

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 376

August 5, 1974

FRANCHISE -- CORPORATION INCOME -- MEASURE OF THE  
TAX-DEDUCTIBLE DIVIDENDS -- DIVIDENDS ELIMINATED FROM INCOME

Dividends which are deducted under Revenue and Taxation Code Section 24402 are included in the measure of the taxes. Where Revenue and Taxation Code Section 24402 and Revenue and Taxation Code Section 25106 are both applicable, Section 24402 controls.

Facts:

Under the provisions of Revenue and Taxation Code Section 24402, a special deduction is allowed for dividends received during the income year declared from income which has been "included in the measure of the taxes n1 imposed under Chapter 2 or Chapter 3 of this part upon the taxpayer declaring the dividends."

n1 The predecessor of Section 24402 which is construed in several of the cases considered herein contained the phrase "measure of the tax" (emphasis added), which is identical to the phrase which is used in Section 24425 and its statutory predecessors.

The present practice in our computation of the allowable deduction percentage of dividends received by a corporation is to consider dividends paid to the corporation which are deducted under Section 24402 as having been included in the measure of the taxes.

Great Western Financial Corporation v. Franchise Tax Board, 4 Cal. 3d 1 (1971), holds that dividends received by a corporation and deducted by the corporation under Section 24402 are not included in income used to measure the tax.

Questions:

1. In view of the Great Western decision, should dividends received by a corporation but which are deducted under Section 24402 be considered as having been included in the measure of the taxes of the recipient corporation for the purpose of computing deductible dividends under Section 24402?

2. Is the answer the same with respect to dividends deducted under Section

24410?

3. Is the answer the same for dividends eliminated from income under Section 25106?

Decisions:

1. Yes.
2. Yes.
3. No, but Section 25106 does not apply where Section 24402 is also applicable.

Discussion:

Questions 1 and 2:

Great Western involves an application of the provisions of Section 24425. Section 24425 deals with the deduction of expenses; it has no application to the question of whether dividends are included in the measure of the tax for the purpose of computing deductible dividends under Section 24402. The decisions of the California Supreme Court in this area clearly demonstrate that the two virtually identical phrases in question are to be construed differently for the different purposes of Section 24402 and Section 24425.

In construing what is now Section 24402, *Rosemary Properties, Inc. v. Franchise Tax Board*, 29 Cal.2d 677 (1947), held that gross income attributable to California sources is "included in the measure of the tax." It follows that dividends which are included in California gross income are "included in the measure of the taxes" of the recipient corporation even if such dividends are subsequently deducted under either Section 24402 or Section 24410.

It has been suggested that the Section 24402 requirement that the dividends be "included in the measure of the taxes imposed . . . upon the taxpayer declaring the dividends" limits the application of Section 24402 to first tier dividend distributions. The limiting language underscored above was not intended to have any such effect. "The insertion of this restriction was prompted by the decision in *Corporation of America v. Johnson*, 7 Cal.2d 295 (60 Pac.2d 417), which interpreted the language "income arising out of business done in this state," which appeared in the 1929 version of Section 8(h)[a predecessor of Section 24402] as not restricted to income from business done by the corporation declaring the dividends." *Rosemary Properties*, supra, at page 705 (Justice Traynor's dissent).

Nor does this restrictive language have any such effect. When a dividend receiving corporation pays dividends to its shareholders from the dividends received, it becomes a taxpayer "declaring the dividends."

The majority of the Rosemary court stated that the Legislature must have used the identical language found in the predecessors of Section 24402 and Section 24425 in the same sense. But in his dissent in Rosemary at page 702, Justice Traynor questioned: "Why must it? The two sections serve different purposes and there is no necessary relation between them." Cf. *Great Western*, supra, particularly at pages 5-6.

The California Supreme Court apparently agreed with Justice Traynor in *Security First National Bank v. Franchise Tax Board*, 55 Cal.2d 407 (1961). In construing what is now Section 24425 the court held that the "measure of the tax" is net income. The court expressly noted the contrary interpretation of the same phrase in Rosemary (and in *Burton E. Green Investment Co. v. McMolgan*, 60 Cal.App.2d 224 (1943)) without disapproving comment. Hence, it is clear that Security-First National Bank did not intend to overrule Rosemary either directly or by implication.

This was confirmed in *Safeway Stores, Inc. v. Franchise Tax Board*, 3 Cal.3d 745 (1970), wherein the California Supreme Court followed Rosemary in holding that the "measure of the tax" means gross income attributable to California sources for the purposes of what is now Section 24402. In holding that the "measure of the tax" means net income for the purposes of Section 24425, *Great Western*, supra, merely followed the precedent set in *Security-First National Bank*. See *Great Western*, supra, at page 6. There is no indication that *Great Western* was intended to extend the *Security-First National Bank* construction of the Section 24425 phrase "measure of the tax" to the similar phrase in Section 24402. To the contrary, in *Great Western* the court expressly stated: "In this instance we are not concerned with Section 24402 . . ."

Under these circumstances there is no sound legal basis for extending to Section 24402 the construction of the "measure of the tax" found in *Great Western*. It can only be concluded that Rosemary is still good law and must be followed in computing deductible dividends under Section 24402.

Question 3:

Section 25106 provides insofar as material here that:

. . . all dividends paid by one to another of such [unitary] corporations shall to the extent such dividends are paid out of such [unitary] income . . . In view of pending litigation concerning the proper treatment of intercompany dividends, it is not intended by enactment of this section that any inference be drawn from it in such litigation. (Emphasis added.)

Since Section 25106 was clearly a legislative response to questions which had been raised in "pending litigation" and since one of the primary taxpayer arguments in such litigation was that a combined report was the equivalent of a federal consolidated return, which disregards the separate corporate entities and provides that intercompany dividends "shall be eliminated" (Federal Income Tax Regulation § 1.1502-14(a)(1), it seems probable that the Legislature used the word "eliminated" in Section 25106 in the same way that word is used in federal law pertaining to consolidated returns. In federal law relating to consolidated returns the word "eliminated" is used in the sense of "nonrecognition." Oscar E. Baan, 45 T.C. 71, 93 (1965).

In a footnote dictum in *Pacific Telephone and Telegraph Co. v. Franchise Tax Board*, 7 Cal.3d 544, 558, the California Supreme Court seems to go even further and states insofar as is pertinent here that: "Section 25106 provides that intercompany dividends are not income. . ." In any event it is clear that dividends "eliminated from income of the recipient" under Section 25106 are not required to be reported in California gross income. It follows that Section 25106 dividends are not included in the "measure of the taxes" within the meaning of Section 24402 as construed by Rosemary.

Just what dividends fall within the ambit of Section 25106 and which fall within the ambit of Section 24402, however, is not precisely certain. Section 25106 purports to apply to "all dividends" paid from unitary income by one unitary corporation to a corporation in the same unitary group whereas Section 24402 applies to all dividends "declared from income [whether unitary or not] which has been included in the measure of the taxes . . ." Hence, where dividends are paid by and to unitary corporations from unitary income which has been included in the measure of the taxes both Section 24402 and Section 25106 are applicable according to their terms.

The question then is which section should be applied in situations where both sections are applicable? Under the usual rules of statutory construction, Section 25106 would apply because it is both the later enactment and the more specific of the two sections.

Applying the usual rules of construction in this instance, however, would result in vitiating the operation of Section 24402 and in frustrating the policy which the Legislature embodied therein. This can be illustrated by means of the following example.

Assume that Sub-1, Sub-2, and Parent are California corporations engaged in a unitary business. Shareholder, also a California corporation, owns stock in Parent but is not engaged in the unitary business. Sub-1 earns \$1,000,000 in unitary income. Eighty-six percent of Sub-1's income is included in the

California measure of the tax.

Sub-1 pays a \$1,000,000 dividend to Sub-2. Sub-2 pays a \$1,000,000 dividend to Parent. Parent pays a \$1,000,000 dividend to Shareholder. n3

n3 For the purpose of simplifying the example we further assume that Sub-1 is the wholly-owned, sole subsidiary of Sub-2; that Sub-2 is the wholly-owned, sole subsidiary of Parent and that Sub-1, Sub-2, and Parent earned no income other than the \$1,000,000 in question.

If Section 25106 is applied, the dividends received by Sub-2 and by Parent are free of tax because both of those two dividends were paid from unitary income by and to corporations belonging to the same unitary group.

Since shareholder is not part of the unitary group, however, Section 25106 does not apply to its \$1,000,000 dividend. The only other section which could protect Shareholder's dividend from tax is Section 24402. Section 24402 applies, however, only to dividends declared from income which has been "included in the measure of the taxes . . . of . . . the taxpayer declaring the dividends." In this example, Parent is the "taxpayer declaring the dividend." The income from which Parent declared the dividend to Shareholder was not included in the "measure of the taxes" because said income was "eliminated from the income" of Parent under Section 25106. Therefore, Section 24402 does not apply. Consequently, that part of the corporate income which was included in Sub-1's California measure of the taxes (86%) is subject in the hands of Shareholder to a second California tax at the corporate level.

One of the major policies inherent in the California Bank and Corporation Tax Law is that corporate income should not be subjected to tax more than once at the corporate level. Section 24402; *Burton E. Green Investment Co.*, supra; *Rosemary Properties*, supra; *Safeway Stores*, supra. Thus, it is clear that following the usual rules of statutory construction and applying Section 25106 in situations where the provisions of Sections 25106 and 24402 overlap results in vitiating the operation of Section 24402 and in frustrating the legislative intent embodied therein.

It is well established that: "Statutes on the same subject matter must be construed together in the light of each other so as to harmonize them if possible, although they were passed at different times, and one deals specifically and in greater detail with the subject than does the other." 45 Cal.Jur.2d § 121. The operation of Section 24402 and Section 25106 can be harmonized and both sections can be given full effect by holding that in those situations where the coverage of Section 24402 and Section 25106 overlap, Section 24402 applies. Therefore, to give effect to the above quoted rule of statutory construction, it is held that where Section 24402 and 25106 both

apply, Section 24402 shall be applied first.

Under this decision a dividend declared from unitary income by a unitary corporation to a California member of the same unitary group is always entirely free of tax. To the extent that such dividend was declared from earnings and profits attributable to California sources it is included in the California measure of the taxes and for that reason it is deductible under Section 24402. To the extent that such dividend was declared from income attributable to sources other than California, it is eliminated from income under Section 25106.

Hence, referring back to our example, eighty-six percent of the dividend received by Sub-2 is deductible under Section 24402. The remaining fourteen percent of the dividend is eliminated from income under Section 25106.

Under Rosemary, a dividend remains in the measure of the recipient's tax even if subsequently deducted under section 24402 or 24410. Consequently, once a dividend is included in the California measure of the tax, then so long as the dividend is paid to California corporations, it remains in the measure of the tax and for that reason it remains deductible under Section 24402 irrespective of the number of corporate levels through which the dividend passes and irrespective of whether the recipient corporations are unitary.

Consequently, eighty-six percent of dividend received by Parent and by Shareholder remains deductible under Section 24402. (Fourteen percent of the dividend received by Parent is also eliminated from income under Section 25106.)

Once such dividend is paid to a corporation outside the unitary group, however, Section 25106 is not applicable, and to such extent the dividend is subject to California tax.

Therefore, the fourteen percent of the dividend received by Shareholder which has never been included in the California measure of the tax is fully taxable.