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

I. Administration: On September 22, 2010 at 1:00 p.m., members of the public attended an interested parties meeting at the Franchise Tax Board's Sacramento central office. 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 tape recorded for reference but there would be no attribution of comments and no transcript. The Hearing Officers were Craig Swieso and Laurie McElhatton. Available handouts were: notice of the meeting, discussion topics, proposed language, Exhibits A through I, and a summary of the first interested parties meeting. Parties were told they had until September 29, 2010 to submit written comments for inclusion in the summary, but that they could also submit written comments at any time, and that a summary of the interested parties meeting would be posted online.

The purpose of the meeting was discussed as being a time for the public to discuss the proposed amendments to CCR § 25106.5-1 to provide further guidance in two areas and to address conformity with federal laws.

II. Discussion: The discussion was organized topically, covering the following three areas:

- Proposed amendments to CCR § 25106.5-1 providing further guidance regarding the proper apportionment treatment of intercompany transactions that are reported utilizing the simplifying rules of Regulation section 25106.5-1, subsection (e).

- Proposed amendments to CCR § 25106.5-1, subsection (f)(1)(B), relating to Deferred Intercompany Stock Accounts (DISA), to provide further guidance addressing mergers and the effect of tiered distributions.

- Proposed amendment to CCR § 25106.5-1, subsection (a)(2), to indicate that the intercompany transaction regulations incorporate Treasury Regulation 1.1502-13, as amended through April 1, 2009. Additionally, proposed amendments to include the IRS website address.

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

The discussion was opened with a request for comments on the proposed amendments pertaining to the simplifying rules.

- A comment was made that because taxpayers are agreeing to recognize intercompany income, that income should be included in the sales factor. A response was made that the rulemaking file was reviewed and summarized in Exhibit A with excerpts in Exhibits B through I and that this summary is the FTB's position on the intent of the simplifying rules. Another response was that over-reporting can be an issue if intercompany sales are included in the sales factor in the year of recognition under a subsection (e) election. Some examples were discussed:

    - One example was where a foreign group member makes a sale to a U.S. group member. The speaker stated that if the gain is recognized in California, then the proceeds should also be included in the sales factor.
    - The second example was a sale from a U.S. group member to another U.S. group member. The speaker thought that if an election were made on those facts to recognize the income currently, that the receipts should also be included in the sales factor.
    - The next example was for a worldwide combined reporting group and a sale from a foreign entity A to a foreign entity B and the reverse, from foreign entity B to foreign entity A. The public comment in this situation was that these would be transactions without economic substance and subject to a penalty but that there would be no reason not to include those receipts in the sales factor.
    - Then the last example was one with multiple tiers with foreign sub A selling to foreign sub B selling to foreign customer C. One comment was that this was not the situation they were concerned with. Another comment was made that this situation follows federal treatment and that the taxpayer should be allowed to make the election.

- A statement was made that it is rare for a federal election requiring permission to be approved and that there is a requirement that there be no greater benefit under the election than if a standard federal 1120 were filed. Another statement was made that taxpayers should simply not elect to recognize the income currently if they don't like the fact that there will be no sales factor representation.

- Another statement was made regarding constitutional implications and that there was no legislative intent for subsection (a)(5) to apply in instances of a subsection (e) election. In fact, the speaker claimed that these are not intercompany transactions and therefore CCR § 25106.5-1, subsection (a), does not apply at all.

- A comment was made that the exhibits from the rulemaking file quote general statements only and there are no express statements of intent regarding the sales factor and a subsection (e) election.
- A response was given that the reason for the subsection (e) election was to streamline recordkeeping rather than create an increased burden through deferral. Taxpayers can elect or not elect depending on their own circumstances. The point is that receipts from intercompany transactions, if included in the sales factor, would be counted once, and then upon sale outside the group, a second time. In addition, the intercompany sale in no way represents the market, which is what the sales factor is intended to measure.

- A statement was made that there is mismatching with deferral as there will be income coming in, such as for example with a foreign entity selling to a California entity.

- There was discussion about whether the regulation should be made to be retroactive. A speaker stated that it should not be retroactive as the interpretation being expressed by amendment was not the original intent. In addition, the speaker expressed concern that there may be penalties for taking the position in earlier years if the regulation is made retroactive. The speaker stated that making this regulation retroactive and subjecting taxpayers to penalties would not be a fair administrative practice.

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

- It was mentioned that a stock redemption was affirmatively included as a transaction that will result in a stock disposition that will trigger the recognition of a DISA. There were no comments pertaining to this revision.

- It was mentioned that pursuant to California Revenue & Taxation Code section 19503, subdivision (b), the revisions to the DISA regulations would be applied retroactively. There were no comments pertaining to this statement.

- It was mentioned that when a subsidiary merges into a parent company, that operates as a liquidation. Pursuant to the language of the existing regulations, a liquidation will trigger the recognition of a DISA. Additionally, when a parent company merges into a subsidiary, that operates as a redemption. Pursuant to the revised language of the regulation, a redemption will trigger the recognition of a DISA. Accordingly, the only type of merger that needs to be additionally addressed is a brother/sister merger.

- It was mentioned that the reason the revised language provides that the relative DISAs pertaining to the non-surviving corporation's stock and the surviving corporation's stock are combined and then divided by the number of shares of the surviving corporation's stock after the merger is to ensure that a pro rata amount of DISA is recognized when the surviving corporation's stock is disposed of. In *Fujitsu It Holdings, Inc. v. FTB* (2004) 120 Cal. App. 4th 459, the issue of the pro ration of earnings and profits arose. The pro ration provision in the revised regulations will forestall a similar problem. There were no comments pertaining to this statement.

C. <u>Effect on Earnings and Profits from Intercompany Transactions Rules of Regulation section 25106.5-1, subsection (j)(4), as they Relate to DISAs.</u>

- With respect to the revisions pertaining to the creation of earnings and profits from tiered distributions, it was questioned why the revised language provides that it only relates to tiered distributions that are made immediately following one another. In response, the concern was about tracking distributions over a multitude of years. However, it was agreed that the distributions don't necessarily need to immediately follow one another. Accordingly, the term "immediately" will be excised from the revised language.

- It was also questioned why the same amount of money must be distributed in order to create earnings and profits from tiered distributions. Again, in response, the concern was about tracking distributions. However, it was agreed that a distribution involving a lesser amount of money should likewise create earnings and profits. Accordingly, another example will be added that includes a fact pattern involving a distribution of a lesser amount of money. (An example that includes a fact pattern involving a distribution of a greater amount of money is already featured in the revised language.)

- It was pointed out that according to the revised language, when a tiered distribution is received by the ultimate parent company, it will result in the ultimate parent company having earnings and profits. Accordingly, when the ultimate parent company makes a distribution to its shareholders, they must treat it as a dividend.

D. <u>Subsequent Capital Contribution Allowed to Reduce or Eliminate an Existing DISA</u>

- Although the revised language did not address this issue, it was significantly discussed during the meeting.

- It was pointed out that Regulation section 25106.5-1, subsection (f)(1)(B), specifically references Internal Revenue Code section 301, subsection (c)(3), as being the statutory basis for the DISA rules. Accordingly, because pursuant to Internal Revenue Code section 301, subsection (c)(3), the gain is necessarily recognized during the tax year when the excess distribution occurred, it follows that a capital contribution made in a subsequent year can't eliminate the gain. In response, it was pointed out that the existing version of

Regulation section 25106.5-1, subsection (f)(1)(B), requires that the gain from the excess distribution is deferred until the underlying stock is disposed of. Therefore, the existing regulation already diverts from Internal Revenue Code section 301, subsection (c)(3). Accordingly, allowing a subsequent capital contribution to reduce or eliminate an existing DISA would only be an extension of the FTB's ability to not be strictly bound by Internal Revenue Code section 301, subsection (c)(3).

- It was commented that the prior regulatory history of Regulation section 25106.5-1 includes a comment by FTB staff that *Safeway Stores, Inc. v. FTB* (1970) 3 Cal. 745 supports requiring current year recognition of gains from excess distributions. However, as the commentator pointed out, *Safeway Stores* pre-dates California's adoption of UDITPA. Therefore, despite FTB staff's prior comments otherwise, *Safeway Stores* has no bearing on the issue.

- It was asked that since the current version of California Revenue & Taxation Code section 25135, subdivision (b), reverts to the rule in *Appeal of Finnigan Corp*., 88-SBE-022, for purposes of recognizing any triggered DISA, will the excess distribution be considered on a separate company basis or cumulatively on the combined reporting group basis. In response, it was pointed out that because the purported reversion to the *Finnigan* rule would necessarily apply to all intercompany transactions, the inquiry is necessarily beyond the scope of this particular regulation project.

- It was asserted that because the DISA rules are tacitly based on the federal consolidated return regulation excess loss account rules (i.e. Treasury Regulation section 1.1502-19), which in turn must be considered in conjunction with the federal consolidated return basis adjustment rules (i.e. Treasury Regulation section 1.1502-32), which allow subsequent capital contributions to increase the stock basis, then similarly subsequent capital contributions should be allowed to increase stock basis for California purposes. However, it was pointed out that for federal purposes there aren't any constitutional limitations of what can be considered as income for basis adjustment rules which is the essence of Treasury Regulation section 1.1502-32. Because there are constitutional limitations on what can be included as California-sourced income, Treasury Regulation section 1.1502-32 cannot be relied upon for California purposes.

E. <u>Conformity with Most Recent Version of Treasury Regulation section 1.1502-13</u>

- Regulation section 25106.5-1, subsection (a), will state that, where applicable, it is in conformity with the version of Treasury Regulation section 1.1502-13 through April 2010.

- It was asked whether this revision will be applied retroactively. In response it was pointed out that since the most recent version of Treasury Regulation 1.1502-13 doesn't conflict with any existing provisions of Regulation section 25106.5-1, this revision will be applied retroactively.

F. <u>Subsequent Written Comments</u>

- Staff's proposed revision to Regulation section 25106.5-1, subsection (j)(4), should read as follows:

  > However, when a member distributes an amount of money or property to another member, who in turn thereafter makes a distribution to another member, any DISA arising from the initial distribution will be treated as earnings and profits from purposes of determining the DISA, if any, arising from the second distribution.

- Because the FTB mirrors the rules embedded in Treasury Regulation section 1.1502-19, the FTB should recognize the rules in their entirety, including the effect of subsequent contributions. Otherwise, phantom income will arise and additional record-keeping and compliance burdens will follow.

- Existing provisions of the California Revenue & Taxation Code, such as sections 24451 and 24912, conform to provisions of the Internal Revenue Code, such as sections 358 and 1012, respectively, which allow subsequent capital contributions to increase an asset's basis. Accordingly, independent of the intercompany transaction regulations, there is existing statutory authority to allow subsequent capital contributions to increase the basis in the stock of a unitary combined reporting group member.

- According to the existing DISA rules, any gain is deferred until there is a triggering event. Likewise, the measurement of the DISA should be deferred until there is a triggering event. In this instance, a subsequent capital contribution would be allowed to reduce or eliminate a DISA.