Staff Proposed Amendments to Regulation § 25106.5-1
(Only those subsections proposed to be amended are set forth)
Additions in <u>Underline</u>
Deletions in ~~Strikethrough~~

(b) Definitions. For purposes of this regulation:

(1) Intercompany transactions.

(A) Except as provided in subsection (b)(1)(B), the term "intercompany transaction" means a transaction between corporations which are members of the same combined reporting group immediately after such transaction. "S" is the member transferring property or providing services, and "B" is the member receiving the property or services. Intercompany transactions include, but are not limited to --

1. S's sale of property (or other transfer, such as an exchange or contribution) to B;

2. S's performance of services for B, and B's payment or accrual of its expenditures for S's performance;

3. S's licensing of technology, rental of property, or loan of money to B, and B's payment or accrual of its expenditures; and

4. S's distribution to B with respect to S stock<u>, to the extent that the distribution is eliminated from income under section 25106 or constitutes a distribution in excess of basis that results in a deferred intercompany stock account (DISA) as described in subsection (f) of this regulation</u>.

5. (B) The term intercompany transaction does not include transactions which produce nonbusiness income or loss to the selling member or income attributable to a separate business activity of the selling member. The term intercompany transaction also does not apply when the asset transferred in the transaction is acquired for the buyer's nonbusiness use or for the use of a separate business activity of the buyer. For purposes of this regulation, such transactions shall be considered as if between corporations that are not members of a combined reporting group.

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(f) Stock of Members.

(1) Unless otherwise provided, this regulation applies the provisions of Treasury Regulation section 1.1502-13(f) relating to stock of members; however, the provisions of subsection (f)(6) of that section shall not apply.

(A) Exception for distributee member. Treasury Regulation section 1.1502-13(f)(2)(ii) shall not apply to exclude intercompany distributions from the gross income of the distributee member. Intercompany dividend distributions described by section 301(c)(1) of the Internal Revenue Code are included in the income of the distributee member unless subject to elimination or deduction under other applicable law, including sections 25106 or 24402 of the Revenue and Taxation Code. The treatment of intercompany distributions described by section 301(c)(3) of the Internal Revenue Code is provided by subsection (f)(1)(B) of this regulation.

(B) Deferred intercompany stock account (DISA). That portion of an intercompany distribution which exceeds California earnings and profits and P's basis in S's stock (the portion of a distribution described by section 301(c)(3) of the Internal Revenue Code) will create a DISA. In this subsection, P is treated like the Buyer (B) for purposes of calculating corresponding and recomputed items.

The DISA will be treated as deferred income. To the extent of a sale, liquidation or any other disposition of shares of the stock, the balance of the DISA with respect to such shares will be taken into account as income or gain to P even if S and P remain members of the same combined reporting group. The disposition shall be treated as a sale or exchange for purposes of determining the character of the DISA income or gain. The DISA is held by the distributee.

1. A disposition of all the shares shall be deemed to have occurred if either S or P becomes a non-member of the combined reporting group or if the stock of S becomes worthless.

2. Because P's DISA is deferred income and not negative basis, the DISA is taken into account upon liquidation, including complete liquidation into the parent. The deferred income restored as a result of the liquidation will be taken into account ratably over 60 months unless the taxpayer elects to take the income into account in full in the year of liquidation. For example, if S liquidates and the exchange of P's S stock is subject to section 332 of the Internal Revenue Code (section 24451 of the Revenue and Taxation Code), P's DISA income taken into account under subsection (f)(1)(B) of this regulation is recognized over 60 months, unless an election is made to recognize the deferred income in the year of liquidation. Nonrecognition or deferral shall not apply to DISA income or gain taken into account as a result of an event described in subsection (f)(1)(B)1. of this regulation.

3. If P transfers the stock of S to another member of the combined reporting group, P's DISA income will be an intercompany item and deferred under the rules of this regulation.

4. If, on the effective date of this regulation, a closing agreement has been executed with the Franchise Tax Board to defer income from distributions described under section 301(c)(3) of the Internal Revenue Code, then such income shall be included in the DISA of the distributee member to the extent that it has not already been taken into account in the income of the distributee member. Thereafter, the balance of the DISA account shall be taken into account under the rules of this regulation.

5. If P receives an intercompany distribution described by section 301(c)(3) of the Internal Revenue Code in an income year beginning prior to the effective date of this regulation, the taxpayer may request a closing agreement under section 19441 of the Revenue and Taxation Code that will allow the gain from the distribution to be deferred in a manner consistent with the provisions of subsection (f)(1)(B) of this regulation. The request shall be mailed within one year after the effective date of this regulation and within the applicable statutes of limitations on deficiency assessments or refund claims for the year of the distribution. The request shall describe the parties to the transaction, including federal identification numbers, the nature of the distribution, the timing and amounts of the income involved, and any other relevant facts. Requests shall be mailed to the following address: California Franchise Tax Board, Legal Branch, Attn: Chief Counsel, P.O. Box 1720, Rancho Cordova, CA 95741-1720.

(2) Examples. The application of this section to intercompany transactions with respect to stock of members is illustrated by the following examples.

Example 1: Dividend exclusion and property distribution.

(Refer to Treas. Reg. § 1.1502-13(f)(7), example 1.)

Facts. On December 31 of Year 1, S had accumulated earnings and profits of $480, and in Year 2, S had an additional $20 in earnings and profits. The earnings and profits from both years were attributable to business income included in the combined report that included S and its parent corporation P and eligible for elimination under section 25106 of the Revenue and Taxation Code. In Year 3, S owns land that is used in the trade or business of the combined reporting group with a $ 70 basis and $ 100 value. ~~On January 1 of Year 1,~~ P's basis in S's stock is $ 100 ~~and S has accumulated earnings and profits of $500 from prior year's combined reports of S and P.~~ During ~~Year 1~~ Year 3, S declares and makes a dividend distribution of the land to P. P also uses the land in the unitary business. S has no earnings and profits from its ordinary business operations in Year 3. Under section 311(b) of the Internal Revenue Code, S has a $ 30 gain. Under section 301(d) of the Internal Revenue Code, P's basis in the land is $ 100. (California law generally conforms to Internal Revenue Code sections 301-385 under section 24451 of the Revenue and Taxation Code.) On July 1 of Year ~~3~~ 4, P sells the land to Y for $ 110.

Dividend treatment. S's distribution of the land is an intercompany distribution to P in the amount of $ 100. Under subsection (j)(4) of this section, the $30 of intercompany gain is not reflected in the earnings and profits of S in Year 3. Instead, that amount is reflected in the earnings and profits of S in Year 4, the year of the sale of the land to Y. Under section 316 of the Internal Revenue Code (applicable for purposes of Part 11 of the Revenue and Taxation Code pursuant to section 24451 of the Revenue and Taxation Code), earnings and profits are first paid from current earnings and profits, and then from earnings and profits of the most recent year of accumulation. Because S had no earnings and profits in Year 3, the distribution in Year 3 is first paid out of Year 2 earnings and profits of S~~,~~ (to the extent of the available $20) and then the remaining $80 (the $100 distribution less the $20 drawn from Year 2) is paid out of the available $480 of earnings and profits of Year 1. Because the entire earnings and profits of both years ~~which~~ are attributable to income that has ~~have~~ been included in a combined report of S and P, the entire $100 dividend ~~it~~ will be eliminated from P's income pursuant to section 25106 of the Revenue and Taxation Code. The payment of the dividend has no effect on P's $100 basis in the stock of S.

Matching rule. Under the matching rule (treating P as the buying member and S as the selling member), S takes its $ 30 intercompany gain into account in Year ~~3~~4 to reflect the $ 30 difference between P's $ 10 corresponding gain ($ 110-$ 100 basis in the land) and the $ 40 recomputed gain ($ 110 - $ 70 basis that the land would have had if S and P were divisions).

Apportionment. ~~The~~Because the entire amount is eliminated from income under section 25106, the intercompany distribution is not reflected in the sales factor in Year ~~1~~3. In Year ~~3~~ 4, unless otherwise excluded, the $ 110 gross receipts from P's sale of the land to Y will be included in P's sales factor. After the distribution in Year ~~1~~3, the land will be included in P's property factor at S's $ 70 original cost basis. Both S's $ 30 gain and P's $ 10 gain relative to the distributed land will be treated as current apportionable business income in Year ~~3~~4.

Example 2: Dividends paid from ~~pre-unitary~~ earnings and profits not included in a combined report.

Facts. The facts are the same as in Example 1 except that only $300 of S's $480 earnings and profits from Year 1 were attributable to income included in a ~~prior~~combined report that included S and P, and thus eligible for elimination under section 25106 of the Revenue and Taxation Code. ~~is only $10. S also has $490 of earnings and profits that arose in years before a unitary relationship existed between S and P.~~

Dividend treatment. Because ~~only $10~~ $20 of S's distribution was paid from earnings and profits attributable to Year 2 business income that was wholly included in a combined report of S and P, ~~only~~ the entire ~~$10~~$20 amount is eliminated under section 25106 of the Revenue and Taxation Code. The remaining $ ~~90~~ 80 of the dividend ~~will be taken into account by P in Year 1~~ is treated as proportionately paid from the whole of the original earnings and profits of Year 1, the next most recent year of accumulation, including both earnings and profits that were attributable to S and P's combined report and those that were not. Thus, $50 ($300 combined report earnings and profits multiplied by the ratio of $80 (the remaining amount of the dividend, drawn from Year 1) to $480 (the total originally available earnings and profits of Year 1) is treated as eliminated under section 25106 of the Revenue and Taxation Code. The remaining $30 paid from earnings and profits of Year 1 ($180 earnings and profits not eligible for elimination under section 25106 multiplied by the ratio of $80 (the remaining amount of the dividend, drawn from Year 1) to $480 (the total earnings and profits of Year 1)) is taxable, subject to any applicable deductions under Revenue and Taxation Code sections 24402, 24410, ~~or~~ 24411 or any other section of the Revenue and Taxation Code that provides that the dividend not included in net income ~~of the Revenue and Taxation Code~~. (See California Code of Regulations, title 18, section 24411, subsection (e) for rules relating to the treatment of distributions that include both earnings and profits eligible for elimination under section 25106 of the Revenue and Taxation Code, and those eligible for deduction under sections 24402, 24410, and 24411 or any other provision of the Revenue and Taxation Code.)

Matching rule. P's corresponding item is not its dividend income, but its income, gain, deduction or loss from the property acquired in the intercompany distribution. Therefore, none of S's intercompany gain will be taken into account in Year ~~1~~3. As in Example 1, S will take its $ 30 intercompany gain into account in Year ~~3~~4 to reflect the $ 30 difference between P's $ 10 corresponding gain and the $ 40 recomputed gain.

Apportionment. The apportionment results are the same as in Example 1, except that to the extent that the Year ~~1~~3 dividend is not eliminated under section 25106 or ~~deducted~~deductible under sections 24402, 24110, ~~or~~ 24411 or any other provision of the Revenue and Taxation Code, P's dividend income will be treated as current apportionable business income in Year ~~1~~3. The intercompany distribution is not included in the sales factor in Year ~~1~~3, to the extent attributable to dividends eliminated from income under section 25106.

Example 3: Deferred intercompany stock accounts.

(Refer to Treas. Reg. § 1.1502-13(f)(7), example 2.)

Facts. S owns all of T's stock with a $ 10 basis and $ 100 value. S has substantial earnings and profits which are attributable to business income included in a combined report of S, T and P. T has $ 10 of accumulated earnings and profits, all of which are attributable to business income included in a combined report of S, T and P. On January 1 of Year 1, S declares and distributes a dividend of all of the T stock to P. Under section 311(b) of the Internal Revenue Code, S has a $ 90 gain. Under section 301(d) of the Internal Revenue Code, P's basis in the T stock is $ 100. During Year 3, T borrows $ 90 from an unrelated party and declares and makes a $ 90 distribution to P to which section 301 of the Internal Revenue Code applies. During Year 6, T has $ 5 of current earnings which is attributable to business income included in the combined report of S, T and P. On December 1 of Year 9, T issues additional stock to Y and, as a result, T becomes a nonmember.

Dividend elimination. P's $ 100 of dividend income from S's distribution of the T stock, and its $ 10 dividend income from T's $ 90 distribution, are eliminated from income under section 25106 of the Revenue and Taxation Code.

Matching and acceleration rules. P has no deferred intercompany stock account (DISA) with respect to T stock because T's $ 90 distribution did not exceed T's $ 10 of earnings and profits and $ 100 stock basis. Therefore, P's corresponding item in Year 9 when T becomes a nonmember is $ 0. Treating S and P as divisions of a single corporation, the T stock would continue to have a $ 10 basis after the distribution from S to P. T's $ 90 distribution in Year 3 would first reduce T's $ 10 earnings and profits to zero, then reduce the $ 10 recomputed basis in T stock to zero and create a $ 70 recomputed DISA. T's $ 5 of earnings in Year 6 does not affect the amount of the DISA. Because the recomputed DISA would be taken into account upon T becoming a nonmember in Year 9, P will have a $ 70 recomputed corresponding item. Under the matching rule, S takes $ 70 of its intercompany gain into account in Year 9 to reflect the difference between P's $ 0 corresponding gain and the $ 70 recomputed gain. S's remaining $ 20 of gain will be taken into account under the matching and acceleration rules based on subsequent events (for example, under the matching rule if P subsequently sells its T stock, or under the acceleration rule if S becomes a nonmember or if the stock of T becomes a nonbusiness asset.)

Apportionment. Neither the distributions in Years 1 and 3, nor T becoming a nonmember in Year 9, have any effect on the sales factor. S's $ 70 intercompany gain will be treated as current apportionable business income in Year 9.