Chapter 14 Intercompany Transactions

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a. Introduction

It is common for affiliates in a unitary business to engage in business transactions with each other. These transactions typically result in a separate accounting (“separate entity”) gain or loss to the intercompany seller. One way to deal with such transactions for tax purposes is to include intercompany income in the combined reporting income in the year in which the transaction occurred (“current recognition”). However, if the unitary group is viewed as a single integrated economic enterprise, the sale produces no economic effect to the group as a whole. Instead, the intercompany sale is analogous to transfers of assets and cash between divisions of a single corporation, which does not produce a tax effect. Generally, the taxation of the income from an intercompany transaction is delayed until the economic effect of the transaction is realized outside of the unitary enterprise.

Refer to MATM 5260 for a more detailed discussion of intercompany transactions. This chapter provides a basis for understanding California Code of Regulations (CCR) §25106.5-1 and its application to partially included water's-edge corporations.

b. Federal

1. Overview

Prior to 1966, income from intercompany transactions was eliminated and the seller's basis was transferred to the intercompany purchaser. In 1966, the Treasury promulgated regulations adopting a deferred intercompany transaction system. (Treasury Regulation (Treas. Reg.) §1.1502-13.)

Under the 1966 regulations, the character of income (as capital or ordinary), source of the income (as U.S. or foreign source), holding periods, and other

tax attributes were determined as a wholly separate entity basis, as if the buyer and seller were unrelated. The rules were mechanical in nature. In time, however, these rules created their own distortions and planning opportunities, so that the Treasury had to frequently provide a new "patch" to close the loophole. In response to a number of problems, the Treasury adopted new intercompany transaction regulations in 1995.

The effects of the 1995 regulations and the 1966 regulations were substantially the same. For example, some of the items that remained substantially the same include:

- The calculation of income and the assignment of that income to the seller (now called the "amount" and "location" of the income);
- The timing of the income on a sale to an outsider (now called "matching"); and
- The restoration of income (now called "acceleration") as a result of disaffiliation remained substantially the same.

A significant difference between the 1995 and the 1966 regulations was the character, source, holding periods, and other tax attributes. These are now determined on a consolidated group basis ("single-entity basis"), as if the consolidated group were a single corporation.

A. Key Definitions and Terms

1. Terms

The 1995 regulations replaced the older mechanical rules with a more conceptual set of rules. It retained the general definition of an intercompany transaction, but adopted a number of new terms. The general convention used is a follows:

- "S" is the member transferring property or providing services
- "B" is the member receiving the property or services
- "P" is a member and the common parent of S and B
- "X or Y" is an unrelated company that deals with B in a subsequent event

2. Definitions

The 1995 federal regulations adopted two general rules regarding the calculation of income from intercompany transactions, the "matching rule" and the "acceleration rule."

A. Matching Rule

The matching rule is one of two principal rules used to determine the timing of intercompany income recognition. In general, S and B are treated as divisions of a single corporation for purposes of taking into account their items from intercompany transactions. The matching rule focuses on the related buyer's intercompany items to determine the timing of income recognition for the seller. For each consolidated return year, the seller is required to recognize its intercompany income to the extent of the difference between the income, deduction, or loss the buyer recognizes on a separate entity basis and the items the buyer would have recognized if the seller and buyer were divisions of a single corporation. (Treas. Reg. §1.1502-13(c).)

The matching rule requires S to take an intercompany item into account reflecting the difference between B's corresponding item and the recomputed corresponding item (the corresponding item B would have taken into account if S and B were divisions of a single corporation). The matching rule also requires the redetermination of attributes (such as character and source) of items to produce a single-entity effect.

The effect of the matching rule is that the intercompany gain is deferred until B disposes of the asset outside of the group.

Note: Refer to WEM Ch. 14, section c for the definition of "corresponding item" and "recomputed corresponding item."

Example – Sale of land followed by sale to a nonmember

Corporations S and B are included in the consolidated federal return of an affiliated group. In 2016, S sells land with a $40 dollar basis to B for $100. Thus, S has a $60 intercompany gain from its sale to B. S's gain is not included in income at the time of the intercompany transaction, but B still gets a $100 basis in the land. In 2017, B resells the land to a nonmember for $90. At that time, S's intercompany gain is recognized to reflect the $60 difference between the $10 loss ($90 sales price - $100 cost basis) B recognizes on the sale to the nonmember on a separate entity basis and the $50 gain B would have recognized if B had succeeded to S's $40 basis in a transfer between divisions of a single corporation ($90 sales price - $40 cost basis).

Example – Performance of services

Corporations S and B are included in the consolidated federal return of an affiliated group. S drills water wells. B operates a cattle ranch. During 2006,

B pays S $100 to drill an artesian well on B's ranch. S incurred $80 of expenses drilling the well (e.g. for employees and equipment). Under its separate entity method of accounting, S would take the income and expenses into account in 2006. B capitalizes the $100 cost for the well. The well has a 10-year life and B deducts $10 in depreciation in years 2007 through 2016.

S's intercompany profit is included in income under the matching rule to reflect the difference between B's items to be taken into account on a separate entity basis (based on its $100 cost basis in the well) and B's items that would have been taken into account if S and B were divisions in a single corporation (based on the $80 basis B would have had if S and B were divisions). Thus, in 2006 S takes into account $80 of the intercompany sales price and the $80 of expenses. In each of the years 2007 through 2016, S takes $2 of the $20 of intercompany profit into account to reflect the annual $2 difference between B's $10 depreciation deduction on a separate entity basis and the $8 in depreciation B would have claimed if S and B were divisions of a single corporation ($80 basis/10-year life). (Treas. Reg. §1.1502-13(c)(7)(ii), Example 7.)

B. Acceleration Rule

The acceleration rule provides additional rules for taking the items into account if the effect of treating S and B as divisions cannot be achieved. Unlike the matching rule where both the intercompany item and corresponding item are taken into account, under the acceleration rule only the intercompany item is taken into account.

The effect of treating the related seller and buyer as divisions cannot be produced if the matching rule will not fully account for the intercompany items in consolidated taxable income (e.g., if the buyer or seller becomes a nonmember) or if the intercompany transaction will be reflected by a nonmember (e.g., if the buyer subsequently transfers the property to a nonmember in a transaction where gain is not recognized by the buyer and the nonmember succeeds to the buyer's cost basis, such as a §351 transfer to a corporation or a §721 transfer to a partnership). Under the acceleration rule, the intercompany items are taken into account immediately before it first becomes impossible to produce the single corporation effect. (Treas. Reg. §1.1502-13(d).)

Example – Becoming a nonmember-timing

Corporations S and B are included in the consolidated federal return of an affiliated group. On January 1, 2010, S sells land with a basis of $70 to B for

$100, thus realizing a profit of $30. On July 1, 2013, parent corporation P sells 60% of S's stock to an unrelated party and, as a result, S becomes a nonmember of the consolidated group. Under the acceleration rule, S's $30 intercompany gain is included in consolidated income immediately before the effect of treating S and B as divisions of a single corporation cannot be produced. Because the effect cannot be produced once S becomes a nonmember, S includes the $30 in income in 2013 immediately before becoming a nonmember of the group. (Treas. Reg. §1.1502-13(d)(3), Example 1.)

c. California

Before 1966, the practices of the Franchise Tax Board with respect to intercompany transaction between unitary members were the same as the elimination and basis transfer system used by the Treasury in those years. When the Treasury adopted the new deferred intercompany transaction system in 1966, that practice was not adopted for combined reporting purposes. However, in the early 1980s, the department issued FTB Publication 1061, Instructions for Corporations Filing a Combined Report, which applied the federal deferred intercompany transaction system for "fixed assets and capitalized items." The elimination of income and adjustment of beginning and ending inventories remained consistent with the elimination and basis transfer system, and, in later years, the Publication 1061 clarified the department's position that the elimination and basis transfer method continued to be applied to intercompany sales of intangibles.

In 2001, effective for intercompany transactions occurring on or after January 1, 2001, the department promulgated regulations under Revenue and Taxation Code (R&TC) §25106.5 that generally adopted the 1995 federal regulations reflected in Treas. Reg. §1.1502-13, as amended through April 1, 2012. (CCR §25106.5-1(a)(2).)

The California rules have significant modifications to reflect differences between a combined report and a consolidated return. For example, the California regulations do not adopt the federal consolidated return rules described in Treas. Reg. §1.1502-13 to the extent that those rules relate to the application of other consolidated return regulations. Thus, provisions of the federal regulations described in Treas. Reg. §1.1502-13 that relate to stock basis adjustments described in Treas. Reg. §1.1502-32 do not apply for California purposes. (CCR §25106.5-1(a)(2).)

A. Definitions and Terms

California adopted the federal terminology. The following are some definitions pertaining to intercompany transactions. (CCR §25106.5-1(b).)

1. **Combined Reporting Group** refers to those corporations whose business income and apportionment factors are permitted or required in computing the income of the individual taxpayer that is derived from or attributable to sources within this state. (CCR §25106.5(b)(3); R&TC §25113(d)(1).)

2. **Intercompany transaction** means a transaction between corporations that are members of the same combined reporting group immediately after the transaction. (CCR §25106.5-1(b)(1).)

   Examples of intercompany transactions include, but are not limited to, sales of property, services, rents, licensing fees, lending of money, and distributions with respect to stock.

   The term intercompany transaction **does not** include transactions which:

   - Produce nonbusiness income or loss to the selling member
   - Produce income attributable to a separate business activity of the selling member
   - The buyer acquires the asset for nonbusiness use
   - The buyer acquires the asset to use in its separate business activity

3. **Intercompany item** refers to the seller's income, deduction, gain or loss realized from an intercompany transaction. S's costs or expenses related to the intercompany transaction are taken into consideration in determining its intercompany item. An item is an intercompany item whether it arises directly or indirectly from an intercompany transaction. (CCR §25106.5-1(b)(3).)

4. **Corresponding item** refers to the buyer's income, deduction, gain or loss from an intercompany transaction or from property acquired in an intercompany transaction. If B sells an intercompany asset to an outsider, the gain or loss (reflecting the difference between the amount realized on a sale to an outsider and the basis equal to the intercompany sales price) is a corresponding gain or loss. This is the amount B would take into account on a separate entity basis. Similarly, if B recovers the cost of property through depreciation, its depreciation deductions are corresponding items. Corresponding items also include amounts that are,

directly or indirectly, permanently disallowed or eliminated. (CCR §25106.5-1(b)(4).)

5. **Recomputed corresponding item** refers to the gain or loss (or other tax effect) that would have resulted if B and S were divisions of a single corporation. (CCR §25106.5-1(b)(5).)

6. **Attributes** is the character (e.g., as capital gain or ordinary income), source, etc. of an income item. (Treas. Reg. §1.1502-13(b)(6); CCR §25106.5-1(b)(9).)

7. **A single entity effect** is the effect on attributes that would have resulted if B and S were divisions of a single corporation. (Treas. Reg. §1.1502-13(a)(2).)

8. **Separate entity effect** is the result that would obtain if S and B were unrelated corporations, not included in a consolidated return. (Treas. Reg. §1.1502-13(a)(2).)

Example

S sells property with a $70 basis to B for $100. B sells the property to an outsider for $90.

- S's intercompany item is $30 ($100 - $70)
- B's basis on the property is $100, the purchase price
- B's corresponding item is a loss of $10 ($90 - $100)
- The recomputed corresponding item is a gain of $20 (determined by comparing the $90 sales price with the $70 basis the property would have had if S and B were divisions of a single corporation).

B. California application of the Matching Rule

California generally adopted the matching rule for combined reporting purposes for intercompany sales between combined reporting members that occur on or after January 1, 2001. However, despite the similarity of the rule, because members of a combined reporting group can be different than the members of a federal consolidated return group, an item deferred for federal consolidated return purposes might not be deferred for California purposes, if the members of the consolidated return group are not in the same California combined reporting group (e.g., if the federal members are not unitary with one another). In addition, an intercompany transaction might be eligible for deferred intercompany transaction treatment for California purposes even if the transaction is currently taxed for federal purposes. For example, if B and S are members of a combined reporting

group, but S is not in the federal consolidated return (e.g., S's stock is only 60 percent owned by the members of the consolidated return group). The gain is eligible for deferred treatment for California purposes even though it is not deferred for federal purposes because S and B are not eligible for membership in a consolidated return group. However, under the facts described, a taxpayer can elect to treat intercompany transactions on a separate entity basis and report the intercompany transaction income on a current year basis. (CCR §25106.5-1(e)(2)(B and C).)

d. Methods for Handling Intercompany Transactions

There are three basic methods for handling intercompany transactions:

- Current recognition
- Elimination and basis transfer
- Deferral

1. Current Recognition Method

Under this method, income or loss from intercompany transactions is recognized in the year the transactions occur, just as if the transaction had occurred between unrelated parties. For federal consolidated return purposes, taxpayers may elect to use current recognition to account for intercompany transactions between members of the consolidated return group. (Treas. Reg. §1.1502-13(e)(3).) A federal election is binding for state purposes unless the taxpayer makes a separate California election to prevent the federal election from applying. (CCR §25106.5-1(e)(2)(A).) In addition, CCR §25106.5-1(e)(2)(B) provides that a separate election can be made for California purposes to report transactions on a separate entity basis when no federal election is required. For example, when there are foreign corporations included in the combined report, the taxpayer can elect to use the separate entity method and recognize any intercompany gains and losses that occur between foreign and domestic corporations. The election is made by recognizing those gains and losses on a timely filed original return. (CCR §25106.5-1(e)(2)(C).) For federal purposes no election is required as income from transactions between a domestic corporation and its foreign affiliates is generally required to be currently recognized, because foreign affiliates are not (with limited exceptions as provided under Internal Revenue Code (IRC) §1504(d)) included in a consolidated federal return. (IRC §267(f).) Furthermore, CCR §25106.5-1(e)(2)(A) provides that a taxpayer may not make an election for California only if a federal election is required but the taxpayer does not request it or is not granted consent by the IRS.

2. Elimination and Basis Transfer Method

When members of a unitary business transact business with one another, the transactions have no economic effect on the group as an integral trade or business (i.e., they do not generate economic income or losses to the unitary enterprise as a whole). (*Chase Brass & Copper Co. v. FTB* (1977) 70 Cal.App.3d 457, 473.) As a result, income of a unitary enterprise should be computed in the same manner as in the case of a single corporate business.

Prior to 2001, the elimination and basis transfer method was the long-accepted method of treatment of intercompany transactions. For example:

- In *Safeway Stores v. FTB* (1970) 3 Cal.3d 745, the Court stated: *". . .net income is consolidated and interest, sales, rents, service charges, and like items incident to operating a unitary business, are eliminated.*"
- In *Chase Brass & Copper Co v. FTB*, supra, the Court held that intercompany sales should be eliminated from the sales factor because "*no net income is realized as a result of the internal sales*."

The elimination and basis transfer method provides for elimination of intercompany income, and a transfer of the basis of the asset that was sold between the companies to the intercompany buyer. Thus, the inherent income from the transaction is preserved in using the transferred basis.

Example

In Year 1, Corporation S (the intercompany seller) and Corporation B (the intercompany buyer) are in a unitary enterprise. Corporation S has an asset with a $70,000 basis, which it sells to Corporation B for $100,000. In Year 2, Corporation B sells the asset to an outsider for $110,000.

In year 1, Corporation S realizes separate entity income of $30,000, which is eliminated, and Corporation B takes Corporation S's basis of $70,000. In Year 2, when the asset is sold to an outsider for $110,000, the enterprise as a whole realizes $40,000 income ($110,000 less $70,000). Thus, the $30,000 of intercompany gain is ultimately preserved until the asset is sold to an outsider, and the total income recognized by the group is still $40,000.

In this Example, if the intercompany item had been inventory, the basis transfer would be reflected in a reduction of the buyer's ending inventory, and its beginning inventory of the following year. This is generally the method used for consolidated financial statements under GAAP.

3. Deferral Method

Under the deferred method, gains and losses from intercompany transactions are placed in a deferred status (unless an election is made to currently recognize intercompany gains and losses). The federal rules apply to any transaction between corporations that are members of the same consolidated group immediately after the transaction. Intercompany transactions include sales of property, performance of services, rental of property, loans, distributions with respect to stock, and any other type of transaction between members of a consolidated return group.

The federal deferral method generally treats the members of the consolidated group as a single entity for purposes of taking into account gains and losses from intercompany transactions. Specifically, the character, source, timing of income recognition, and other attributes (e.g., treatment of an item as excluded from gross income, treatment of an item as nondeductible, etc.) of intercompany income items are determined as if the members of the group were divisions of a single corporation (single entity treatment). However, the amount and location (i.e., which entity earned the income) of intercompany income items are determined as if separate returns were filed (separate entity treatment). In contrast to the elimination method where the seller's basis in the asset carries over to the related buyer, the buyer gets its own cost basis under the federal deferral method (i.e., its purchase price).

In general, intercompany items are taken into income to produce the same result on consolidated taxable income as if the seller and buyer were divisions of a single corporation. The timing of gain recognition is determined under either a "matching rule" or an "acceleration rule." (Treas. Reg. §1.1502-13.)

Example

In Year 1, Corporation S (the intercompany seller) and Corporation B (the intercompany buyer) are in a unitary enterprise, and Corporation S has an asset with a $70,000 basis, which it sells to Corporation B for $100,000. In Year 2, Corporation B sells the asset to an outsider for $110,000. Corporations S and B are in the consolidated return for both years.

Under a deferred intercompany transaction system, Corporation S would realize and recognize income of $30,000 from the intercompany transaction, but the income would be deferred, as long as Corporations S and B remain in the consolidated return group. Corporation B would take a basis of $100,000, the amount it paid for the asset.

In year 2, when Corporation B sold the assets to an outsider, the $30,000 of intercompany income is "restored," and the $10,000 gain from Corporation B's sale to the outsider is also taken into account, resulting in consolidated return taxable income of $40,000.

If Corporations S and B became disaffiliated before the sale of the asset to the outsider, the $30,000 of deferred intercompany income would be restored to the consolidated group immediately before the disaffiliation event.

e. Effects of Intercompany Transactions on Net Income for Water's-Edge Electors

The rules of CCR §25106.5-1 apply to intercompany transactions between corporations that are subject to a water's-edge election under R&TC §25110. (CCR §25110(e).)

In general, a transaction between a corporation within the water's-edge group and another corporation outside of the water's-edge group will be taxed currently as if the transaction had occurred between unrelated entities. If a member in a combined reporting group has a deferred intercompany transaction with another member, and either the buyer or the seller become excluded from the water's-edge group pursuant to an election under R&TC §25110 (with the other member remaining in the water's-edge group), intercompany gain or loss is taken into account under the acceleration rule described above. Because the acceleration of deferred income is taken into account "immediately before" the event that causes the buyer and seller not to be properly treated as divisions of a single corporation, the deferred income is taken into account in the taxable year immediately before the year affected by the water's-edge election.

1. Partially Included Entities with U.S. Source Income

Under R&TC §25110(a)(2)(i), a corporation that is not wholly included in a water's-edge group but has U.S. source income is included in the water's-edge group to the extent of its U.S. source income and related apportionment factors. If such an entity engages in a transaction with a member of the water's-edge group, and the income from that transaction would have been included in water's-edge combined reporting income (e.g., would have been U.S. source income), then income from the transaction will be treated as an intercompany transaction subject to the deferral, matching, and acceleration rules described above.

For example, if a wholly included U.S. corporation provides engineering services with respect to U.S. real property held by a foreign corporation that is partially included in the water's-edge combined report under R&TC §25110(a)(2)(i), the income from those services is considered an intercompany transaction, and is deferred. If similar services are provided to the entity with respect to foreign held property of the partially included entity, the income is not an intercompany transaction and is not deferred.

A special acceleration rule applies if the gain on the sale of the asset subject to intercompany transaction treatment later would produce foreign-source income. Detailed examples of intercompany transaction involving corporations subject to partial inclusion as a result of having U.S. source income are found in CCR §25106.5-1(j)(3)(D)(Examples 1-6).

Example

In year 1, engineering services are provided by a corporation wholly included in the water's-edge group (S) to an entity (B) partially included in the water's-edge combined report under R&TC §25110(a)(2)(i). The services relate to equipment to be used within the U.S. Assume that in year 2 the buyer (B) transfers the property to Germany, and the property, if sold, would produce foreign-source income.

The income from the engineering services is treated as an intercompany transaction and is deferred. Because the property is later removed from the U.S., and would produce foreign-source income if sold, the intercompany income is accelerated and taken into account in year 2.

Sales of stock of affiliated members to a partially included entity with U.S. source income, will not be treated as an intercompany transaction (i.e., will be currently taxed), unless the stock is a U.S. real property interest, as described in IRC §897(c). Deferred income from the sale of a U.S. real property interest is accelerated if the stock ceases to qualify under IRC §897(c). (CCR §25106.5-1(j)(3)(A)(3).)

2. Partially Included Entities with Subpart F Income

Under R&TC §25110(a)(2)(ii), a controlled foreign corporation (CFC) that has subpart F income (as defined in IRC §952) is partially included in water's-edge group. (Hereafter a "partially included CFC.") The CFC includes its income and apportionment factors in the water's-edge combined report by multiplying its total income and factors by a "partial inclusion ratio," the numerator of which is the CFC's subpart F income, and the denominator of which is the CFC's current year earnings and profits.

In general, a transaction between a partially included CFC and another corporation that is wholly included in the water's-edge combined report is fractionally considered a deferred intercompany transaction, to the extent of the CFC's partial inclusion ratio. Thus, if a partially included CFC has an inclusion ratio of 60 percent, and has a transaction with a wholly included member of the water's-edge group, the transaction will be considered a deferred intercompany transaction to the extent of 60 percent of the CFC's income from that transaction. The other 40 percent is taken into account in the year of the sale, and 40 percent of the sales price is reflected in seller's sales factor as if a third-party sale.

Similarly, a sale by a wholly included member of the water's-edge group to a partially included CFC will be considered a deferred intercompany transaction to the extent of the CFC's partial inclusion ratio. Thus, if a wholly included member of the water's-edge group has a transaction with a partially included CFC that has an inclusion ratio of 60 percent, the transaction will be considered a deferred intercompany transaction to the extent of 60 percent of the wholly included member's income from that transaction. The other 40 percent is taken into account in the year of the sale, and 40 percent of the sales price is reflected in seller's sales factor, as if a third-party sale.

If a transaction occurs between two partially included CFCs, the transaction is a deferred intercompany transaction to the extent of the product of both partially included CFCs' respective partial inclusion ratios. Thus, a transaction between a CFC with a 40 percent partial inclusion ratio and a CFC with a 60 percent partial inclusion ratio will be considered a deferred intercompany transaction to the extent of 24 percent (60% x 40%) of the income from the transaction.

f. Water's-Edge Acceleration Rules

In addition to the normal acceleration rules, a special acceleration rule requires complete restoration of deferred income in any year in which either of the following occurs:

- Partially included CFCs:
  - The partial inclusion ratio of either S or B is an amount equal to or lower than 50 percent of its partial inclusion ratio for the year of the intercompany transaction
  - The partial inclusion ratio of either S or B drops below 10 percent. (CCR §25106.5-1(j)(3)(B)(4).)
- Income derived from or attributable to sources within the United States:

- Either S or B has no includible income pursuant to R&TC §25110(a)(2)(i). (CCR §25106.5-1(j)(3)(A)(4).)

Detailed examples of intercompany transactions involving corporations subject to partial inclusion, as a result of having subpart F income, are found in CCR §25106.5-1(j)(3)(D)(Examples 7-13).