

INITIAL STATEMENT OF REASONS FOR THE
ADOPTION OF REGULATION SECTION 25106.5-1

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS.

Section 25106.5 of the Revenue and Taxation Code was enacted in 1987 to delegate broad quasi-legislative authority to the Franchise Tax Board to promulgate regulations dealing with combined reporting. (See *Yamaha v. State Board of Equalization* (1998) 19 Cal. 4th 11 [78 Cal.Rptr.2d. 1].) When corporations file a combined report, a methodology must be devised to report intercompany transactions among the members of the combined reporting group. Currently, the procedures for reporting intercompany transactions are reflected in FTB Publication 1061. While California's method of combined reporting may be analogized to the federal consolidated return, the two methods are not identical. Therefore, the procedures set forth in FTB Publication 1061 and included in the proposed regulation are not, and cannot be, in complete conformity with the federal rules, which are set forth in Treasury Regulation section 1.1502-13.

SPECIFIC PURPOSE OF THE REGULATION.

This proposed regulation will provide detailed rules relating to the reporting of intercompany transactions. In general, rules pertaining to the treatment of gains from intercompany transactions, acceleration, conversion of asset(s) to nonbusiness use, installment obligations, intercompany distributions, partially included water's-edge entities, and foreign country operations are provided for in the proposed regulation. In addition, the proposed regulation will override and eventually result in the repeal of certain provisions contained in subsection (e) of Regulation section 25110 (relating to intercompany transactions involving water's-edge electors) in Title 18 of the California Code of Regulations.

NECESSITY.

The Franchise Tax Board does not have a comprehensive set of regulations that deal with the mechanics of reporting intercompany transactions. For the most part, the mechanics of reporting intercompany transactions have been developed by years of audit experience, with the guidance of federal and generally accepted accounting rules, and this administrative practice has, over the years, been reflected in FTB Publication 1061. However, even that publication does not set forth many of the specific rules relating to reporting intercompany transactions. Instead, the effects of intercompany transactions on members of a combined reporting group have, for the most part, been illustrated by example. Moreover, because of numerous amendments to the federal rules, California's current methodology has fallen further behind in the area of federal/state conformity, thereby forcing taxpayers to prepare and maintain separate records for California tax purposes.

There are similarities between the California combined report and the federal consolidated return, but they are not identical. Many of the differences arise because of constitutional restrictions which are applicable to the states but not the federal government. As a consequence, federal consolidated return regulations cannot be relied upon for combined report purposes; instead, the federal regulations may be used as a template for the combined report regulations.

In addition, the Franchise Tax Board has an obligation to regulate when it seeks to prescribe rules of general application.

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS.

In proposing these regulatory changes, the Franchise Tax Board relied upon the following technical, theoretical, or empirical studies, reports, or documents: FTB Publication 1061; Treasury Regulation section 1.1502-13; "Summary of California Law on Intercompany Transactions Between Members of a Unitary Group," Bruce Daigh (paper submitted at 1995 California Tax Policy Conference); "Intercompany Transactions in a Combined Report – Preview of Upcoming Draft Regulations", Ligia Machado (paper submitted at 1995 California Tax Policy Conference); "State Tax Treatment of Intercompany Transactions Between Members of a Unitary Group," Michael E. Brownell (from presentation at Georgetown University Law Center, 1993 Institute on State and Local Taxation); "The Final Intercompany Transaction Regulations: Out With the Mechanical and In With the Conceptual," Bryan P. Collins and Mark A. Schneider, *The Journal of Corporate Taxation* (Spring 1996); "The Final Intercompany Transaction Regulations and International Transactions: A Methodology for Analysis," Steven K. Rainey and James K. Sams, *Tax Management International Journal* (Oct. and Nov. 1995); "The Consolidated Return Regulation Revision: Its Genesis and Objectives," Irving Salen, *The Tax Executive*, Vol. 17, No. 2 (Jan. 1965).

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS.

In accordance with Government Code section 11346.5(a)(12), the Franchise Tax Board has determined that no alternative considered by it would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed regulatory action. In addition, the proposed regulation pertains to corporate taxpayers and, therefore, does not affect private individuals.

ADVERSE ECONOMIC IMPACT ON BUSINESS.

The Franchise Tax Board has determined that the proposed regulatory action will not have a significant adverse impact on business. The proposed changes will result in timing issues for certain assets (i.e., inventory and intangibles), and will require

taxpayers to take deferred items into account using current apportionment factors; depending on economic conditions and their corporate organization, some taxpayers will benefit from these changes and some will not.