

## TITLE 18. FRANCHISE TAX BOARD

As required by section 11346.4 of the Government Code, this is notice that a public hearing has been scheduled to be held at 10:00 a.m., July 14, 2000, in Room 1040 at 9645 Butterfield Way, Sacramento, California, to consider adoption of section 25106.5-1 under Title 18 of the California Code of Regulations, authorized under section 25106.5 of the California Revenue and Taxation Code, pertaining to the mechanics of reporting intercompany transactions on a combined report.

An employee of the Franchise Tax Board will conduct the hearing. Thereafter, a report will be made to the three-member Franchise Tax Board for its consideration. Government Code section 15702(b) provides for consideration by the three-member Board of any proposed regulatory action if any person makes such a request. The three-member Board will consider the proposed regulation and comments submitted with respect to the proposed regulation prior to acting upon it at one of its meetings.

Interested persons are invited to present comments, written or oral, concerning the proposed regulatory action. It is requested, but not required, that persons who make oral comments at the hearing also submit a written copy of their comments at the hearing.

### WRITTEN COMMENT PERIOD:

Written comments will be accepted until 5:00 p.m., July 14, 2000. All relevant matters presented will be considered before the proposed regulatory action is taken. Comments should be submitted to the agency officer named below.

### AUTHORITY & REFERENCE:

Section 19503 of the Revenue and Taxation Code authorizes the Franchise Tax Board to prescribe regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.2 (commencing with section 18401), Part 10.7 (commencing with section 21001) and Part 11 (commencing with section 23001) of the Revenue and Taxation Code. In addition, section 25106.5 of the Revenue and Taxation Code provides specific authority to adopt regulations relating to combined reporting. The proposed regulatory action interprets, implements, and makes specific section 25106.5 of the Revenue and Taxation Code.

### INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW:

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].) In general, a combined report refers to the

schedules that must be attached to a corporation's tax return if that corporation is a member of a unitary group.

A unitary group is a group of corporations that is treated as conducting a single trade or business under section 25101 of the Revenue and Taxation Code. If a unitary group conducts part of its business in California, it is required to apportion part of its combined business income to this state. The apportionment rules are provided in sections 25120 through 25141 of the Revenue and Taxation Code, and related regulations.

Oftentimes, members of a unitary group will engage in transactions among and/or between themselves (intercompany transactions), which must be properly reflected in a combined report. Presently, procedures for reporting intercompany transactions are contained only in FTB Publication 1061 and in the case law. The proposed regulation will provide detailed guidance regarding the steps involved in reporting intercompany transactions.

Under section 19503(a) of the Revenue and Taxation Code, regulations relating to statutory provisions enacted prior to January 1, 1998, apply with retroactive effect unless prescribed by the Franchise Tax Board to the contrary. The proposed regulation will apply prospectively commencing with its effective date.

For ease of administration and compliance, the proposed regulation conforms to the extent possible to the federal rules for treating intercompany transactions contained in Treasury Regulation section 1.1502-13. Modifications to the federal rules are provided when necessary to account for differences between federal and state law, such as combined reporting, apportionment, and water's-edge elections. Because the proposed regulation incorporates and builds upon Treasury Regulation section 1.1502-13, the structure and numbering generally follow that Treasury regulation in order to facilitate cross-referencing between the two regulations.

In conformity with federal treatment, the draft regulation requires intercompany transactions to be reported in accordance with a matching rule and an acceleration rule. Essentially, the matching rule provides that intercompany transactions shall be taken into account as if the seller and buyer were divisions of a single corporation. The acceleration rule operates to take intercompany items into account when the effect of treating the seller and buyer as divisions of a single corporation cannot be achieved, such as when either the seller or buyer leaves the combined reporting group. This methodology is consistent with unitary theory because it generally results in the deferral of items of income, gain, deduction or loss from intercompany transactions until such time as there is an economic effect to the unitary business as a whole.

The most significant modifications to the federal treatment of intercompany transactions are as follows:

(a) Apportionment. Federal income tax rules do not include rules of geographic apportionment, which are required, as a constitutional matter, for state corporate franchise and income taxation. Consistent with the approach that intercompany

transactions are taken into account as if the seller and buyer are divisions of a single corporation, intercompany transactions are eliminated from the apportionment factors. Intercompany items are treated as current apportionable business income in the period in which they are taken into account.

(b) Acceleration rule triggered by conversion to nonbusiness use. Federal income tax rules do not include the concepts of business and nonbusiness income, which are included in the Uniform Division of Income for Tax Purposes Act, as adopted and contained in sections 25120 through 25141 of the Revenue and Taxation Code. If an asset which was the object of an intercompany transaction is converted to a nonbusiness use, then it is no longer part of the unitary business operations. Therefore, any intercompany gains attributable to that asset will be taken into account under the acceleration rule immediately before the nonbusiness conversion.

(c) Intercompany distributions. Federal income tax law for commonly owned businesses include joint liability for consolidated return members and elective filing rules that are not part of the Revenue and Taxation Code. Although the draft regulation generally applies the provisions of Treasury Regulation section 1.1502-13(f) relating to stock of members, the federal rules will not be applied to intercompany dividend distributions. Intercompany dividend distributions are included in the income of the distributee member unless subject to elimination or deduction under other applicable sections of the Revenue and Taxation Code, including sections 25106 and 24402. California does not conform to Treasury Regulation section 1.1502-32 relating to investment adjustments to the basis of the stock of a subsidiary, or to Treasury Regulation section 1.1502-19 relating to excess loss accounts. However, the proposed regulation provides for a "deferred intercompany stock account" which will operate in a manner similar to the federal excess loss account for the limited purpose of deferring gain from intercompany distributions which exceed the payor's earnings and profits and stock basis.

(d) Entering or withdrawing from the state. An objective of the draft regulation is to minimize state-only recordkeeping by conforming as closely as possible to the federal treatment, thus making it more likely that intercompany items will be taken into account in the same period for state purposes as for federal purposes. In furtherance of this objective, taxpayers who enter the state will bring deferred intercompany items with them as if this regulation had been applied in the year of the intercompany transaction. Likewise, taxpayers who withdraw from the state will take their intercompany items with them, and no acceleration will be applied to capture that income within the state. This is consistent with the divisional analogy of the matching rule.

(e) Partially included water's-edge entities. California law includes a "water's-edge election" which has no federal counterpart. Rules are provided to clarify the application of this proposed regulation to corporations which are partially included in a water's-edge combined reporting group under Revenue and Taxation Code sections 25110(a)(4) and 25110(a)(6). These rules will supersede the rules currently stated in Title 18 of the Cal. Code Regs., section 25110(e), for eliminating intercompany accounts between entities included in a water's-edge combined reporting group.

(f) Foreign country operations. For purposes of determining the tax liability for corporations doing business in this state, California law allows for the inclusion of entities organized in foreign countries on a combined report. Federal law generally

excludes such entities. Thus, reasonable approximations will be permitted in order to minimize the compliance burden for foreign corporations which are not required to follow a similar deferral system for federal income tax or any other purposes. Such corporations may report intercompany transactions using the method used for consolidated financial reporting purposes as long as that method reasonably reflects income and approximates the result that would be obtained by using the rules in this proposed regulation. Adjustments may be permitted or required for any material transaction or series of transactions if the financial reporting method does not produce a result which reasonably approximates the results that would be obtained under this proposed regulation.

#### COORDINATION WITH FEDERAL REGULATIONS:

While proposed Regulation section 25106.5-1 of the California Code of Regulations, Title 18, draws heavily on, and attempts to track, Treasury Regulation section 1.1502-13, the proposed regulation nevertheless deals with combined reporting, which is specific to California law and has no federal tax law counterpart.

#### DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION:

Mandate on local agencies and school districts: None.

Cost or savings to any state agency: None.

Cost to any local agency or school district which must be reimbursed under Part 7, commencing with Government Code section 17500, of Division 4: None.

Other non-discretionary cost or savings imposed upon local agencies: None.

Cost or savings in federal funding to the state: None.

Significant adverse economic impact on business including the ability of California businesses to compete with businesses in other states: None.

Potential cost impact on private persons or businesses directly affected: None.

Significant effect on the creation or elimination of jobs in the state: None.

Significant effect on the creation of new businesses or elimination of existing businesses within the state: None.

Significant effect on the expansion of businesses currently doing business within the state: None.

Effect on small business: The effect on small businesses will be minimal because the regulation applies primarily to multijurisdictional businesses. In addition, many of the provisions of the proposed regulations reflect existing administrative practices.

The Franchise Tax Board has determined that it is not feasible to draft the text of the proposed regulation in plain English due to the technical nature of the regulation. However, a non-controlling plain English summary of the text of the proposed regulations is available from the agency contact person named in this notice.

Significant effect on housing costs: None.

#### CONSIDERATION OF ALTERNATIVES:

In accordance with Government Code section 11346.5(a)(12), the Board must determine 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.

The proposed regulatory action pertains to corporate taxpayers and therefore does not affect private persons.

#### AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS:

An initial statement of reasons has been prepared setting forth the facts upon which the proposed regulatory action is based. The statement includes the specific purpose of the proposed regulatory action and the factual basis for determining that the proposed regulatory action is necessary.

The express terms of the proposed text of the regulation and the initial statement of reasons and the rulemaking file are prepared and available upon request from the agency contact person named in this notice.

#### CHANGE OR MODIFICATION OF ACTIONS:

The proposed regulatory action may be adopted by the three-member Franchise Tax Board after consideration of any comments received during the comment period.

The regulation may also be adopted with modifications if the changes are nonsubstantive or the resulting regulation is sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulation as modified could result from that originally proposed. The text of the regulation as modified will be made available to the public at least 15 days prior to the date on which the regulation is adopted. Requests for copies of any modified regulation should be sent to the attention of the agency officer named below.

#### ADDITIONAL COMMENTS:

If you plan on attending or making an oral presentation at the regulation hearing, please contact the agency officer named below.

The hearing room is accessible to persons with physical disabilities. Any person planning to attend the hearing who is in need of a language interpreter or sign language assistance, should contact the officer named below at least two weeks prior to the hearing so that the services of an interpreter may be arranged.

#### CONTACT:

All inquiries concerning this notice or the hearing should be directed to Colleen Berwick at the Franchise Tax Board, Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Telephone (916) 845-3306; Fax (916) 845-3648; E-Mail: [colleen\\_berwick@ftb.ca.gov](mailto:colleen_berwick@ftb.ca.gov). The notice, initial statement of reasons and express terms of the regulation are also available at the Franchise Tax Board's website at [www.ftb.ca.gov](http://www.ftb.ca.gov).