FTB NOTICE
California Franchise Tax Board - Legal Branch

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February 21, 1997

FTB NOTICE 97-2

SUBJECT: COMBINED REPORTING TREATMENT OF PARENT'S GAIN FROM NONDIVIDEND DISTRIBUTIONS IN EXCESS OF BASIS

The Franchise Tax Board ("FTB") has received numerous inquiries regarding taxation under existing California Bank and Corporation Tax Law of a nondividend distribution from a unitary subsidiary to its parent in excess of the basis of the stock. The purpose of this Notice is to advise the public of the potential to defer recognition of this income pursuant to the execution of a closing agreement with the Franchise Tax Board under Section 19441, Revenue and Taxation Code.

Discussion

If a nondividend distribution with respect to stock exceeds the basis of the stock, Internal Revenue Code (IRC) Section 301(c)(3) (applicable to California under Section 24451, Revenue and Taxation Code) provides that the excess is treated as income from the sale of property. However, if the distribution occurs between members of a consolidated return group, the federal consolidated return regulations defer such income by placing it in an excess loss account (Treas. Reg. Sections 1.1502-13 and 1.1502-19).

At present, California has no rules for deferral of income recognized from a distribution in excess of basis between members of a combined report. For California purposes, distributions between corporations are generally currently recognized under the code, whether or not the members are unitary (Safeway Stores v. Franchise Tax Board (1970) 3 Cal.3d 745), except where expressly provided to the contrary (e.g., Section 25106, Revenue and Taxation Code). On the other hand, income from intercompany sales between members of a combined reporting group is generally not currently subject to taxation. Instead, income from intercompany transactions is either eliminated and the basis of the asset is transferred to the purchaser or, in the case of fixed assets and capitalized items, the income is deferred and restored when there is a disposition of the asset, as the asset is depreciated, or when a party to the intercompany transaction leaves the combined reporting group. (See FTB Publ. 1061, Guidelines for Corporations Filing a Combined Report.)

The Franchise Tax Board is drafting regulations under Section 25106.5, Revenue and Taxation Code, which would prospectively provide for a deferral system for income from distributions between members of a combined report when the distribution exceeds stock basis. The policy support for the regulation is that intercompany transaction income should not be currently subject to taxation if it does not enhance the economic position of the combined group as a whole, so long as the members remain in the combined report.

Currently, there is no mechanism in California unitary law which provides for either deferral of such income or its restoration. Thus, the only means to create a deferral mechanism and a binding restoration counterpart is by closing agreement. In order to effect such a deferral for any year open to the state of limitations, taxpayers may request a closing agreement with the Franchise Tax Board under Section 19441, Revenue and Taxation Code.

Requests for closing agreements must be in writing and should describe the parties to the transaction including federal identification numbers, the nature of the distribution, the timing and amounts of the income involved, and any other relevant facts. Requests must be made within one year from the date of this notice or before the due date of the return for the year of the distribution, whichever is later.

Requests for closing agreements should be mailed to the following address:

California Franchise Tax Board - Legal Branch
Multistate Tax Bureau
Attn: Glenn Rigby
P. O. Box 1720
Rancho Cordova, CA 95741-1720

Drafting Information

The principal author of this notice is Cody C. Cinnamon of the Franchise Tax Board, Legal Branch. For further information regarding this ruling, contact Ms. Cinnamon at the Franchise Tax Board, Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720.