

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Committee on Rev & Tax Analyst: Marion Mann DeJong Bill Number: SB 2171

Related Bills: See Legislative History Telephone: 845-6979 Introduced Date: 02/25/2000

Attorney: Patrick Kusiak Sponsor: Franchise Tax Board

**SUBJECT:** Insurance Dividend Deduction/Remove Commercial Domicile Limitation on Dividend Receipts

### SUMMARY

This bill would remove from Revenue and Taxation Code (R&TC) Section 24410 the prohibition on corporations that are commercially domiciled outside of California on deducting dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax. All corporations would be permitted to deduct dividends, regardless of where commercially domiciled.

If the commercial domicile restriction in Section 24410 is not removed from California law, it is likely to be found unconstitutional. Thus, this bill would resolve a constitutional issue.

### EFFECTIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would apply to all open income years in which the Franchise Tax Board may propose an assessment or allow a claim for refund.

### LEGISLATIVE HISTORY

AB 1218 (1997/1998) would have (1) removed the commercial domicile restriction from R&TC Section 24410 and (2) would have allowed corporations to deduct interest expense attributable to dividends that are received from an insurance company subsidiary and are excluded from income. AB 1218 was held in Senate Appropriations Committee.

SB 1229 (Stats. 1999, Ch. 987) would have removed the commercial domicile restriction from R&TC Section 24410. However, 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 1129 made only technical changes to R&TC Section 24410.

### Board Position:

<u> X </u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> </u> PENDING

### Department Director

### Date

Alan Hunter for GHG

3/22/00

SPECIFIC FINDINGS

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

**Existing state law** (Section 24402) excludes from taxable income 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 existing state law** (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, 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 similar relief from double taxation as is provided to general corporations under the dividends received deduction of Section 24402.

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 (1945) 68 Cal. App. 2d 48.) Earlier versions of California Regulation Section 25120(c)(4) reflected this traditional 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) Franchise Tax Board regulations were invalid because they were contrary to those statutory tests. (Appeal of Standard Oil Company of California, supra.) The Franchise Tax Board then amended Regulation Section 25120(c)(4) to apply transactional/functional tests to determine the classification of dividend income as either 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 facially discriminatory against interstate commerce, without legitimate local purpose, and thus unconstitutional. (See, e.g., Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine (1997) 520 U.S. 564, 137 L. Ed. 2d 852.) Thus, it is likely that Section 24410 would be found unconstitutional, to the extent the deduction is allowed only to a California domiciled corporation, 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 a State appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

**This bill** 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.

#### 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 company 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 original enactment, such dividends generally were thought to be nonbusiness income, allocated to commercial domicile. By removing the commercial domicile restriction from Section 24410, this bill 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 a state appellate court declares California law to be in violation of federal law. In fact, the department recently lost such a case at trial court and has filed an appeal with the appellate court. Removing the commercial domicile restriction in Section 24410 would prevent the department from incurring litigation costs on the constitutionality of existing Section 24410. Further, this bill would relieve taxpayers from expending corporate resources to defend against the administrative application of a law that is likely unconstitutional under existing case law.

Implementation of the commercial domicile provisions would occur during the department's normal annual system update.

### FISCAL IMPACT

#### Departmental Costs

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

#### Tax Revenue Estimate

The revenue impact of this bill 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 commercial domicile provisions 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.

The commercial domicile provisions would be effective for all years for 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.

### BOARD POSITION

Support.

The Franchise Tax Board voted at its January 12, 1998, meeting to sponsor the language in this bill.