Combined Report Mechanics Training

I. Introduction

A. Model of Taxation. Source of Income.

1. In California (and most states) corporations are taxed only on their income from sources in the state.

2. Compare: Federal. Domestic entities are taxed on worldwide income, with a credit for taxes paid to other countries. Foreign entities are taxed only on U.S. source income.

B. Apportionment and Allocation as Source

1. California does not conform to U.S. sourcing rules, except for certain water's edge electors (see below). For corporations and other businesses, source is determined by allocation and apportionment.

2. Business income is apportioned to the state by multiplying business income by an apportionment percentage.

   a. Composition of the apportionment percentage: In general, the sum of the payroll factor, the property factor and twice the property factor, divided by four.

   b. In general, the sales factor is the sales in the state over total sales everywhere.

3. Nonbusiness income is allocated to a specific state or states.

C. The general rule is apportionment of worldwide business income. However, taxpayers may elect to exclude the income and apportionment factors of certain foreign corporations by making a water's-edge election.

D. UDITPA is applied to multiple corporations in a unitary business. (*Edison California Stores*) The authority for a unitary combined report is broadly based on the general requirement to apportion. The California Supreme Court in *Edison California Stores* applied apportionment to unitary corporations as a logical extension of the unitary concept.

E. A unitary business exists if business segments or separate corporations satisfy the traditional tests for unity, including the three unities test of *Butler Bros*, contribution or dependency test of *Edison California Stores*, or functional integration, centralization of management, and economies of scale.

F. Holding Companies.

1. If a holding company holds intangibles that have a corresponding expense within the group (e.g., patents, copyrights, trade names, etc.) the holding company would almost always be treated as having a unitary relationship and thus be considered satisfying the contribution or dependency test.

2. If the holding company only holds stock in another subsidiary, and has no other business operations of its own, in some cases the holding company is treated as a member of the combined reporting group.

    a. Situation One: Holding company is a parent corporation of a group of subsidiaries that are themselves members of a unitary group. Under FTB Legal Ruling 95-7, the parent corporation is considered a member of the combined reporting group. See also *Appeal of PBS Building Systems, Inc.* (Cal. State Board of Equalization, 94-SBE-008).

    b. Situation Two: Holding company is an "intermediate holding company," i.e., it is held by a parent operating corporation, and itself holds stock of another operating corporation. Assume that the parent corporation is unitary with the second tier operating company. Under FTB Legal Ruling 95-8, the intermediate holding company is considered a member of the combined reporting group.

    c. In all other circumstances, the status of the holding company is a "facts and circumstances" determination.

    d. Issues impacted by combination of holding companies.

        1. Leveraged buy-out debt
        2. Dividends
        3. Gains on the sale of stock

G. Only taxpayer members of a unitary group are subject to taxation. A taxpayer member is one that has nexus in the state. Thus, the entire unitary group is not

properly characterized as a taxpayer. Because tax is a function of California numerator activity, if an entity has nexus but no numerator activity, it may not have a tax liability.

1. Income that is subject to tax is based on the specific taxpayer member's share of unitary business income.

2. The taxpayer member's share of unitary business income is determined by process commonly known as "intrastate apportionment." The worldwide unitary business income of the group is multiplied by the member's specific intrastate apportionment percentage.

3. Each member's intrastate apportionment percentage is composed of the four factors (payroll, property, and doubled weighted sales) divided by four. However, each factor for that entity is composed of the ratio of the specific member's California numerator activity to the group's worldwide denominator activity.

4. Illustration of Intrastate Apportionment.

H. Each member has independent filing requirements.

1. Tax is measured by a composition of California source income. It is the sum (or net) of the following:

    a. Share of unitary income (by intrastate apportionment)

    b. Nonbusiness allocated to California

    c. Share of unitary income from another unitary business

    d. Business income from a separate apportionable business

    e. Separate business wholly in California

2. Illustration

3. Rationale: The purpose of unity is sourcing of commonly earned unitary business income--Once apportionment is complete, unitary status becomes irrelevant--separate taxpayer status takes over. Thus, nonunitary income items are taxed only to the entity that earns them.

4. Nonbusiness income is specific to the entity that earns it.

    a. Example: A California nonbusiness loss can only be used by the entity that incurred the loss, and only against that entity's *share* of California post-apportioned income.

    b. Example: One entity's share of apportioned business loss cannot be used to offset another entity's nonbusiness gain. That entity's *share* of California apportioned loss can be used only to offset that specific entity's nonbusiness gain.

5. The possible presence of nonbusiness income, or separate nonunitary business income, is the reason why there cannot be a tax liability for the group as a whole.

    a. The constitutional premise (the linchpin) for treating a group as if a single trade or business is limited to apportionment of *common* unitary business income (*Container Corp*).

    b. Nonunitary income must be constitutionally separated (*Allied Signal*)

6. Computation of Tax for each member is on aggregate (or net) of each member's California source income.

7. Tax Credits are allowed as a credit against that tax. Generally, tax credits are available only against the tax by the entity that incurred the creditable expense. (*Appeal of AeroVironment, Inc.*, Cal. State Board of Equalization, 97-SBE-001)

II. Steps of Combination

A. Calculation of Separate Entity Income.

1. Identify the separate accounting income of each member of the combined report. At this step, in general, separate entity income is determined without reference to the other members of the group. However, special rules apply for the treatment of capital gain, and may also be appropriate for allocation of expenses between entities.

2. Adjust separate book income to be in accordance with the R&T Code and IRC provisions in which the state is in conformity. (Note that

corporations with a U.S. filing requirement start with their federal return and make state adjustments. See Form 1061, schedule 1-B.)

3. Separate accounting elections can be made for each member's income. The taxpayer members of the group can make accounting elections for the unitary business income of nontaxpayer members.

B. Steps to arrive at business income subject to apportionment.

1. Identify and remove nonbusiness items.

2. Identify and remove any income from a separate nonunitary business.

3. Remove any income items related to deferred income that was apportioned in a prior year.

   a. Installment sale income is apportioned using historic apportionment factor in accordance with the Court of Appeal in *Tenneco West v. FTB*

   b. Long-term construction contract income (18 Cal. Code of Regs. §25137-2).

4. Match expenses related to items removed in steps B.1. and B.2. and remove from unitary business income (See Reg. 25120(d)).

5. Adjust for intercompany transactions.

   a. Generally, intercompany income that is restored is added in, and intercompany income that is deferred is removed. (See discussion below regarding intercompany transactions).

   b. Note that to the extent that the same entities are in the consolidated 1120 federal return and the combined report, such adjustments would already have been done for transactions between consolidated members.

6. Remove any capital gains and losses, if applicable. (A special calculation and limitation applies to such items; see below.)

7. Remaining income is unitary business income subject to apportionment.

C. Fiscalization.

1. It is common for members of a unitary group, particularly for members not in a federal consolidated return group, or foreign members, to have different fiscal years.

2. In that case, each member's unitary business income is assigned to a common member's accounting period, known as fiscalization. The common member is described as the "principal member," and is usually (but not always) the common parent.

3. California will generally allow the taxpayers to elect any member as their principal member, but cannot again change except with permission, and then must make adjustments to reconcile to the new fiscal period.

4. Income is assigned (fiscalized) to the principal member by one of two methods:

   a. Interim accounting. This method requires that the taxpayer's accounting income must be adjusted to "cut off" the accounting period to include only income and expense actually earned during the principal member's year.

   b. Proration.

      1. This method allows the taxpayer on a different fiscal year to allocate its 12 months of income based on the number of months a given year has in common with the principal member.

      2. Thus, if the principal member is a 2003 calendar year corporation, and one of its members has a 3/31/2003 fiscal year, that member will assign 3/12s of its income from the period ended 3/31/2002, and 9/12s of its income from the period ended 3/31/2003.

   c. Property, payroll, and sales data must also be adjusted to the principal member's common year end using a similar method (See Form 1061, schedule 2).

D. Apportionment of Fiscalized Business Income.

1. Each taxpayer member computes its own California apportionment percentage with each factor based on its numerator divided by the total group denominator. This is known as "intrastate apportionment." (See Form 1061 schedule 4-D).

2. For example, the sales factor of a specific taxpayer member is that member's California sales divided by the total worldwide sales of the entire unitary group.

3. California currently determines the numerator of the California sales factor using the "Joyce" method.

    a. This means that if an entity is exempt from California taxation, but has California destination sales, those sales are NOT considered in the California numerator, even if other members are taxable in the state.

    b. Likewise, if an entity is exempt from taxation in another destination state, and the taxpayer ships its goods from California, that sale is "thrown back" into the California numerator, even if another entity in the group is taxable in the destination state.

4. The sales factor is either double or single weighed, depending upon industry type. Weighting is determined by reference to the group as a whole.

5. The worldwide unitary business income of the group is multiplied by the taxpayer's apportionment percentage to arrive at that entity's intrastate apportioned California business income. (See Form 1061, schedule 4-D line 13).

6. Place the intrastate apportioned income back onto the taxpayer's tax return year-end by reverse fiscalization (see Form 1061, schedule 4-E).

D. Determination of California Source Income.

1. Begin with the specific taxpayer's share of California apportioned income, from above.

2. Apply any business income apportioned in a previous year (installment sales, long term contracts, etc.)

3. Add or subtract California nonbusiness income or loss

4. Add or net separate nonunitary business apportioned items

5. Add California source positive capital gains

6. Apply any California net operating loss deduction (NOL).

7. Result: California source income subject to tax.

E. Net Operating Loss. If a loss results at step D.5 above, a California source net operating loss is created (NOL).

1. The NOL is a specific entity carryover of California losses that includes intrastate apportioned business income or loss and entities' nonbusiness income or loss.

2. An NOL deduction is available only against that member's California source income in succeeding years.

3. The NOL can be applied against any California source income in a later year.

F. Compute Alternative Minimum Tax (AMT) consistent with combined report procedures listed above, with adjustments for alternative minimum taxable income items).

G. Compute tax, and alternative minimum tax.

H. Apply tax credits (see below).

III. Intercompany Transactions.

A. Treatment of Intercompany Transactions in Consolidated Financial Statements.

1. Purpose of an audited financial statement. Reflection and presentation of income generation and value of entire enterprise, not just the parent corporation.

2. Mechanics of Preparing an Consolidated Financial Statement

   a. Books are not kept on a consolidated basis.
   b. Starts with separate accounting data.
   c. Prepared in a consolidated worksheet at the end of the year.
   d. Intercompany profit is eliminated from the income statement.
   e. Consolidated inventory values are adjusted downward to remove intercompany profit.
   f. Reason: From shareholder's (and lender's) perspective the economic position of the consolidated group has not changed.

      (1) Reflecting income from intercompany transactions artificially inflates the combined income statement of the entire enterprise, because within that enterprise, the assets (cash and property) have merely moved around.

      (2) Effectively would allow corporations to restate their books at fair market value (after a series of intercompany transactions) in contravention of the GAAP accounting convention to reflect assets at historical cost.

   g. Consolidated Financial Worksheets have a "going concern" assumption, i.e., that the enterprise will remain intact in future years.

      (1) The next year's consolidated financial statement will reflect any reduction of unsold inventory values from the previous year.

      (2) Income in the consolidated financial statement from a sale of intercompany inventory to an outsider will reflect the prior year elimination of intercompany income. It will show up in a smaller cost of goods sold, and thus a higher gross profit, than would be seen as income on the seller's separate books.

      (4) Example.

h. However, when the enterprise is broken up, new consolidated financial statements are prepared for the residual members.

(1) Example: Old group had 10 corporate members. Five members are sold.

(a) The next year's consolidated financial statement reflects only the remaining 5 members.
(b) Consolidated worksheet starts with the separate books of those 5 members.
(c) The previous year income and balance sheet comparison also uses the separate books of those 5 members. Constructed as if only those 5 members had been around.
(d) If an intercompany transaction had occurred in the earlier year between one of the remaining members and one of the departing members, the next year's statement will reflect the separate accounting income of the selling member in the prior year comparison.
(e) Thus, intercompany profit from a prior year's transaction will not show up in the current year income statement.

(2) Effect: in a disaffiliation, intercompany transaction income will not be reflected in a *current* income statement. If intercompany event occurred before the immediately preceding year, the effect of the intercompany income will show only in retained earnings.

B. Pre-1966 Consolidated Return Regulations.

1. Used a similar elimination of income and reduction of historical cost as in consolidated financial statements.

2. Unlike consolidated financial statement methodology, reduction of historical cost was a permanent transfer of tax basis.

3. Tax basis even transferred into a separate accounting year (i.e., after the consolidated return was terminated) (See *Commissioner v. Liberty National* (1932) 58 F.2d 57.)

4. That assured that intercompany transaction income would not disappear from a current year tax return. Thus, year-to-year consistency preserved, even if the buyer and seller disaffiliate.

5. If buyer and seller disaffiliate, "going concern" assumption no longer appropriate. This created problems with elimination and basis transfer:

    a. Wrong Entity. With the basis transfer rule, the wrong entity is responsible for the gain.

        (1) Example: Corporation A sells an asset to Corporation B, with a basis of $60, for $100 in an intercompany transaction.

        (2) After a disaffiliation, Corporation A enjoys the benefit of the $100 sale, but pays no tax. Corporation B parted with $100, and when it sells the asset to an outsider for $100 (no economic profit) it is "stuck with the tab" related to the $40 gain.

    b. Disappearing income.

        (1) Same facts, except Corporation B sells the asset to an outsider in anticipation of a complete liquidation. Under old Section 337, IRC, no gain or loss on the sale.

        (2) Corporation A enjoys the benefit of the sale, and, after the liquidation of Corporation B, the income escapes taxation.

C. Post 1966 Federal Consolidated Return Treatment of Intercompany Transactions.

1. Treated an intercompany transaction as if it were a realized and recognized transaction, but the intercompany transaction income was merely deferred.

2. Intercompany income restored to *seller* on a break-up of the consolidated group, departure of buyer or seller from the group, or sale of asset to an outsider.

3. Because treated as realized and recognized on the first intercompany sale, the intercompany event and sale to an outsider were treated as separate transactions.

    a. Thus, the intercompany transaction would be treated as foreign or U.S. source or capital or ordinary, no matter how the subsequent sale to the third party was treated.

    b. Example: Intercompany sale of a ship in a foreign harbor would be treated as foreign source income, whereas the sale of the same ship to an outsider in a U.S. harbor would be treated as domestic source income.

    c. Example: Intercompany sale of land might be a capital transaction for the intercompany sale (resulting in capital gain) even if the land subdivided by the consolidated purchaser and sold to customers (ordinary income).

4. This was seen as a problem, leading to the 1996 regulations, because there was too much of a difference occurring in character and source as between a consolidated group, and a single corporation transferring assets between divisions.

C. Intercompany Transactions under the 1996 Federal Consolidated Regulations

1. Hybrid of two preceding methods. Intercompany income is treated as recognized and deferred, but only as to amount (assuring that on a disaffiliation, the right entity reported the income).

2. Source and character on a sale to an outsider was determined by reference to the group as a whole, as if divisions of a single corporation. Thus foreign or domestic source in whole, or capital gain or ordinary income in whole, as the case may be.

3. Mechanism of the regulation.

    a. Sale to an outsider invokes the "matching rule."

    b. Terms of Art.

        (1) Intercompany Item (deferred income attribution to seller).

(2) Corresponding Item (income item to intercompany buyer, when sold to outsider, reflecting separate accounting basis).

(3) Recomputed Corresponding Item (income that would have been taken into account if buyer and seller were divisions of a single corporation. This step controls character and source of the whole.

4. Acceleration Rule.

   a. If deferred intercompany transaction income exists, and the fiction of divisions of a single corporation can no longer be sustained, the acceleration rule requires the deferred income to be taken into account.

   b. Acceleration events: disaffiliation, termination of election, seller or buyer leaving the group.

5. Timing. Income is taken into account in the consolidated return immediately before the acceleration event.

D. California Treatment of Intercompany Transactions.

1. General practice of elimination and basis transfer, analogous to pre-1966 federal consolidated return rules. Not officially adopted as such, just informal practice. (e.g., *Chase Brass v. FTB*)

2. In 1981, FTB Publication 1061, adopted the federal deferral model, but only as to fixed assets and capitalized items.

   a. Department never adopted the federal consolidated return regulations in any other context.
   b. General rule, federal consolidated return regulations do not generally apply to combined reporting unless specifically incorporated. *Appeal of Safeway Stores, Appeal of Rapid American*.
   c. Source of the present controversy in Yamaha/Pentel.

3. For 2001 intercompany transactions, California generally follows the new federal consolidated regulations for intercompany transactions.

a. Restore income if asset sold to an outsider, accelerate if the buyer and the seller no longer are in the same combined reporting group.
b. No longer in same group: disaffiliation, cease unitary status, water's edge election, sold to another member's nonbusiness use, conversion to nonbusiness use.
c. However, source of restored/accelerated income is determined by reference to apportionment, as is true for combined reporting generally.
d. In general, deferred income is restored and reported as current business income and is apportioned using current year apportionment factors.
e. Intercompany sales do not create sales factor events (divisional analogy), and property factor not stepped up to reflect intercompany purchase price.
f. Special election: If taxpayer reports income currently for U.S. or foreign tax purposes, may instead or deferring, elect to report intercompany income on a current basis for state purposes, as a method of accounting. Year-to-year consistency required.
g. Special rules apply to so-called "partially included entities," which are created as a result of a Water's Edge Election.

(1) Partially included:

(a) Foreign entity with U.S. Source income.
(b) Foreign entity with Subpart F income.

(2) Intercompany transaction income between a member and a partially included entity is only partially deferred.

IV. Capital Gain/Loss.

A. Summary of Federal Netting Rules (Corporations).

1. Involuntary Conversion Gains and Loss.
2. Section 1231 Gains and Losses
3. Long Term Gains and Losses
4. Short Term Gains and Losses
5. Federal: Long Term Gains Preferentially Taxed.
6. If Net Loss, Carryforward for 5 Years.

B. California Conforms to Federal Capital Gain Rules.

C. However, in combined report, federal netting rules apply after apportionment. Rationale: It is not constitutionally appropriate for one member's nonbusiness income or loss to affect the other member's treatment of business income or their own items of nonbusiness income. Same as the rationale for intrastate apportionment, discussed above.

D. Steps.

1. Net Business Gains and Losses of Items of Involuntary Conversion, Section 1231, Long Term, and Short Term, WITHOUT NETTING BETWEEN CLASSES.
2. Apportion the net gain or loss in each class using taxpayer member's apportionment percentage.
3. Staying within the class, net apportioned gains or losses with nonbusiness gains or loss.
4. Thereafter apply the federal netting rules.
5. If Gain, treated as ordinary income (California does not have preferential rates for capital gains.)
6. If Loss, carry forward as a California source Short Term capital loss for five years.
7. Loss only available to that specific member's apportioned or allocated gains in successive years.

V. Credits.

A. In General, tax credits are available only to the specific taxpayer member that incurred creditable costs.

B. Reason for Limiting Credits to Specific Taxpayer

1. The Unitary Business Principle is Limited to Sourcing Income.

a. The purpose of UDITPA, sections 25120 – 25140, and Section 25101, the authority for combined reporting, is to source income to California.
b. The members of the combined group determine their net income after state adjustments consistent with the code (outside of UDITPA).
c. The combined members then apply UDITPA to source their income to California.
d. Next step is to apply the tax rate and credits, both of which are outside of UDITPA.

e. Once sourcing is complete, there is no authority for disregarding separate legal entity.

2. R&TC section 23036(g) states "unless otherwise provided, if two or more taxpayers share in costs that would be eligible for a tax credit allowed under this part, each taxpayer shall be eligible to receive the tax credit in proportion to its respective share of the costs paid or incurred."

3. Most of the statutory rules allowing for a credit provide that the "taxpayer" is entitled to the credit. For example, R&TC section 23612.2(a) states "there shall be a credit … an amount equal to the sales or use tax paid or incurred by the taxpayer…" Outside of UDITPA, the term "taxpayer" refers to a single corporate entity (R&TC section 23038).

4. The structure of the code also shows a similar effect: credits apply to the entire tax liability of a taxpayer, including tax attributable to nonbusiness income and income from nonunitary businesses.

5. Case authority holds to similar effect: *Appeal of AeroVironment*, SBE, 1/10/97 and *Appeal of Guy F. Atkinson*, SBE, 5/19/97. In addition, the Court of Appeal in a non-citable decision held that credits were specific to the entity that incurred creditable costs in *Guy F. Atkinson v. FTB (cite)*.

C. Statutory overrides.

1. Occasionally, there have been statutory exceptions to single entity credits: e.g. agricultural irrigation, old solar credit (as if one taxpayer).

2. More recent exceptions include low income housing credit (taxpayer elects on the original return to assign it to any affiliate) and R&D credit (due to federal conformity the credit is spread based on qualified R&D costs of each affiliate).

V. Schedule R, R-7. (California Apportionment Schedule, Group Returns)

1. If there are many taxpayer members in a unitary group, each are responsible for filing their own return and attaching a combined report reflecting all of the member's income and apportionment.

2. This presents a mass of paper, as the combined reporting information is repeated over and over. As a filing convenience, in lieu of separate returns, the

Schedule R-7 allows taxpayer members to designate a parent corporation to file on their behalf (a so-called "group return"), as an agent representative, and as surety for payment of tax.

3. Not a statutory based concept. Essentially enforceable in contract. If a member repudiates their R-7 relationship, they will not generally have filed their own return, and are thus broadly open to an unlimited statute of limitations.

4. Combined reporting and tax liability data are reflected in a spreadsheet, rather than separate returns.

5. The members designate one of their members to act as spokesperson and paymaster for the group (agent and surety). Because the responsibility for filing a return is still that of each, the spreadsheet doesn't change the respective liability of the members. The parent as agent can waive the statute of limitations for all members.

6. The parent represents the taxpayer members even if later audit adjustment determines that a taxpayer filing on a unitary basis is not unitary.

7. The election is made each year, and the agency/surety relationship continues even if one of the members later disaffiliates. Any refunds attributable to a disaffiliated entity are paid to the surety, with the expectation that those funds (as is the case for any agent) will be remitted to the actual taxpayer.

8. Department plans to put the R-7 contract practices into regulation at some future date.