SCS Agency
Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Alpert　Analyst: Marion Mann DeJong　Bill Number: SB 1739

Related Bills: See Legislative History　Telephone: (916) 845-6979　Introduced Date: 02/18/98

Attorney: Doug Bramhall　Sponsor: Franchise Tax Board

SUBJECT: Federal Action (RAR) Clean-Up/Remove Commercial Domicile Limit On Dividend Receipt

SUMMARY

This bill, sponsored by the Franchise Tax Board, would make several changes relating to federal adjustments. See RAR Clean-Up on page 2. Specifically, this bill would do the following:

- Define the final federal determination date as the date on which each adjustment or resolution (assessment, refund or no change) resulting from an IRS examination is assessed pursuant to Internal Revenue Code (IRC) Section 6203 (commonly known as the 23C date).
- Clarify that taxpayers must notify the Franchise Tax Board (FTB) of any federal change that increases tax for any year and to require Bank and Corporation (B&CT) taxpayers to report all changes or corrections to gross income or deductions, even if the changes or corrections do not result in an increase in tax payable for any year.
- Clarify that taxpayers, who are required to report federal changes, are required to (1) report each final federal determination, and (2) report changes to any item reportable on the federal income tax return.
- Remove an unclear phrase from Revenue and Taxation Code (R&TC) Section 19060.

This bill also would remove the commercial domicile restriction from R&TC Section 24410, permitting all corporations, regardless of where commercially domiciled, to deduct dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax. See Remove Commercial Domicile on page 5.

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE　　____ GOVERNOR'S APPOINTMENT

Board Position:	Agency Secretary Position:	**GOVERNOR'S OFFICE USE**
__X_ S　____ O	____ S　____ O	
____ SA　____ OUA	____ SA　____ OUA	Position Approved ____
____ N　____ NP	____ N　____ NP	Position Disapproved ____
____ NA　____ NAR	____ NA　____ NAR	Position Noted ____
________ PENDING	DEFER TO ____________	
Department Director Gerald H. Goldberg　3/9/98	Agency Secretary　Date	By:　Date:

BOARD POSITION

Support.

The Franchise Tax Board voted at its January 12, 1998, meeting to sponsor RAR clean-up legislation and legislation to remove the commercial domicile restriction from R&TC Section 24410. At this meeting, the Board also requested staff to consider modifying the statute of limitation (SOL) when information is received from the Internal Revenue Service (IRS) instead of the taxpayer. The Board voted at its February 4, 1998, meeting to sponsor legislation modifying the SOL. See Attachment A for amendments to modify the SOL.

1. RAR Clean-Up

EFFECTIVE DATE

This provision would apply to federal determinations that become final on or after January 1, 1999.

LEGISLATIVE HISTORY

SB 571 (Stats. 1992, Ch. 335), SB 3 (Stats. 1993, Ch. 31), SB 673 (Stats. 1993, Ch. 887).

BACKGROUND

Enactment of SB 571 (Stats. 1992, Ch. 335) created parallel but not duplicate code sections regarding the reporting of federal changes in Section 18451 of the Personal Income Tax (PIT) Law and Section 25432 of the B&CTL. PIT taxpayers were required to report only changes or corrections that affected the amount of tax payable (either a refund or assessment) while B&CT taxpayers were required to report all changes (an exemption clause was included in the PIT law). Upon the creation of the Administration of the Franchise and Income Tax Laws (AFITL) by SB 3 (Stats. 1993, Ch. 31), these two code sections were combined. The exemption clause found in the prior PIT law was modified to require only the reporting of changes that increased the amount of tax payable and was made applicable to all taxpayers.

SPECIFIC FINDINGS

Current state law requires the taxpayer to notify FTB if the amount of gross income or deductions reported to the IRS for any year is changed, either by the taxpayer or federal authorities. However, a change in the amount of gross income or deductions that does not result in an increase in the amount of California tax payable by the taxpayer is arguably not required to be reported to FTB.

The taxpayer can report a change by sending FTB a copy of the federal change documents or by filing an amended tax return. If required to be reported, the change must be reported within six months after a “final federal determination” of this change or correction. “Final federal determination” is defined in regulations (Cal. Code of Regs., title 18, Section 18586.3) as an irrevocable determination or adjustment of a taxpayer’s federal tax liability from which there exists no further right of appeal either administrative or judicial. The regulation lists three examples of different types of final federal determinations:

- A closing agreement pursuant under IRC Section 7121.
- The notice of deficiency (IRC Section 6213(a)) or the expiration of the appeal period for the judgment of the court of last resort.
- The assessment of deficiency pursuant to a waiver filed under IRC Section 6213(d).

Changes that must be reported to California when they increase the amount of tax payable include:

- Amendments made on a return filed by the taxpayer with the IRS,
- Results of a revenue agent's examination or other changes or corrections by the IRS,
- Change or correction by any other officer of the U.S. or other competent authority, or
- Renegotiation of a contract or subcontract with the U.S.

If a change is timely reported by the taxpayer, FTB has two years from the date the change is reported to assess any additional tax resulting from the change. If a taxpayer does not report the change as required, or fails to file an amended return with the state, the statute of limitations for assessment by FTB is suspended and FTB may issue an assessment at any time. If the taxpayer advises FTB of a change, but does so only after the expiration of the six-month period for reporting, FTB has four years from the date the change is reported to issue an assessment with respect to the change.

A change in the amount of gross income or deductions which results in a federal refund of tax is not required to be reported to FTB. However, in order for a state refund to be allowed the taxpayer must file a claim for refund resulting from a change within two years from the date of the final federal determination.

Through reciprocity arrangements with the IRS, FTB generally receives directly from the IRS copies of examination reports of individuals with California addresses. FTB staff reviews the reports and issues applicable assessments, not waiting for notice from the taxpayer. However, FTB does not always receive copies of examination reports for bank and corporation taxpayers with business locations in multiple states or with out-of-state addresses.

This provision would define the final federal determination date. The date of final federal determination would be the date on which each adjustment or resolution (assessment, refund or no change) resulting from an IRS examination is assessed pursuant to IRC Section 6203 (commonly known as the 23C date).

This provision would clarify that taxpayers must notify FTB of any federal change that increases tax for any year and to require B&CT taxpayers to report all changes or corrections to gross income or deductions, even if the changes or corrections do not result in an increase in tax payable for any year. This amendment would not change the period of time allowed for assessments or refunds.

This provision would clarify that taxpayers, who are required to report federal changes, are required to report (1) each final federal determination, and (2) changes to any item reportable on the federal income tax return.

This provision would remove an unclear phrase from R&TC Section 19060.

Policy Considerations

This provision would raise the following policy considerations.

- When the Franchise Tax Board sponsored SB 571 (Stats. 1992, Ch. 335), it recognized that PIT and B&CT taxpayers should be treated differently. However, when SB 3 (Stats. 1993, Ch. 31) combined former Revenue and Taxation Code Sections 18451 and 25432, the exemption clause contained in the prior PIT law was inadvertently made applicable to all taxpayers.

- The date that each adjustment or resolution resulting from an IRS examination is assessed pursuant to IRC Section 6203 is a fixed date that can easily be determined by both the taxpayer and the department. Using this date for the final federal determination date would clarify when the statute of limitations begins and ends.

Implementation Considerations

This provision would reduce disputes between taxpayers and the department by defining the final federal determination date. Taxpayers can easily identify the date since the taxpayer receives an assessment, refund or "no change" report once the adjustment or resolution is assessed pursuant to IRC Section 6203 (commonly known as the "23C date"). The department can identify this date by checking for corresponding entries on the Internal Revenue Service Master File. Taxpayers and the department can verify the date by requesting a copy of Form 23C (or its equivalent) from the IRS.

This provision also would reduce disputes between taxpayers and the department by clarifying current law.

This provision would reinstate the provisions of the B&CT Law (Part 11) that existed prior to the creation of the AFITL, providing FTB staff with the information necessary to verify that income or losses are reported correctly in subsequent years.

Implementation of this bill would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

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

Tax Revenue Estimate

Requiring taxpayers to notify the FTB of all federal changes (unless exempt under the PIT exclusion) encourages taxpayers to report accurately in subsequent years and also enables FTB staff to conduct effective examinations of tax returns. To the extent this provision improves compliance and/or the effectiveness of audits, it potentially could generate additional revenue annually. However, no data are available to measure or even suggest an order of magnitude.

2. Remove Commercial Domicile

EFFECTIVE DATE

Specific language in this bill would apply the amendments to Section 24410 to all income years in which the statute of limitations remains open.

BACKGROUND

Insurance companies in California are taxed by levying a flat percentage tax (2.35%) on their gross written premiums, with certain deductions. This tax is imposed under Article XIII, Section 28 of the California Constitution and is intended to be “in lieu of” all other taxes or methods of taxation. Thus, a corporation engaged in the insurance business is not subject to the Bank and Corporation Tax Law and is not included in a unitary group’s combined report.

Many insurance companies have adopted a corporate structure in which theparent corporation (which is subject to the Bank and Corporation Tax Law) is a holding company with an insurance company subsidiary. One advantage of this structure is that the parent holding company can borrow and invest where the insurance company subsidiary is prohibited for regulatory reasons.

To prevent double taxation (gross premiums tax on the insurance company subsidiary and taxable dividends to the corporate parent), a dividend exclusion was enacted in the Bank and Corporation Tax Law.

SPECIFIC FINDINGS

Federal law allows a deduction from gross income for dividends received from a domestic corporation that is subject to income tax. This deduction is limited by stock ownership. One hundred percent of the 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 which is 20% but less than 80% owned; and 70% of the deduction is allowed when received from a corporation less than 20% owned. The percentage owned refers to the percentage of stock, by vote and value, owned by the recipient corporation. Preferred stock is not considered in determining the percentage of stock owned. In addition, 100% of the deduction is allowed for dividends received by a small business investment company.

The total dividend deduction cannot exceed 70% (80% in the case of a 20% owned corporation) of the recipient corporation’s recomputed taxable income. When recomputing taxable income, any net operating loss deduction, dividend received deduction, capital loss carryback and certain special deductions are not allowed.

Current state law (Bank and Corporation Tax Law - B&CTL) provides for the use of an apportionment formula when assigning *business* income of multistate and multinational corporations to California for tax purposes. For most corporations, this formula is the average of the factors of property, payroll and double-weighted sales applied against worldwide income. Each factor is the ratio of in-state activity to worldwide activity. *Nonbusiness* income is generally allocated to the taxpayer's commercial domicile.

California Regulation Section 25120(c)(4) applies 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 will also 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 which 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., 3/2/83).

Generally, dividends are *nonbusiness income* when the stock is held as an investment unrelated to the taxpayer's trade or business activities. **The B&CTL** (Section 25126) provides that *nonbusiness* dividend income is allocated to the taxpayer's commercial domicile.

The B&CTL (Section 24402) excludes from taxable income a portion of dividends received in taxable years beginning after 1989 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 corporation income at the corporate level. The exclusion is in the form of a deduction from gross income. For the recipient corporation to claim such a deduction, the paying corporation must have had income from sources in California that required the filing of a California income or franchise tax return. The Franchise Tax Board makes a computation each year, after the returns are filed, to determine the percentage of dividends paid during the year which are deductible by recipient corporations. The deduction is further limited based on the recipient's percentage ownership in the distributing corporation, similar to the federal stock ownership rules.

Under the B&CTL (Section 24410), corporations *commercially domiciled in California* are permitted to deduct dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax, provided 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.

The rationale for Section 24410 is to provide a similar relief from double taxation as is provided to general corporations under the dividends received deduction of Section 24402. Section 24410 essentially determines the hypothetical income that would have been properly imposed on an insurance company if it were in fact subject to the franchise tax, and treats the gross premiums tax as having been imposed on that income.

When Section 24410 was enacted (Stats. 1968, Ch. 1379), essentially all dividends were thought to be nonbusiness income unless receipt of dividends was the taxpayer's principal trade or business (i.e., dealers in stocks and securities). This theory was based on pre-Uniform Division of Income for Tax Purposes Act (UDITPA) case law that held the source of the dividend income was the shares of stock and the situs of such stock was traditionally the commercial domicile of the investing corporation (Southern Pacific Co. v. McColgan, 68 Cal. App. 2d 48 (1945)). Earlier versions of California regulation Section 25120(c)(4) reflected this theory.

Subsequently, California case law held that dividends could be business income if the dividends met the transactional/functional tests implicit in Section 25120, and that the (former) FTB regulations were invalid because they were contrary to those statutory tests (Appeal of Standard Oil Company of California, Cal. St. Bd. of Equal., March 2, 1983). The Franchise Tax Board amended Regulation Section 25120(c)(4) to apply transactional/functional tests to determine the classification of dividend income as business or nonbusiness income.

Because dividends can be treated as business income, the commercial domicile restriction in Section 24410 operates as a preferential treatment only for California commercially domiciled corporations. Recent court decisions have found similar laws to be unconstitutional as a discrimination against interstate commerce as facially discriminatory, and without legitimate local purpose (e.g., Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine [1997] 520 U.S. ____, 137 L. Ed. 2d 852). Thus, it is likely that Section 24410 would be found unconstitutional as discriminatory against interstate commerce.

Article III, Section 3.5 of the California Constitution provides that an administrative agency does not have the power to declare a statute unenforceable, or refuse to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute, unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

This provision would remove the commercial domicile restriction from Section 24410. Thus, all corporations, regardless of where commercially domiciled, would be permitted to deduct dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax.

In addition, **this provision** makes minor technical changes to R&TC Section 24410.

Policy Considerations

There does not appear to be specific tax policy to support relief from double corporate taxation only for California domiciled holders of insurance stock. Further, the objective of Section 24410 appears to be the same as the objective of Section 24402: to provide relief from double taxation. The commercial domicile restriction of Section 24410 was probably included because, at the time of enactment, such dividends were generally thought to be nonbusiness income, allocated to commercial domicile. By removing the commercial domicile restriction from Section 24410, this proposal would make the tax policy of Section 24410 consistent with Section 24402.

Implementation Considerations

If the commercial domicile restriction in Section 24410 is not removed from California law, the department is required by the state's Constitution to enforce the restriction until an appellate court declares California law to be in violation of federal law. In fact, the department is currently litigating such a case and must incur litigation costs for a tenuous position. Removing the commercial domicile restriction in Section 24410 would prevent the department from incurring litigation costs on the constitutionality of Section 24410. Further, this proposal would relieve taxpayers from using resources to defend against the administrative application of a law that is probably unconstitutional.

Implementation of this proposal would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

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

Tax Revenue Estimate

The revenue impact of this provision would be determined by the amount of insurance dividends (from insurance subsidiaries operating in California) deducted by recipient corporations domiciled outside California, the average apportionment factor of each recipient, and the franchise tax rate.

The provision would result in annual revenue losses that cannot be quantified. Sufficient data do not exist to estimate the magnitude of losses. Even without the provision, revenue losses are likely as the result of cases testing the constitutionality of the current statute under which only commercially domiciled corporations are allowed the deduction.

It is assumed the provision would be enacted after June 30, 1998, and effective for all years in which the statute of limitations remains open. For issues of this sort, generally it is assumed the statute would be open for roughly six income years.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

ATTACHMENT A

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1739
As Introduced February 18, 1998

AMENDMENT 1

On page 3, modify line 22 as follows:

<u>must be sufficiently detailed to allow computation of the resulting California tax change and</u> shall be reported in the form and manner as prescribed

AMENDMENT 2

On page 3, between lines 28 and 29 add the following:

SEC. 2. Section 19059 of the Revenue and Taxation Code is amended to Read:
19059. (a) If a taxpayer is required by subdivision (a) of Section 18622 to report a change or correction by the Commissioner of Internal Revenue or other officer of the United States or other competent authority and does report the change or correction within six months after the final federal determination,<u>or the Internal Revenue Service reports that change or correction within six months after the final federal determination,</u> a notice of proposed deficiency assessment resulting from those adjustments may be mailed to the taxpayer within two years from the date when the notice is filed with the Franchise Tax Board by the taxpayer <u>or the Internal Revenue Service</u>, or within the periods provided in Section 19057, 19058, or 19065, whichever period expires later.
(b) If a taxpayer is required by subdivision (b) of Section 18622 to file an amended return and does file the return within six months of filing an amended return with the Commissioner of Internal Revenue, a notice of proposed deficiency assessment in excess of the self-assessed tax on the amended return, and resulting from the adjustments may be mailed to the taxpayer within two years from the date when the amended return is filed with the Franchise Tax Board by the taxpayer, or within the periods provided in Section 19057, 19058, or 19065, whichever period expires later.

AMENDMENT 3

On page 3 line 29, strikeout "SEC. 2" and insert:

SEC. 3

ATTACHMENT A

AMENDMENT 4

On page 4, modify lines 1 through 9 as follows:

(b) If, after the six-month period required in Section 18622, a taxpayer<u>or the Internal Revenue Service</u> reports a change or correction by the Commissioner of Internal Revenue or other officer of the United States or other competent authority or files an amended return as required by Section 18622, a notice of proposed deficiency assessment resulting from the adjustment may be mailed to the taxpayer within four years from the date the taxpayer <u>or the Internal Revenue Service</u> notifies the Franchise Tax Board of that change or correction or files that return.

AMENDMENT 5

On page 4 line 10, strikeout “SEC. 3” and insert:

SEC. 4

AMENDMENT 6

On page 4 line 24, strikeout “SEC. 4” and insert:

SEC. 5

AMENDMENT 7

On page 6 line 3, strikeout “SEC. 5” and insert:

SEC. 6

AMENDMENT 8

On page 6 line 7, strikeout “SEC. 6” and insert:

SEC. 7