Request to Amend Regulations 24411 and 25106.5-1
Dividend Ordering Rules and the *Fujitsu* (*Amdahl*) Case

In *Fujitsu IT Holdings, Inc. v. Franchise Tax Board*[1] (2004) 120 Cal.App.4th 459, the First District Court of Appeal addressed an important question regarding the ordering of dividends distributed from earnings and profits. The court held that when a corporation issues a dividend, dividends that are eligible for elimination under Revenue and Taxation Code section 25106[2] should be considered distributed out of unitary earnings and profits before other earnings and profits. The effect of that holding is that tax-preferred dividends (such as dividends eligible for elimination under section 25106) are considered to be distributed before other dividends.

One of the specific questions raised in the case was whether dividends described by section 25106, which eliminates dividends paid from income previously included in a combined report, should take an ordering preference over dividends described by section 24411. Section 24411 generally allows water's edge taxpayers to claim a 75% deduction for dividends paid from certain foreign corporations. The court of appeal acknowledged that regulations adopted under section 24411 provided that distributions from earnings and profits a portion of which are eligible for section 25106 treatment and a portion of which are eligible for section 24411 treatment should be prorated. The court, however, saw a different rule in an example in regulations dealing with intercompany transactions between members of a combined reporting group. As it read that example, the court stated that the "regulations *seem to* indicate that when a dividend is paid out of a mix of" earnings eligible for section 25106 treatment and other earnings and profits, section 25106 dividends "are deemed distributed first, dollar for dollar." Finding these provisions potentially in conflict, the court found an absence of "any clear and controlling guidance on this question" and held that section 25106 dividends should be considered to have been paid from earnings and profits first.

The intercompany transaction regulation in question, Cal. Code Regs., tit. 18, §25106.5-1, subsection (f)(2),[3] was not in effect for the years at issue in the case (1988-1992). Under reg. §25106.5-1, subsection (k), the whole of reg. §25106.5-1 applied only to intercompany transactions occurring on or after January 1, 2001. Thus, it was not appropriate for the court to rely upon those regulations to find a conflict. If those regulations did not apply by their terms, there was no conflict.

But more importantly for purposes of this request, the court appeared to have misconstrued the example upon which it relied. The facts of the example (reg. §25106.5-

[1] At earlier levels of the proceedings of this case, the case was referred to as *Amdahl Corporation v. Franchise Tax Board*.
[2] All section numbers indicated hereafter refer to the Revenue and Taxation Code, unless otherwise indicated.
[3] All regulation sections adopted under Cal. Code Regs., tit.18, referred to hereafter shall be described as "reg. §."

1, subsection (f)(2), example 2) described a situation involving $10 of earnings and profits from "prior combined reports" and also $490 of earnings and profits that arose in "years before a unitary relationship existed." In the example, a dividend of $100 was issued, and the example concluded that $10 of that amount was eliminated and $90 was subject to tax. The court apparently construed that example as giving an ordering preference to section 25106 dividends regardless of the year in which earnings and profits arose.

However, the normal statutory rules for earnings and profits found in Internal Revenue Code section 316, incorporated into California law under section 24451, require that earnings and profits be drawn first from current year earnings and profits, and then from the most recently accumulated earnings and profits. In other words, earnings and profits are drawn from the current year until exhausted, and then drawn from successive years, backwards in time. This basic principle is reflected in reg. §24411, subsection (e)(1), which states that "dividends shall be considered paid out of the current year's earnings and profits to the extent thereof and from the most recently accumulated earnings and profits by year thereafter."

Under the facts of the example relied upon by the court, the $10 attributable to earnings and profits in a combined report was *from a more recent year* than the earnings and profits that were not included in a combined report. According to the example, the $490 of earnings and profits "arose *in years before* a unitary relationship existed." (Emphasis added). Thus, the example merely illustrated a simple proposition: the section 25106 dividends were treated as distributed first, NOT because they are treated preferentially, but because they came from a more recent year, under the application of the standard federal rule. Thus, the court found an ambiguity where there was none. Accordingly, the court should not have relied upon that regulation example to support its holding.

If the statutory ordering rules of Internal Revenue Code section 316 are properly applied, the issue of proration will only occur when a dividend distribution is drawn from a specific year, and the earnings and profits of that year are not wholly exhausted. If a distribution entirely consumes a given year's earnings and profits, then the entire amount in that pool of earnings and profits is drawn out, and proration is unnecessary. If the distribution does not exhaust the pool of earnings and profits of that year and the earnings and profits consist of both unitary and non-unitary earnings and profits, reg. §24411, subsection (e), clearly prescribes that the distribution be considered drawn from both classes of earnings and profits on a pro rata basis.

The principle of prorating dividend payments against all of the earnings and profits is a long established principle in California law. The issue arose under section 24402, which allowed a dividends-received-deduction to the extent a dividend was paid out of earnings previously taxed by California. The source of dividends reflects both the apportionment of income and the allocation of nonbusiness income and for purposes of section 24402 dividends were treated as being paid proportionately from California source and non-California source income. The California Supreme Court in *Safeway Stores Inc. v. Franchise Tax Board* (1970) 3 Cal 3rd 745, 753 acknowledged and endorsed this principle. "The method employed in the present case would be a section 8, subdivision (h), [the predecessor to 24402] deduction for each dividend in the ratio that the earnings and profits of each payor attributable to California bears to its total earnings and profits. No error is shown." *Safeway* itself involved the method for extending this principle in a combined report setting.

Because the *Fujitsu* court's holding was based on a misconstruction of a regulation, which by its terms was not applicable to the year in question and by its example didn't apply to the issue presented to the court, and because of the court's open disregard of a regulation which it acknowledged was on point, the court's holding appears to be in error.

Staff recommends that regulations under both section 25106.5-1 and 24411 be amended to provide examples that would remove any possibility of misconstruction by a court, or reliance by taxpayers on an erroneous holding of the court. Draft amendments to the regulations are attached that would do that.

There are two alternative approaches available. First, the staff could be authorized to immediately proceed to the formal hearing process. Second, staff could be directed to hold a symposium and after consideration of input received at the symposium, report back to the Board to request authorization to proceed to hearing.

Staff recommends proceeding on the first alternative. There is a need to proceed expeditiously so as to avoid taxpayer reliance on the decision in *Fujitsu.* Holding a symposium, the second alternative, would appear to serve little purpose as there is no need to develop alternatives.

Note: In the process of developing those amendments, staff discovered what it believes to be a technical error in the intercompany transaction regulation (reg. §25106.5-1). The regulation appears to indicate that taxable dividends (i.e., that are not eliminated from income under section 25106) paid between unitary members should be disregarded in the sales factor. Taxable dividends are, by definition, paid from income *other than* income that was included in a combined report. Thus, they are paid from activities that are not part of the combined report activity of the shareholder and its subsidiary, and should not be eliminated. If the income is to be taxed, then the factors relating to the taxability of those dividends should be represented in the apportionment formula that will be used to assign that income to the various states. The attached regulation reflects that change. In addition, clarifying amendments were added to section 24411 to 1) provide that section 24411 applies even if a dividend distribution is from earnings and profits of a year before the year for which water's edge election was made and 2) explicitly state that dividends attributable to construction projects are not allowed as a deduction under section 24411 to the extent otherwise allowed as a deduction or eliminated from income.

Staff Proposed Amendments to Regulation 24411
Additions in Underline
Deletions in ~~Strikethrough~~

(a) Allowance of deduction. Revenue and Taxation Code section 24411 allows taxpayers that have elected to compute their income derived from or attributable to sources within California pursuant to Article 1.5 of Chapter 17 of the Corporation Tax Law a deduction with respect to qualifying dividends. In general, the deduction is an amount equal to 75 percent of such qualifying dividends. However, a deduction in an amount equal to 100 percent is allowed with respect to such qualifying dividends derived from specified construction projects. No deduction is allowable under section 24411 with respect to dividends for which a deduction is allowable or otherwise eliminated from net income under some other provision of the Revenue and Taxation Code.

(b) Definitions.

(1) Qualifying dividends.

(A) "Qualifying dividends" are those dividends received by any member of the water's-edge group from a corporation, the average of whose property, payroll and sales factors within the United States is less than 20 percent and of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned directly or indirectly by the water's-edge group at the time the dividend is received. The dividend payor need not be in a unitary relationship with the recipient of the dividend or any other member of the water's-edge group, and the dividend can be a "qualifying dividend" even if it is paid from earnings and profits from a year before a year for which the water's-edge election was made. ~~A dividend received from a member of the water's edge group may be a qualifying dividend when it is treated as being paid out of earnings which were not included in a combined report with those of the recipient~~. Qualifying dividends shall be classified as business or nonbusiness income pursuant to the rules established in regulations adopted pursuant to Part 11 of the Revenue and Taxation Code. (See Cal. Code Regs., tit. 18, § 25120, sub. (c), and applicable administrative and judicial decisions.)

(B) For purposes of the definition of "qualifying dividends" in Revenue and Taxation Code section 24411, subdivision (a), the term "corporation" shall include banks for taxable years beginning on or after January 1, 1998.

(C) Qualifying dividends do not include amounts deemed to be dividends pursuant to Internal Revenue Code sections 78, 951 et seq., and 1248, or otherwise, unless there is a distribution, actual or constructive, or a provision in the Revenue and Taxation Code requiring that a dividend be deemed to have been received.

(2) United States. For purposes of this section the "United States" means the 50 states of the United States and the District of Columbia.

(3) Water's-edge group. "Water's-edge group," for purposes of the calculations required by Revenue and Taxation Code section 24411, means all banks, corporations or other entities whose income and apportionment factors are considered pursuant to Revenue and Taxation Code section 25110 in computing the income of the individual taxpayer for the current taxable year which is derived from or attributable to sources within this state.

(c) Computation of amount allowable.

(1) In general. The amount of the deduction allowable under Revenue and Taxation Code section 24411 is equal to 100 percent of the qualifying dividends described in ~~Revenue and Taxation Code~~ section 24411, subdivision (c), and 75 percent of other qualifying dividends, to the extent that either class of qualifying dividend is not otherwise ~~allowed~~ allowable as a deduction or eliminated from income.

(2) Dividends deductible under other sections. In no event shall a deduction be allowed with respect to a dividend for which a deduction is allowable ~~has otherwise been allowed~~ (e.g., Revenue and Taxation Code sections 24402 or 24410) or which is ~~has been~~ eliminated from income (e.g., Revenue and Taxation Code section 25106). (See subsection (e) below.)

(d) Dividends derived from construction projects.

(1) General. A deduction in the amount of 100 percent shall be allowed for qualifying dividends derived from construction projects, the locations of which are not subject to the control of the taxpayer. If the payor of the dividend has earnings and profits derived from both construction projects and other activities, the dividend shall be treated as paid from construction projects as described in subsection (d)(5) of this regulation.

(2) Construction project. "Construction project" for purposes of Revenue and Taxation Code section 24411, subdivision (c), means an activity undertaken for an entity, including a governmental entity, which is not affiliated with the water's-edge group, the majority of the cost of performance of which is attributable to an addition to real property or to an alteration of land or any improvement thereto as those terms are defined in the Revenue and Taxation Code and the regulations adopted pursuant thereto.

(A) A "construction project" does not include the operation, rental, leasing or depletion of real property, land or any improvement thereto.

Example: An oil company drills a successful oil well in a foreign country and produces oil. Dividends arising from the production of oil are not derived from a construction project.

(B) For purposes of this subsection (2), an entity is affiliated if it is a member of a commonly controlled group of which a member of the water's-edge group is also a member. (See Cal. Code Regs., tit. 18, § 25110, sub. (b)(2).)

(3) Location not subject to taxpayer's control. A "location is not subject to the taxpayer's control" when the majority of the construction, measured by costs of performance, must be performed at the site in the foreign location because of the nature and character of the project, not because of the terms of the contract.

(4) Examples:

(A) A construction project is undertaken to build a dam. The location is not subject to the taxpayer's control because the dam must be built at a specific site.

(B) A construction project is undertaken to build a skyscraper. The location is not subject to the taxpayer's control because the skyscraper must be built at a specific site.

(C) A construction project is undertaken for the erection of pre-fabricated buildings. The majority of the cost involves pre-fabrication of the components, not their assembly and erection. The components can be pre-fabricated anywhere. The location of the project is under the control of the taxpayer.

(D) An engineering firm designs an oil refinery. The project does not qualify for a deduction under Revenue and Taxation Code section 24411, subdivision (c), because (1) it does not involve construction, and (2) the activity can be conducted anywhere.

(5) Determination of dividends attributable to construction projects the location of which is not subject to the taxpayer's control. For purposes of determining whether dividends are attributable to construction projects the location of which is not subject to the taxpayer's control, dividends shall be considered to be paid out of the current year's earnings and profits to the extent thereof and from the most recently accumulated earnings and profits, by year, thereafter. For any year in which the dividend payor has earnings and profits from activities other than construction projects the location of which is not subject to the taxpayer's control, the dividend shall be attributed to construction projects the location of which is not subject to the taxpayer's control in the ratio which the total earnings and profits from construction projects the location of which is not subject to the taxpayer's control bears to the total earnings and profits for the year. For purposes of applying such ratio, earnings and profits attributable to any particular construction project or other activity of the payor of the dividend shall include all costs and expenses directly attributable to such project or activity as well as an allocable portion of the total other costs and expenses of the payor which are not attributable to a particular project or activity. The total of such other costs and expenses will be allocated among all of the projects and activities of the payor on the basis of their relative gross receipts, or on any other reasonable basis which the payor uses to apportion or allocate such expenses. Following the allocation of all costs and expenses of the payor, any deficit in earnings and profits for any project or activity will be ignored in calculating the ratio referred to above.

Example: Following the allocation of all costs and expenses, the payor has total earnings and profits of $ 150, comprised of earnings and profits of $ 100 each from projects A and B and a deficit of $ 50 for activity C. Of the total earnings and profits of $ 150, $ 75 will be attributable to A and $ 75 to B. No earnings and profits will be attributable to C.

(e) Classification of distributions.

(1) Ordering. For purposes of determining the application of Revenue and Taxation Code sections 24402, 24410, 24411 and 25106 (or any other section of the Revenue and Taxation Code that provides that a dividend is not included in net income), dividends shall be considered to be paid out of the current year's earnings and profits to the extent thereof and from the most recently accumulated earnings and profits by year thereafter. (See section 316 of the Internal Revenue Code (applicable for purposes of Part 11 of the Revenue and Taxation Code pursuant to section 24451 of the Revenue and Taxation Code).) If a dividend is paid out of the earnings and profits of a given year, and the dividend is not sufficient to exhaust the total earnings and profits of that year, the dividend shall be considered a dividend eligible for treatment under Revenue and Taxation Code sections 24402, 24410, 24411, or 25106 (or any other section of the Revenue and Taxation Code that would provide that the dividend is not included in net income), respectively, on a pro rata basis, based on the ratio of earnings and profits drawn from that year to the total earnings and profits originally available to be drawn from that year.

(2) Partially included entities. In the case of an affiliated corporation, a portion of whose net income and apportionment factors are included in a combined report by reference to Revenue and Taxation Code section 25110, subdivision (a), paragraphs (4) or (6), which pays dividends to other members of the taxpayer's water's-edge group, the following rules shall apply:

(A) Dividends shall be considered to be paid out of current earnings and profits to the extent thereof and from the most recently accumulated earnings and profits thereafter. (See section 316 of the Internal Revenue Code (applicable for purposes of Part 11 of the Revenue and Taxation Code pursuant to section 24451 of the Revenue and Taxation Code).)

(B) Dividends which are considered paid out of earnings and profits of a year in which only a portion of the dividend-paying entity's income and factors were considered in determining the amount of income derived from or attributable to California sources of another entity shall be considered subject to the provisions of Revenue and Taxation Code section 25106, to the extent paid out of that portion of the earnings and profits attributable to income included in the combined report, under the rules provided in subsection (e)(1) of this section.

(3) Subpart F income. For purposes of Revenue and Taxation Code section 25110, subdivision (a), paragraph (6), a portion of the income and apportionment factors of an entity with Subpart F income, as defined in the Internal Revenue Code, is included in the combined report used to determine the income of the water's-edge group derived from or attributable to sources within this state. For purposes of the Internal Revenue Code, Subpart F income is treated as a deemed dividend to the owner of the corporation. This is different from the treatment provided for in Revenue and Taxation Code section 25110. As a consequence, the rules established in the Internal Revenue Code and the regulations adopted pursuant thereto with regard to the classification of distributions from an entity with Subpart F income have no application for purposes of the Corporation Tax Law. The classification of a distribution for an entity that has Subpart F income shall follow the rules set forth in subsections (e)(1) and (2) of this regulation.

(4) Examples:

~~Example 1: Corporation A files a water's edge election which allows it to exclude Corporation C, a foreign incorporated unitary subsidiary with none of its property, payroll, and sales factors within the United States. Corporation C has current earnings and profits of $100 and retained earnings and profits of $100 during years when C was included in the combined report filed by A.~~

~~C declares a dividend of $100. The entire payment is subject to the provisions of Revenue and Taxation Code section 24111.~~

~~C declares a dividend of $150. The dividend is deemed to be paid first our of the current year's earnings and profits of $100. The remaining $50 is paid from accumulated earnings and profits earned in years when C was included in the combined report filed by A.~~

~~A portion of the payment, $100, is subject to the provisions of Revenue and Taxation Code section 24411. The remaining $50 is subject to the provisions of Revenue and Taxation Code section 25106 and is eliminated from A's income.~~

Example 1: Corporation A owns more than 50% of the voting stock of Corporation B, a foreign corporation that had no property, payroll, or sales within the United States. Corporation B was excluded from Corporation A's water's edge group pursuant to a water's-edge election made for the current year. Corporation B had earnings and profits for the current year (Year 2) in the amount of $400, and had earnings and profits of $500 for the immediately preceding year (Year 1). None of the earnings and profits for either year was attributable to a construction project. All dividends drawn from Corporation B's earnings and profits of Year 2 are eligible for the 75% deduction provided by section 24411 of the Revenue and Taxation Code. In Year 1, the water's-edge election was not in place. In Year 1, Corporation B had earnings and profits of $300 attributable to income included in the combined report of Corporations A and B, and dividends drawn from those earnings and profits are eligible for elimination under section 25106 of the Revenue and Taxation Code. The remaining $200 of earnings and profits was not attributable to income included in the combined report of Corporations A and B. Because section 24411 applies only to qualifying dividends not otherwise deductible or eliminated from income, only $200 of dividends paid from the earnings and profits for Year 1 is eligible for the 75% deduction provided by section 24411. During Year 2, Corporation B issued a dividend to Corporation A of $800.

The dividend is first considered drawn from the earnings and profits of the current year, Year 2. Because the current year's earnings and profits are exhausted, the pro rata rule of subsection (e)(1) of this section does not apply to dividends paid from that year. Thus, the entire $400 of dividend paid from Year 2 earnings and profits is eligible for the 75% deduction provided by section 24411. The remaining $400 portion of the dividend ($800 less the $400 drawn from the current year's earnings and profits) is then drawn from the earnings and profits of Year 1. Because the earnings and profits of Year 1 are not exhausted by the dividend paid, the dividend is treated as drawn proportionately from all earnings and profits of that year under subsection (e)(1) of this section. Thus, $240 of the dividend from that year is eliminated from income under section 25106 ($300 eligible for section 25106 treatment times the ratio of the amount drawn from Year 1 ($400) to the original amount available to be drawn from that year ($500)). Dividends of $160 are eligible for the 75% deduction under section 24411 ($200 eligible for section 24411 treatment times the ratio of the amount drawn from Year 1 ($400) to the amount originally available to be drawn from that year ($500)), because section 24411 applies regardless of the year of earnings and profits from which the dividend is paid. The total amount of earnings and profits paid as a dividend that is eligible for the 75% deduction under section 24411 is $560 ($400 from Year 2 and $160 from Year 1). The taxpayer's deduction under section 24411 is $420 ($560 x 75%).

Example 2: Corporation A has filed a water's-edge election effective January 1 ~~1988~~ of Year 1, which would allow it to exclude ~~corporation~~ Corporation F except for the fact Corporation F has Subpart F income that causes Corporation F to be a partially included controlled foreign corporation. The partial inclusion ratio equals Subpart F income of the controlled foreign corporation divided by current earnings and profits. Corporation F has a partial inclusion ratio of ~~66.67%~~80% and total earnings and profits of $150 in ~~1988~~ Year 1. Therefore, ~~$100~~ $120 represents earnings and profits attributable to income ($150 earnings and profits times the ~~x~~ ~~66.7%~~80% inclusion ratio = ~~$100~~$120) included in the combined report required pursuant to Revenue and Taxation Code section 25110, and dividends paid from those earnings and profits are eligible for elimination under section 25106. In ~~1989~~Year 2, Corporation F has a partial inclusion ratio of ~~50%~~60% and total earnings and profits of $100. Therefore, ~~$50~~$60 represents earnings and profits attributable to income ($100 earnings and profits x ~~50%~~60% inclusion ratio = ~~$50~~$60) included in the combined report required pursuant to Revenue and Taxation Code section 25110, and dividends paid from those earnings and profits are eligible for elimination under section 25106. None of the earnings and profits was attributable to construction projects.

Corporation F declares a dividend of $75 in ~~1989~~Year 2. The distribution is not sufficient to exhaust the $100 of earnings and profits for Year 2 and the pro rata rule of subsection (e)(1) of this section applies. Thus, $45~~$37.50~~ of the dividend ~~for 1989~~paid in Year 2 (~~$50~~$60 eligible for section 25106 treatment x $75/$100) is treated as having been paid from the available ~~$50~~$60 of earnings and profits attributable to income included in the combined report in ~~1989~~Year 2 and is eliminated from income. The remaining $30 portion of the dividend ($40 x $75/$100) is not eligible for elimination under section 25106 but is eligible for the 75% deduction under section 24411.

In summary, Corporation A has dividend income of ~~$37.50~~$45 which is subject to the provisions of Revenue and Taxation Code section 25106 and is therefore eliminated from income and ~~$37.50~~$30 of dividends subject to the provisions of Revenue and Taxation Code section 24411. Corporation A's deduction under section 24411 is $22.50 ($30 x 75%).

Example 3: Assume the same facts as in Example 2, except that Corporation F declares a dividend of $200 in ~~1989~~Year 2. The distribution exceeds the $100 of earnings and profits for Year 2, and thus the pro rata rule of subsection (e)(1) of this section does not apply to the distributions of that year. Thus, ~~$50~~$60 of the dividend is treated as having been paid from the ~~$50 of~~entire $60 of earnings and profits attributable to income included in the combined report in

~~1989~~Year 2, and ~~$50~~$40 of the dividend is treated as having been paid from the ~~other~~whole of the remaining $40 of earnings and profits that were attributable to income that was not included in the combined report in ~~1989~~Year 2. The remaining $100 ($200 less the $100 earnings and profits drawn from Year 2) is treated as having been paid from ~~1988~~Year 1 earnings and profits. Because the remaining $100 distribution does not exhaust the earnings and profits for Year 1, the pro rata rule of subsection (e)(1) of this section applies. Thus, ~~$66.67~~ $80 of the dividend ($120 x $100/$150) is treated as being paid from earnings and profits attributable to income included in the combined report in ~~1988~~Year 1. ~~and the~~ The remaining ~~$33.33~~$20 ($30 x $100/$150) is from earnings and profits attributable to income that was not included in the combined report in ~~1988~~Year 1, and is eligible for the 75% deduction under section 24411.

In summary, Corporation A has dividend income of ~~$116.67 ($50 (1989) + $66.67 (1988))~~$140 ($60 from Year 2, and $80 from Year 1) which is subject to the provisions of Revenue and Taxation Code section 25106 and is therefore eliminated from income. Corporation A's remaining ~~$83.33 ($50 (1989) + $33.33 (1988))~~$60 ($40 from Year 1 and $20 from Year 2) of dividend income is subject to the provisions of Revenue and Taxation Code section 24411. Corporation A's deduction under section 24411 is $45 ($60 x 75%).

Example 4: Corporation A files a water's-edge election which allows it to include Corporation P, a foreign incorporated unitary subsidiary with less than 20 percent of the average of its property, payroll and sales factors within the United States only to the extent of its United States income and factors. Corporation P has current earnings and profits of $100 of which $10 represents earnings and profits attributable to income included in the water's-edge combined report pursuant to Revenue and Taxation Code section 25110, subdivision (a)(4). None of its earnings and profits is attributable to construction projects.

P declares a dividend of $50~~.~~, which is not sufficient to exhaust the earnings and profits of the current year. Thus, the pro rata rule of subsection (e)(1) of this section applies to the current year's dividend paid . Of ~~such amount~~the dividend paid, $5 ($10 x $50/$100) is subject to elimination under Revenue and Taxation Code section 25106, and $45 ($90 x $50/$100) is subject to the provisions of Revenue and Taxation Code section 24411. Corporation A's deduction under section 24411 is $33.75 ($45 x 75%).

Staff Proposed Amendments to Regulation § 25106.5-1
(Only those subsections proposed to be amended are set forth)
Additions in <u>Underline</u>
Deletions in ~~Strikethrough~~

(b) Definitions. For purposes of this regulation:

(1) Intercompany transactions.

(A) Except as provided in subsection (b)(1)(B), the term "intercompany transaction" means a transaction between corporations which are members of the same combined reporting group immediately after such transaction. "S" is the member transferring property or providing services, and "B" is the member receiving the property or services. Intercompany transactions include, but are not limited to --

1. S's sale of property (or other transfer, such as an exchange or contribution) to B;

2. S's performance of services for B, and B's payment or accrual of its expenditures for S's performance;

3. S's licensing of technology, rental of property, or loan of money to B, and B's payment or accrual of its expenditures; and

4. S's distribution to B with respect to S stock<u>, to the extent that the distribution is eliminated from income under section 25106 or constitutes a distribution in excess of basis that results in a deferred intercompany stock account (DISA) as described in subsection (f) of this regulation</u>.

5. (B) The term intercompany transaction does not include transactions which produce nonbusiness income or loss to the selling member or income attributable to a separate business activity of the selling member. The term intercompany transaction also does not apply when the asset transferred in the transaction is acquired for the buyer's nonbusiness use or for the use of a separate business activity of the buyer. For purposes of this regulation, such transactions shall be considered as if between corporations that are not members of a combined reporting group.

* * *

(f) Stock of Members.

(1) Unless otherwise provided, this regulation applies the provisions of Treasury Regulation section 1.1502-13(f) relating to stock of members; however, the provisions of subsection (f)(6) of that section shall not apply.

(A) Exception for distributee member. Treasury Regulation section 1.1502-13(f)(2)(ii) shall not apply to exclude intercompany distributions from the gross income of the distributee member. Intercompany dividend distributions described by section 301(c)(1) of the Internal Revenue Code are included in the income of the distributee member unless subject to elimination or deduction under other applicable law, including sections 25106 or 24402 of the Revenue and Taxation Code. The treatment of intercompany distributions described by section 301(c)(3) of the Internal Revenue Code is provided by subsection (f)(1)(B) of this regulation.

(B) Deferred intercompany stock account (DISA). That portion of an intercompany distribution which exceeds California earnings and profits and P's basis in S's stock (the portion of a distribution described by section 301(c)(3) of the Internal Revenue Code) will create a DISA. In this subsection, P is treated like the Buyer (B) for purposes of calculating corresponding and recomputed items.

The DISA will be treated as deferred income. To the extent of a sale, liquidation or any other disposition of shares of the stock, the balance of the DISA with respect to such shares will be taken into account as income or gain to P even if S and P remain members of the same combined reporting group. The disposition shall be treated as a sale or exchange for purposes of determining the character of the DISA income or gain. The DISA is held by the distributee.

1. A disposition of all the shares shall be deemed to have occurred if either S or P becomes a non-member of the combined reporting group or if the stock of S becomes worthless.

2. Because P's DISA is deferred income and not negative basis, the DISA is taken into account upon liquidation, including complete liquidation into the parent. The deferred income restored as a result of the liquidation will be taken into account ratably over 60 months unless the taxpayer elects to take the income into account in full in the year of liquidation. For example, if S liquidates and the exchange of P's S stock is subject to section 332 of the Internal Revenue Code (section 24451 of the Revenue and Taxation Code), P's DISA income taken into account under subsection (f)(1)(B) of this regulation is recognized over 60 months, unless an election is made to recognize the deferred income in the year of liquidation. Nonrecognition or deferral shall not apply to DISA income or gain taken into account as a result of an event described in subsection (f)(1)(B)1. of this regulation.

3. If P transfers the stock of S to another member of the combined reporting group, P's DISA income will be an intercompany item and deferred under the rules of this regulation.

4. If, on the effective date of this regulation, a closing agreement has been executed with the Franchise Tax Board to defer income from distributions described under section 301(c)(3) of the Internal Revenue Code, then such income shall be included in the DISA of the distributee member to the extent that it has not already been taken into account in the income of the distributee member. Thereafter, the balance of the DISA account shall be taken into account under the rules of this regulation.

5. If P receives an intercompany distribution described by section 301(c)(3) of the Internal Revenue Code in an income year beginning prior to the effective date of this regulation, the taxpayer may request a closing agreement under section 19441 of the Revenue and Taxation Code that will allow the gain from the distribution to be deferred in a manner consistent with the provisions of subsection (f)(1)(B) of this regulation. The request shall be mailed within one year after the effective date of this regulation and within the applicable statutes of limitations on deficiency assessments or refund claims for the year of the distribution. The request shall describe the parties to the transaction, including federal identification numbers, the nature of the distribution, the timing and amounts of the income involved, and any other relevant facts. Requests shall be mailed to the following address: California Franchise Tax Board, Legal Branch, Attn: Chief Counsel, P.O. Box 1720, Rancho Cordova, CA 95741-1720.

(2) Examples. The application of this section to intercompany transactions with respect to stock of members is illustrated by the following examples.

Example 1: Dividend exclusion and property distribution.

(Refer to Treas. Reg. § 1.1502-13(f)(7), example 1.)

Facts. On December 31 of Year 1, S had accumulated earnings and profits of $480, and in Year 2, S had an additional $20 in earnings and profits. The earnings and profits from both years were attributable to business income included in the combined report that included S and its parent corporation P and eligible for elimination under section 25106 of the Revenue and Taxation Code. In Year 3, S owns land that is used in the trade or business of the combined reporting group with a $ 70 basis and $ 100 value. ~~On January 1 of Year 1,~~ P's basis in S's stock is $ 100 ~~and S has accumulated earnings and profits of $500 from prior year's combined reports of S and P.~~ During ~~Year 1~~ Year 3, S declares and makes a dividend distribution of the land to P. P also uses the land in the unitary business. S has no earnings and profits from its ordinary business operations in Year 3. Under section 311(b) of the Internal Revenue Code, S has a $ 30 gain. Under section 301(d) of the Internal Revenue Code, P's basis in the land is $ 100. (California law generally conforms to Internal Revenue Code sections 301-385 under section 24451 of the Revenue and Taxation Code.) On July 1 of Year ~~3~~ 4, P sells the land to Y for $ 110.

Dividend treatment. S's distribution of the land is an intercompany distribution to P in the amount of $ 100. Under subsection (j)(4) of this section, the $30 of intercompany gain is not reflected in the earnings and profits of S in Year 3. Instead, that amount is reflected in the earnings and profits of S in Year 4, the year of the sale of the land to Y. Under section 316 of the Internal Revenue Code (applicable for purposes of Part 11 of the Revenue and Taxation Code pursuant to section 24451 of the Revenue and Taxation Code), earnings and profits are first paid from current earnings and profits, and then from earnings and profits of the most recent year of accumulation. Because S had no earnings and profits in Year 3, the distribution in Year 3 is first paid out of Year 2 earnings and profits of S~~,~~ (to the extent of the available $20) and then the remaining $80 (the $100 distribution less the $20 drawn from Year 2) is paid out of the available $480 of earnings and profits of Year 1. Because the entire earnings and profits of both years ~~which~~ are attributable to income that has ~~have~~ been included in a combined report of S and P, the entire $100 dividend ~~it~~ will be eliminated from P's income pursuant to section 25106 of the Revenue and Taxation Code. The payment of the dividend has no effect on P's $100 basis in the stock of S.

Matching rule. Under the matching rule (treating P as the buying member and S as the selling member), S takes its $ 30 intercompany gain into account in Year ~~3~~4 to reflect the $ 30 difference between P's $ 10 corresponding gain ($ 110-$ 100 basis in the land) and the $ 40 recomputed gain ($ 110 - $ 70 basis that the land would have had if S and P were divisions).

Apportionment. ~~The~~Because the entire amount is eliminated from income under section 25106, the intercompany distribution is not reflected in the sales factor in Year ~~1~~3. In Year ~~3~~ 4, unless otherwise excluded, the $ 110 gross receipts from P's sale of the land to Y will be included in P's sales factor. After the distribution in Year ~~1~~3, the land will be included in P's property factor at S's $ 70 original cost basis. Both S's $ 30 gain and P's $ 10 gain relative to the distributed land will be treated as current apportionable business income in Year ~~3~~4.

Example 2: Dividends paid from ~~pre-unitary~~ earnings and profits not included in a combined report.

Facts. The facts are the same as in Example 1 except that only $300 of S's $480 earnings and profits from Year 1 were attributable to income included in a ~~prior~~combined report that included S and P, and thus eligible for elimination under section 25106 of the Revenue and Taxation Code. ~~is only $10. S also has $490 of earnings and profits that arose in years before a unitary relationship existed between S and P.~~

Dividend treatment. Because ~~only $10~~ $20 of S's distribution was paid from earnings and profits attributable to Year 2 business income that was wholly included in a combined report of S and P, ~~only~~ the entire ~~$10~~$20 amount is eliminated under section 25106 of the Revenue and Taxation Code. The remaining $ ~~90~~ 80 of the dividend ~~will be taken into account by P in Year 1~~ is treated as proportionately paid from the whole of the original earnings and profits of Year 1, the next most recent year of accumulation, including both earnings and profits that were attributable to S and P's combined report and those that were not. Thus, $50 ($300 combined report earnings and profits multiplied by the ratio of $80 (the remaining amount of the dividend, drawn from Year 1) to $480 (the total originally available earnings and profits of Year 1) is treated as eliminated under section 25106 of the Revenue and Taxation Code. The remaining $30 paid from earnings and profits of Year 1 ($180 earnings and profits not eligible for elimination under section 25106 multiplied by the ratio of $80 (the remaining amount of the dividend, drawn from Year 1) to $480 (the total earnings and profits of Year 1)) is taxable, subject to any applicable deductions under Revenue and Taxation Code sections 24402, 24410, ~~or~~ 24411 or any other section of the Revenue and Taxation Code that provides that the dividend not included in net income ~~of the Revenue and Taxation Code~~. (See California Code of Regulations, title 18, section 24411, subsection (e) for rules relating to the treatment of distributions that include both earnings and profits eligible for elimination under section 25106 of the Revenue and Taxation Code, and those eligible for deduction under sections 24402, 24410, and 24411 or any other provision of the Revenue and Taxation Code.)

Matching rule. P's corresponding item is not its dividend income, but its income, gain, deduction or loss from the property acquired in the intercompany distribution. Therefore, none of S's intercompany gain will be taken into account in Year ~~1~~3. As in Example 1, S will take its $ 30 intercompany gain into account in Year ~~3~~4 to reflect the $ 30 difference between P's $ 10 corresponding gain and the $ 40 recomputed gain.

Apportionment. The apportionment results are the same as in Example 1, except that to the extent that the Year ~~1~~3 dividend is not eliminated under section 25106 or ~~deducted~~deductible under sections 24402, 24110, ~~or~~ 24411 or any other provision of the Revenue and Taxation Code, P's dividend income will be treated as current apportionable business income in Year ~~1~~3. The intercompany distribution is not included in the sales factor in Year ~~1~~3, to the extent attributable to dividends eliminated from income under section 25106.

Example 3: Deferred intercompany stock accounts.

(Refer to Treas. Reg. § 1.1502-13(f)(7), example 2.)

Facts. S owns all of T's stock with a $ 10 basis and $ 100 value. S has substantial earnings and profits which are attributable to business income included in a combined report of S, T and P. T has $ 10 of accumulated earnings and profits, all of which are attributable to business income included in a combined report of S, T and P. On January 1 of Year 1, S declares and distributes a dividend of all of the T stock to P. Under section 311(b) of the Internal Revenue Code, S has a $ 90 gain. Under section 301(d) of the Internal Revenue Code, P's basis in the T stock is $ 100. During Year 3, T borrows $ 90 from an unrelated party and declares and makes a $ 90 distribution to P to which section 301 of the Internal Revenue Code applies. During Year 6, T has $ 5 of current earnings which is attributable to business income included in the combined report of S, T and P. On December 1 of Year 9, T issues additional stock to Y and, as a result, T becomes a nonmember.

Dividend elimination. P's $ 100 of dividend income from S's distribution of the T stock, and its $ 10 dividend income from T's $ 90 distribution, are eliminated from income under section 25106 of the Revenue and Taxation Code.

Matching and acceleration rules. P has no deferred intercompany stock account (DISA) with respect to T stock because T's $ 90 distribution did not exceed T's $ 10 of earnings and profits and $ 100 stock basis. Therefore, P's corresponding item in Year 9 when T becomes a nonmember is $ 0. Treating S and P as divisions of a single corporation, the T stock would continue to have a $ 10 basis after the distribution from S to P. T's $ 90 distribution in Year 3 would first reduce T's $ 10 earnings and profits to zero, then reduce the $ 10 recomputed basis in T stock to zero and create a $ 70 recomputed DISA. T's $ 5 of earnings in Year 6 does not affect the amount of the DISA. Because the recomputed DISA would be taken into account upon T becoming a nonmember in Year 9, P will have a $ 70 recomputed corresponding item. Under the matching rule, S takes $ 70 of its intercompany gain into account in Year 9 to reflect the difference between P's $ 0 corresponding gain and the $ 70 recomputed gain. S's remaining $ 20 of gain will be taken into account under the matching and acceleration rules based on subsequent events (for example, under the matching rule if P subsequently sells its T stock, or under the acceleration rule if S becomes a nonmember or if the stock of T becomes a nonbusiness asset.)

Apportionment. Neither the distributions in Years 1 and 3, nor T becoming a nonmember in Year 9, have any effect on the sales factor. S's $ 70 intercompany gain will be treated as current apportionable business income in Year 9.