ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

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Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	02-23-2001
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SUBJECT: Insurance Dividend Deduction/Remove Commercial Domicile Limitation on Dividend Receipts

SUMMARY

This bill would allow all corporations a deduction for dividends received from an insurance company subsidiary.

PURPOSE OF THE BILL

The purpose of this bill appears to be to remove a limitation on the deduction for dividends received from an insurance company subsidiary that was recently found unconstitutional by the California Court of Appeal.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed to resolve how dividends received from an insurance company subsidiary should be treated since the statute has been found to be unconstitutional. See “Implementation Considerations” below.

ANALYSIS

BACKGROUND

Generally, Section 24410 of the Bank and Corporation Tax Law (B&CTL) allows only corporations domiciled in California to claim a deduction for dividends received from an insurance company subsidiary subject to the gross premiums tax. The amount deductible is limited according to a formula based upon the subsidiary's gross receipts, payroll, and property within California.

On December 21, 2000, the California Court of Appeal ruled in *Ceridian Corp. v. Franchise Tax Board* (2001) 85 Cal App 4th 875 (modified 86 Cal App 4th 483(g)), that the deduction for dividends received by corporations domiciled in California from insurance company subsidiaries is unconstitutional.

Board Position:			Department Director	Date
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There are differing views on whether or how the deduction for dividends received from insurance company subsidiaries should be applied after *Ceridian*. Department staff and the Franchise Tax Board are currently reviewing this issue. Although the Franchise Tax Board considered the *Ceridian* decision at its May 2, 2001, meeting. The Board deferred action until its next meeting to provide time for department staff and industry to provide more information.

FEDERAL/STATE LAW

Federal law allows a deduction for dividends received from a domestic corporation that is subject to income tax. The deduction is subject to specific reductions and limitations. Generally, the amount of the deduction is determined by the percentage of ownership as follows:

- 100% deduction is allowed when received from a corporation that is a member of the same affiliated group (generally, 80% or more common ownership).
- 80% of the deduction is allowed when received from a corporation that is 20% but less than 80% owned.
- 70% of the deduction is allowed when received from a corporation less than 20% owned.

Federal law does not allow a deduction for dividends received from a foreign corporation unless the foreign corporation is wholly owned and has only effectively connected U.S. source income. If a domestic corporation owns 10% or more of a foreign corporation, it can elect to receive a tax credit for taxes paid to the foreign country.

Federal law does not contain business/nonbusiness income concepts because those concepts were developed by the states in response to constitutional limitations on state taxation. Therefore, there is no requirement under federal law to make expense allocations between business and nonbusiness income. Federal law does make expense allocations between foreign (non-U.S.) and domestic income and, by regulation, uses methods similar to those provided for in Regulation Section 25120(d) of title 18 of the California Code of Regulations.

Under California law, corporations deriving income from sources both within and outside California are required to measure their California tax liability by reference to their income derived from or attributable to sources within California. The amount of income derived from California is calculated by first characterizing income as business and nonbusiness.

To determine the portion of *business* income that is attributable to California, an apportionment formula is used. For most corporations, this formula is worldwide income multiplied by the average of the factors of property, payroll, and double-weighted sales. Each of these factors is the ratio of in-state activity to worldwide activity. Business income assigned to California is determined by multiplying total business income by the average California apportionment percentage.

Nonbusiness income is all income that is not *business* income and it is assigned by statute to a specific state. *Nonbusiness* income from intangible property is generally allocated to the taxpayer's commercial domicile. *Nonbusiness* income from tangible property is generally allocated to the physical location of the property.

California Regulation Section 25120(c)(4) applies the transactional/functional tests to determine the classification of dividend income as business or nonbusiness income. Under these tests, dividends are *business income* when (1) the stock was acquired in the regular course of the taxpayer's trade or business operations, or (2) the purpose for acquiring and holding the stock is related to or incidental to the trade or business operations.

Thus, dividends are *business income* when the stock from which those dividends are derived is held in the ordinary course of business, such as by a stockbroker. Generally, dividends also will be *business income* if they are derived from stock held as current assets or excess working capital. More recently, dividends have been considered to be *business income* when the stock is held for a purpose that furthers the unitary business operations, such as when stock of a supplier is held in order to ensure a steady source of raw materials. (*Appeal of Standard Oil Company of California*, Cal. St. Bd. of Equal., March 2, 1983.)

Generally, dividends are *nonbusiness income* when the stock is held as an investment unrelated to the taxpayer's trade or business activities.

Existing state law (B&CTL Section 25126) provides that *nonbusiness* dividend income is allocated to the taxpayer's commercial domicile.

Existing state law (B&CTL Section 24402) allows a deduction for a portion of any dividends received that are paid out of income that was subject to either the franchise tax, the alternative minimum tax, or the corporation income tax in the hands of the paying corporation. The intent of this law is to avoid double taxation of corporate income at the corporate level.

Under the statute reviewed in *Ceridian* (B&CTL Section 24410), corporations commercially domiciled in California are permitted to deduct dividends received from an insurance company subsidiary operating in California that is subject to the gross premiums tax. The deduction is allowed if at least 80% of each class of stock of the insurance company is owned by the parent corporation. The deduction is based on the portion of the dividend attributable to California sources, determined by applying a special three-factor formula based upon the subsidiary's gross receipts, payroll, and property within California.

The purpose of Section 24410 is to provide relief from double taxation similar to the relief provided to general corporations under the dividends received deduction of Section 24402.

Ceridian Case

The taxpayer in *Ceridian* challenged the limitation on the deduction for dividends received from insurance company subsidiaries set forth in B&CTL Section 24410. *Ceridian* was denied the deduction because the corporation was domiciled outside of California.

The California Court of Appeal ruled that the deduction for dividends received by holding companies from insurance company subsidiaries under B&CTL Section 24410 is unconstitutional for two reasons. First, it violated the commerce clause by allowing a deduction for insurance company dividends only to corporations domiciled in California. Second, it violated the commerce clause because the amount of the deduction is limited according to a formula based on the subsidiary's gross receipts, payroll, and property within California.

<u>THIS BILL</u>

This bill would remove provisions that prohibit corporations that are commercially domiciled outside of California from deducting dividends received from an insurance company subsidiary subject to the gross premiums tax. Thus, all corporations would be permitted to deduct such dividends regardless of where they are commercially domiciled.

This bill would also make minor technical amendments to B&CTL Section 24402 and 24410.

<u>IMPLEMENTATION CONSIDERATIONS</u>

Although this bill would remove a limitation that was held to be unconstitutional, it does not address whether or how the deduction for dividends received from insurance company subsidiaries should be applied after *Ceridian*. Department staff and the Franchise Tax Board are currently reviewing this issue. Once the Franchise Tax Board has approved the policy direction regarding this issue, department staff will provide the author with suggested amendments.

LEGISLATIVE HISTORY

SB 1229 (Committee on Revenue and Taxation, Stats. 1999, Ch. 987) and *SB 2171 (Committee on Revenue and Taxation, 1999/2000)* both contained provisions to remove “commercial domicile” from B&CTL Section 24410. SB 1229 was tied to SB 1125 (a bill that would have allowed corporations to deduct interest expense attributable to dividends that are received from an insurance company subsidiary and are excluded from income), so that if only SB 1229 were enacted, only technical changes would be made. SB 1125 was vetoed on October 10, 1999; thus, SB 1229 made only technical changes to B&CTL Section 24410. SB 2171 was held in the Senate Appropriations Committee.

OTHER STATES’ INFORMATION

Information regarding how *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York* treat dividends received from insurance company subsidiaries could not be found. The laws of these states were reviewed because their tax laws are similar to California’s income tax laws.

Review of *Florida, Illinois*, and *New York* laws found the following general information regarding deductible dividends.

Under *Florida* and *Illinois* laws, corporate income is determined by making adjustments to federal taxable income. Thus, the corporation is allowed the federal dividends received deduction. Some modifications are made to federal amounts if the amounts include Internal Revenue Code Section 78 dividends or dividends from foreign subsidiaries.

Under *New York* law, the federal deduction for dividends received is not allowed. However, 50% of all dividends from corporations other than from subsidiaries that were used in computing federal taxable income are allowed as a deduction.

FISCAL IMPACT

Implementing this bill would not affect the department's programs and operations.

ECONOMIC IMPACT

The baseline for determining the revenue impact of this bill depends how or even if the deduction for dividends received from insurance company subsidiaries should be applied after *Ceridian*. Currently, there is no clear direction on how the deduction should be applied. Until clear direction is provided, the revenue impact cannot be determined.

LEGISLATIVE STAFF CONTACT

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