California Multistate Audit Technique Manual -- Section 5000 Calculation of Business Income

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual

Multistate Audit Technique Manual

5000 CALCULATION OF BUSINESS INCOME

Once you have identified the various components or entities involved in the unitary business (MATM 3000) and segregated the income or loss from nonbusiness activities (MATM 4000), the next step is to verify the business income reported by the taxpayer. In some cases, such as when the income reported by the taxpayer cannot be traced to any verifiable source or when you are combining or decombining entities, it may be necessary for you to reconstruct business income.

This section of the manual will cover the various sources that may be used to verify business income and will provide guidance for performing a reconciliation of net income.

Starting at MATM 5190, the discussion will turn to adjustments and special computations that may be required for calculating the business income reportable to California.

5100 SOURCES FOR INCOME VERIFICATION

There are several sources that may be used to verify business income. Each source has its strengths and weaknesses, and these will be discussed in the following sections. Usually, you will find it necessary to use more than one source in order to overcome the shortcomings that the various sources have when considered individually. Use of these sources in the income reconciliation is discussed in MATM 5130.

5105 Consolidated Financial Statements (Annual Reports, Sec 10-Ks)

The financial statements presented in U.S. annual reports and SEC 10-Ks are prepared in accordance with GAAP and are required to be on a consolidated basis. The parent corporation and all majority-owned subsidiaries will generally be included. The annual report will not usually identify each of the entities included in the consolidation, but such a listing will usually be attached to the SEC 10-Ks.

If any material majority-owned affiliates have been excluded from the consolidation for any reason, this will be disclosed in the footnotes (usually Footnote #1). Although 100 percent of the operations of the affiliates will be presented in the consolidated statements, any income or investment attributable to minority interests will be deducted as separate line items. Any subsidiaries, joint ventures or other investments that have been accounted for under the equity method will also be identified. Rather than consolidating each line item of the subsidiary with the corresponding items for the rest of the affiliated group, the equity method reports the net income or loss of the subsidiary as a lump sum amount. This lump sum is reported as a separate line item on the income statement. Since 1988, the equity method is not allowed for subsidiaries owned more than 50 percent. These consolidation requirements are found in FASB 94, effective for fiscal years ending on or after December 16, 1988.

Since the financial statements of foreign-owned groups may not be prepared in accordance with GAAP, you will have to ascertain which entities have been included. Sometimes, a foreign parent will have separate financial statements prepared to reflect only the domestic affiliates. If so, you should also request the financial statements for the group as a whole. It may be necessary to request a translated version.

Strengths

Audited financial statements accompanied by an unqualified opinion from the outside CPA are generally the most reliable source for verifying the income base. The data included in these financial statements has been audited and has been determined to fairly represent the financial status of the business. Since consolidated financial statements

will either include all majority-owned affiliates or will disclose any affiliates that have not been included, you can be assured that no unitary affiliates are being left out. Another benefit of using audited financial statements when auditing a worldwide group is that intercompany eliminations will already have been made.

Weaknesses

The weakness of using financial statements as a verification source is that they represent book income rather than taxable income. Therefore, an analysis of the Schedule M-1 or M-3, if applicable, will also be necessary if financial statements are used to reconcile income. If foreign entities are included in the unitary group, further analysis will also need to be done to determine whether any significant book/tax differences exist with respect to those entities. Adjustments based upon book income should not be made without first giving the taxpayer the opportunity to make book/tax adjustments.

Since the financial statements themselves do not usually disclose income on an entity basis, you will have to consult additional verification sources if the members of the combined report differ from the entities included in the consolidated financial statements.

5110 Consolidating Workpapers to the Financial Statements

The consolidating workpapers used to compile the financial statements show how the separate income items from each of the affiliates have been consolidated into a single statement. These workpapers are where the intercompany eliminations and other consolidating adjustments have been made for book purposes. For large groups, several levels of consolidation may have been made. For example:

Consolidating Workpapers to the Financial Statements

The workpapers for the highest level of consolidation should tie to the data reported on the financial statements. These are often termed the “top” consolidating workpapers. You should verify that the figures do in fact agree to the financial statements. The annual reports are prepared from the consolidating workpapers, so the figures should agree. Since revisions to the workpapers are often made as the workpapers pass through the review process, the verification should be done to ensure that the taxpayer has provided the final version. The detail shown on the top level consolidating workpapers is often sufficient to enable you to reconcile income (see MATM 5130). If not, then you should request the workpapers for the lower levels of consolidation.

The consolidating workpapers will contain “off book” entries that will not be posted to the individual books of account. Consolidation adjustments and reserves for restructuring are examples of some types of adjustments that are not posted to the books of the separate entities. A review of these journal entries will help you to understand what is being included in the financial statements, and may identify potential audit issues.

Strengths

If the figures on the consolidating workpapers tie to the audited financial statements, then the workpapers share the reliability of those financial statements. These workpapers contain the detail that will enable you to adjust annual report net income for entities that are not included in the combined report.

Weaknesses

As with the financial statements, book/tax differences will need to be taken into account when the consolidating workpapers are used as a starting point. Also, many taxpayers are reluctant to provide the consolidating workpapers to the financial statements. If the information from those workpapers is necessary in order to properly verify the income base and adequate information cannot be obtained from other sources, then you should be prepared to issue a formal demand for the workpapers. See MAP 6.7 for policy concerning a taxpayer's failure to furnish information.

5115 Consolidated Federal Form 1120

Every U.S. corporation, which is not expressly exempt from tax, must file an annual income tax return for federal purposes, regardless of whether there is positive income or a tax due. The return form for most corporations is the federal Form 1120. Other corporate returns are federal Form 1120F for domestic operations of foreign companies, federal Form 1120- FSC for Foreign Sales Corporations, and federal Form 1120-DISC for Domestic International Sales Corporations. Federal Form 1120X, Amended U.S. Corporation Income Tax Return, is used to amend the original

Form 1120.

If certain conditions are met, domestic members of an affiliated group of companies may elect to file a consolidated federal Form 1120. The federal consolidated return includes a parent corporation and all affiliates owned, directly or indirectly, at least 80 percent by that parent. As a result, only parent/subsidiary groups may file on a federal consolidated basis. Brother/sister groups owned by an individual or by a foreign corporation will not be eligible. See IR S Publication 542, *Corporations,* for a more in-depth discussion of Form 1120 filing requirements.

Since the California combined report includes foreign corporations and brother/sister groups, and only requires common ownership of more than 50 percent, the California combined report may include entities that are not included in the federal consolidated return. Also, since federal consolidation is based on ownership rather than unity, non-unitary affiliates may be included in the federal consolidated return but will not be included in the California combined report.

The consolidated federal Form 1120 is often the starting point used by both taxpayers and auditors for determining combined business income for California tax purposes. If the Federal 1120 has been subject to a comprehensive federal audit, then the Federal 1120 net income can be used to verify domestic net income before state adjustments.

This reflects the department's policy of conserving audit resources whenever possible by not duplicating work performed by the IRS.

On the other hand, if the federal 1120 has not been audited, then you should review the income statement for material issues and unusual transactions. This does not mean that you are required to perform detailed income and expense audits on all taxpayers that have not undergone a federal audit, but it does mean that you cannot assume that no issues exist with respect to income and expenses just because the items were reported the same way for federal and state purposes. In addition, if an income reconciliation is prepared from an unaudited federal return, the results should be double-checked against a reconciliation of income from another source, such as audited financial statements. If a material difference is detected, than additional audit work will be necessary. See MATM 5130 for additional detail regarding income reconciliation procedures.

If the IRS scopes a return and performs preliminary audit procedures before determining that the return will be accepted as filed, the federal return is considered to be unaudited. Since the return has not been subjected to a complete IRS examination, you should look upon the income and expense items reported on the federal return as having no greater reliability than state-only items reported on an unaudited California return.

Strengths

The benefit of reconciling net income to an audited federal return is that the IRS will already have audited the income base and the book/tax adjustments. Although you should still perform a quick review of the components of net income and the Schedule M-1 or M-3, if applicable, adjustments to look for items which result in federal/state differences, this review will be substantially less detailed than the review that would be required if no federal audit had been performed.

Weaknesses

Since the federal consolidated return does not include brother/sister groups or foreign corporations, it is not as useful as the consolidated financial statements for identifying unitary affiliates that may have been left off the combined report. In addition, although other sources may be used to verify the income of non-consolidated corporations, once they have been identified) intercompany eliminations will not have been taken into account.

5120 Verification Sources for Foreign Corporations

If the Federal Form 1120 is used to verify domestic income, another source will be needed to verify foreign income. Often, separate financial statements will have been prepared for each foreign entity or group of entities. Since these financial statements may not be prepared in accordance with GAAP, substantial adjustments may be required to adjust the foreign income to a California tax basis. Separate financial statements will not reflect intercompany transactions between the unitary affiliates. The workpapers to the consolidated financial statements will generally identify the income of foreign affiliates and may be used as a source for verifying foreign income. Although book/tax adjustments will still have to be considered, the consolidating workpapers will be more helpful for identifying intercompany transactions involving the foreign entities. If the financial statements have not been printed in English, you should ask the taxpayer to translate the statements.

For taxable years beginning on or after January 1, 1990, California conformed to IRC §6038A, including the record maintenance requirements for foreign-owned corporations and the provision that such records requested by the IRS/FTB must be translated into English. (For more information, see R&TC §19141.5; Treas. Reg. § 1.6038A-3; and Chapter 20A, Water's-Edge Manual.)

Publicly held foreign corporations often trade their securities or American Depository Receipts in the United States. ADRs are negotiable instruments that represent securities on deposit with a custodian. Such corporations are required to register with the Securities and Exchange Commission (SEC), and annually file SEC Form 20-F. This report is similar to the Form 10-K used by domestic entities. For purposes of the Form 20-F, the financial statements must either be prepared in accordance with GAAP or must disclose the variations from GAAP and contain a schedule, which reconciles income statement and balance sheet items to the amounts that would have been presented if GAAP had been used.

For federal purposes, domestic parents are required to file Form 5471 for each foreign subsidiary. This form contains an income statement that may be useful. The Form 5471 is only an information return, however, and is not generally audited by the IRS. Taxpayers are, therefore, not always as diligent in preparing the Form 5471 as they might otherwise be. Consequently, you should be wary about relying upon information presented on the Form 5471. Although the instructions for the Form 5471 require that the income statement and balance sheet be presented in accordance with GAAP, book/tax adjustments will not have been made.

5130 INCOME RECONCILIATION

A reconciliation of the income reported in the California tax return to some verifiable source should always be done. The purpose of the reconciliation is to validate the income computation and to verify that all unitary members of the group have been accounted for in the income computation. The reconciliation may also identify book/tax adjustments that have bypassed the Schedule M-1 or M-3, if applicable. An analysis of the Schedule M-1 or M-3 adjustments will only be meaningful once you have established that the starting point is valid. Whenever possible, the audited consolidated financial statements should be used for this reconciliation.

When a reconciliation is based on the financial statements, it is reconciling Schedule M-1 or M-3 book income; not taxable income. This type of reconciliation must be followed by an analysis of the Schedule M-1 or M-3 adjustments in order to verify the tax base. See MATM 5140 for a discussion of the Schedule M-1 analysis.

As discussed in MATM 5115, reconciliations to Federal Consolidated 1120s can also be beneficial, so it is a good idea to reconcile California income to both the financial statements and to Federal Form 1120 income.

Before actually beginning the reconciliation, you need to have an understanding of how the taxpayer determined its income for California purposes. For example, did the taxpayer use the consolidated federal Form 1120 for domestic income and the Forms 5471 for foreign income, or were the consolidated financial statements used as the base? These questions can be asked during the initial meeting with the tax department personnel. Once this information is obtained, you will have a better idea of what adjustments will be required to calculate the income reconciliation, and will be aware of areas where potential problems may exist. For example, use of the federal Forms 1120 and 5471 may not properly reflect intercompany transactions between domestic and foreign entities. It may be helpful to review income reconciliations from prior audit cycles to see how the income was determined and whether the prior auditors identified any problems. After this groundwork has been set, you may begin the reconciliation.

The steps for performing an income reconciliation based upon audited consolidated financial statements are:

Step 1: Identify the basis for consolidation.

Step 2: Compare the net income.

Step 3: Analyze the differences between the income reported on the financial statements and on the tax returns.

Step 1: Identify the basis for consolidation

The first step in reconciling net income to the consolidated financial statements is to identify which affiliates are included in the consolidation. If the financial statements include affiliates that are not in the combined report, the consolidating workpapers will be necessary to derive the items attributable to those affiliates that will need to be

backed out. This may also trigger a question as to whether those affiliates may in fact be unitary. If the combined report includes entities that are not in the financial statements, alternative sources, such as the entity's separate financial statements, will need to be consulted to verify the income of those entities.

Step 2: Compare the net income

In its simplest form, the income reconciliation consists of a comparison between net income from the consolidated financial statements and Line 1 of the Form 100 Schedule M-1. In reality, however, the calculations are usually more complex. Since most taxpayers use the Schedule M-1 from the federal Form 1120, foreign entities will not be included. Differences will also occur if the financial statements include any entities that are not in the combined report or the federal return, if a federal M-1 is used.

One method for taking these differences into account is as follows:

	Consolidated Financial Statement Net Income (after tax)
+	Combined entities not included in the financial statements (after tax)
-	Entities included in the financial statements, but not the combined report (after tax)
-	Amount from Schedule M-1, line 1 (this should be an after tax amount)
+	Schedule M-1, line 1 amounts pertaining to entities not in the combined report
-	*After tax book income for combined entities not included in the Schedule M-1*
=	*DIFFERENCE*

You will need to be flexible in applying this method based upon the available information. For example, if you only have pre-tax income for foreign entities, which are not included in the consolidated Schedule M-1, then the rest of the computation should be revised to also reflect pre-tax income:

	Consolidated Financial Statement Net Income Before Income Taxes
+	Combined entities not included in the financial statements (before taxes)
-	Entities included in the financial statements, but not the combined report (before taxes)
-	Amount from Schedule M-1, line 1
-	Amount from Schedule M-1, line 2
+	Sch M-1, line 1 and 2 amounts pertaining to entities not in the combined report
-	*Pre-tax book income for combined entities not included in the Schedule M-1*
=	*DIFFERENCE*

If pre-tax income is used in the reconciliation, an analysis of the provision for income taxes may need to be done. Since state or foreign income taxes may have been deducted from the amount on Schedule M-1 line 1, an adjustment may be required to add back those taxes in order to place M-1 income and financial statement income on a comparable basis.

Step 3: Analyze the Differences between the income reported on the financial statements and on the tax returns

Significant differences resulting from the above reconciliation will usually fall into one of three categories: (1)

intercompany transactions; (2) off-book adjustments; and (3) “ghost” or hidden M-1 adjustments. To understand these adjustments, it is helpful to keep in mind the format that the consolidating workpapers commonly use:

Parent	*Subsidiaries*	*Eliminations*	*Adiustments*	*Consolidated Total*

The first two columns represent the amounts from the separate books of the entities (or from partially consolidated subgroups from the lower levels of the consolidating workpapers — see MATM 5110). The “eliminations” column represents the elimination of intercompany transactions. The “adjustments” column represents adjustments other than intercompany eliminations that are made only for consolidation or financial statement presentation purposes, and are not posted to the separate books of account. An example of an item that may be found in this column would be an adjustment to back out a minority interest in a consolidated subsidiary. The “consolidated totals” are the amounts that are carried to the actual consolidated financial statements.

Intercompany transactions

Intercompany eliminations between the domestic entities and the foreign entities or any other entities that were not consolidated in the federal return, will not have been made for federal tax purposes. The Form 1120 Schedule C should be reviewed to determine whether any intercompany dividends between those entities need to be eliminated. The federal Forms 5471 and 5472 should identify intercompany transactions between domestic and foreign corporations. The Schedule M-1 adjustments may also reveal eliminating adjustments that had been made for financial statement purposes but not for federal purposes.

Similarly, if financial statement income is adjusted to exclude affiliates who are not in the combined report, then adjustments may also be necessary to restore the eliminated intercompany profit and loss attributable to those entities. You should be able to derive these amounts from the consolidating workpapers to the financial statements.

Off-book adjustments

Instead of starting with consolidated net income when not all of the affiliated entities are included in the consolidated Federal Form 1120, the taxpayer may have aggregated the separate book income amounts in order to derive line 1 of the Schedule M-1. Since consolidating adjustments are not posted to the separate books of the individual entities, this method may not pick up the consolidating adjustments for purposes of the Schedule M-1 book income. For example, assume that a consolidating adjustment was made to establish a reserve for restructuring of $100 million. This provision was not posted to the separate books of any individual entity. If the taxpayer calculated the Schedule M-1 book income by aggregating the separate net income amounts for each corporation included in the federal return, the $100 million deduction would not be reflected in the M-1 book income.

By examining the workpapers used to prepare the Schedule M-1 or by asking the taxpayer how the net income was compiled, you should be able to determine quickly whether this type of situation exists.

“Ghost” or Hidden M-1 Adjustments

Ghost M-1 adjustments are book/tax differences that are buried in the Schedule M-1, line 1 amount and do not appear as a separate M-1 item. For example, assume a corporation capitalizes its leases for book purposes, but treats them as operating leases for tax purposes. Rather than making an M-1 adjustment to convert book lease income to tax lease income, the taxpayer may restate its book income as *if* it had used operating lease accounting for book purposes. The workpapers used to prepare the Schedule M-1 should identify whether these types of restatements have occurred.

If you are not able to easily reconcile net income to the consolidated financial statements, the taxpayer should be asked to provide a reconciliation. In a complex income reconciliation, it may not be possible to completely reconcile the amounts. As long as the differences are relatively minor and you can be reasonably assured that the starting point for the Schedule M-1 is valid and includes all unitary members, then no adjustments are necessary. On the other hand, if the taxpayer is unable to adequately explain material differences, you should consider proposing an audit adjustment for the unreconciled amount, or reconstructing net income using the consolidated financial statements as a verifiable starting point.

Reconciliation of Income from an Audited Federal Return

Occasionally it will not be possible to reconcile net income based upon consolidated financial statements. This may occur with smaller, privately held taxpayers who are not required to prepare annual reports or file SEC reports. It may also occur in foreign parent cases where the foreign financial statements are not prepared on a consolidated basis, or where the accounting methods are so far removed from GAAP as to be of little use for our purposes. In such cases, you may reconcile domestic net income before state adjustments to federal taxable income. Foreign income will have to be reconciled using the most reliable source available. See MATM 5120 for suggestions.

When using this method, you should be careful to consider whether any intercompany transactions took place between the domestic and foreign entities, and whether any book/tax adjustments are applicable to the foreign entities (MATM 5120). Since this method may not identify unitary entities, which have not been included in the federal return or combined report, you should be sure to utilize other methods to test for this issue, such as consulting a corporate directory such as Moody's Investors Service.

Since the IRS will already have audited domestic M-1 adjustments, you will not have to conduct an extensive M-1 analysis other than to review for federal/state differences. See MATM 5140.

If the federal return has not been audited, then you will have to verify the reasonableness of the net income computation based upon the records that are available, separate profit and loss statements, trial balances, or general ledger summaries. In addition, you should review the income statement for material issues and unusual transactions.

5140 SCHEDULE M-1 ANALYSIS

Once book income from line 1 of the Schedule M-1 has been reconciled to the consolidated financial statements, an analysis of the Schedule M-1 adjustments should be performed to verify the net income for tax purposes, before state adjustments. If the IRS has already audited the federal return, this analysis can be limited to a general review in order to gain an understanding of what is included in the tax base, to identify items, which may be treated differently for state and federal purposes, and to explore unfamiliar items to determine whether any California implications exist. The taxpayer's workpapers used to prepare the Schedule M-1 will be useful in conducting this review. The taxpayer can be asked to explain any unusual or unfamiliar items. Some additional tips for performing the Schedule M-1 analysis are discussed at MATM 2602.

In some cases, the audit adjustments will disregard the taxpayer's income computations and reconstruct net income from scratch using the consolidated financial statements as a starting point. This sometimes occurs when you cannot reconcile the taxpayer's net income figures or you are proposing significant adjustments to the taxpayer's method of filing. If the financial statements were prepared in accordance with U.S. generally accepted accounting principles (GAAP), then it may be reasonable for you to convert book income of the domestic companies to a tax basis by using the following formula:

Worldwide pre-tax book income prepared under GAAP

+	Lines 4 and 5 of Schedule M-1
-	*Lines 7 and 8 of Schedule M-1*
=	Worldwide income with domestic corps on federal tax basis

On the other hand, if the consolidated financial statements are prepared under the accounting practices of a foreign country, and the book income per the Schedule M-1 is based on the domestic corporations' profit and loss statement prepared in accordance with GAAP, then the M-1 adjustments may not be applicable to the underlying income used in the above formula. A more accurate approach under these circumstances may be as follows:

	Worldwide pre-tax book income from foreign financial statements
-	book income attributable to domestic corps (from consolidating workpapers or trial balances used to prepare the foreign financial

	statements)
+	*Federal income (from line 28 of the consolidated federal return)*
=	Worldwide income with domestic corps on federal tax basis

Before applying either of the above methods, you should verify that the Schedule M-1 adjustments are applicable for California. In particular, you should look for M-1 adjustments related to foreign-domestic transactions, such as gain from sales to foreign affiliates which is eliminated for book purposes but included in federal income because the foreign entities are not in the federal Form 1120. You should also be alert for “ghost” or hidden book/tax adjustments that have already been incorporated into line 1 of the Schedule M-1 (see MATM 5130).

5145 Adjustments To Conform Foreign Book Income To State Methods

If the combined report contains foreign entities, the taxpayer may not have adjusted the foreign book income to reflect U.S. or California tax accounting. CCR §25106.5-10 and MATM 5320 describe how the taxpayer should compute income from foreign operations. Once you have determined the starting point used by the taxpayer to compute foreign income, you should review the income statement to determine whether adjustments would be appropriate. Some of the more common book/tax adjustments associated with foreign financial statements are listed in Exhibit J. In addition to looking for book/tax adjustments that are unique to a particular country's accounting practices, you should not forget to look for the same types of book/tax adjustments that might exist for domestic companies. It will usually be necessary to work with the taxpayer to determine the proper book/tax adjustment.

For example, foreign income statements will often deduct additions to various special-purpose reserves. Although these deductions are not applicable for California purposes, the taxpayer should be allowed to deduct the expenses when and if they are actually incurred. Rather than simply disallowing the deduction, you should ask the taxpayer to provide the amount of the allowable deduction under California law. If this information is not readily available, reasonable approximations may be necessary (see below).

As another example, large losses may be taken for write-downs in the value of assets. Since these losses are unrealized, they are not deductible for California purposes. When the assets are eventually disposed of, or depreciated, California will have a higher basis in the assets, thereby reducing California income in that period. When proposing to disallow devaluation losses, you should determine whether any offsetting adjustments resulting from the disposition or depreciation of the assets are applicable.

When combining foreign entities for the first time, you should ask the taxpayer to provide any book/tax adjustments that it wishes to make with respect to those entities. For example, the taxpayer may be entitled to use LIFO inventory methods (MATM 6075) or accelerated depreciation methods (MATM 6020) for its foreign entities.

In many cases, it will be difficult for the taxpayer to obtain the information needed to completely conform foreign income to the methods acceptable for California tax purposes. CCR §25106.5-10(e)(1) provides:

“In computing the income and any of the factors required for a combined report, the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information. In appropriate cases, such as when the necessary data cannot be developed from financial records maintained in the regular course of business, the Franchise Tax Board shall accept reasonable approximations.”

One of the key elements in the U.S. Supreme Court's analysis in *Barclays Bank Plc. v. Franchise Tax Board* (114 S.Ct. 2268 (1994)) was the fact that the department had recognized the difficulties foreign parent businesses face in attempting to file a worldwide combined report. The Court confirmed that the department must consider whether the cost and effort of producing information justifies the submission of reasonable approximations. The types of approximations that will be necessary will vary taxpayer by taxpayer, as will the types of records that are available. Materiality is obviously a primary consideration. Other criteria that may be considered could include the size of the item relative to the corporation's total assets or income, the consistency with which the practice has been applied, and whether it is a recurring or nonrecurring item. Based upon your knowledge of the taxpayer, and your experience with auditing similarly situated taxpayers, you will have to make judgments as to what is reasonable and what is not.

5190 CAPTIVE INSURANCE SUBSIDIARIES

Corporations often form captive insurance subsidiaries to provide for their insurance needs. The traditional captive insurance situation, in which the insurance subsidiary insures only its parent and/or members of the affiliated group, is really a form of “self-insurance” because the parent ultimately retains all of the risk. For example, assume a captive insurance company has an investment account of $1.1 million, insurance liabilities of $1 million, and capital of $100,000. The captive insurance company has an insurance claim of $1,050,000. The claim reduces dollar for dollar the value of the parent's investment in the subsidiary. Taxpayers who place funds into a reserve for losses do not get a deduction until the losses are actually incurred. By the same token, taxpayers who structure the same result by paying premiums to a wholly owned subsidiary should not get a deduction. California follows Revenue Ruling 77-316, 1977-2 CB 53, which provides that premiums paid to a captive insurance subsidiary are not deductible to the extent that there are no reinsurance agreements with unrelated insurers.

Legal Ruling 385 concludes that an insurance company cannot be included in a combined report. The Department of Insurance applies the gross premiums tax equally to all admitted insurers without distinguishing between captive and noncaptive insurers. The Franchise Tax Board will consider a captive insurance company to be an insurance company for purposes of Legal Ruling 385. Thus, the captive will not be included in the combined report to be consistent with the practices of the Department of Insurance.

Legal Ruling 385 also states that an out-of-state insurance company not subject to the gross premiums tax is treated in the same manner as an in-state insurance company that is subject to the gross premiums tax.

Although combination of a captive insurance company is not the department's policy, the issue of what the proper deduction is for insurance expense is still present.

INSURANCE EXPENSE DEDUCTION

Taxpayers are allowed a deduction for amounts paid for insurance as an ordinary and necessary business expense. When insurance insures only the parent of a captive insurance company, the circumstance of “self-insurance” exists because the parent is the party that ultimately retains the risk. Each dollar of loss incurred at the insurance subsidiary level concomitantly reduces the parent's investment in the insurance subsidiary.

Determining whether a true insurance relationship exists

In the past, premiums paid to any wholly owned insurance subsidiary were disallowed, irrespective of whether the subsidiary regularly insured unrelated parties (Rev. Rul. 88-72, 1988-2 CB 31). A series of court cases in 1992 changed this practice (AMERCO v. Comm'r, 96 TC 18, 979 F.2d 162 (9th Cir. 1992); *The Harper Group v. Comm'r,* 96 TC 45, 979 F.2d 1341 (9th Cir. 1992); *Sears Roebuck & Co. v. Comm'r,* 96 TC 61, 972 F.2d 858 (7th Cir. 1992)). The courts established a three-prong test for determining whether a true insurance relationship existed:

• The arrangement must involve the existence of an insurance risk.

• There must be both risk shifting and risk distribution. Risk shifting may be found to occur if the subsidiary has an existence separate and apart from its parent, is financially able to satisfy the claims, and in fact pays claims. A co-insurance arrangement whereby the insured affiliate shares in a portion of the loss will result in no shifting of risk with respect to that portion of the insurance arrangement.

• Risk distribution occurs when the insurance company pools the affiliates' premiums with premiums from a significant number of unrelated insureds. The courts have not defined the level of unrelated risk that is required to constitute sufficient risk distribution. In Gulf *Oil Corp.* (3d. Cir. 1990) 914 F.2d 396, the court held 2 percent unrelated insurance to be de minimis, and found the insurance subsidiary to be a captive. In *The Harper Group* on the other hand, unrelated insurance constituting 30 percent of the pool was found to be enough to meet this prong of the test.

• The arrangement must be for insurance in its commonly accepted form. This prong will be met if the subsidiary is organized and operated as an insurance company, is adequately capitalized, is regulated as an insurance company, and uses valid, binding insurance policies that result from arm's-length transactions.

Parent/subsidiary relationships vs. Brother/sister relationships

In *Humana Inc. v. Commissioner* (6th Cir. 1989) 881 F.2d 247, the Sixth Circuit distinguished between premiums paid by the parent corporation and by the insurance subsidiary's brother/sister corporations. In that case, there were no unrelated insureds, and the court did not find a true insurance relationship to exist between the parent and its wholly

owned insurance subsidiary. On the other hand, because the brother/sister subsidiaries had no direct control or investment in the insurance subsidiary, the court held that risk shifting and risk distribution occurred with respect to those subsidiaries. Deductions were allowed for the premiums paid by the brother/sister subsidiaries. The department follows the *Humana* decision.

Audit techniques

The search for related corporations that are normally performed to reveal unitary issues may reveal insurance subsidiaries. The existence of insurance subsidiaries may also be identified in the annual reports, SEC 10-Ks, or the Form 1120.

To determine whether premiums paid to an insurance subsidiary are deductible, you must first determine the nature of the arrangement. Often, a primary insurer, the company that issued the policy for the insured, will transfer a portion of its premiums to another insurance company, the reinsurer, in return for the reinsurer assuming a portion of the insurance risk. (This is termed “reinsurance,” and the primary insurer is considered to have “ceded” its risk.) To the extent that an insurance subsidiary reinsures its risk with an unrelated party, the risk has shifted outside the affiliated group, and the premiums will be deductible. Conversely, premiums paid directly to an unrelated company may not be deductible if the risk is reinsured by the captive insurance subsidiary.

To the extent that the insurance risk remains with related entities, you must consider the three-prong test to determine whether a true insurance relationship exists. Most domestically organized insurance companies will be subject to regulation by the insurance departments of the states in which they operate. Reports filed with the state insurance departments will be good sources of information regarding the insurance company's operations. For insurance companies organized in offshore locations such as Bermuda, you should determine what types of reports are filed. Because insurance companies use specialized accounting procedures, it may be helpful for you to consult publications on the insurance industry (industry audit guides issued by the AICPA, for example) to understand how transactions are reported.

Careful scoping of the tax return is needed to determine if the potential premium adjustment is worth auditing. Inclusion of the insurance company's investment income in the combined report is not an option because captive insurance companies are not combined. Auditing Subpart F income of insurance Controlled Foreign Corporations (CFC's) for partial combination in the Water's Edge combined report is not an issue because the insurance subsidiary cannot be combined.

The only potential issue is the disallowance of part of the parent's insurance expense as provided by R&TC §24343 (IRC §162). The first step is to identify whether an insurance relationship exists with a related party. The payment of insurance premiums may be to either a domestic or foreign entity. For domestic insurance companies, a review of the consolidated federal Form 1120 will identify whether an insurance subsidiary was consolidated. For foreign entities, a review of the federal Form 5471 may disclose the amount of potential adjustment.

For example, a review of the federal Form 5471 or attached financial statements may disclose:

Premiums from parent	4,000,000	
Premiums from affiliates	1,000,000	
	_____	
Subtotal		5,000,000
Investment income		15,000,000
Reinsurance expense		(4,000,000)
Accrued insurance expense		(2,000,000)
		_____
Net income		14,000,000

For scoping purposes, it should be assumed that the reinsurance expense relates proportionately to the insurance of

the parent and the affiliates (in this case 80 percent of the reinsurance, or $3,200,000, relates to the parent's insurance). The tax effect of the potential insurance adjustment is $4,000,000 insurance paid by the parent, less the proportionate share of reinsurance of $3,200,000, for a potential adjustment of $800,000. $800,000 times the apportionment factor (assume 20 percent), times a 8.84-percent tax rate, would result in a potential tax change of $14,144.

Once the potential deficiency or overassessment is known, you must determine if the potential tax change warrants the amount of resources necessary to propose an adjustment. To make the adjustment you must read the relevant case law as cited above and check for current developments. You need to determine the facts by reviewing the insurance subsidiary's general ledger or financial statements to confirm the amount of insurance paid by the parent and its related reinsurance expense.

5195 ELECTION TO FILE A GROUP RETURN

California law requires a corporate taxpayer to file its own tax return, including taxpayers that are members of a combined reporting group. CCR §25106.5-11 allows taxpayer members of a combined reporting group to elect to file a group return, provided that they meet certain requirements such as:

• The taxpayer member is required to file a return in this state under R&TC §18601.

• The taxpayer is a member of a combined reporting group, which includes the key corporation.

• The taxpayer has the same taxable year as the key corporation or has a taxable year wholly within the key corporation's taxable year.

• The taxpayer has the same statutory return filing due date as the key corporation for the taxable year.

Due to the statutory filing requirements, taxpayer members of a combined reporting group that have different tax year-ends cannot be included in a group return. These California taxpayers must file separate returns and must apportion their business income following the requirements for corporations that have different accounting periods (CCR section 25106.5-4).

5200 CORPORATIONS HAVING DIFFERENT ACCOUNTING PERIODS (FISCALIZATION)

The income of all corporations included in a combined report must be determined on the basis of the same accounting period. When members of the combined report have differing fiscal years for tax purposes, it becomes necessary to make certain adjustments so that the income and factors included in the combined report will be representative of the income and factors for the common accounting period. This process is known as “fiscalization.”

Where there is a parent/subsidiary relationship, the common accounting period for the unitary group should generally be determined on the basis of the parent's taxable year.

Where there is no common parent corporation, the income of the related corporations should generally be determined on the basis of the taxable year of the corporation required to file a California return. If more than one member is required to file in California, the income should be determined on the basis of the taxable year of the California reporting corporation expected to have the largest amount of California income on a recurring basis.

The most accurate method of fiscalization requires the taxpayer to determine the income for the common accounting period based upon the actual books of account of each member of the group. The difficulty with this method is that many of the closing and consolidating entries that are necessary to properly determine the interim income will not be prepared by some taxpayers until the end of the fiscal year. Although most larger taxpayers will have a quarterly filing requirement with the SEC, this may not be helpful if the common accounting period does not correspond with one of the quarters of the fiscal year.

As long as the results do not materially misstate the income apportioned to California, taxpayers may choose to use a pro-rata method of fiscalizing their income. Under this method, the income attributable to the common accounting period is determined on the basis of the number of months in the fiscal periods that fall within the common accounting period. For example, assume a parent corporation operates on a calendar year basis and a unitary subsidiary operates on a September 30 taxable year. To determine the subsidiary's income attributable to the 1992 calendar year, it is necessary to assign 9/12 of the subsidiary's unitary income from the 9/30/92 fiscal year, and 3/12 of the unitary income

from the 9/30/93 fiscal year. In some cases, this procedure results in using the income of a corporation whose taxable year has not yet closed. When that situation occurs, it may be necessary for the taxpayer to estimate the income based on available information and amend the return at a later date.

After the combined unitary income is determined on the basis of a common taxable year, the next step is to apportion the combined income. The apportionment factors should be computed on the basis of the same common taxable year used to compute the unitary income. If an interim closing of the books was done to determine the income attributable to the common taxable year, then the actual figures from the books should also be used to determine the apportionment factors attributable to the common accounting period. Otherwise, the pro-rata method may be used by determining the factors in accordance with the number of months of the fiscal years that fall within the common accounting period.

Once the factors for the common accounting period have been determined, the California business income attributable to each of the taxpayers is calculated using the intrastate apportionment procedures described in MATM 7900. Each taxpayer's share of the unitary business income is then converted back to that taxpayer's normal accounting period.

Example: A parent corporation operating on a calendar year-end files a combined report with its unitary subsidiary for IYE 12/92. The subsidiary has a September 30 fiscal year-end. This example will illustrate the computations necessary to fiscalize the income and apportionment factors under the pro-rata method:

The subsidiary's income and factors for the fiscal periods falling within the 1992 calendar year are as follows:

	IYE 9/30/92	IYE 9/30/93		IYE 9/30/92	IYE 9/30/93
			Payroll:		
Income	40,000	48,000	Total	40,000	50,000
			California	12,000	25,000
Property:			**Sales:**		
Total	200,000	300,000	Total	3,000,000	4,000,000
California	60,000	120,000	California	900,000	2,400,000

	PARENT	SUBSIDIARY			Total for 12 months ending 12/31/92
	IYE 12/31/1992	(a) IYE 9/30/92 (9/12ths)	(b) IYE 9/30/1993 (3/12ths)	Total for 12 months (a) + (b)	
Business Income	558,000	30,000	12,000	42,000	600,000
Total Property	525,000	150,000	75,000	225,000	750,000
CA Property	375,000	45,000	30,000	75,000	450,000
Property %	50%			10%	60%
Total Payroll	262,500	30,000	12,500	42,500	305,000
CA Payroll	152,500	9,000	6,250	15,250	167,750
Payroll %	50%			5%	55%
Total Sales	5,250,000	2,250,000	1,000,000	3,250,000	8,500,000
CA Sales	4,250,000	675,000	600,000	1,275,000	5,525,000
Sales %	50%			15%	65%
Average Apportionment %	50%			10%	60%

Business income apportioned to California	300,000		60,000	360,000
	=======		======	=======

This calculation reflects the income for the calendar year ended 12/31/92. Since the subsidiary reports on a September 30 year-end, it is necessary to convert the subsidiary's California income back to a fiscal year basis. The following computation will accomplish this:

9/12ths of Subsidiary's income for 12 months ended 12/31/92:	45,000
3/12ths of Subsidiary's income for 12 months ended 12/31/91: 1 :	10,000

Subsidiary's California business income for IYE 9/30/92:	55,000
	=======

1 Note: The computation for this amount is not shown. It represents 3/12ths of the combined California income of S for the calendar year 1991 computed in the same manner as shown herein for 1992. The remaining 3/12ths of the calendar year 1992 income ($60,000 × 3/12 = 15,000) will be carried forward to compute the income for IYE 9/30/93.

The above example reflects a single-weighted sales factor. For taxable years beginning on or after January 1, 1993, the computation will usually have to be adjusted to reflect a double-weighted sales factor. Variations of these computations may also be made in certain cases if the circumstances warrant.

Financial statements prepared under GAAP do not require that all consolidated affiliates have the same fiscal year so long as each of the fiscal year ends are within three months of the balance sheet date (FASB 94). When the affiliates included in the consolidated financial statements do not share a common fiscal year, this fact should be disclosed in the footnotes (usually footnote #1).

Foreign affiliates will often operate on different accounting periods than the U.S. affiliates. When numerous non-California reporting entities are reporting on a different fiscal year, the auditor must decide whether the time and effort necessary to fiscalize the entities is necessary. Both the materiality of the adjustments and the benefits from achieving consistency should be considered.

5220 FSCS AND DISCS

FSCs

The FSC provisions (IRC sections 921 through 927) were repealed as part of the FSC Repeal and Extraterritorial Income Exclusion Act of 2000.

Foreign Sales Corporations (FSC's) are corporations organized under the laws of certain eligible foreign countries or U.S. possessions in order to take advantage of favorable U.S. tax provisions for export sales. The use of a FSC permits a portion of a domestic exporter's income from export sales to be immunized from federal income tax. California has no similar provisions. For California purposes, FSCs are treated as regular corporations and are fully included in the combined report whether the group files under worldwide or water's-edge.

FSCs are not permitted to be included in a federal consolidated return; their income is reported on Federal Form 1120-

FSC. To qualify as a FSC for federal purposes, a foreign corporation must maintain an office and a permanent set of books of account at a location outside the United States, and must meet certain other requirements specified in IRC §922. (See MATM 7550.) If a corporation meets these qualifications, a portion of its foreign trade income is treated as foreign source income not effectively connected with the conduct of a trade or business within the United States, and is therefore exempt from federal income taxation. The exempt portion consists of 16/23rds of the foreign trade income from transactions that are subject to the federal administrative pricing rules, and 32 percent of the foreign trade income derived from arms-length pricing subject to IRC §482 reallocation. (IRC §923(a).) Deductions attributable to foreign trade income must be allocated between exempt and non-exempt income.

Since a FSC's primary function is the export of goods for its domestic affiliate, it will almost always be unitary with that affiliate for California purposes. The FSC will not be included in the federal consolidated return, so some ways to identify the existence of a FSC are:

• Check the list of company affiliates in the SEC Form 10-K

• Scan the dividends on Schedule C of the federal Form 1120 for FSC dividends

• Review the detail to “Other Deductions” (line 26, Form 1120) for commissions paid to a FSC

• Check the Form 1120 Schedule M-1 or Schedule M-3 for items related to FSCs.

The income reconciliation procedures discussed at MATM 5130 may also reveal the existence of a FSC.

The FSC income included in the combined report should be verified to ensure that no federally exempt foreign trade income has been excluded for California purposes. Although reconciliation of the FSC book income may be part of the normal income reconciliation described in MATM 5130, give special attention to the Schedule M-1 analysis to verify that the federal book/tax adjustments exempting foreign trade income have been reversed. These book/tax adjustments will usually appear on lines 5b and 7b of the Federal Form 1120-FSC Schedule M-1.

The method that gives the most accurate results in reconciliation of FSC income is the Schedules A-G 1120 FSC method, if properly executed. It is the most complicated method and you must pay careful attention so not to double count items of income and expense. Both column (a) and (b) must be combined when preparing the calculation. If you are reconciling FSC income to an audited Form 1120-FSC and Schedules A-G, the following method may be used:

Total Foreign Trading Gross Receipts (1120-FSC, Sch B, line 6a — combine columns (a) and (b)):	xxxx
Less: Cost of goods sold (1120-FSC, Sch. B, line 7 — combine columns (a) and (b)):	(xxxx)
Less: Expenses attributable to foreign trade income (1120-FSC, Sch. G, line 15 — combine columns (a) and (b))	(xxxx)
Plus: Nonexempt foreign trade income not included above (1120-FSC, Sch. B, line 14 — combine columns (a) and (b)):	xxxx
Plus: Nonforeign trade income (1120-FSC, Sch. B, line 17)	xxxx
Less: Excess income of small FSC already included in Sch. B, line 6a (1120-FSC, Sch. F, line 7)	(xxxx)

FSC Income for California purposes (before normal state adjustments such as depreciation, taxes measured by income, etc.):	**xxxx**

The line numbers referenced in this computation were taken from the 1997 Form 1120-FSC. Since the line numbers and format of the form may change slightly from year to year, care must be taken to adapt this computation if necessary.

In addition to reconciling the FSC income, ensure that intercompany eliminations have been properly made (MATM 5260), and that any FSC dividends have been properly treated. (FSC dividends are treated in the same manner as dividends received from any other corporation, and are subject to deduction or elimination under R&TC sections 25106 and 24411. See MATM 6030, MATM 6032, MATM 6036). Adjustments to the apportionment factors may also be necessary (MATM 7550).

Further discussion of FSCs may be found in Chapter 2, Section 2.3, of the Water's-Edge Manual.

DISCs

Domestic International Sales Corporations (DISC) are domestically incorporated sales corporations that meet certain requirement set forth in IRC section 992. To qualify as a DISC, at least 95 percent of its gross receipts must be “qualified export receipts” as defined in IRC section 993(a). For federal purposes, DISCs are subject to favorable transfer pricing rules and partial deferral of income on foreign sales. For California purposes, DISCs are treated the same as any other corporation. (See MATM 7550.)

Since 1984, most DISCs have been replaced by FSCs. Federal law still provides for DISCs to a limited extent however, so you will still run across these entities occasionally. As with FSCs, DISCs are not included in the federal consolidated return. DISC income is reported for federal purposes on the federal Form 1120-DISC. The 1120-DISC taxable income before net operating loss and special dividend deduction should be used as the base for DISC income reportable to California.

Often a DISC will report on a different fiscal year than the domestic affiliates to take advantage of special rules allowing the deferral of DISC income for federal purposes. Since the federal deferral rules are not applicable for state purposes, the income of a DISC reporting on a different accounting period should be fiscalized to the common accounting period of the unitary group as discussed in MATM 5200.

When a DISC corporation is included in a combined report, any DISC deemed dividends included in the federal taxable income of its parent should be eliminated. It may also be necessary to adjust the sales factor (MATM 7550) and eliminate income from intercompany sales of goods (MATM 5260).

5240 INCOME ATTRIBUTABLE TO MINORITY INTERESTS

You should verify that taxpayers filing a combined report are including 100 percent of the income of combined unitary corporations. When taxpayers own less than 100 percent of a subsidiary, they will occasionally exclude a portion of the subsidiary's income as being attributable to a minority stock interest. Although this treatment is correct for book purposes under GAAP, it is not acceptable for California tax purposes. The income reconciliation will usually identify this error (MATM 5130).

5260 INTERCOMPANY TRANSACTIONS

The combined report is based on the premise that the same apportionment result should be obtained whether the unitary business is conducted by a single corporation or by multiple corporations. Therefore, combined reporting theory supports the position that intercompany gain or loss incurred by individual members of a combined report is not recognized until the position of the group is altered.

Intercompany transactions are transactions that occur between corporations that are members of the same combined reporting group immediately after the transaction. The term “group” means the affiliated corporations (or portions thereof) properly included in a combined report. The treatment of intercompany transactions affects the timing of income recognition, deductions, apportionment factors, and in some cases may affect whether a gain or loss is taxable to California at all. Although the rules regarding intercompany transactions are complex, issues involving intercompany transactions can often be very material. The materiality may result either from the magnitude of individual transactions or because of a large volume of smaller transactions.

The FTB adopted regulations to provide a methodology for taking into account intercompany transactions within a combined report. CCR §25106.5-1 applies to intercompany transactions occurring on or after January 1, 2001. Systems are also in place under both GAAP and the federal consolidated return regulations to deal with intercompany transactions. Prior to discussing Regulation 25106.5-1, it is necessary to understand the methods used for book and federal tax purposes. In addition, following the discussion of CCR §25106.5-1, which is effective for intercompany transactions occurring on or after January 1, 2001, a discussion is included for intercompany transactions occurring

prior to January 1, 2001.

Book Treatment: Elimination/Basis Transfer

Under U.S. GAAP (and also under the generally accepted accounting principles of many foreign countries), all transactions between members of the consolidated financial statements are eliminated. When assets are sold intercompany, the buyer takes the related seller's basis in the asset. The buyer will recognize any appreciation in value that took place while the seller held the asset when the asset is sold to an unrelated party or through lower depreciation deductions.

Example 1: Corporations S and B are included in the consolidated financial statements of an affiliated group. In 2001, S sells machinery to B for $100. At the time of the sale, S's basis in the machinery had been $75. Although S has realized a $25 gain from the sale, the gain is eliminated and B will have a $75 basis in the machinery. By taking S's lower basis in the asset, B's depreciation deductions will be reduced. This effectively spreads the $25 gain over the remaining life of the asset.

Assume instead that B was to immediately sell the machinery to an unrelated party for $100 before any depreciation was taken. Although B paid $100 for the asset, the $75 basis would result in a $25 gain to B.

For book purposes, the eliminating entries are made on the workpapers to the consolidated financial statements. These entries are not posted to the books of the individual corporations. This distinction is important because the adjustments necessary to convert book income and property balances to the amounts applicable for California tax purposes will vary depending upon whether the tax return is based on pre- or post-consolidation figures. For example, if the taxpayer computed its property factor using pre-consolidation book balances, adjustments may be necessary to back out step-ups in basis that resulted from the intercompany sales (see MATM 7121). If the property factor were based upon the consolidated figures from the annual report, these eliminations should already have been made.

Federal Tax Treatment

TRANSACTIONS OCCURRING IN YEARS BEGINNING PRIOR TO JULY 12, 1995

Under the federal regulations in effect prior to July 12, 1995, gains and losses from intercompany transactions were not truly eliminated, but merely deferred (Treas. Reg. §1.1502-13 (1994 Regulations)). The seller's gain was put into a deferred status (unless the taxpayer had elected not to defer — see below), and would eventually be recognized when a “restoration” event occurred. A restoration event generally occurred at the point in time when the consolidated group realized the economic benefit of the seller's gain, such as when depreciation was deducted, when the asset was sold outside the group, or when either the buyer or seller left the consolidated group. In contrast to the elimination method wherein the seller's basis in the asset carried over to the related buyer, the buyer takes its own tax basis under the deferral method.

Example 2: Assume the same facts as in Example 1, but now consider the transaction from the point of view of the federal consolidated return. S's $25 gain is not reported at the time of the intercompany transaction, but B still gets a $100 basis in the machinery. As B depreciates the machinery, the consolidated group benefits by the incremental portion of the depreciation attributable to the step-up in basis from the intercompany sale. This is considered a partial restoration event. In each year in which depreciation is claimed, S will recognize a portion of its gain determined as follows:

Total Deferred Gain X B's Depreciation Deduction/B's Depreciable Basis of the Asset

By the time that the machinery is fully depreciated, S will have recognized its entire deferred gain of $25.

Now assume as in the previous example that B sold the machinery to an unrelated party for $100. Since B had a $100 basis, it would not recognize any gain or loss. With respect to S however, the outside sale is a restoration event that would have triggered recognition of the $25 gain.

The federal deferral rules applied to intercompany sales of property and to intercompany expenditures where the amount of the expenditure was capitalized. Examples of such capitalized expenditures would include architect's fees included in the basis of a self-constructed building, and prepaid rents. Deferral did not apply to transactions for which the seller/service provider recognized income in the same period as the buyer/service recipient deducted a corresponding expense. An example of such an item would be when the corporation receiving the service deducts

management fees that are generally reported by the entity providing the service in the same period as the fees. Since the income and expense are a wash in the consolidated return, there was no need for elimination or deferral for federal purposes.

As an alternative to deferral, taxpayers may request the IRS's consent to recognize income from intercompany transactions currently for federal purposes (Treas. Reg. §1.1502-13(c)(3) (1994 Regulations)). This election could be made for intercompany transactions with respect to all property or any class or classes of property (for example, a taxpayer could elect not to defer income from intercompany sales of inventory, but could still defer gain from intercompany sales of other assets). Once the election was made, current recognition of intercompany income was an accounting method and had to be used for all consolidated return years.

TRANSACTIONS OCCURRING IN YEARS BEGINNING ON OR AFTER JULY 12, 1995

The federal regulations governing the treatment of intercompany transactions were substantially revised as of July 12, 1995. Although the new rules are still basically a deferral system, the approach and terminology are very different. For most common types of intercompany transactions, the amount and timing of gain recognition will be the same under the new federal method as under the old method, but attributes such as character and source of the gain may differ.

The new federal rules apply to any transaction between corporations that are members of the same consolidated group immediately after the transaction. The buyer in an intercompany transaction still takes its own cost basis (its purchase price) in the asset. The amount and location (location refers to which corporation recognizes the intercompany item) of intercompany items are determined on a separate entity basis. Unlike the old regulatory scheme where only the timing of intercompany items was determined on a single entity basis, the new rules also determine the character, source and other attributes of intercompany items as if the members of the consolidated return are divisions of a single entity.

Example: Assume the selling member (S) is in the trade or business of selling land, and sells a parcel of land to the buying member (B). B holds the land as an investment. On a separate entity basis, B would receive capital gain treatment from a subsequent sale of the land to a third party. If S and B are treated as divisions of a single entity however, then S's activities may cause B's gain to be characterized as ordinary income.

CCR section 25106.5-1

The FTB adopted regulations to provide a methodology for taking into account intercompany transactions within a combined report. CCR §25106.5-1 applies to intercompany transactions occurring on or after January 1, 2001.

CCR §25106.5-1 provides for a deferral method, which is substantially in conformity with federal Treasury Regulation section 1.1502-13. (The current deferral method under Treasury Regulation §1.1502-13 was adopted July 12, 1995.) The basic approach of the federal regulation is to prevent intercompany transactions from affecting the overall taxable income of the consolidated group. The regulation replaces the mechanical rules of the former Treasury Regulation section 1.1502-13 and Treasury Regulation section 1.1502-14 with broad, general principles using numerous examples to illustrate the new system.

In general, under the California regulation, income from intercompany transactions is generally deferred until immediately before such time that:

• The asset leaves the group by a sale or other disposition to a nonmember;

• The buyer and the seller no longer constitute members of the same combined reporting group, including by means of a water's edge election; or

• The purchaser converts the asset to a nonbusiness use.

Prior to the enactment of this regulation, the policy of the FTB was to eliminate the intercompany gains and losses from the sale of inventory used in the unitary business operations (elimination/carryover basis method). This policy was incorporated in FTB Publication 1061 *Guideline For Corporations Filing a Combined Report.* Intercompany profits from the sale of inventory were eliminated from beginning and ending inventories to compute cost of goods sold and the property factor. This treatment is similar to the book elimination/basis transfer method. The gain or loss would be recognized when the buying member resells the asset outside the combined report. See the discussion near the end of this section for more details regarding California's treatment of intercompany transactions occurring prior to January 1, 2001.

Example (deferral method versus elimination method):

S and B are members of the same combined reporting group. S sold inventory with a basis of $70 to B for $100 in year 1. B sells the inventory to X, a nonmember, in year 3 for $110.

Under the elimination method, the intercompany gain of $30 ($100 less $70) is eliminated from income in year 1 and included in income in year 3. The total profit of $40 ($110 less $70) is included in the income of B. The $30 intercompany profit is eliminated from income in year 1 through adjustments to ending inventory (which effects cost of goods sold). Adjustments are made to beginning inventory in year 3 in order to include the $30 of intercompany profit in income.

Under the deferral method the $30 of intercompany profit is deferred (not eliminated) until year 3. S reports the intercompany profit of $30 and B reports the corresponding profit of $10.

Under both methods, the total profit of $40 is included in income in year 3. Under the elimination method, B reports the total profit of $40 whereas under the deferral method B reports $10 and S reports $30.

If either S or B becomes nonmembers in year 2 (either sold or no longer unitary), then the acceleration rule applies under the deferral method and S recognizes the intercompany profit in year 2. There is no comparable rule under the elimination method.

Under the deferral method, the intercompany gain or loss is deferred (not eliminated) and taken into account under either the acceleration rule or matching rule. The buying member's basis in the property is its own cost basis (or purchase price) whereas under the elimination method, the buying member's basis reflects the selling member's cost basis (carryover basis). The amount, timing (when the intercompany item or corresponding item is taken into account), location (the entity that reports the intercompany or corresponding item), and character (e.g., capital or ordinary) are determined under the matching and acceleration rules. Typically the selling member reports the intercompany item whereas the buying member reports the corresponding item.

Treasury Regulation §1.502-13(a)(2) provides that the matching and acceleration rules encompass the single entity theory and separate entity theory. The single entity theory treats the buying member and selling member as divisions within a single entity. The timing and character are determined under the single entity theory whereas the amount and location are determined under the separate entity theory. The separate entity theory treats the buying and selling members as separate entities.

The matching rule and acceleration rules are explained below. There are many examples to illustrate the mechanics of the regulation. In the examples below, S is the seller of the property or service and B is the buyer of the property or service. Both S and B are members of the same combined reporting group.

MATCHING RULE

Timing. The federal intercompany regulations use the terms “corresponding item” and “recomputed corresponding item” to determine the timing of the intercompany item (*Treas. Reg. § 1.502-13(c)(2)*). The corresponding item is the income, gain, deduction or loss recognized by the buying member from an intercompany transaction (*Treas. Reg. § 1.502-13(b)(3)*). The recomputed corresponding item is typically the income, gain, deduction or loss that the buying member would take into account if the seller and buyer were divisions within a single entity (*Treas. Reg. § 1.502-13(b)(4)*). The intercompany item is taken into account in the year there is a difference between the recomputed corresponding item and the corresponding item (*Treas. Reg. § 1.502-13(c)(2)(ii)*).

Example: S and B are members of the same combined reporting group. S holds land with a basis of $70 for use in its trade or business. S sells the land to B for $100 in year 1. B sells the land to X, a nonmember, in year 2 for $110. The intercompany gain is $30 ($100 - $70) and the corresponding gain is $10 ($110 - $100). The recomputed corresponding gain is $40 ($110 - $70) for year 2. Year 2 is the first year where there is a difference between the recomputed corresponding gain and the corresponding gain (In year 1, the corresponding gain is 0 and the recomputed corresponding gain is also 0); therefore, year 2 is when the intercompany gain of $30 will be taken into account by S. B will take into account the $10 corresponding gain in year 2.

Location. As provided in CCR §25106.5-1(b)(9) the location refers to the member that reports the intercompany item and corresponding item. In the above example, S reports the intercompany gain of $30. B reports the corresponding

gain of $10. In general, the selling member reports intercompany items and the buying member reports corresponding items.

Keep in mind that under the elimination method, B would have reported the total gain of $40. Under the deferral method, B reports only a $10 gain and S reports the remaining $30 gain. If the taxpayer incorrectly prepared the combined report under the elimination method, an adjustment should be made to correct the income of S and B. There are certain code sections that use the separate entities income to determine deduction limitations, such as IRC §163(j); therefore the correct income of each entity is needed.

Character. The federal intercompany regulations do not provide specific guidelines for determining the character of an income item. The regulations instead provide general rules that are subject to various exceptions. The general rule is that the single entity theory is used to determine the character of an income item (Treas. Reg. §1.1502-13(a)(2)). CCR §25106.5-1(c) provides that the separate entity attributes of the selling member's intercompany item and buying member's corresponding item are re-determined to the extent necessary to produce the same effect on the total group combined report business income as if seller and buyer were divisions of a single corporation, and the intercompany transaction was a transaction between divisions. In the above example, the intercompany gain and corresponding gain would be characterized as a capital gain.

The holding period is the aggregate of the holding period of both the seller and buyer.

Inventory example: S manufactures and sells inventory to B in year 1. The cost to manufacture the inventory is $70 and the inventory was sold to B for $100. In year 2 B sells the inventory to X, a nonmember, for $110. S reports the intercompany gain of $30 ($100 - $70) in year 2, which is when the recomputed corresponding gain ($40) is different from the corresponding gain ($10). B will report the corresponding gain of $10 in year 2. Both the intercompany gain of $30 and the corresponding gain of $10 will be classified as ordinary income.

For the effect on the apportionment factor, see a more detailed discussion later in this section.

Service income example: S provides a service to B. B pays S $100 and S incurs $80 of expenses related to the service. The service was provided in year 1. The $100 of gross income and $80 of related expenses are both included in determining S's intercompany profit of $20. The $100 paid by B to S is the corresponding item and the recomputed corresponding item is the $80 of expenses incurred by S. Therefore the intercompany item ($20) is taken into account in year 1 since that is the year in which the recomputed corresponding item is different from the corresponding item. B deducts the $100 paid to S and S reports $100 of gross income and the $80 related expense.

For the effect on the apportionment factor, see a more detailed discussion later in this section.

Depreciation example: S buys property on January 1st of year 1 for $100. The property has a 10-year useful life. S begins depreciating the property in year 1 using the straight line (“S/L”) method. S sells the property to B for $130 on January 1st of year 3. B determines that the useful life of the property is 10 years from the date of B's acquisition. B uses the S/L method. The intercompany gain is $50 ($130 - $80) (The adjusted basis of $80 is determined by subtracting the two years of depreciation ($10 + $10) from the cost of $100). In year 3, B deducts $13 of depreciation ($130/10 years = $13). Although the property was not sold to a nonmember, S would take into account $5 of its intercompany gain in year 3 because the corresponding item is $13 of depreciation and the recomputed corresponding item is $8 of depreciation expense. The recomputed corresponding item is determined by treating S and B as divisions within a single entity. If S and B were treated as divisions, then the depreciation would only be $8 (The $80 remaining basis at the time B purchased the property is divided by a 10-year useful life. The 10-year useful life was redetermined at the time the property was purchased by B).

If B had determined that the remaining useful life (at the time of purchase) was 8 years instead of 10, then the recomputed corresponding item would be $10 ($80 remaining basis/8 years) and the corresponding item would be $16.25 ($130/8). Therefore the intercompany item taken into account by S would be $6.25.

ACCELERATION RULE

Except as otherwise provided, CCR §25106.5-1(d) adopts the acceleration provisions of Treasury Regulation section 1.1502-13(d). Acceleration occurs when intercompany items and corresponding items are taken into account (no longer deferred) because the parties to the transaction cannot be treated as divisions of a single corporation (CCR §25106.5-1(d)). 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 following are some circumstances, which will cause the acceleration rule to apply:

• The seller and buyer are no longer in the same combined reporting group; or

• The asset in an intercompany transaction is converted to nonbusiness use (CCR § 25106.5-1(d)(1)(A)).

CCR §25106.5-1(d)(2) provides that if the circumstances, which would trigger the acceleration rule, are not known in time for the taxpayer to file an accurate return, it may be necessary to make an estimate and amend the return at a later date.

Example — Becoming a nonmember: S and B are members of a consolidated federal return. They are also included in a California combined report. S sells land to B for $100 in year 1. S's basis in the land is $70.

S has a $30 intercompany gain, which is not taken into account under the matching rule because there is no difference between B's corresponding gain of $0 and the recomputed corresponding gain of $0. (B has not disposed of the land.)

In year 3, 60 percent of S's stock is sold to Y, a nonmember. As a result of the sale of S's stock, S becomes a nonmember of the unitary group. S and B can no longer be treated as divisions of a single corporation. Therefore, under the acceleration rule, S's intercompany gain of $30 is taken into account in Year 3 immediately before S becomes a nonmember. S's intercompany gain of $30 will be treated as current apportionable business income.

For the effect on the apportionment factor, see a more detailed discussion later in this section.

In the above example, S's stock was sold, resulting in the recognition of the intercompany gain under the acceleration rule. If B's stock had been sold instead of S's stock, the acceleration rule would still apply and S's intercompany gain of $30 would be taken into account in Year 3.

Example — Conversion to nonbusiness use: S and B are members of a consolidated federal return. They are also included in a California combined report. S sells land to B for $100 in year 1. S's basis in the land is $70.

S has a $30 intercompany gain, which is not taken into account under the matching rule because there is no difference between B's corresponding gain of $0 and the recomputed corresponding gain of $0.

In year 3, B converts the land to a nonbusiness use. Once B converts the land to nonbusiness use, the effect of treating S and B as divisions of a single corporation cannot be achieved. The acceleration rule causes S to take its $30 gain into account immediately before the conversion to nonbusiness use takes place.

S's intercompany gain of $30 will be treated as current apportionable business income

For the effect on the apportionment factor, see a more detailed discussion later in this section.

B's conversion of the property to nonbusiness use would not affect the treatment on the federal return. Therefore, S's intercompany gain will continue to be deferred for federal purposes.

Example — Change in combined reporting group, S & B remain affiliated and unitary: S and B are members of a consolidated federal return. They are also included in a California combined report. S sells land to B for $100 in year 1. S's basis in the land is $70.

S has a $30 intercompany gain, which is not taken into account under the matching rule because there is no difference between B's corresponding gain of $0 and the recomputed corresponding gain of $0.

In year 3 both S and B are sold to Y, a nonmember, resulting in the exclusion of both S and B from the combined report. If S and B remain unitary after the sale, then the sale will not cause S's intercompany items to be taken into account under the acceleration rule. S's intercompany gain of $30 remains deferred until either the matching rule or acceleration rule causes the item to be taken into account.

For the effect on the apportionment factor, see a more detailed discussion later in this section.

For federal purposes under Treasury Regulation §1.1502-13(d)(1), the sale of S and B together results in the

acceleration rule applying, therefore the intercompany gain is taken into account. However, CCR §25106.5-1(j)(1)(B) provides that since the intercompany item is taken into account for federal purposes, the taxpayer may elect the same treatment for California purposes by taking the intercompany item into account on a timely filed original California return.

Example — Consolidated group enters state and a member is subsequently sold: S and B are members of a unitary group which conducts all of its business activity in the U.S. Both are members of a federal consolidated group. In year 1 when no member of the group is a California taxpayer, S sells land to B for $100. S's $30 gain is treated as a deferred intercompany item in S and B's consolidated return.

In year 2, a member of the consolidated group starts doing business in California. A combined report is filed including S and B. No event occurred which would have caused the intercompany item to be taken into account.

In year 3, S is sold, and becomes a nonmember of the group.

Once the stock of S is sold, the effect of treating the unitary operations of S and B as divisions of a single corporation cannot be achieved. Therefore, under the acceleration rule of *Treasury Regulation section 1.1502-13(d)S*'s $30 intercompany gain is taken into account in Year 3 immediately before S becomes a nonmember. S's intercompany gain will be treated as current apportionable business income in Year 3.

For the effect on the apportionment factor, see a more detailed discussion later in this section.

Although the unitary group that included S and B was not doing business in California when the intercompany transaction took place, the intercompany gain is still deferred for both federal and California purposes. Therefore when either the matching or acceleration rule applies after the group becomes taxable in California, the intercompany gain will be taken into account for California purposes (CCR §25106.5-1(j)(2)).

STOCK AND DEBT TRANSACTIONS

California intercompany regulations with respect to transactions involving stock and obligations of members are modeled after the federal regulations with modifications, as explained below.

Dividend distributions. Dividend distributions between members of the consolidated federal Form 1120 are eliminated under Treasury Regulation §1.1502-13(f), whereas the authority for eliminating intercompany dividends for California purposes is found under R&TC §25106. California does not conform to the federal regulation. Therefore, none of the federal provisions referenced under CCR §25106.5-1 provide authority for eliminating intercompany dividends.

Deferred Intercompany Stock Account (DISA). Distributions are dividends to the extent that they are paid out of earnings and profits. Once the earnings and profits have been depleted, the distributions will reduce the shareholder's basis in stock. Distributions in excess of both earnings and profits and shareholder's basis are treated as a capital gain distribution under IRC §301(c)(3). Under IRC §301(c)(3), this is income to the shareholder. For transactions occurring prior to January 1, 2001, the taxpayer was allowed to enter into a closing agreement with the FTB to defer the capital gain (FTB Notice 1997-2).

Example: S owns all of T stock with a basis of $20 and T has no accumulated earnings and profits but does have $10 of current unitary earnings and profits. T makes a distribution to S of $70. If S and T are included in the combined report, then S will treat the $70 distribution as follows: since T has $10 of earnings and profits, $10 of the distribution will be treated as a dividend and eliminated under R&TC §25106. The distribution is then treated as a return of capital to the extent of S's basis in T stock. Therefore $20 of the distribution is a tax-free return of capital and S will reduce its basis in T stock to zero. To the extent the distribution exceeds both earnings and profits and shareholder basis, the distribution will be treated as a capital gain distribution under IRC §301(c)(3). The capital gain distribution is $40 ($70-$10-$20 = $40).

CCR §25106.5-1(f)(1)(B) provides that for transactions occurring on or after January 1, 2001, the capital gain distribution is put into a Deferred Intercompany Stock Account (DISA). Under CCR §25106.5-1(b)(8), the balance of each DISA account must be disclosed annually on the taxpayer's return. The income is then deferred until either the distributor or recipient is no longer included in the combined report as provided in CCR §25106.5-1(f)(1)(B). If there is a partial stock sale of the distributor and the distributor remains in the combined report after the stock sale, then the DISA will be taken into account to the extent of the stock sale.

Example: S owns all of the T stock with a basis of $20 and T has no accumulated earnings and profits but does have $10 of current unitary earnings and profits. T makes a distribution of $70 to S. If S and T are both included in the combined report, then S will have a $40 DISA which will be deferred until either S or T are no longer included in the combined report. If S sells 30 percent of its T stock in the following year, then S will have to include $12, or 30 percent of the DISA, in income in the year of sale. If 51 percent of the T stock were sold, then 100 percent of the DISA would have to be taken into account by S in the year of sale since S would no longer be included in the combined report.

For federal purposes, capital gain distributions create Excess Loss Accounts (ELA). The ELA creates a negative basis in the stock, which is restored to income when the stock of the distributor is sold. For federal purposes, the stock basis is adjusted every year by the earnings of the subsidiary and is decreased by the dividends paid out of those earnings (Treas. Reg. § 1.1502-32). Since California does not conform to these adjustments the California stock basis may be materially different from the federal basis. (See *Appeal of Rapid-America Corp.,* 96-SBE-019, October 10, 1996.) CCR §25106.5-1(f)(1)(B)2 provides that if the distributor is liquidated into the distributee under IRC §332, then the DISA is taken into account over a 60-month period upon liquidation. However, the taxpayer can elect to take all of the income into account in the year of liquidation.

Example: S owns all of the T stock with a basis of $20 and T has no accumulated earnings and profits but does have $10 of current unitary earnings and profits. T makes a distribution of $70 to S. If S and T are both included in the combined report, then S will have a $40 DISA which will be deferred until either S or T are no longer included in the combined report. If T is liquidated into S under IRC §332 in the following year, then S will have to include one fifth ($8) of the income in the year of liquidation and one fifth in each of the following four years. S can elect to include the full $40 of DISA in unitary business income in the year of liquidation.

If the taxpayer has entered into a closing agreement with the FTB to defer a capital gain distribution that occurred prior to January 1, 2001, then the deferred income will be included in the DISA of the distributee (to the extent it has not already been taken into account) for taxable years beginning on or after January 1, 2001. Thereafter, the balance of the DISA will be taken into account under the rules of the intercompany regulations (CCR § 25106.5-1(f)(1)(B) 4).

IRC §311(b) transactions. Prior to January 1, 2001, a corporation recognized gain but not loss when it made a nonliquidating distribution of appreciated property to its shareholder. The distribution was treated as a sale of property at the property's fair market value. If the distribution occurred between members of the same combined reporting group, the gain was eliminated and the shareholder's basis in the property reflected the distributor's basis (carryover basis).

Example: S owns all of the T stock with a basis of $20 and T has no accumulated earnings and profits but does have $80 of current unitary earnings and profits. S and T are included in the same combined report. T distributes land (instead of cash) to S out of current earnings and profits. The land has a FMV of $70 and a basis of $10. The distribution is treated as a dividend to S of $70.

The dividend is eliminated under R&TC §25106. In addition there is an IRC §311(b) transaction since T distributed property with an appreciated value to S. The IRC §311(b) gain is $60 ($70 FMV less $10 basis). Prior to January 1, 2001, an IRC §311(b) gain would be eliminated since this is an intercompany transaction and the basis of the land in the hands of S would be $10.

Under CCR §25106.5-1(f) and Treasury Regulation section 1.1502-13(f)(2)(iii), the $60 IRC §311(b) gain is deferred until either the land is sold to a nonmember, converted to a nonbusiness use, or S or T is no longer included in the combined report.

For example, if S is no longer unitary with the combined reporting group, then T takes the $60 deferred gain into account.

Intercompany loans. Unless otherwise provided, California conforms to Treasury Regulation section 1.1502-13(g) relati ng to the obligations of members. (CCR § 25106.5-1 (g).) Intercompany obligations are obligations between members of the same combined reporting group. Typically the creditor will report the interest income and the debtor will report the interest expense in the year it is reported for federal purposes. The interest income and interest expense will offset each other, resulting in no net interest income or expense.

INTANGIBLES

Gain or loss from intercompany sales of intangibles is eliminated from business income and the seller's basis in the

asset is carried over to the buying member.

APPORTIONMENT FACTORS

Receipts from intercompany sales and other intercompany revenues are not included in the sales factor. Authority for this position can be found in *Chase Brass & Copper Co. v. Franchise Tax Board,* (1977) 70 Cal.App. 3d 457, 138 Cal. Rptr. 901. See MATM 7518 for further discussion of sales factor implications.

Although the deferral method requires the basis of property acquired in an intercompany sale to be stepped up to reflect the intercompany sales price, the asset must still be reflected in the property factor at the seller's original cost. If the gain on the intercompany transaction had been currently recognized, however, then the property factor value should reflect the intercompany sales price. See MATM 7121 for a discussion of this issue.

GAIN FROM DISTRIBUTIONS IN EXCESS OF BASIS

Distributions are dividends to the extent that they are paid out of earnings and profits. Once earnings and profits have been depleted, the distributions will reduce the shareholder's basis in the stock. After the stock basis has been reduced to zero, any excess distribution is treated as a capital gain to the shareholder (IRC § 301(c)(3)). Elimination under R&TC section 25106 only applies to the dividend portion of a distribution, not to the portion of a distribution that is in excess of stock basis (MATM 6032).

Because the general rule under IRC section 301 provides for current recognition of gains from distributions in excess of basis, elimination or deferral of such gains will not generally be allowed for California even though both the payor and payee are members of a single combined report.

To the extent that distributions exceed federal stock basis, they should be identified as a capital gain for federal purposes. For federal consolidated return purposes, however, stock basis is adjusted every year by the earnings of the subsidiary and is decreased by dividends paid out of those earnings (Treas. Reg. §1.1502-32). Since California does not conform to these adjustments (See *Appeal of Rapid-American Corp.,* 96-SBE-019-A, October 10, 1996), the California stock basis may be materially different from the federal basis. State and federal E & P amounts may also be different. Consequently, material distributions in excess of basis may exist for California but not for federal purposes. The by-company detail to the Schedule M-2 should identify any distributions. If material distributions have been made, you should consider analyzing the taxpayer's E & P and stock basis computations to determine whether the distribution has been reported correctly.

Although excess distributions may occur in a variety of situations, you should be especially careful to look for them after a leveraged buy-out (LBO). For example, after acquiring a target corporation, a parent may cause the target to liquidate its pension plan assets and distribute the cash up to the parent. The parent will use the cash to pay for the acquisition. If the cash distributed exceeds the target's E&P and the parent's stock basis, then the excess distribution will be a capital gain. (In this type of situation, even the dividend portion of the distribution will probably be paid from pre-acquisition E&P, so will not be eligible for R&TC §25106 intercompany dividend elimination.)

For additional discussion of intercompany transaction issues, see Chapter 17, Water's-Edge Manual. The discussion in the Water's-Edge Manual is very in-depth, and much of it is applicable to worldwide filers as well as water's-edge taxpayers.

APPORTIONMENT FACTOR

In general, intercompany items should not be included in the apportionment factor. This is the same policy that existed prior to the adoption of the intercompany regulations as provided in CCR §25106.5-1. Below are the more common rules associated with the sales factor and property factor.

Sales factor. The gross receipts from an intercompany transaction should never be included in the sales factor. CCR §25106.5-1(a)(5)(A)(1) provides that sales attributable to intercompany items are not included in the sales factor in either the year that the intercompany transaction takes place or the year that the intercompany transaction is taken into account. However, the gross receipts from the corresponding item should be included in the sales factor by the buying member in the year of sale as provided in CCR §25106.5-1(a)(5)(A)(2).

Example: S sells property used in its trade or business to B in year 1 for $100. The basis in the property is $80; therefore the intercompany gain of $20 is deferred until it is taken into account under the acceleration or matching rule.

In year 2, B sells the property to X, a nonmember, for $110. Under the matching rule, both the intercompany gain of $20 and the corresponding gain of $10 is taken into account in year 2. B will include $110 of gross receipts in its sales factor for year 2. S will not include the $100 of intercompany receipts in the sales factor.

Assume instead that the stock of B is sold in year 2 and B is therefore excluded from the combined report. The acceleration rule applies resulting in the recognition of the intercompany gain of $20 by S in year 2. There is no corresponding gain. Since the intercompany gain must be recognized and included in business income in year 2, will the gross receipts of $100 be included in the sales factor? The answer is no, the intercompany receipts are never included in the sales factor.

Property factor. CCR §25106.5-1(a)(5)(B)(1) provides that on the date that property is transferred from the seller to the buyer, the property will be included in the property factor of the buying member at the seller's original cost (carryover basis). B's purchase price from S is not used for property factor purposes.

CCR §25106.5-1(a)(5)(B)(4) states that if the acceleration rules apply resulting in the recognition of the intercompany gain by S, then the basis of the property is stepped up to the buyer's purchase price. The increase in the property factor should reflect the amount of gain recognized by the seller.

Example: S sells property used in its trade or business to B on January 1st of year 1 for $100. S's basis in the property is $80, therefore, the intercompany gain is $20. On January 1st of year 2, the stock of S is sold to a nonmember, and S is no longer included in the combined report. B will include the property in its property factor for year 1 at $80 (S's costs basis). B will also include the property in its factor for year 2. The property will be increased to $100, however, to reflect the gain recognition by S under the acceleration rule. If for some reason the gain recognition were only $15, then B would only increase the property factor to $95.

If S and B are sold together and continue to remain unitary, then the acceleration rule does not apply. Therefore B's property factor would continue to be reflected at the carryover basis (S's cost).

CCR §25106.5-1(a)(5)(B)(2) provides that intercompany rent should also be excluded from the property factor.

SIMPLIFYING RULES

The purpose of CCR §25106.5-1 is to reflect the taxable income of the taxpayer members as if the intercompany transactions within the group occurred between divisions of a single corporation.

However, CCR § 25106.5-1(e) applies the simplifying rules of Treasury Regulation section 1.1502-13(e)(3) allowing an election to report transactions on a separate entity basis (currently recognized). A federal election is binding for state purposes unless the taxpayer makes a separate California election to prevent the federal election from applying as provided in CCR §25106.5-1(e)(2)(A).

Example: S sells land to B for $100 in year 1. The basis is $70. For federal purposes, an election was made to recognize the $30 intercompany gain in year 1 even though neither the acceleration nor matching rules applied. The taxpayer will have to report the $30 gain in year 1 for California purposes unless a separate election is made on an original California return. The federal election automatically applies for California purposes, unless an election is made by the taxpayer on its original California return.

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 since foreign corporations are not included in the consolidated federal Form 1120. The reason for making the election for California purposes is to avoid keeping two separate sets of books. (One set of books would be kept for the deferral method for California and one under the separate entity method for federal purposes.) If the consolidated federal Form 1120 is used as the basis for preparing the California combined report, then the separate entity method would apply to any transactions with related foreign corporations unless a state adjustment is made to use the deferral method. The election is made for the first year in which the election is to apply.

CCR §25106.5-1(e)(2)(B) provides that an election can be made for all items or for items from a class or classes of transactions. For example, intercompany sales to a controlled foreign corporation included in a water's-edge return

may be considered a class of transactions for which a separate state election can be made. Furthermore, CCR §25106.5-1(e)(2)(C) provides that the election shall be treated as an accounting method and will apply to the class each year thereafter.

Any election made to treat intercompany transactions on a separate entity basis will not apply to losses and deductions deferred under IRC §267(f) as provided in CCR §25106.5-1(e)(2)(D). Such deductions or losses are deferred until the property is transferred outside of the controlled group. In addition, an election cannot be made with respect to transactions related to stock or obligations of members. CCR §25106.5-1(f) provides specific rules for stock of members and CCR §25106.5-1(g) provides specific rules for obligations of members. See the discussion on stock and debt transactions above for more details.

If the combined reporting group change results in the seller's intercompany item being taken into account for federal purposes (ownership drops below 80 percent), the seller may make an election to take those same items into account for California purposes, by including them on a timely filed original return.

AUDIT CONSIDERATIONS

In general, either the consolidated federal Form 1120 or the worldwide annual report is used as the basis for preparing the California combined report. Different issues may exist depending on which method is used by the taxpayer.

If the consolidated federal Form 1120 is used as the basis for preparing the combined report, then issues will usually exist when the acceleration rule applies for California purposes and not for federal. The following are situations in which the intercompany item will have to be recognized for state purposes but not federal:

• If the selling member is no longer unitary with the combined group but is still included in the consolidated federal Form 1120, then the intercompany item will be taken into account for California purposes under the acceleration rule whereas for federal purposes the intercompany item will continue to be deferred.

• If the buying member is no longer unitary with the combined group but is still included in the consolidated federal Form 1120, then the intercompany item will be taken into account for California purposes under the acceleration rule whereas for federal purposes the intercompany item will continue to be deferred.

• If the property is no longer used in the unitary business but is instead used for a nonbusiness purpose, then the intercompany item will be taken into account for California purposes but continue to be deferred for federal purposes.

• If there are members of the consolidated federal Form 1120 that are not included in the combined report (i.e. nonunitary corporations), then the transactions between the nonunitary members will be recognized for California purposes but deferred for federal purposes.

In contrast, the following are situations in which the intercompany item will be taken into account for federal purposes but not for California purposes:

• The ownership percentage in the selling member drops below 80 percent but remains above 50 percent. If the selling member is still unitary with the combined reporting group, then the intercompany item will be recognized for federal purposes under the acceleration rule (since it is no longer included in the consolidated federal Form 1120) but not for California purposes.

• The ownership percentage in the buying member drops below 80 percent but remains above 50 percent. If the buying member is still unitary with the combined reporting group, then the intercompany item will be recognized for federal purposes under the acceleration rule, since it is no longer included in the consolidated federal Form 1120 but not for California purposes.

• If both the buying member and selling member are sold together and are no longer included in the combined reporting group (and consolidated group), then the intercompany item will be recognized for federal purposes under the acceleration rule but remain deferred for California purposes. This is one area where California did not conform to the federal regulation.

• If there are corporations included in the combined report that are not included in the consolidated federal Form 1120 (i.e. foreign corporations) then any intercompany transactions with those corporations will be recognized for federal purposes but not for California purposes. The taxpayer can elect, however, to use the separate entity method by

recognizing those items on a timely filed original California return.

Depreciation can also affect the timing of the intercompany item. Under the matching rule, the intercompany item is taken into account to the extent that depreciation claimed by the buying member (corresponding item) exceeds the depreciation that would have been claimed if the buying member and selling member were divisions within a single corporation (recomputed corresponding item). Therefore if there are significant differences between the federal and state depreciation methods, then there should be a state adjustment to the intercompany item recognized for federal purposes.

If the combined report was prepared using a worldwide annual report, then most likely the combined report will reflect the elimination method as opposed to the deferral method. Adjustments should be made by the taxpayer to reflect the deferral method. However, if the taxpayer has not made any adjustment, you should address the following issues:

• If the buying member is no longer unitary with the combined reporting group, then the acceleration rule applies requiring the intercompany item to be taken into account by the selling member. Under the elimination method, the intercompany item will not be taken into account.

• If the selling member is no longer unitary with the combined reporting group, then the acceleration rule applies requiring the intercompany item to be taken into account by the selling member immediately before becoming a nonmember. Under the elimination method, the intercompany item will not be taken into account.

• If the buying member is sold and is therefore no longer included in the combined report, the acceleration rule applies requiring the intercompany item to be taken into account by the selling member. Under the elimination method, the intercompany item will not be taken into account.

• If the selling member is sold and is therefore no longer included in the combined report, the acceleration rule applies requiring the intercompany item to be taken into account by the selling member immediately before becoming a nonmember. Under the elimination method, the intercompany item will not be taken into account.

• If the property is no longer used in the unitary business and is therefore reclassified as nonbusiness property, then the acceleration rule applies requiring the intercompany item to be taken into account by the selling member. Under the elimination method, the intercompany item will not be taken into account.

• Under the elimination method both the intercompany item and corresponding item are reported by the buying member, whereas under the deferral method the intercompany item is reported by the selling member and the corresponding item is reported by the buying member. If the net income of each member is needed to determine a deduction limitation for another section such as IRC §163(j), then an adjustment should be made to each member's net income to reflect the deferral method and not the elimination method.

California Treatment for transactions occurring prior to January 1, 2001

Intercompany transactions that occurred before January 1, 2001 are governed by preexisting elimination and carryover basis practices, even if, in a later year, the asset which was the object of an intercompany transaction is later resold to a nonmember or the seller and the purchaser discontinue their combined reporting relationship. Accordingly, the prior practices of the FTB are summarized below:

INVENTORIES

Income from intercompany sales of inventory is eliminated from unitary business income. The seller's basis in the inventory will carry over to the buyer in the intercompany sale. Intercompany profits in inventory will be eliminated for property factor purposes.

For a discussion of state adjustments and property factor adjustments related to intercompany profits in inventory, see MATM 6070 and MATM 7173, respectively.

FIXED ASSETS AND CAPITALIZED ITEMS

These rules apply to intercompany sales or exchanges of fixed assets, such as equipment or land; and to intercompany expenditures where the amount of the expenditure is capitalized. Gain or loss on intercompany transactions involving these items is deferred in a manner similar to the federal methodology (although if the taxpayer

elects not to defer for federal purposes, the federal election will be allowed for California). Deferred intercompany gains or losses are restored based upon the same types of events that would trigger restoration for federal purposes (e.g., a sale of the asset to a nonmember of the combined report, depreciation of the asset, or either the selling or buying member leaving the combined report). When deferred gain or loss is recognized or restored into income, it will generally be apportioned using the current apportionment factors for that restoration year.

In cases where the deferred gain is triggered as a result of the selling or buying member being excluded from the combined report because of a water's-edge election, FTB Notice 1989-601 will allow the restoration of deferred gain to be spread over five years (see Chapter 17, Water's-Edge Manual).

As long as records are provided to substantiate their computations however, taxpayers will also be allowed to use the historical apportionment percentage from the taxable year in which the intercompany transaction occurred. In some cases you may require the use of this historical apportionment percentage, but the department will not impose historical apportionment factors on taxpayers unless both of the following conditions are met:

• The historical apportionment percentage varies by more than 10 percent from the apportionment percentage for the year in which the gain is reported, and

• The use of the historical apportionment percentage results in more than $100,000 additional income apportioned to California.

These criteria for the use of historical apportionment factors are consistent with the guidelines concerning restoration of deferred gains after a water's-edge election (FTB Notice 1989-601.)

Although the methodology for treating intercompany transactions involving fixed assets and capitalized items is the same for federal and state purposes, differences may still result when the members of the consolidated return are different from the unitary group. For example, assume that Corporations A and B are both included in the federal consolidated return, but are not unitary. If A realizes a gain from an intercompany transaction with B, the gain will be deferred for federal purposes. Since B is not in the combined report, the gain will be currently taxable for California.

The by-company detail to the federal Form 1120 income computation will usually include an eliminations column. An analysis of the entries in this column should reveal whether intercompany income attributable to entities not included in the combined report has been deferred (it may be necessary to request the workpapers used to prepare the federal consolidated return in order to obtain enough detail to perform this analysis). The annual report or SEC Form 10-K may also disclose material transactions between related parties.

In addition to ensuring that current year transactions have been reported correctly, you should look for prior year deferrals that may require restoration in the current year:

Example: Assume that Corporations S and B are members of a combined report. In 1988, S sold an asset to B for an intercompany gain of $1 million. The gain was properly deferred. As a result of an audit of TYE 12/93, the FTB auditor determines that B is no longer unitary with the remainder of the group. The decombination is a triggering event that will require the restoration of the deferred gain for California. Since S and B are still included in the federal consolidated return, no restoration will be reported for federal purposes.

This issue may be difficult to identify. When you notice that a material intercompany gain has been deferred during the audit cycle, a note of the transaction should be made in the audit narrative so that future auditors can be on the lookout for a restoration event. The workpapers used by the taxpayer to track its federal deferred income account may also be useful in identifying this issue.

5280 OVERHEAD ALLOCATIONS, INTRA-GROUP CHARGES

Often, one corporation in an affiliated group will provide services to the other members of the group. A corresponding intercompany charge will generally be entered onto the books of the corporations receiving those services. This practice does not present a problem when all of the corporations are included in the combined report because the intercompany income and expense items will usually result in a wash (for example, the deduction for management fees charged to a subsidiary will be offset by the management fee income reported by the unitary parent). When one of the corporations is not a member of the combined report, the deduction of overhead allocations and other similar items may present an audit issue.

The discussion in this section focuses on allocating charges between corporations when one of those corporations is not included in the combined report. This is different from the issue of allocating the expenses of a single corporation between business and nonbusiness income, or between two or more nonunitary trade or business activities engaged in by that corporation. That issue is covered in MATM 4060.

Charges between related corporations are subject to the same criteria as any other deduction. They are deductible only if the taxpayer establishes that they are ordinary and necessary business expenses as defined by IRC §162 (See *Appeal of Jenkel-Davidson,* 81-SBE-101, May 19, 1981). With respect to interest expense, IRC section 163 operates to allow deductions only to entities incurring debt. Therefore, an intercompany interest charge is allowed only where there is an intercompany debt.

Interest expense incurred by one member of a group (on indebtedness to a third party) cannot be “assigned” to other affiliates.

The consolidating workpapers to the financial statements may reveal whether material intercompany charges exist between non-unitary affiliates. You may also be able to extract the intercompany charges from the general ledger summaries by identifying intercompany accounts from the taxpayer's chart of accounts. Since the existence of such charges is often an indication of unity, you should verify that the corporations are not in fact unitary before moving forward. Refer to MATM section 3000.

Once you have identified charges, you should question the taxpayer about its method for allocating the charges. If management agreements or written overhead allocation policies exist, you should request copies. Whether an allocation method is reasonable will depend upon the type of expense allocated. For example, it may be reasonable to allocate the costs of maintaining the parent's personnel department based upon the number of employees or the total compensation paid by each subsidiary. On the other hand, an allocation that was based upon sales or net income may not bear a reasonable relationship to the personnel services that were provided. If it appears that a problem may exist, you should ask the taxpayer to document the services or benefits that were actually rendered, and only allow a reasonable deduction to the extent that a corresponding benefit has been established.

If the charges to the subsidiaries were not reasonable in relationship to the benefits received, or if no payments were made for services that were received, then you might consider a reallocation under the authority of IRC §482 (R&TC §24725) to reflect an arm's length charge for such services. Such a reallocation may only be done if necessary to clearly reflect a taxpayer's income, and must be performed in accordance with the rules under Treasury Regulation sections 1.482-1 and 1.482-9. In general, the regulation requires that the allocations be consistent with the intended benefits of the services. The benefits must be direct enough that an unrelated party would have charged for the services, and they must not duplicate services that the subsidiary already provides for itself. Examples of these principles may be found in the regulation.

IRC §482 (and R&TC §24725) may only be invoked by the Commissioner (or by FTB). Its use is therefore subject to your discretion. A taxpayer may not compel FTB to use IRC §482 simply because it has changed its mind about how to allocate overhead items to its subsidiaries. For taxable years beginning after April 13, 1993, a limited exception to this rule will allow taxpayers to correct pricing problems by reporting the proper amount of income under IRC §482 on a timely filed return (Treas. Reg. §§ 1.482-1(a)(3), 1.482-1(e)(2)).)

Interest Expense

Under the provisions of Treasury Regulation §1.163-1, a deduction for interest expense is only allowed to the extent that it represents a charge arising under an interest-bearing obligation. An entity that has not incurred a debt is not entitled to an interest deduction. Therefore, intercompany interest charges are only deductible where there is a corresponding intercompany debt. Interest expense incurred by one member of a group cannot be assigned to other affiliates.

5300 PARTNERSHIP INCOME

CCR §25137-1 provides the rules for apportionment and allocation of partnership income and describes how the corporate partners take partnership income into account.

In accordance with the standard partnership rules set forth in Subchapter K of the Internal Revenue Code, the net income of a corporate partner will reflect that partner's distributive share of partnership items. In order to determine how the partnership items are to be treated on the corporate partner's return, you must first determine the business or

nonbusiness character of those items. Refer to MATM 4000. CCR §25137-1(a) provides that this determination is made at the partnership level. Partnership income arising from transactions and activity in the regular course of the partnership's trade or business will constitute business income to the partnership.

If the activities of the partnership are unitary with the activities of the corporate partner under established standards, disregarding the ownership requirement, then the partner's share of the partnership business income is included in the partner's business income. The partner's share of the property, payroll and sales of the partnership are also reflected in that partner's apportionment factors (see MATM 7195 (property), MATM 7360 (payroll) and MATM 7570 (sales)).

On the other hand, if the partnership has business income but the activities of the partnership and the partner are not unitary, then CCR §25137-1 (g) provides that the corporate partner is considered engaged in two separate business activities. The partnership income would be apportioned separately using only the partnership factors (See MATM 5340 and examples illustrating this concept in CCR §25137-1(g)). This treatment applies whether the taxpayer is a general or limited partner.

The SBE has approved of CCR §25137-1 and has determined that the regulation should be applied to apportioning and allocating partnership income for years to which UDITPA is applicable (*Appeal of Saga Corp.,* 82-SBE-102, June 29, 1982). On occasion, even in years after the Board's decision in *Saga,* the SBE has characterized income from a nonunitary partnership as being allocable outside of the state under authority of R&TC section 23040, e.g. *Appeal of Peel Construction,* 87-SBE-007, January 6, 1987, and *Appeal of W.R. Thomason,* 87-SBE-25, March 3, 1987. However, in *Appeal of Holiday Inns,* 86-SBE-074, April 9, 1986, the Board held that R&TC §23040 has no application to the extent that UDITPA applies.

In *Peel Construction* and *W.R. Thomason,* whether the partnership distributive income was characterized as allocable under R&TC §23040 or as business income from a separate trade or business conducted entirely outside of the state under CCR §25137-1 would have had no effect on income apportioned or allocated to California. In either case, the income would be wholly assigned to an out-of-state location. However, the R&TC §23040 analysis of these cases should not be applied, and CCR §25137-1 should be applied instead. It is particularly important to do so if the nonunitary partnership is conducting its trade or business within and without California. In that case, the income of the partnership would be subject to apportionment as a separate apportionable trade or business, not as an allocable activity. The taxpayer's distributive share of that income, apportioned at the partnership level, would be aggregated with any California source apportioned business income or nonbusiness income in determining the taxpayer's income subject to tax.

CCR §25137-1 does not distinguish between general and limited partnerships. However under partnership law a limited partner, in order to retain its capacity as a limited partner, ordinarily cannot participate in the control of the limited partnership business. (Cal. Corp. Code § 15903.03.) Unless the general partner of a limited partnership is a member of the limited partner's commonly controlled group, unity between the limited partnership and its limited partners based upon strong central management grounds is highly unlikely. If the limited partnership shares significant operational ties with the limited partner, CCR §25137-1 does not preclude combination of the partner's share of distributive income from the partnership with the partner's trade or business. If the limited partnership and partner are not unitary, the income from the partnership is considered income from a separate trade or business of the partner and separately apportioned. (See *Appeal of Gasco Gasoline, Inc.,* 88-SBE-017, June 1, 1988, where the SBE held that limited partnership interests in oil and gas drilling operations were not unitary with the taxpayer.)

The allocation of income or loss, which is characterized as nonbusiness at the partnership level, is discussed at MATM 4040.

Normally, a corporate partner's net income and apportionment factors will include its share of partnership items for any partnership year ending within or with the partner's taxable year (CCR § 25137-1(a) and CCR § 25137-1(f)). If necessary, in order to avoid distortion, CCR §25137-1(f)(5) states that partnership income and factors may be fiscalized on the basis of the corporate partner's taxable year. As with most other situations involving distortion, the burden of proving that distortion exists will be on the party seeking the benefit of the fiscalization provision. In cases where distortion can be established, the computations necessary to fiscalize the partnership items will be similar to those covered in MATM 5200.

The detail to the federal Form 1120, line 10 “Other Income” will often identify partnership income or loss. Material partnership interests may also be disclosed in the annual reports, *SEC Form 10-Ks*, or in the notes to the financial statements. You should be aware that joint ventures can operate either in partnership form or corporate form. If operated in partnership form, the unity of ownership test is not applicable, and the partnership rules discussed in this

section apply. If operated in corporate form, the joint venture is treated the same as any other corporation, and is combinable only if the unity of ownership test is met.

For additional criteria to consider when the partnership takes the form of a working interest in oil and gas drilling operations see MATM 4053.

5310 RAR ADJUSTMENTS

If a federal audit has been performed, it may be necessary for you to modify net income to reflect the federal adjustments. Procedures for handling RARs and guidelines regarding the weight to be given to federal audit adjustments are covered in MAP 16-3.

Before picking up the federal adjustments, you should consider whether the adjustments are applicable under state law. It is important for you to verify that the federal RAR does not include adjustments attributable to corporations that are not included in the combined report. Adjustments to items such as state income tax expense or federal NOL deductions will not be applicable for California. Adjustments to dividend income may or may not be applicable to California depending upon whether the dividend is subject to intercompany elimination for state purposes. Although federal changes to Subpart F income will not affect worldwide filers, those changes may lead to revisions in the percentage of a controlled foreign corporation's income and factors that are includable in a water's-edge return. You should analyze the RAR adjustments in conjunction with the taxpayer's state adjustments to ensure that the state adjustments are consistent with revised federal income.

You may need to review the detail of material RAR adjustments to determine whether those adjustments are applicable for California. For example, because California does not generally conform to federal depreciation methods, federal changes to the taxpayer's depreciation computations may not apply for state purposes. On the other hand, a review of the detail underlying a federal depreciation adjustment may reveal that the depreciation was revised because of an adjustment to the cost basis of the asset. If the reasons for revising the cost basis are applicable to California, than the state depreciation deduction should be revised accordingly.

RARs may include IRC §482 transfer pricing adjustments to reallocate income or deductions between members of a commonly controlled group. This type of adjustment might be necessary based on the application of the arm's-length standard if prices charged in transactions between related parties do not reflect arm's-length prices. For worldwide filers, the corporations at both ends of the intercompany transactions will usually be in the combined report, so the federal IRC §482 adjustments will generally have a wash effect for state purposes and the combined net income will remain the same. The IRC §482 adjustments will have an effect on the earnings and profits of each party to the transaction. Collateral adjustments may also be identified on the RAR as correlative or conforming adjustments. As an example of a collateral adjustment, assume that the IRS determines that a U.S. subsidiary paid inflated prices for inventory and equipment purchased from its foreign parent. The RAR might increase the U.S. subsidiary's taxable income, recharacterize a portion of the payments as a dividend, and reduce the basis of the equipment. The basis reduction would lead to a correlative adjustment to reduce the allowable depreciation adjustment.

When federal IRC §482 adjustments are made involving a taxpayer that is a California water's-edge filer, while the IRC §482 adjustment does affect both sides of the related-party transaction, only one of the entities might be in the water's-edge group if the foreign entity is excluded from the water's-edge combined report due to the water's-edge election. However, in some situations the foreign entity might be partially or fully included in the water's-edge group. When you deal with a water's-edge filer, all collateral adjustments should still be taken into account as well as the effect on earnings and profits for both sides of the related-party transaction, even if one of the entities is excluded from the water's-edge combined report.

More detail regarding IRC §482 adjustments and collateral adjustments can be found in Chapter 18 of the Water's-Edge Manual. The effects of IRC §482 and related collateral adjustments on earnings and profits are discussed in Chapter 11, Water's-Edge Manual.

5320 TRANSLATION OF FOREIGN CURRENCY

5325 Realized & Unrealized Currency Gains & Losses

When operations are conducted in foreign countries, it is usually necessary to translate income into U.S. dollars. The method used to perform the translations is set forth in CCR §25106.5-10 (formerly CCR sections 25137-6 and 25106.5-3). In general, the procedures are as follows:

Each foreign branch or corporation should prepare its profit and loss statements in the currency in which it maintains its books of account, usually the local currency, also called the functional currency. (CCR §25106.5-10(b)(1)(A).)

The above profit and loss statements must be adjusted to conform to U.S. GAAP and to California tax accounting standards. (CCR §25106.5-10(b)(1)(B), See MATM 5145.)

The profit and loss statements for each branch should then be translated into the currency in which the parent company maintains its books. For domestic parents, the profit and loss statements would be translated into U.S. dollars. For foreign parents, each subsidiary, including the U.S. subsidiaries, would translate their profit and loss statements to the currency of the foreign parent. (CCR §25106.5-10(b)(1)(D).)

The property, payroll and sales factors should be calculated in the currency of the parent corporation. The resulting apportionment percentage will also reflect the parent corporation's currency. (CCR §25106.5-10(c)(1)(E) and (2)(C).)

CCR §25106.5-10(b)(2) provides that in lieu of the procedures set forth in CCR §25106.5-10(b)(1), the FTB may allow a corporation to determine its income on the basis of the consolidated profit and loss statement prepared for SEC or shareholder reporting purposes. Adjustments may be required to conform the consolidated profit and loss statement to GAAP and California accounting standards, and to eliminate unrealized translation gains/losses.

If the parent corporation's currency is other than U.S. dollars, California income should be translated back to U.S. dollars after allocation and apportionment. (CCR §25106.5-10(b)(2)(E).)

Exhibit H contains an example of audit schedules that cover these steps. In addition, the PASS schedules provide for these computations.

Exchange Rates

The necessary translations should be made at the following exchange rates (CCR §25106.5-10(b)(4) CCR §25106.5-10(c)):

• **Depreciation:** Depreciation, depletion or amortization shall be translated using the historical rate for the period in which the cost of the asset was incurred.

• **Dividends:** Dividends or income otherwise repatriated during the year are translated at the exchange rate at the date of repatriation.

• **All other income and expense items** are translated at either the end-of-year exchange rate or at the simple average exchange rate for the period.

• **Property factor:** Fixed assets are translated at the exchange rate as of the date of acquisition. After the annual rental rate of rented property is capitalized by eight, it is translated using the simple average rate for the period.

• **Payroll and Sales factors:** Payroll and sales are translated using the simple average exchange rate for the period. An exception will occur if the closing rate for any month ending within the period varies by more than 10 percent from the closing rate for any preceding month within the period. In such a case, the appropriate exchange rate would be either a simple average of month-end rates, or a weighted average that takes into account the volume of transactions for the months within the period.

The regulation states that the exchange rates may be derived from any source that reflects actual transactions of representative amounts conducted in a free market. If the taxpayer is unable to demonstrate that its source meets this criteria, the rates should be determined by reference to the free market rate. (CCR §25106.5-10(d)(1).) You can verify exchange rates via the sites linked to the MSA webpage.

Translation Under GAAP

For U.S. financial accounting purposes, FASB 52 covers translation of foreign currency. As a general rule, FASB 52 utilizes the weighted average exchange rate for the period for translating all revenue and expense items, and the current rate at the balance sheet date for translating assets and liabilities. Exceptions to this general rule apply (1) for remeasurement of local branch operations into the “functional currency” of the foreign entity; and (2) for entities

operating in hyperinflationary economies. For these limited exceptions, assets, liabilities, depreciation and other asset-related items are translated at historical rates.

When using GAAP financial statement income as a base for determining net income for California, you should be aware of the following differences between GAAP and California tax translations:

• The financial statements translate depreciation at current exchange rates, while CCR §25106.5-10(b)(4)(A) requires translation at the historical rates for the period in which the asset was acquired. In determining the tax potential associated with this issue, you should consider the materiality of the foreign depreciation expense, and whether the exchange rates have fluctuated significantly over the period in which the assets were owned. The practicality of obtaining the information necessary to calculate the adjustment should also be taken into account.

• Balance sheets prepared in accordance with GAAP will generally present property at current exchange rates rather than at the historical rates required under CCR §25106.5-10(c)(1)(A) for property factor purposes. Depending upon the significance of the foreign assets in the factor and the stability of the exchange rates over the life of the assets, using book translations in the factor may affect the apportionment factor. Again, you should weigh the materiality of the adjustment against the practicality of obtaining the necessary information before pursuing this issue.

The remeasurement of hyperinflationary currencies and branch income under GAAP may result in the inclusion of unrealized translation gains and losses in net income. Foreign currency transactions that are not settled as of the balance sheet date may also result in unrealized gains or losses under GAAP. This issue is discussed below in MATM 5325.

The translation rules are very complex, and there are exceptions to the general rules stated above. If you are faced with a material translation issue, it may be helpful to research FASB 52 and related accounting pronouncements on the subject. For foreign financial statements, the accounting practices of the foreign country should be researched. Refer to Exhibit J.1 and J.2 for research tools.

Prior to 1982, FASB 8 determined currency translation under GAAP. The rules under FASB 8 allowed both realized and unrealized translation items to be included in income. See FTB Bank & Financial Handbook Section 0440 for a summary of the FASB 8 provisions.

Federal Treatment:

The federal rules for translation of foreign currency transactions are found in IRC sections 985-989. The methodology is substantially the same as FASB 52, although special federal rules apply with respect to translating operations in hyperinflationary economies (Treas. Reg. § 1.988-2). The issues discussed above with respect to GAAP/California differences will also be applicable when the income of foreign entities in the combined report is based upon the federal Forms 5471 Information Return of U.S. Persons With Respect to Certain Foreign Corporations.

5325 Realized & Unrealized Currency Gains & Losses

Only realized currency gains and losses are recognized for tax purposes. Unrealized gains and losses from currency translation and balance sheet restatements are not taken into account. (CCR §25106.5-10(a)(2).)

Realized currency gain and losses result from completed transactions. They occur when the exchange rate changes between (1) the time a purchase or sale in a different currency is consummated and (2) the time of actual payment or receipt. Unrealized gains or losses result from translations of assets and liabilities. The difference between realized and unrealized gains and losses is illustrated in the following example:

Example: USA Corporation is a calendar year taxpayer. On November 1, 2005, USA Corp purchases a machine from a German supplier under the following terms:

Purchase DM 171,100

Price:

Delivery: The machine is received and placed in service on November 1, 2005.

Payment Date: Payment is due in the German supplier's functional currency (DM) on May 1, 2006.

On November 1, 2005 (the date that title to the machine passed to USA Corp), the exchange rate was DM 1.711 = US $1. At this exchange rate, the cost of the machine to USA Corp was US $100,000 (DM 171,100/1.711). The following journal entry would be made on USA Corp's books to record the transaction:

Machinery	100,000
Accounts Payable	100,000

As of USA Corp's year-end on December 31, 2005, the exchange rate had fluctuated to 1.7263. If USA Corp were to pay its liability to the supplier on that date, its cost would be US $99,114 (DM 171,100/1.7263). The difference between USA Corp's recorded cost of $100,000 and the $99,114 is $886. If USA Corp were to restate its liability to reflect the current translation, an unrealized gain of $886 would result. Since the transaction has not been completed, the unrealized gain is not relevant for tax purposes.

On May 1, 2006, the exchange rate was 1.6412. USA Corp paid US $104,192 to satisfy its liability to the supplier (DM 171,000/1.6412). The $4,192 excess of the amount paid over the $100,000 cost basis of the machinery is a realized currency transaction loss, and may be deducted for tax purposes. Deduction of this loss will not affect the $100,000 cost basis used for depreciation and property factor purposes.

For GAAP purposes, a transaction that requires settlement in a currency other than the entity's functional currency is termed a “foreign currency transaction.” The transaction in the above example is a foreign currency transaction. Financial statements prepared under GAAP will recognize exchange gains or losses on foreign currency transactions outstanding as of the balance date, even though the gain or loss is not yet realized.

Example: Assume the same facts as in the above example. For financial statement purposes, the $886 gain would be recognized in 2005. In 2006, USA Corp would recognize a $5,078 loss ($104,192 - $99,114). Schedule M-1 or M-3 adjustments would be required in 2005 and 2006 to reflect the book/tax timing differences.

Under the general rule, GAAP does not include unrealized gains and losses from balance sheet translations in income, but reports these as a separate component of stockholder's equity. With respect to operations in countries with hyperinflationary economies, both GAAP and federal translation methods include unrealized translation gains and losses in income. Economies are considered to be hyperinflationary when there is more than 100 percent inflation over a three-year period. Countries in Central and South America, Africa, and Eastern Europe will frequently fall into this classification. Under GAAP, unrealized gains and losses resulting from the remeasurement of local branch operations into the functional currency of the foreign entity may also be included in net income.

The notes to the financial statements will usually identify any material unrealized translation gains and losses. A review of the tax returns may also disclose translation or currency gains and losses. Commonly, they will be reported as “other income” or “other deductions,” however they may be included in virtually any income or expense category. Unless the gains and losses are identified as unrealized, an analysis of the translation adjustments will usually be necessary in order to determine whether the amounts are properly includable in income.

It is common for realized and unrealized gains and losses to be netted together on the tax return. The workpapers supporting the financial statements should show how the exchange gain or loss was determined on a country-by-country basis. By analyzing this information, you can determine whether unrealized gains or losses were recognized. When determining the materiality of an adjustment, you should consider the fact that the difference between realized and unrealized exchange gains or loss is often just timing. If an unrealized exchange loss is disallowed in one year, an adjustment may be necessary to allow the loss in a subsequent year when the loss becomes recognized.

5340 TWO OR MORE BUSINESS ACTIVITIES

The Regulations recognize that a taxpayer may be engaged in more than one business activity (CCR §25120(b)). This may occur when one corporation has two operating divisions that are so distinctly separate that no contribution or dependency exists between the divisions. If the divisions are determined under established standards to be non-unitary, then separate combined report computations must be made to compute the business income and apportionment factors for each.

You must first identify the income and factors for each business activity. Since taxpayers that operate on a divisional basis will generally keep separate accounts for each division, income and expenses that are directly attributable to a division will usually be easy to identify. Corporate overhead expenses, such as executive salaries, utilities, rent and similar items which cannot be directly attributed to any single division should be allocated to the separate divisions in a manner which fairly distributes the deduction among the classes of income (CCR §25120(d)). Not all such expenses must be allocated by the same method. Gross receipts may be an appropriate basis for allocating expenses such as executive salaries. Square footage of floor space might be a better basis to use for the allocation of building expenses. In general, any method of proration, which is reasonable under the circumstances, will be allowable.

The overhead allocation described herein is different from the overhead issues discussed in MATM 5280. That section dealt with overhead charges between entities, while this discussion deals with overhead incurred within a single entity.

After the business income of each separate trade or business is determined, the apportionment factors applicable to that trade or business are computed. A separate apportionment computation is performed for each trade or business to derive the amount of income attributable to this state. The apportioned California income for each trade or business is netted together and adjusted by any nonbusiness income or loss to arrive at the final measure of tax for California.

Example: Corporation W has two operating divisions engaged in unrelated business activities. The divisions are determined to be non-unitary. Corporation W's income apportioned and allocated to this state is computed as follows:

	Division A	Division B
Business income attributable to each division:	1,000,000	-500,000
Apportionment Factor	X 50%	X 30%
	--------	--------
Business income (loss) apportioned to California:	500,000	-150,000
Net Divisions A and B	350,000	
Add nonbusiness income	75,000	

Corporation W's net income for California:	425,000	

Multiple business activities conducted by more than one corporation

When more than one corporation is involved, the computation of California income from two or more separate trades or businesses becomes a little more complex. The basic computation is made in the same manner as illustrated above. For example, assume Parent Corporation has two divisions: one is engaged in manufacturing paint, and one operates a chain of retail appliance stores. The divisions are not unitary with each other. Subsidiary Corporation manufactures appliances, and is unitary with Parent Corporation's appliance division, but not with the paint division. The steps for computing California net income are as follows:

• Business income and factors attributable to Parent Corporation's two divisions are segregated and computed. Subsidiary Corporation's business income and factors are computed.

• Business income attributable to Parent's paint division is apportioned based upon the paint division's separate apportionment factors.

• Subsidiary Corporation's business income is combined with the business income of Parent's appliance division, and the combined total is apportioned based upon the combined factors for the appliance trade or business. Intrastate apportionment is applied to determine the portion of the California income attributable to Subsidiary and to Parent.

• Subsidiary Corporation will report its intrastate apportioned share of income from the appliance business (adjusted by any nonbusiness income or loss).

• Parent Corporation will net its intrastate apportioned share of income from the appliance business with the apportioned income from the paint division, and apply any nonbusiness income or loss. The net result will be Parent's net income apportioned and allocated to California.

Revised: December 2013