as opposed to the normal scheme of deferral, that the sales factor for the year of election should contain the gross receipts related to the income recognized currently due to the election, which results in a higher sales factor denominator and reduced California apportioned income.

7. Possible Amendment: Staff believes that it is prudent to clarify that a Regulation section 25106.5-1, subsection (e), election does not allow taxpayers to include intercompany transaction receipts in their sales factor denominator in the year of election. Instead, receipts are only included in the sales factor when the intercompany items are sold to third parties, giving rise to economic gain or loss to group as a whole. If intercompany receipts were to be recognized currently due to the election, the receipts that arise when the items are eventually sold outside the group would result in a double count of the actual economic activity in the sales factor. Furthermore, inclusion in the sales factor in the current year due to a subsection (e) election is inconsistent with Regulation section 25106.5(a)(5)(A) and (a)(5)(B).

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Comments: The public was then asked for comments and the following topics were discussed:

1. Effective Date: Comment was made that the effective date should be prospective only because this is a "change" in the law, there was a lack of intent, and regulations are statutory so they should not be made retroactive. Response was that this is a clarification and it had not yet been decided whether amendments would be recommended to be retroactive.

2. Economic Change to Group: A comment was made that recognition of income should necessarily require inclusion of receipts from the intercompany transaction underlying the income. The response given was that the reason the receipts are not included in the sales factor at the time of the intercompany transaction under a subsection (e) election is because there has been no economic change to the group as a whole. Further comment was made disagreeing; saying that the fact that the income is being taxed currently means that there is an economic change. Response was that while there is taxation under the election, the fact that something is being taxed does not mean that there has been an economic change to the group as a whole. An asset has merely moved from one entity's books to another and an expense recorded in the other direction, with no overall change to the group. Further response was given that this issue is really only as to transactions in the last month of the taxable year. Those transactions in the first eleven months would normally not be subject to an election because for the most part, those would have been sold outside the group within that time and currently recognized by the triggering event of the outside sale, hence not needing an election for current recognition.

3. Double Counting: In addition to the lack of economic change to the group from intercompany transactions, another reason given for not including the receipts from the intercompany transaction in the sales factor was that this would effectively be a double counting of receipts, or more, depending on the number of intercompany transactions. Further comment was made that this could be a counting of receipts 100 times if there were that many intercompany transactions for a particular asset. Responsive comment was that the taxpayer community would not execute hundreds of intercompany transactions. The question was asked, how much is too much, five, 100, 200 intercompany transactions for the same asset? Another responsive comment was that the taxpayer does not have to make this election. It is entirely voluntary to accelerate this income and the purpose of it was ease of administration and simplification. A comment was that the problem is that the factor is so enormous compared to the tiny amount of income associated with it. Also raised was the question of whether the purposes of the federal and state elections are the same, since the California election was modeled after the Federal election. Since the purposes of the federal and state

elections are the same, it should be noted that the federal election is disallowed where it is driven by tax benefits.

4. Intent: The question was asked repeatedly why receipts associated with intercompany transactions that give rise to taxable income should not be included in the sales factor. Response was that this was not the intent of the Regulation 25106.5-1, subsection (e) simplifying rules. Further question was how the FTB knows what the intent was at the time of drafting. Response was that Ms. McElhatton had read the rulemaking file and there was no discussion of including the intercompany receipts in the sales factor when making a subsection (e) election. The comment that followed was that silence does not indicate intent. The response was that Ms. McElhatton will read the rulemaking file again and try to find documents that help to clarify intent.

Written Comments: Following the interested parties meeting, the following written comments were submitted:

1. Regulation section 25106.5-1 (e) should not be clarified. The election under Regulation section 25106.5-1(e) should apply to treat intercompany transactions on a separate entity basis for both income recognition and inclusion of gross receipts relating to those transactions.

2. The subsection (e) election is an election to treat intercompany transactions on a separate entity basis. Since the taxpayer must recognize the income or loss on a separate entity basis in the year of the election, it follows that the electing taxpayer should also include gross receipts associated with those transactions in its sales factor in the year of the election. If this is not done, then the income or loss will be apportioned using an apportionment formula that does not fairly reflect where or how that income or loss was generated and thus is flawed.

3. The FTB commented that the purpose of the subsection (e) election was to mirror the federal election that only addresses income or loss and not apportionment and the FTB recognized that federal consolidated return regulations are not subject to Commerce Clause or other constitutional constraints, unlike the FTB regulations. It is because FTB's regulations have constitutional constraints that there should be matching of income/loss with related gross receipts in the year of the election so that the income/loss is fairly apportioned to California.

4. Current mechanisms such as RTC section 25137 are in place to address any distortion problem. A rule to prevent distortion should not give rise to distortion by causing a mismatch of income and apportionment factors.

5. Double counting is not distortive per se. Rather; there are several cases that stand for the opposite view that inclusion of income necessitates representation in the factors. There are other means to cure distortion than amending Regulation section 25106.5-1.

6. Amendments to Regulation section 25106.5-1 to clarify existing law are not supported by law or equitable standards. There is no authority provided that a regulation may be clarified to address unintended consequences of application of the regulation. Taxpayers are entitled to rely on the laws in existence during the taxable year when the transactions were made.

7. "Treatment as a separate entity" is defined at Regulation section 25106.5-1(b)(6) which turns off all aspects of Regulation section 25106.5-1 other than the rules of subsection (a)(4). There is no carve out for subsection (a)(5). Therefore, the FTB did not intend to maintain application of the sourcing rules to a taxpayer that made the election to treat intercompany sales on a separate entity basis.

8. For legislation to be given retroactive effect the legislature must provide a clear statement of the public purpose for such retroactive legislation and this same burden should be met for legislative regulations.

B. <u>The DISA rules of Regulation section 25106.5-1 subsection (f).</u>

Craig Swieso opened the discussion with a presentation of the underlying DISA principles.

1. California's intercompany transaction regulations specifically provide that other existing law is applicable. Therefore, if the application of existing law allowed for a taxpayer's desired result there isn't any need to revise the regulations. Conversely, if the existing law doesn't allow the desired result, then the regulations must necessarily be revised in order to achieve the desired result.

2. The DISA rules encompass California's treatment of excess distributions in accordance with Internal Revenue Code section 301(c)(3), which California Revenue and Taxation Code section 24451 conforms to.

3. The intercompany regulations require all DISA balances to be reported annually on the tax return. If this doesn't occur, at its discretion, the FTB can take the unreported DISA balance into account.

4. The federal consolidated return regulations can't be relied upon in lieu of the DISA rules primarily because the federal stock basis adjustment rules are a function of unapportioned income, which includes income from whatever source. On the other

hand, due to constitutional limitations, by definition California-sourced income is apportioned and doesn't necessarily reflect nonbusiness income.

5. Pursuant to the DISA rules, any applicable Internal Revenue Code section 301(c)(3) gain is deferred until the underlying stock is disposed as the result of a sale, liquidation, or any other disposition. The deferred gain will also be taken into account when either the distributor or distributee ceases to be a member of the combined reporting group or if the associated stock is deemed worthlessness.

6. When the deferred Internal Revenue Code section 301(c)(3) gain is taken into account, it is sourced with reference to that year's apportionment factors.

7. California Government Code section 19146 prohibits the intercompany transaction regulations from repealing or diminishing any existing statute, including Internal Revenue Code section 301(c)(3).

8. The intercompany transaction regulations preclude any intercompany transactions from being reflected in any combined reporting group member's separate company earnings and profits.

Following this presentation, participants made the following comments.

1. In a brother/sister merger, the DISA attributable to the nonsurviving corporation's stock can be transferred and suitably allocated to the surviving corporation's stock. Thereafter, the DISA can be taken into account when the surviving corporation's stock is eventually disposed of. Accordingly, the DISA regulations should be revised to provide that a brother/sister merger won't cause a DISA to be taken into account.

2. As it is ordinarily applied, Internal Revenue Code section 301(c)(3) gain must be currently recognized in the year in which the excess distribution occurred. However, the DISA rules allow the gain to be deferred pending a triggering event. Prior to a triggering event, if a subsequent capital contribution is allowed to increase the distributee's basis in the distributor's stock, any corresponding deferred gain would be reduced or eliminated. This treatment would follow the federal treatment of determining the gain that must be recognized on the disposition of a consolidated return group member's stock wherein there is an associated negative basis. Accordingly, the DISA regulations should be revised to allow a subsequent capital contribution to reduce or eliminate the deferred Internal Revenue Code section 301(c)(3) gain. However, it must be pointed out that this treatment would provide for the elimination of deferred income, which isn't necessarily allowed under general tax principles.

3. Assuming that there aren't sufficient earnings and profits or stock basis attributable to any of the affiliates, if the same amount is distributed through a chain of tiered affiliates, it will create DISAs at each level. Accordingly, the DISA regulations should be revised to only require that one DISA is created if the same amount is distributed through a chain of tiered affiliates.

4. As the result of a triggering event, a combined reporting group member will be required to take any deferred Internal Revenue Code section 301(c)(3) gain into account. If the Internal Revenue Code section 301(c)(3) gain that is taken into account is treated as creating earnings and profits, any subsequent distribution by that member will correspondingly reduce or eliminate any DISA attributable to that distribution. Accordingly, the intercompany transaction regulations should be revised to allow Internal Revenue Code section 301(c)(3) gain that is taken into account to create earnings and profits for the distributee.

5. Presuming that California Government Code section 19146 prohibits the intercompany transaction regulations from repealing or diminishing an existing statute, the current intercompany transaction regulations violate this rule because they do in fact repeal or diminish existing statutes. For instance, California Revenue and Taxation Code section 25120 provides that sales include all gross receipts. However, the intercompany transaction regulations specifically provide that receipts from intercompany transactions can't be included in the sales factor denominator.

6. Subsequent to the Interested Parties Meeting, the following written comments were submitted.

    a. The elimination approach with respect to intercompany transactions is more consistent with the unitary business principle and combined reporting procedures as opposed to the deferral approach.

    b. When California Revenue & Taxation Code section 25106.5 was enacted, it shouldn't be presumed that the California Legislature granted the FTB with broad, quasi-legislative authority. Therefore, the FTB's authority to create the DISA regime is highly questionable. With this in mind, any regulations issued under California Revenue & Taxation Code section 25106.5 must be consistent with the unitary business principle, as well as California Revenue and Taxation Code sections 25101, 25106, and 25120 through 25139, as well as the case law that interprets this statutory provision.

    c. The DISA regime should not create phantom income to the unitary business through artificial, in not arbitrary, rules regarding basis and the calculation of earnings and profits.

d. The DISA rules should incorporate the federal consolidated return intercompany regulations basis and earnings and profits rules.

e. The intercompany transaction regulations should allow deferred income attributable to intercompany transactions to create earnings and profits.

f. The DISA regulations should be revised to allow subsequent capital contributions to reduce DISA balances. This treatment would be consistent with the basis rules contained in the federal consolidated return regulations.

g. Any type of merger should not trigger the DISA to be taken into account because no assets will have left the combined reporting group.

h. The revised DISA regulations should be applied on a retroactive basis.

C. <u>Conformity of Regulation section 25106.5-1 to Treasury Regulation section 1.1502-13</u>

There was only brief discussion regarding amending Regulation section 25106.5-1 to the most recent version of Treasury Regulation section 1.1502-13. Staff will review the Treasury Regulation and make recommendations regarding conformity.

Subsequent to the Interested Parties' Meeting a written comment was submitted. It was suggested that Regulation section 25106.5-1 be amended to provide that it incorporate the most recent version of Treasury Regulation section 1.1502-13 that is in effect for the year in which the relevant intercompany transaction occurs.