Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Oropeza | Analyst: Marion Mann DeJong | Bill Number: AB 263

Related Bills: See Prior Analysis | Telephone: 845-6979 | Amended Date: 03/25/2003

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Dividends Received Deduction/Ceridian Issue

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

____ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

__X__ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO _____.

__X__ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 4, 2003, STILL APPLIES.

____ OTHER - See comments below.

SUMMARY

This bill would specify how to apply the tax statute allowing a deduction for dividends received from an insurance company after the statute was found unconstitutional in the *Ceridian* decision.

SUMMARY OF AMENDMENTS

The March 25, 2003, amendments made modifications to how the deduction for dividends received from an insurance company would apply and made changes to the legislative intent language.

Except for the "This Bill," "Implementation Considerations," "Technical Considerations," and "Legal Considerations" discussions in the department's analysis of the bill as introduced February 4, 2003, the prior analysis still applies.

New "This Bill," "Implementation Considerations," "Technical Considerations," and "Legal Considerations" discussions are provided below. The Board position remains pending.

Summary of Suggested Amendments

Amendments are needed to resolve the department's implementation concerns regarding the election. Department staff is available to assist the author with the amendments. In addition, amendments are provided to resolve the department's technical considerations. See "Implementation Considerations" and "Technical Considerations" below.

Board Position:			Legislative Director	Date
_____ S	_____ NA	_____ NP	Brian Putler	04/04/03
_____ SA	_____ O	_____ NAR		
_____ N	_____ OUA	__X__ PENDING		

THIS BILL

This bill would repeal and reenact Revenue and Taxation Code (RTC) Section 24410 to allow taxpayers that own 80% or more of a subsidiary engaged in an insurance business a deduction for an unspecified percentage of dividends received from that subsidiary. The deduction would be allowed regardless of whether the insurance company is engaged in business in California. The deduction would apply to taxable years beginning on or after January 1, 2003.

For taxable years ending on or after December 1, 1997, and beginning before January 1, 2003, a taxpayer could elect to deduct an unspecified percentage of dividends received from an insurance company subsidiary. To make the election, the taxpayer must:

- timely file, within 180 days of the effective date of this bill, amended returns for all tax years within the period,
- expressly elect to be subject to the dividends received deduction and the percentage provided by statute with respect to dividends that are business income, and
- report and remit all amounts due pursuant to the election.

For purposes of determining taxable income for the taxable years for which an election could be made (beginning on or after December 9, 1997 and before January 1, 2003), RTC Section 24425 would not apply to any expense related to Section 24410 dividends. Thus, taxpayers would not be required to reduce any expenses related to the Section 24410 dividends.

The election would be irrevocable once made and would apply to all taxable years within the period.

The bill also would make the following legislative declarations:

- The amendments to Section 24410 serve a public purpose and are necessary to provide for the equitable tax treatment of insurance company dividends in light of: (1) the *Ceridian* decision held that Section 24410 violates the Commerce Clause of the United States Constitution, (2) that insurance company dividends do not qualify for a deduction under Section 24402 and are not eligible for elimination from income as provided for in Section 25106, and (3) that a number of corporations filed returns claiming deductions for all or part of the dividends they received from insurance subsidiaries because of uncertainty following the *Ceridian* decision.

- The amendments to Section 24410 serve a public purpose and are in furtherance of the public interest in avoiding the unanticipated denial of a deduction for insurance company dividends. Denial of this deduction would have a detrimental effect upon the economy of California.

- The retroactive application of the amendments to Section 24410 serve the public purpose and promotes sound tax policy by affording equitable tax relief to taxpayers that relied upon Section 24410 in expectation that they would be entitled to a deduction with respect to a portion of the dividends received from insurance companies.

- Section 24425 denies a deduction with respect to any amount otherwise allowable as a deduction that is allocable to a class of income that is not included in the measure of tax. The department contends that where a taxpayer claims a dividend received deduction for insurance company dividends, expenses incurred to produce income not included in the measure of tax are disallowed under Section 24425. In contrast, the industry contends that Section 24425 does not apply.

- The amendment to Section 24410 that declares Section 24425 to be inapplicable to the dividends received deduction for tax years ending on or after December 1, 1997, and before January 1, 2003, represents an integral part of the legislative resolution to the uncertainty created by the *Ceridian* decision, and accordingly furthers the same valid public purposes identified above.

- No inferences should be made with respect to the application of Section 24425 to the dividends received deduction for taxable years ending before December 1, 1997, or beginning on or after January 1, 2003.

- The tax treatment of insurance company dividends as provided by this bill is unrelated to and distinguishable from the tax treatment of the deduction of general corporate dividends under Section 24402 and the application of Section 24425 to those deductions.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill should not significantly impact the department's programs and operations. However, there is some uncertainty regarding the election that could cause disputes between taxpayers and the department if the election is not clarified. Clarification should be provided for the following issues:

- The election applies to taxable years ending on or after December 1, 1997, and beginning before January 1, 2003. It is unclear whether this election overrides the normal statute of limitations. For example, if the 1998 tax year is closed by the normal statute of limitations, can a taxpayer make this election? Would the requirement that an amended return be filed within 180 days of enactment of this bill override the normal filing deadline for the 2002 tax year? Clarification of this issue would ensure that the bill is implemented as the author intended and would prevent disputes between taxpayers and the department.
- It appears that the taxpayer must make the election for *all* tax years between 1997 and 2003. However, the bill requires a separate amended return for each year. This may cause confusion regarding whether the election must be made consistently for all years.
- Failure to remit the full amount of tax underpayment would void the election. It is unclear whether this would include penalties and interest. Further, it is unclear whether the election could be made if the taxpayer originally claimed no deduction and amending the return to claim a percentage of the deduction indicates a refund is due.
- The provisions of the bill with respect to the dividends received deduction for the 1997 to 2003 period provides a flat percentage deduction, whether or not the dividends constitute business income. However, other provisions applicable for that same period require an electing taxpayer to agree that dividends that constitute business income are deductible only in the percentage provided. While the latter provision does not diminish the percentage deductible, this reference to dividends that are business income creates ambiguity with respect to the author's intent for this provision.

In addition, this bill would impact cases that are currently pending before the Board of Equalization, see "Legal Impact" below.

TECHNICAL CONSIDERATIONS

Amendments 1 and 2 would make subdivision (b) of Section 24410 consistent with subdivision (a) and provide relief with respect to the same type of dividends received for taxable years commencing on or after December 1, 1997 and before January 1, 2003, as to those dividends entitled to relief for taxable years beginning on or after January 1, 2003.

Amendment 3 would delete redundant language.

Amendment 4 would correct an awkward sentence.

Amendment 5 would replace a word with the correct form of the word.

LEGAL IMPACT

Currently, the industry and the department disagree regarding the application of RTC Section 24425 to insurance company dividends. The department contends that where a taxpayer claims a dividend received deduction for insurance company dividends, expenses incurred to produce income not included in the measure of tax are disallowed under RTC Section 24425 (thereby preventing a double benefit). In contrast, the industry contends that application of RTC Section 24425 causes double taxation and does not apply.

This bill would specify that Section 24425 does not apply for taxable years ending on or after December 1, 1997, and beginning before January 1, 2003. It would impact two cases currently on appeal at the Board of Equalization; one case with a California domiciled parent corporation and the other with a parent corporation domiciled in another state.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 263
As Amended March 25, 2003

AMENDMENT 1

On page 4, modify line 1 as follows:

California Constitution, whether or not the insurer is engaged in business in California, in an amount equal to ____ percent of the

AMENDMENT 2

On page 4, modify line 2 as follows:

dividends received, if at the time of each dividend payment at least 80 percent of each class of stock of the insurer was owned, directly or indirectly, by the corporation receiving the dividend.

AMENDMENT 3

On page 6, delete lines 8 through 10, inclusive and insert:

under Section 24410 of the Revenue and

AMENDMENT 4

On page 6, modify lines 12 and 13 as follows:

Revenue and Taxation Code does not apply to a deduction described by Section 24410 of the Revenue and Taxation Code ~~deduction~~ under any

AMENDMENT 5

On page 7, line 10, delete "applicable" and insert:

application