

# 2016 Instructions for Schedule H (100S)

## S Corporation Dividend Income Deduction

### Important Information

California Revenue and Taxation Code (R&TC) Section 24410 was repealed and re-enacted to allow a "Dividends Received Deduction" for qualified dividends received from an insurer subsidiary. The deduction is allowed whether or not the insurer is engaged in business in California, if at the time of each payment, at least 80% of each class of stock of the insurer was owned by the corporation receiving the dividend. An 85% deduction is allowed for qualified dividends. A portion of the dividends may not qualify if the insurer subsidiary paying the dividend is overcapitalized for the purpose of the dividends received deduction. See Part III, Specific Instructions, for more information.

Dividend elimination is allowed regardless of whether the payer/payee are taxpayer members of the California combined unitary group return, or whether the payer/payee had previously filed California tax returns, as long as the payer/payee filed as members of a comparable unitary business outside of California when the earnings and profits (E&P) from which the dividends were paid arose.

In addition, dividend elimination is allowed for dividends paid from a member of a combined unitary group to a newly formed member of the combined unitary group if the recipient corporation has been a member of the combined unitary group from its formation to its receipt of the dividends. Earnings and profits earned before becoming a member of the unitary group do not qualify for elimination. See R&TC Section 25106 for more information.

In *Farmer Bros. Co. vs. Franchise Tax Board* (2003) 108 Cal App 4th 976, 134 Cal Rptr. 2d 390, the California Court of Appeal found R&TC Section 24402 to be unconstitutional. A statute that is held to be unconstitutional is invalid and unenforceable. Therefore, the R&TC Section 24402 deduction is not available.

### Specific Instructions

California follows the federal dividend distributions ordering rule where dividends are deemed to be paid out of current year E&P first, and then layered back on a last-in, first-out (LIFO) basis.

A corporation may eliminate or deduct dividend income when certain requirements are met. The available eliminations or deductions are described below.

#### Part I – Elimination of Intercompany Dividends

Dividends paid to an electing S corporation from earnings and profits accumulated during any taxable year in which the dividend payer was included in the combined report, which included the dividend payee, qualify for the 100% intercompany dividend elimination. See R&TC Section 25106 for more information.

A corporation that has made a valid election to be treated as an S corporation is generally not included in a combined report. However, in some cases, the FTB may use combined reporting methods to clearly reflect income of an S corporation, see R&TC Section 23801 (d)(1).

If no entry in Part III, enter the total from Part I, line 4, column (d) on Form 100S, Side 2, line 9.

#### Part II – Deduction for Dividends Paid to a Fully Included Member of a Water's-Edge Combined Report

R&TC Section 24411 allows for a 75% deduction of a portion of the dividends received and included in the water's-edge return. Dividends received from banks qualify for the water's-edge dividend deduction. Both business and nonbusiness dividends qualify for the dividend deduction. The allowable business dividend deduction is determined by multiplying the total dividend deduction (business and nonbusiness) by the ratio of business dividends to total dividends. The remaining dividend deduction is the nonbusiness dividend deduction.

A deduction of 100% is provided for dividends derived from certain foreign construction projects (FCP). A construction project is defined as an activity attributable to an alteration of land or any improvement thereto. The construction project, the location of which is not subject to the taxpayers' control, must be undertaken for an entity, including a governmental entity, that is not affiliated with the water's-edge group. For more information, see R&TC Section 24411 and Form 100W, California Corporation Tax Booklet — Water's-Edge Filers.

Report the dividends received from certain foreign construction projects in Part II, column (g). Write the dividend payer's name and enter dividends received from certain foreign construction projects as "FCP" in Part II, column (a).

In no event will an R&TC Section 24411 deduction be allowed with respect to a dividend for which a deduction was allowed under R&TC Section 24410 or which was eliminated under R&TC Section 25106.

Current year qualifying dividends are dividends received by any current member of the water's-edge group from a corporation (regardless of the place of incorporation) if both of the following apply:

- The average of the payer's property, payroll, and sales factors within the U.S. is less than 20%.
- More than 50% of the total combined voting power of all classes of voting stock is owned directly or indirectly by a member of the water's-edge group at the time the dividend is received.

#### Interest Expense Deduction

The amount of interest expense incurred for purposes of foreign investments that must be offset against deductible foreign dividends must be computed by multiplying the amount of interest expense by the same percentage used to compute the deductible portion of the qualifying foreign dividends.

The payer need not be in a unitary relationship with the recipient or any other member of the water's-edge group.

Intercompany dividends received within the current taxable year's water's-edge group should be eliminated pursuant to R&TC Section 25106 before computing the dividend deduction.

Complete Part II and enter the total of line 4 column (g) on Form 100S, Side 2, line 10. For Part II, column (d), if any portion of a dividend also qualifies for the intercompany elimination in Part I, enter the balance from Part I, column (g) in Part II, column (d).

#### Part III – Deduction for Dividends Paid to a California Corporation by an Insurance Company

R&TC Section 24410 provides that a corporation that owns 80% or more of each class of stock of an insurer is entitled to an 85% dividends received deduction for qualified dividends received from that insurer. The deduction would be allowed regardless of whether the insurer does business in California.

The amount of the dividends that qualify for the dividends received deduction is the total amount of dividends received from that insurer, multiplied by the insurer's qualified dividend percentage. The qualified dividend percentage is determined under R&TC Section 24410(c).

To complete Part III:

1. Fill in columns (a) through (c).
2. Enter in column (d) the total amount of insurance dividends received.
3. Enter the qualified dividend percentage in column (e).
4. Multiply the amount in column (d) by the qualified dividend percentage in column (e) and enter that amount in column (f).
5. Multiply the amount in column (f) by 85% and enter the result in column (g).
6. Total amounts in Part III, column (g). Add amounts from Part I, line 4, column (d). Enter the result here and on Form 100S, Side 2, line 9.

The calculation of the qualified dividend percentage should be presented in a supplemental schedule that is attached to the taxpayer's return. The supplemental schedule should identify the amount of the net written premiums for all the insurance companies in the commonly controlled group for the preceding five years (including an identification of property/casualty premiums, life insurance premiums, and financial guarantee premiums), the relative weight given to each class of net written premiums, and the total income of the insurance companies in the commonly controlled group (including premium and investment income for the preceding five years). For more information, see R&TC Section 24410.