Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Benoit | Analyst: Gail Hall | Bill Number: AB 1277

Related Bills: None | Telephone: 845-6111 | Amended Date: April 10, 2007

Attorney: Tommy Leung | Sponsor:

SUBJECT: Eliminate Potential Double Inclusion In Income When Dividend Distributions Are Made To Newly Formed Corporations Within Unitary Group

SUMMARY

This Franchise Tax Board sponsored bill would provide rules for the elimination from income of certain dividends received.

SUMMARY OF AMENDMENTS

The April 10, 2007, amendments made the following changes to the bill:

1. removed the provisions relating to charitable contribution deductions.
2. added provisions relating to the elimination of certain dividend distributions from income.

PURPOSE OF THE BILL

The purpose of this bill is to provide relief and fair treatment to certain entities that may have the same income taxed twice and to clarify existing law to increase compliance and reduce taxpayer conflicts and misinterpretations.

EFFECTIVE/OPERATIVE DATE

This bill would be effective on January 1, 2008, and specifically operative for taxable years beginning on or after January 1, 2007. In addition, the bill adds a no inference clause for prior years with respect to the amendments added by this bill.

Board Position:			Department Director	Date
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_______ N	_______ OUA	___X___ PENDING		

ANALYSIS

FEDERAL LAW

Under federal law, a group of affiliated corporations that meet certain ownership requirements may elect to file a single tax return called a consolidated tax return. In general, if a corporation owns at least 80 percent[1] of another corporation or of multiple corporations, those corporations are considered an affiliated group and can file a consolidated tax return.

A 100-percent dividend elimination is allowed to the dividend recipient (payee) if at the close of the day on which the dividend is received the payor and payee are members of the same affiliated group[2] and had been affiliated members for each day of the year preceding the date the dividends are paid.[3]

A federal regulation provides relief for dividends paid between a member of an affiliated group and a newly organized holding company of the group. The regulation provides an exception to the general rule for a newly formed corporation that fails the statute's requirement of being a member of the affiliated group for each day of the year preceding the date the dividend was paid.[4]

STATE LAW

Under state law, a group of affiliated corporations (which is determined under state law using a more than 50 percent, rather than 80 percent, ownership test) is referred to as a "commonly controlled group." Corporations in a "commonly controlled group" that meet certain requirements must file on a combined basis if they are part of a unitary business.

State law provides that dividends paid by one member of a combined unitary group out of "income previously described of the unitary business" to another member of the group are eliminated from the recipient's taxable income. Income "previously described of the unitary group" means income that is considered "business income" under California law and that has been assigned by use of an apportionment formula. "Nonbusiness income" by contrast is income that is assigned to a specific single entity instead of by use of an apportionment formula. The phrase "previously described of the unitary business" was clarified in *Willamette Industries, Inc.* v. *Franchise Tax Board* (1995) 34 Cal.App.4th 1396, to mean dividends paid out of earnings and profits created when the payor and payee were members of the same combined unitary group.

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[1] At least 80% of the stock possessing the voting power and at least 80% of the total value of all the classes of stock. [Internal Revenue Code (IRC) section 1504(a)(2)].
[2] IRC section 243(b)(1)(A).
[3] Treasury Regulation section 1.243-4(a)(2)(ii).
[4] Treasury Regulation section 1.243-4(a)(5).

A “dividend” is defined as a distribution of earnings and profits by a corporation to its shareholders. “Earnings and profits” is an accounting concept meant to reflect what a corporation will have available for distribution to shareholders as a dividend at any specific time. A corporation’s net profits or surplus is often referred to as earnings and profits. Under specific statutory rules, dividends are assumed to be paid first from a corporation’s current earnings and profits, and thereafter from prior years' accumulated earnings and profits[5]. For California purposes, earnings and profits may be calculated as follows:

State net income after state tax adjustments
Plus: nontaxable income (i.e., intercompany dividends)
Plus: artificially created deductions (i.e., depreciation)
<u>Less: nondeductible expenses (i.e., federal income tax)</u>
Equals: State earnings and profits

Generally, a dividend received by a corporation is included in income. Dividends paid out of the earnings and profits of a member of a unitary business are eliminated from the income of the recipient corporation if the dividend was paid from the payor's earnings and profits accumulated in a year when the payor and payee of the dividends were affiliated corporations in a unitary business. The intent of the elimination was to prevent including the same income twice in determining the tax base of the unitary group return.

PROGRAM BACKGROUND

The literal reading of current law’s dividend elimination statute[6] could be interpreted to mean the payor and/or payee must be California taxpayers before the payee may eliminate dividends received from the payor. The department has determined that the statute is unclear on its face. It has been the department’s practice to allow the dividend elimination provided by the current statute regardless of whether the payor and payee are taxpayer or “non-taxpayer” members of the California combined unitary group return. Taxpayer members of the combined unitary group are those entities that are doing business in California or have qualified to do business in California and therefore are required to file a California tax return. “Non-taxpayer” members of the combined unitary group are members that have their business income included in the calculation of the combined group’s taxable income, but are separately considered by California as doing business solely outside of the state and not subject to California tax.

In addition, department staff views the current dividend elimination statute as unclear whether earnings and profits, accumulated when the payor and payee were members of a combined group taxable only outside of California, would be used in the calculation of dividend elimination. It has been the department’s practice to allow the dividend elimination provided by the current statute regardless of whether the payor or payee had previously filed California returns, as long as the payor and payee filed as members of a comparable unitary business outside of California when the earnings arose.

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[5] IRC section 316(a)(2) and R&TC section 24451.
[6] Revenue and Taxation Code (R&TC) section 25106.

THIS BILL

This bill would make the following changes to existing law:

- Conform to the department's practice that if dividends are paid from income earned in years prior to the payor and payee becoming members of a California combined group filing, dividend elimination would be allowed if the earnings and profits are from a return filed on a comparable combined unitary basis in another state that included the payor and payee.
- Conform to the department's practice that dividends paid out of the earnings and profits of a non-taxpayer member of the California combined unitary group to another non-taxpayer member of the group are eliminated from business income.
- Expand the dividend elimination rules to include dividends paid from a member of a combined unitary group to a newly formed member of the combined unitary group if the recipient has been a member of the combined unitary group from its formation to its receipt of the dividends. (See Appendix A for an example of current law and the proposed law relating to this provision.)
- Add anti-abuse provisions relating to newly formed members of a combined unitary group.
- Grant the Franchise Tax Board legislative rulemaking authority to adopt appropriate regulations relating to the purpose of the section, which is to prevent inclusion of the same income twice.

This bill would apply to a member of a unitary combined group whether doing business wholly within California or doing business within and outside of the state.

TECHNICAL CONSIDERATIONS

The department has identified the following technical considerations. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

1. The bill may be interpreted to require a recipient of a dividend to be a member of the combined unitary group at the time the tax return is filed before dividend income may be excluded. The bill should be amended to clarify that the recipient corporation must be a member of the unitary group only at the time the dividend was paid.
2. The bill provides an operative date of January 1, 2007, for amendments that are declaratory of existing law. The operative date for the declaratory language should be removed.
3. The amendments described in paragraph (2)(A) of the bill relating to a newly formed member are a change in existing law instead of a declaration of existing law as provided in the bill. The legislative findings section should be revised accordingly.
4. The amendments relating to dividends paid from income earned in years prior to the payor and payee becoming members of a California combined group filing could be misinterpreted. This language can be interpreted to mean California must accept the income determination rules of another state. The language should be revised to close this loophole.

OTHER STATES' INFORMATION

The states surveyed include *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida and *Illinois* generally follow current federal law relating to dividends paid between members of an affiliated group. Massachusetts allows a deduction from net income equal to 95 percent of the value of all dividends received by the taxpayer if the taxpayer owns at least 15 percent of the voting stock of the corporation paying such dividends. *Michigan* and *New York* lack provisions allowing dividend received deductions, and *Minnesota* allows a dividend-received deduction between members of a unitary group calculated using a formula based on the ownership and apportionment percentage.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1277 Effective for tax years BOA 1/1/2007 Enacted after 7/01/2007		
2006/07	2007/08	2008/09
Minor*	Minor*	Minor*

* Revenue loss of less than $500,000.

Revenue Discussion

The revenue impact of this legislative proposal was estimated to be minor for the following reasons:

- The department's audit staff confirms that the inclusion of the same income twice when dividends are paid from a member of the unitary business group to a newly created member is uncommon. Most taxpayers are aware of the potential double inclusion of income in the unitary group's business income and can apply tax planning techniques to avoid the inclusion of income twice.
- The clarification of existing law relating to the earnings and profits from nontaxpayer members of a combined unitary business results in no revenue impact because the amendments conform to the department's current practice.

Even though the revenue impact of this legislative proposal was estimated to be minor, it is possible, but unlikely, that the revenue loss for a particular year may be more than minor because a taxpayer may be unaware of the inclusion of the same income twice "trap" from forming a new corporation in the unitary group.

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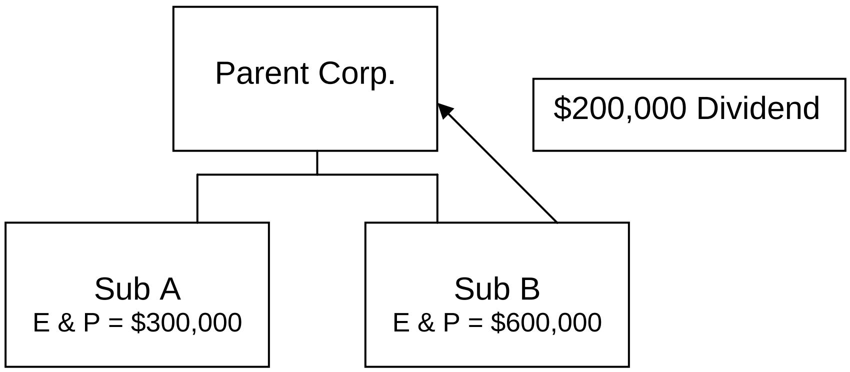
APPENDIX A
AB 1277

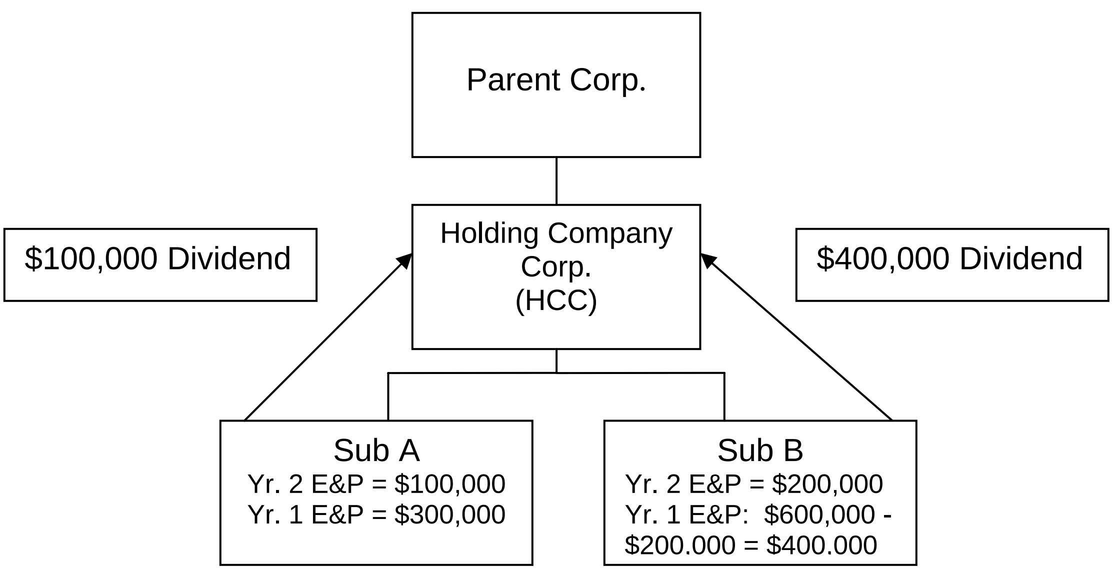
The Year 1 example below illustrates current law and the Year 2 example shows how the unintended inclusion of the same income twice may occur between members of a unitary business when a corporation is newly formed.

Current Law Example: Year 1



In Year 1, Parent Corp. and Subs A and B were members of a combined unitary business. Sub A had current year earnings and profits (E & P) of $300,000 and Sub B had E & P of $600,000. Sub B paid Parent Corp. a dividend equal to $200,000, and Parent Corp. eliminated the $200,000 dividend from taxable income because the dividends were paid out of earnings and profits when Parent Corp. and Sub B were members of a unitary business.

Newly Formed Corporation Example: Year 2



In Year 2, Parent Corp. forms a new subsidiary, HCC. Sub A pays HCC a $100,000 dividend and Sub B pays HCC a $400,000 dividend. The combined business income of Parent Corp, Sub A, and Sub B is included in a California combined unitary business. HCC may eliminate from income the $100,000 dividend received from Sub A because the dividend was paid from earnings and profits (year 2) when HCC and Sub A were members of a combined unitary business. HCC may eliminate from income only $200,000 of the $400,000 dividend received from Sub B because only $200,000 of the dividend was paid from earnings and profits accumulated when HCC and Sub B were members of a combined unitary business (year 2). The other $200,000 of dividend was paid from Sub B's earnings and profits from a year before HCC became a member of the combined unitary business (year 1).

The Year 2 example illustrates when the inclusion of the same income twice may occur if a dividend is paid to a newly formed corporation in the combined unitary business. The dividends distributed in year 2 from earnings and profits were already included in income for year 1, but would again be included in income in year 2 because the newly formed corporation HCC and Sub B were not members of the unitary business in year 1. If instead HCC was never created and the dividends had been paid directly to Parent Corp., Parent Corp. could have eliminated from income the dividends received from Sub B because Parent Corp. was a member of the unitary business in Year 1.