STAFF REPORT, STAFF RECOMMENDATION, AND REQUEST FOR REVISIONS TO CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTIONS 24411 AND 25106.5-1, RELATING TO THE ORDERING OF DIVIDENDS

On April 4, 2005, staff held an interested parties meeting to request public input regarding a proposed regulatory response to the California Court of Appeal's decision in *Fujitsu IT Holdings, Inc. v. Franchise Tax Board*, relating to the ordering of dividends.

The staff asked the Franchise Tax Board, at its April 4, 2007 meeting, if it could proceed with the formal regulatory process. The Franchise Tax Board directed staff to begin the formal rulemaking process to adopt a regulation to address the ordering of dividend issue.

A formal Notice of Public Hearing was published on November 9, 2007. On January 16, 2008, Craig Swieso of the Legal staff held the required public hearing at the Franchise Tax Board's central office to receive public comments on the proposed revisions to the existing regulations. There were 19 attendees at the hearing. Five persons presented comments orally at the hearing, four of whom had also presented written comments.

Included, as Exhibit A to this report, are detailed responses to the comments received during the formal regulatory process. The comments received during the formal regulatory process are attached as Exhibit B to this Report. The transcript of the Regulatory Hearing is included as Exhibit C. The final versions of the revisions to the regulations are included as Exhibit D to this Report. The Economic and Fiscal Impact Statement (Form 399) is included as Exhibit E to this Report.

Staff recommends that the Board authorize the Executive Officer to proceed with the final requirements for the adoption of the revisions to Regulation sections 24411 and 25106.5-1, the language of which is set forth in Exhibit D of this package.

March 6, 2008

STAFF SUMMARY OF COMMENTS, RESPONSES AND RECOMMENDATIONS IN CONJUNCTION WITH PUBLIC HEARING OF JANUARY 16, 2008

Written Comments from Apple Computer, Inc., dated January 15, 2008.

1. *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*) is a final published decision. Under the doctrine of *stare decisis*, the Franchise Tax Board, (hereinafter FTB) and the State SBE (hereinafter SBE) must follow the holding in *Fujitsu*.

Response:

Auto Equity Sales, Inc. v. Superior Court, (1962) 57 Cal. 2d 450, 455, states: "Under the doctrine of *stare decisis*, all **tribunals** exercising inferior judgment are required to follow decisions of courts exercising superior jurisdiction" (Emphasis added). In the SBE decision in the *Appeal of Apple Computer, Inc.*, 2006-SBE-002 (hereinafter *Apple*), it was noted that the decision in *Fujitsu* was inconsistent with the holding of the California Supreme Court in *Safeway Stores Inc. v. FTB*, (1970) 3 Cal. 3d 745. The California Supreme Court is a tribunal superior to the California Court of Appeal and under the doctrine of *stare decisis* its decision should be followed.

In addition, at the taxpayer's discretion, the SBE is the initial administrative appellate review body for the FTB's actions and its published decisions are precedential for the FTB. The revisions to the regulations are following the authority of what is tantamount as the initial appellate review body for the FTB. The Court of Appeal and California Supreme Court can only reconcile the decisions of the SBE in *Apple* and the Court of Appeal in *Fujitsu*. However, without that reconciliation the state will be whipsawed because a taxpayer can choose the tribunal it wishes to proceed before.

While the SBE might qualify as a tribunal, the FTB certainly does not. Therefore, the doctrine of *stare decisis* does not apply to the FTB's actions in seeking to revise California Code of Regulations, title 18, sections 24411 and 25106.5-1.

Recommendation:

No change to the revisions of the regulations is necessary.

2. In refusing to follow *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*), the FTB violates the separations of powers. Judicial power is vested in the California courts, which cannot be exercised by any other branch of the California government. Therefore, the FTB cannot usurp the powers of the courts by ignoring *Fujitsu* by seeking to revise California Code of Regulations, Title 18, (hereinafter CCR) sections 24411 and 25106.5-1.

Response:

Pursuant to California Revenue and Taxation Code (hereinafter CRTC) section 19503, the California Legislature has given the FTB the authority to generally prescribe regulations necessary for the enforcement of the California Corporation Tax Law, which is the relevant tax law for purposes relating to the revisions to CCR section 24411. Furthermore, CRTC section 25106.5 grants the FTB specific legislative rulemaking authority to promulgate regulations relating to combined reports, which is the relevant authority for purposes of revising CCR sections 25106.5-1. Based on this statutory grant of authority to prescribe regulations, it follows that the Legislature has given the FTB the authority to revise regulations. Therefore, by seeking to revise CCR sections 24411 and 25106.5-1, the FTB's is only acting in accordance with the authority given to it by the California Legislature and is not attempting to exercise judicial power

Furthermore, by its actions, the FTB is not ignoring *Fujitsu*. Rather, the FTB is clarifying provisions of the regulations the court in *Fujitsu* interpreted in a manner that is inconsistent with the California Supreme Court's position regarding the pro rata rule of ordering distributions:

> When, as in the present case, the adjustments relate to a large multicorporate [enterprise] which operates through a series of subsidiaries, some of which do business only in California, some of which do business only outside of California and some of which do business both within and without California **and have nonunitary as well as unitary income**, then the computations grow quite involved. **The method employed in the present case would allow a …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.** *Safeway Stores v. FTB* (1970) 3 Cal. 3d 745, 753 (hereinafter *Safeway*). (Emphasis added).

In *Appeal of Apple Computer, Inc.*, 2006-SBE-002, the SBE relied on *Safeway* to make its determination that the appropriate rule for ordering distributions is the pro rata rule.

Moreover, as the California Court of Appeal has stated:

> The adoption of a clarifying regulation after a controversy has arisen cannot be taken as a determination that the former policy was unreasonable or erroneous, but must simply be regarded as a commendable effort to avoid any similar controversy in the future. *Nadler v. California Veterans Board*, (1984) 152 Cal.App.3d 707, 719.

The revisions to CCR sections 24411 and 25106.5-1 must be viewed as an effort by the FTB to avoid any additional controversy brought about by the court in *Fujitsu* relying on the preferential rule of ordering distributions, which is inconsistent with the California Supreme Court's holding in *Safeway*.

Recommendation:

No change to the revisions of the regulations is necessary.

3. The revisions to California Code of Regulations, Title 18, (hereinafter CCR) sections 24411 and 25106.5-1 do not meet the necessity, consistency, and reference standards of the Administrative Procedures Act.

Response:

Necessity:

Government Code section 11349, subdivision (a), defines necessity as follows:

> "Necessity" means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record. For purposes of this standard, evidence includes, but is not limited to, facts, studies, and expert opinion.

The regulatory changes proposed meet this standard because there is currently no clear guidance regarding the proper method for the allocation of distributions such that a taxpayer can determine what amounts are subject to the deduction available under CRTC section 24411. In *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*), at page 480, the Court of Appeal confirmed this lack of guidance when it stated: "No statute, regulation or other administrative pronouncement provides clear guidance on this question." At the same page, the Court stated that CCR section 25106.5-1(f)(2), which did not come into effect until 2001, nine years after the years at issue in *Fujitsu*, "seem[ed] to indicate" that preferential ordering of distributions should be utilized rather than the pro rata rule of allocating distributions. The court's use of the term "seem[ed] to indicate", coupled with the court's admission that there was not guidance on this point, provides the basis for meeting the necessity standard for the revisions to these regulations. The decision of the court in *Fujitsu* also fails to provide a clear interpretation of these provisions because it is inconsistent with the California Supreme Court's earlier decision in *Safeway Stores v. FTB* (1970) 3 Cal. 3d 745 (hereinafter *Safeway*). In *Appeal of Apple Computer, Inc.*, 2006-SBE-002 (hereinafter *Apple*), the preferential ordering of distributions was rejected by the SBE, which relied on *Safeway* in doing so.

Moreover, as the California Court of Appeal has stated:

> The adoption of a clarifying regulation after a controversy has arisen cannot be taken as a determination that the former policy was unreasonable or erroneous, but must simply be regarded as a commendable effort to avoid any similar controversy in the future.

Nadler v. California Veterans Board, (1984) 152 Cal.App.3d 707,719.

Revising CCR sections 24411 and 25106.5-1 is necessary to avoid any additional controversy brought about by the court in *Fujitsu* relying on the preferential rule of ordering distributions, which is inconsistent with the California Supreme Court's holding in *Safeway*.

Consistency:

Government Code section 11349, subdivision (d), defines consistency as follows:

> "Consistency" means being in harmony with, and not in conflict with or contradictory to, existing statutes, court decisions, or other provisions of law.

The proposed regulatory amendments meet this standard because they are consistent with the California Supreme Court's decision in *Safeway*, which set forth the proper dividend ordering rule as being a pro rata method. The proposed amendments are not inconsistent with the Court of Appeal decision in *Fujitsu* because the court in *Fujitsu* did not interpret the statute to require a preferential ordering treatment; rather the court interpreted the regulations to provide for such a method.

The *Fujitsu* opinion does not contain much statutory construction analysis, if any at all. The only statutes that are substantively addressed are CRTC sections 24411 and 25106. The only comments made by the Court with respect to these statutes are to distinguish one from the other. CRTC section 24411 provides for a 75% deduction of the qualifying dividends, while CRTC section 25106 provides for a 100% elimination of qualifying dividends. The court did not rely on statutory construction to make its determination. Instead, the Court focused upon CCR sections 24411 and 25106.5-1. In essence, *Fujitsu* is about regulatory construction and not statutory construction. Consequently, CCR sections 24411 and 25106.5-1 need to be revised because they provide a guide to interpreting CRTC sections 24411 and 25106.5. However, in *Apple*, the SBE was unequivocal about its ability to appreciate the distinctions between the pro rata rule of allocating distributions in contrast to the preferential ordering of distributions. Consequently, the revision to CCR section 24411 and 25106.5-1 is consistent with the position that the SBE took in *Apple*, which was congruent with the pro rata rule set forth in *Safeway*. Accordingly, the revisions to CCR sections 24411 and 25106.5-1-1 are consistent with *Safeway*.

Reference:

Government Code section 11349, subdivision (e), defines reference as follows:

> "Reference" means the statute, court decision or other provision of law which the agency implements, interprets, or makes specific by adopting, amending or appealing a regulation.

The revisions to CCR sections 24411 and 25106.5-1 will impart clarity as to how those statutes adhere to the pro rata rule of distributions, as confirmed by *Safeway*.

Recommendation:

No change to the revisions of the regulations is necessary.

4. California Revenue and Taxation Code (hereinafter CRTC) section 24411 already contains an ordering rule because it provides it is only operable to the extent that dividends are not otherwise deducted or eliminated under other CRTC provisions.

Response:

CRTC section 24411 contains the provision that it is only operable to the extent that dividends are not otherwise deducted or eliminated under other CRTC provisions to ensure that a taxpayer does not get the benefit of a double deduction. For example, according to this provision in California Code of Regulations, Title 18, section 24411, a taxpayer may not eliminate dividends under CRTC section 25106 and then attempt to get a partial deduction with respect to the same dividends under CRTC section 24411. When a dividend is theoretically capable of being deducted under two different provisions of the CRTC, there is no guidance as to the amounts that are subject to each provision. That is the guidance that the regulatory amendments provide.

Recommendation:

No change to the revisions of the regulations is necessary.

5. The pro rata rule for allocating distributions is inconsistent with California Revenue and Taxation Code (hereinafter CRTC) section 25106, as stated in *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*).

Response:

Pursuant to CRTC section 25106, to the extent that a unitary affiliate's income has been reflected in its unitary groups' combined report, any dividends paid from that previously included income are eliminated. The revisions to California Code of Regulations, title 18, sections 24411 and 25106.5-1, do not conflict with CRTC section 25106's dividend elimination rule. They only provide that distributions should be pro rated between income previously included in the combined report and income not previously included in the combined report. While the holding in *Fujitsu* favors the preferential ordering of distributions, it does not state that the pro rata rule of allocating distributions is inconsistent with CRTC section 25106.

Recommendation:

No change to the revisions of the regulations is necessary.

6. The SBE's *Appeal of Apple Computer, Inc.*, 2006-SBE-002 (hereinafter *Apple*) decision is erroneous and cannot provide support for the revisions to California Code of Regulations, Title 18 (hereinafter CCR), sections 24411 and 25106.5-1.

Response:

CRTC section 19333 provides that the SBE can determine a taxpayer's appeal from an action by the FTB. Unquestionably, CRTC section 19333 implicitly provides the SBE with the authority to use its discretion to decide issues between the FTB and a taxpayer. The *Apple* decision is illustrative of the SBE applying its discretion. *Apple* also provides support for the revisions to CCR sections 24411 and 25106.5-1 by illustrating that uncertainty exists regarding the proper application of the law and also that the court's *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4^{th} 459 (hereinafter *Fujitsu*) decision is itself suspect and inconsistent with *Safeway Stores v. FTB* (1970) 3 Cal. 3d 745 (hereinafter *Safeway*).

In addition, the SBE is the first level of review of decisions of the FTB and its decisions are precedential for the FTB. The regulation is following the authority of the initial appellate review body for the FTB. The Court of Appeal and California Supreme Court can only reconcile the decisions of the SBE in *Apple* and the Court of Appeal in *Fujitsu*. Without that reconciliation the state will be whipsawed because a taxpayer can choose the tribunal it wishes to proceed before.

It also should be noted that the SBE has jurisdiction over appeals from every appellate district of California so its jurisdiction is broader than the jurisdiction of any single appellate district.

Recommendation:

No change to the revisions of the regulations is necessary.

7. Proceeding with the revisions to California Code of Regulations, Title 18 (hereinafter CCR), sections 24411 and 25106.5-1 is inappropriate because Apple Computer, Inc. has filed a claim for refund suit challenging the SBE's *Appeal of Apple Computer, Inc.*, 2006-SBE-002 decision.

Response:

Even if Apple Computer, Inc. prevailed in its trial court case, it is likely that the decision would be appealed to obtain clarity. Conversely, if Apple Computer, Inc. did not prevail in its trial court case, it is likely that it would appeal that decision to the California Court of Appeal. Furthermore, the trial court and the California Court of Appeal would not decide whether *Apple* is correct because all of the facts and issues would be addressed de novo. All told, the Apple Computer, Inc. claim for refund suit could conceivably be ongoing for many more years.

With respect to the revisions to CCR sections 24411 and 25106.5-1, a "symposium" (i.e. an "interested parties hearing") and a formal hearing have already been held. Indefinitely delaying the regulation process in order to await the dispositive result in Apple Computer, Inc.'s claim for refund suit would be tantamount to beginning the regulation process all over again. Consequently, the efforts of all of the taxpayers and tax practitioners whom have already participated in this regulation process would have been pointless. Revising CCR sections 24411 and 25106.5-1 would eliminate any uncertainty that the pro rata rule is the proper rule for allocating distributions. This would most likely result in less litigation over the matter because potentially affected taxpayers will have guidance with respect to properly filing their returns.

Recommendation:

No change to the revisions of the regulations is necessary.

<u>Written Comments from Franklin Templeton dated January 16, 2008</u>

Based on Generally Accepted Accounting Principles (hereinafter GAAP) rules, double taxation will result if the pro rata ordering rule of allocating distributions from foreign subsidiaries is followed, while the preferential ordering rule relating to distributions from foreign subsidiaries will not result in double taxation. The assertion about double taxation is predicated on the application of GAAP relating to the parent company's financial statements, which includes its income statement.

Accounting Principles Board Number 23 (hereinafter APB 23), provides that the undistributed earnings from a parent company's foreign subsidiaries will not be required to be reflected in the parent company's income statement, which would result in the accrued tax expense being increased, so long as the parent company has established a policy whereby all of the undistributed earnings of a subsidiary (including foreign subsidiaries) are indefinitely invested back into the subsidiary.

However, because Subpart F income (Internal Revenue Code section 951, et seq. provides the definitions and rules relating to Subpart F income) is deemed to be income of the parent, these amounts are subject to accrual for tax expenses in the income statement and are not eliminated from the income statement under APB 23. Because the Subpart F earnings are already reflected in the parent's income statement, the foreign subsidiary is able to distribute that portion of its earnings represented by its Subpart F earnings to its parent company without any additional accrued tax expense because the Subpart F earnings are already reflected on the parent company's income statement.

Under this scenario, it is argued that the use of the pro rata method will result in double taxation because the dividend paid by the foreign subsidiary, which for book purposes is deemed to be all subpart F income and therefore does not result in any additional tax accrual expenses, will be subjected to tax expense accrual a second time. This is due to the pro rata method treating the dividend as only partially paid from subpart F income, with the remainder of the dividend paid from other earnings and profits. Additionally, treating a portion of the foreign subsidiary's distribution as being paid from its non-Subpart F earnings will violate APB 23 because it would be a repatriation of previously undistributed earnings that were not previously subject to U.S. tax.

Response:

The commentator arguments about double taxation are based on financial accounting standards, such as APB 23. However, it is a well-established rule of tax law that financial accounting standards and the application of tax principles serve different purposes. (See *Guardian Investment Corp. v. Phinney* (1958) 253 F.2d 326, 330; *Freedman v. U.S.* (1959) 266 F.2d 291,295; *Thor Power Tool Co. v. Comm. of IRS* (1979) 439 U.S. 522.) Therefore, although the pro rata rule of allocating foreign subsidiary distributions might have an adverse impact on the parent company's income statement by increasing its accrued tax expense, in no way does the use of the pro rata rule result in double taxation for California purposes. Furthermore, despite the commentator's assertions to the contrary, in *Safeway Stores v. FTB* (1970) 3 Cal. 3d 745, the California Supreme Court held that the pro rata rule of allocating distributions from subsidiaries is the correct methodology. While it may be possible to deem a dividend to be paid only from subpart F income for book purposes, there is no authority for the proposition that this "earmarking" is appropriate for tax purposes.

Recommendation:

No change to the revisions of the regulations is necessary.

<u>Written Comments from Chevron Corporation dated January 16, 2008</u>

1. By seeking to revise California Code of Regulations, Title 18 (hereinafter CCR), sections 24411 and 25106.5-1, the FTB is attempting to elevate the ruling in *<u>Appeal of Apple Computer, Inc.</u>*, 2006-SBE-002 (hereinafter *Apple*) over the ruling in *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*).

Response:

In *Fujitsu*, at page 480, the Court of Appeal stated: "No statute, regulation or other administrative pronouncement provides clear guidance on this question." At the same page, the Court stated that CCR section 25106.5-1 (f)(2), which did not come in to effect until 2001, nine years after the years at issue in *Fujitsu*, "seem[ed] to indicate" that preferential ordering of distributions should be utilized rather than the pro rata rule of allocating distributions. Based on these comments, it is apparent that the court did not appreciate the distinctions between the pro rata rule of allocating distributions in contrast to the preferential ordering of distributions. However, in *Apple*, the SBE was unequivocal about its ability to appreciate the distinctions between the pro rata rule of allocating distributions in contrast to the preferential ordering of distributions. Furthermore, in *Apple*, the SBE relied on *Safeway Stores v. FTB* (1970) 3 Cal. 3d 745 (hereinafter *Safeway*), wherein the California Supreme Court held that pro rata rule of allocating distributions from subsidiaries is the correct methodology. The revisions to CCR sections 24411 and 25106.5-1 merely illuminate the existing pro rata rule of allocating distributions set forth in *Apple* and *Safeway*.

In addition, the SBE is the first level of review of decisions of the FTB and its decisions are precedential for the FTB. The regulation is following the authority of the initial appellate review body for the FTB. The Court of Appeal and California Supreme Court can only reconcile the decisions of the SBE in *Apple* and the Court of Appeal in *Fujitsu*. Without that reconciliation the state will be whipsawed because a taxpayer can choose the tribunal it wishes to proceed before.

It also should be noted that the SBE has jurisdiction over appeals from every appellate district of California so its jurisdiction is broader than the jurisdiction of any single appellate district.

Recommendation:

No change to the revisions of the regulations is necessary.

2. The *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*) decision remains valid. Taxpayers are entitled to rely upon it.

Response:

The *Fujitsu* opinion became final in October of 2004. In March of 2005 the FTB staff commenced the process of revising the regulations by announcing a "symposium" (i.e. "an interested parties meeting") and making available the language of the proposed revisions. Therefore, taxpayers were on notice that the FTB staff did not believe that the *Fujitsu* opinion would be applicable for taxpayers other than Fujitsu, and that staff intended to pursue a change to the existing regulations to formalize this position. Generally, the tax law is constantly in a state of flux. Taxpayers might take a position on other issues and find that the law has been subsequently changed.

Recommendation:

No change to the revisions of the regulations is necessary.

3. The SBE is a "quasi-judicial body". According to *Auto Equity Sales, Inc. v. Superior Court*, (1962) 57 Cal. 2d 450 (hereinafter *Auto Equity*), based on the doctrine of *stare decisis, Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*) must take precedence over *Appeal of Apple Computer, Inc.*, 2006-SBE-002 (hereinafter *Apple*)

Response:

CRTC section 19333 provides that the SBE can determine a taxpayer's appeal from a final action of the FTB. Unquestionably, this CRTC section 19333 implicitly provides the SBE with the authority to use its discretion to decide issues between the FTB and a taxpayer. The *Apple* decision is illustrative of the SBE applying its discretion.

In support of its assertion, the commentator references *Auto Equity Sales, Inc. v. Superior Court*, (1962) 57 Cal. 2d 450 (hereinafter *Auto Equity*). However, at page 455, *Auto Equity* states: "Under the doctrine of *stare decisis*, all **tribunals** exercising inferior judgment are required to follow decisions of courts exercising superior jurisdiction" (Emphasis added). In *Apple*, it was noted that the decision in *Fujitsu* was inconsistent with the holding of the California Supreme Court in *Safeway Stores Inc. v. FTB*, (1970) 3 Cal. 3d 745. The California Supreme Court is a tribunal superior to the California Court of Appeal and under the doctrine of *stare decisis* its decision should be followed.

In addition, at the taxpayer's discretion, the SBE is the initial administrative appellate review body for the FTB's actions and its decisions are precedential for the FTB. The revisions to the regulations are following the authority of what is tantamount as the initial appellate review body for the FTB. The Court of Appeal and California Supreme Court can only reconcile the decisions of the SBE in *Apple* and the Court of Appeal in *Fujitsu*. However, without that reconciliation the state will be whipsawed because a taxpayer can choose the tribunal it wishes to proceed before.

While the SBE might qualify as a tribunal, the FTB certainly does not. Therefore, the doctrine of *stare decisis* does not apply to the FTB's actions in seeking to revise California Code of Regulations, title 18, sections 24411 and 25106.5-1.

Recommendation:

No change to the revisions of the regulations is necessary.

4. The revisions to California Code of Regulations, Title 18 (hereinafter CCR) sections 24411 and 25106.5-1 do not meet the Administrative Procedure's Act's necessity standard.

Response:

Necessity:

Government Code section 11349, subdivision (a), defines necessity as follows:

> "Necessity" means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record. For purposes of this standard, evidence includes, but is not limited to, facts, studies, and expert opinion.

The regulatory changes proposed meet this standard because there is currently no clear guidance regarding the proper method for the allocation of distributions such that a taxpayer can determine what amounts are subject to the deduction available under CRTC section 24411. In *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*), at page 480, the Court of Appeal confirmed this lack of guidance when it stated: "No statute, regulation or other administrative pronouncement provides clear guidance on this question". At the same page, the Court stated that CCR section 25106.5-1(f)(2), which did not come in to effect until 2001, nine years after the years at issue in *Fujitsu*, "seem[ed] to indicate" that preferential ordering of distributions should be utilized rather than the pro rata rule of allocating distributions. The court's use of the term "seem[ed] to indicate", coupled with the court's admission that there was not guidance on this point provides the basis for meeting the necessity standard for the revisions to these regulations. The decision of the court in *Fujitsu* also fails to provide a clear interpretation of these provisions because it is inconsistent with the California Supreme Court's earlier decision in *Safeway Stores v. FTB* (1970) 3 Cal. 3d 745 (hereinafter *Safeway*). In *Appeal of Apple Computer, Inc*. 2006-SBE-002(hereinafter *Apple*), the preferential ordering of distributions was rejected by the SBE, which relied on *Safeway* in doing so.

Moreover, as the California Court of Appeal has stated:

> The adoption of a clarifying regulation after a controversy has arisen cannot be taken as a determination that the former policy was unreasonable or erroneous, but must simply be regarded as a commendable effort to avoid any similar controversy in the future.
> *Nadler v. California Veterans Board*, (1984) 152 Cal.App.3d 707,719.

Revising CCR sections 24411 and 25106.5-1 is necessary to avoid any additional controversy brought about by the court in *Fujitsu* relying on the preferential rule of ordering distributions, which is inconsistent with the California Supreme Court's holding in *Safeway*.

Recommendation:

No change to the revisions of the regulations is necessary.

5. California Revenue and Taxation Code (hereinafter CRTC) section 25106 was relied on in *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*) in support of the use of the preferential ordering rule.

Response:

In *Fujitsu*, with respect to the ordering of distributions issue, the only mention of CRTC section 25106 involves the elimination of dividends received from previously included earnings. *Fujitsu* does not rely on CRTC section 25106 to make its determination. Instead, *Fujitsu* focuses upon the application of California Code of Regulations, title 18, sections 24411 and 25106.5-1, and not CRTC section 25106.

Recommendation:

No change to the revisions of the regulations is necessary.

6. The incorporation of Internal Revenue Code section 316 in the revision to California Code of Regulations, Title 18, section 24411 will provide that only two layers of earnings and profits exist: 1) the current years earnings and profits and 2) the cumulative earnings and profits from all preceding years.

Response: Internal Revenue Code section 316(a) defines a dividend as a "distribution of property made by a corporation to its shareholders – (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year." It continues "Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits." This last quoted sentence certainly provides that there are year-by-year layers of earnings and profits.

Recommendation:

No change to the revisions of the regulations is necessary.

7. California Revenue and Taxation Code (hereinafter CRTC) section 24411 already contains an ordering rule because it provides it is only operable to the extent that dividends are not otherwise deducted or eliminated under other CRTC provisions.

Response:

CRTC section 24411 contains the provision that it is only operable to the extent that dividends are not otherwise deducted or eliminated under other CRTC provisions to ensure that a taxpayer does not get the benefit of a double deduction. For example, according to this provision in California Code of Regulations, title 18, section 24411, a taxpayer may not eliminate dividends under CRTC section 25106 and then attempt to get a partial deduction with respect to the same dividends under CRTC section 24411. When a dividend is theoretically capable of being deducted under two different provisions of the CRTC, there is no guidance as to the amounts that are subject to each provision. That is the guidance that the regulatory amendments provide.

Recommendation:

No change to the revisions of the regulations is necessary.

<u>Written Comments from California Taxpayers' Association dated January 16, 2008</u>

1. The revisions to California Code of Regulations, Title 18 (hereinafter CCR), sections 24411 and 25106.5-1 do not meet the necessity and consistency standards of the Administrative Procedures Act.

Response:

<u>Necessity</u>:

Government Code section 11349, subdivision (a), defines necessity as follows:

> "Necessity" means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record. For purposes of this standard, evidence includes, but is not limited to, facts, studies, and expert opinion.

The regulatory changes proposed meet this standard because there is currently no clear guidance regarding the proper method for the allocation of distributions such that a taxpayer can determine what amounts are subject to the deduction available under CRTC section 24411. In *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*), at page 480, the Court of Appeal confirmed this lack of guidance when it stated: "No statute, regulation or other administrative pronouncement provides clear guidance on this question". At the same page, the Court stated that CCR section 25106.5-1(f)(2), which did not come in to effect until 2001, nine years after the years at issue in *Fujitsu*, "seem[ed] to indicate" that preferential ordering of distributions should be utilized rather than the pro rata rule of allocating distributions. The court's use of the term "seem[ed] to indicate", coupled with the court's admission that there was not guidance on this point provides the basis for meeting the necessity standard for the revisions to these regulations. The decision of the court in *Fujitsu* also fails to provide a clear interpretation of these provisions because it is inconsistent with the California Supreme Court's earlier decision in *Safeway Stores v. FTB* (1970) 3 Cal. 3d 745 (hereinafter *Safeway*). In <u>*Appeal*</u>

of Apple Computer, Inc., 2006-SBE-002 (hereinafter *Apple*), the preferential ordering of distributions was rejected by the SBE, which relied on *Safeway* in doing so.

Moreover, as the California Court of Appeal has stated:

> The adoption of a clarifying regulation after a controversy has arisen cannot be taken as a determination that the former policy was unreasonable or erroneous, but must simply be regarded as a commendable effort to avoid any similar controversy in the future. *Nadler v. California Veterans Board*, (1984) 152 Cal.App.3d 707,719.

Revising CCR sections 24411 and 25106.5-1 is necessary to avoid any additional controversy brought about by the court in *Fujitsu* relying on the preferential rule of ordering distributions, which is inconsistent with the California Supreme Court's holding in *Safeway*.

Consistency:

Government Code section 11349, subdivision (d), defines consistency as follows:

> "Consistency" means being in harmony with, and not in conflict with or contradictory to, existing statutes, court decisions, or other provisions of law.

The proposed regulatory amendments meets this standard because they are consistent with the California Supreme Court's decision in *Safeway*, which set forth the proper dividend ordering rule as being a pro rata method. The proposed amendments are not inconsistent with the Court of Appeal decision in *Fujitsu* because the court in *Fujitsu* did not interpret the statute to require a preferential ordering treatment; rather the court interpreted the regulations to provide for such a method.

Recommendation:

No change to the revisions of the regulations is necessary.

2. Rather than revising California Code of Regulations, Title 18 (hereinafter CCR), sections 24411 and 25106.5-1 to eliminate any confusion between Appeal of Apple Computer, Inc., 2006-SBE-002 (hereinafter *Apple*) and *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*), the FTB should have just given deference to *Fujitsu*.

Response:

In *Fujitsu*, at page 480, the Court of Appeal stated: "No statute, regulation or other administrative pronouncement provides clear guidance on this question." At the same page, the Court stated that CCR section 25106.5-1(f)(2), which did not come in to effect until 2001, nine years after the years at issue in *Fujitsu*, "seem[ed] to indicate" that preferential ordering of distributions should be utilized rather than the pro rata rule of allocating distributions. Based on these comments, it is apparent that the court did not appreciate the distinctions between the pro rata rule of allocating distributions in contrast to the preferential ordering of distributions. However, in *Apple*, the SBE was unequivocal about its ability to appreciate the distinctions between the pro rata rule of allocating distributions in contrast to the preferential ordering of distributions. Furthermore, in *Apple*, the SBE relied on *Safeway Stores Inc. v. FTB*, (1970) 3 Cal. 3d 745 (hereinafter *Safeway*) wherein the California Supreme Court held that pro rata rule of allocating distributions from subsidiaries is the correct methodology. The revisions to CCR sections 24411 and 25106.5-1 merely elucidate the existing pro rata rule of allocating distributions set forth in *Apple* and *Safeway*.

Recommendation:

No change to the revisions of the regulations is necessary.

3. If the revisions to California Code of Regulations, Title 18 (hereinafter CCR) sections 24411 and 25106.5-1 are promulgated, it will increase the tax liabilities of taxpayers who have relied on *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4^{th} 459 (hereinafter *Fujitsu*).

Response:

The *Fujitsu* opinion became final in October of 2004. In March of 2005 the FTB staff commenced the process of revising the regulations by announcing a "symposium" (i.e. "an interested parties meeting") and making available the language of the proposed revisions. Therefore, taxpayers were on notice that the FTB staff did not believe that the *Fujitsu* opinion would be applicable for taxpayers other than Fujitsu, and that staff intended to pursue a change to the existing regulations to formalize this position. Generally, the tax law is constantly in a state of flux. Taxpayers might take a position on other issues and find that the law has been subsequently changed, thereby increasing their tax liabilities.

The proposed amendments to the regulations are clarifying in nature, reflect the holding of the California Supreme Court in *Safeway Stores Inc. v. FTB*, (1970) 3 Cal. 3d 745, and reflect the established federal rule for the ordering of dividends. They do not represent a change in the department's position or established law. No tax increase results from application of existing law.

Recommendation:

No change to the revisions of the regulations is necessary.

4. The revisions to California Code of Regulations, Title 18 (hereinafter CCR), sections 24411 and 25106.5-1 are contradictory to existing law. They will presumably be retroactively applied, which will result in tax increases that only the California Legislature may enact.

Response:

The revisions to CCR sections 24411 and 25106.5-1 are consistent with the position that the SBE took in *Appeal of Apple Computer, Inc.*, 2006-SBE-002 (hereinafter *Apple*). Furthermore, in *Apple*, the SBE relied on *Safeway Stores Inc. v. FTB*, (1970) 3 Cal. 3d 745 (hereinafter *Safeway*) wherein the California Supreme Court held that pro rata rule of allocating distributions from subsidiaries is the correct methodology. The revisions to CCR sections 24411 and 25106.5-1-1 are consistent with *Safeway*, which is existing law.

The proposed amendments to the regulations are clarifying in nature, reflect the holding of the California Supreme Court in *Safeway*, and reflect the established federal rule for the ordering of dividends. They do not represent a change in the department's position or established law. No tax increase results from application of existing law.

The California Legislature enacted CRTC section 19503, which generally provides that regulations are to be applied retroactively unless the Franchise Tax Board provides otherwise. Therefore, there should be no undue tax increases if the revisions to CCR sections 24411 and 25106.5 are applied retroactively.

Recommendation:

No change to the revisions of the regulations is necessary.

Oral Comments from Barry Weissman dated January 16, 2008

1. Revising California Code of Regulations, Title 18 (hereinafter CCR) sections 24411 and 25106.5-1 will create more confusion because *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*) clearly held that priority should first be given to those distributions coming from previously included income before distributions from income that was not previously included.

Response:

In *Fujitsu*, at page 480, the Court of Appeal stated: "No statute, regulation or other administrative pronouncement provides clear guidance on this question." At the same page, the Court stated that CCR section 25106.5-1(f)(2), which did not come into effect until 2001, nine years after the years at issue in *Fujitsu*, "seem[ed] to indicate" that preferential ordering of distributions should be utilized rather than the pro rata rule of allocating distributions. Based on these comments, it is apparent that the court did not appreciate the distinctions between the pro rata rule of allocating distributions in contrast to the preferential ordering of distributions.

Recommendation:

No change to the revisions of the regulations is necessary.

2. By seeking to revise California Code of Regulations, Title 18 (hereinafter CCR) sections 24411 and 25106.5-1-1, the FTB is attempting to elevate the ruling in Appeal of Apple Computer, Inc., 2006-SBE-002 (hereinafter *Apple*) over the ruling in *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*).

Response:

In *Fujitsu*, at page 480, the Court of Appeal stated: "No statute, regulation or other administrative pronouncement provides clear guidance on this question." At the same page, the Court stated that CCR section 25106.5-1(f)(2), which did not come into effect until 2001, nine years after the years at issue in *Fujitsu*, "seem[ed] to indicate" that preferential ordering of distributions should be utilized rather than the pro rata rule of allocating distributions. Based on these comments, it is apparent that the court did not appreciate the distinctions between the pro rata rule of allocating distributions in contrast to the preferential ordering of distributions. However, in *Apple*, the SBE was unequivocal about its ability to appreciate the distinctions between the pro rata rule of allocating distributions in contrast to the preferential ordering of distributions. Furthermore, in *Apple*, the SBE relied on *Safeway Stores Inc. v. FTB* (1970) 3 Cal. 3d 745 (hereinafter *Safeway*), wherein the California Supreme Court held that the pro rata rule of allocating distributions from subsidiaries is the correct methodology. The revisions to CCR sections 24411 and 25106.5-1 merely illuminate the existing pro rata rule of allocating distributions set forth in *Apple* and *Safeway*.

In addition, the SBE is the first level of review of decisions of the FTB and its decisions are precedential for the FTB. The regulation is following the authority of the initial appellate review body for the FTB. The Court of Appeal and California Supreme Court can only reconcile the decisions of the SBE in Apple and the Court of Appeal in Fujitsu. Without that reconciliation the state will be whipsawed because a taxpayer can choose the tribunal it wishes to proceed before.

It also should be noted that the SBE has jurisdiction over appeals from every appellate district of California so its jurisdiction is broader than the jurisdiction of any single appellate district.

Recommendation:

No change to the revisions of the regulations is necessary.

3. *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4^{th} 459 (hereinafter *Fujitsu*) is a final published decision. Under the doctrine of *stare decisis*, the FTB and the SBE must follow the holding in *Fujitsu*.

Response:

Auto Equity Sales, Inc. v. Superior Court (1962) 57 Cal. 2d 450, 455 states: "Under the doctrine of *stare decisis*, all **tribunals** exercising inferior judgment are required to follow decisions of courts exercising superior jurisdiction" (Emphasis added). In the SBE decision in the Appeal of Apple Computer, Inc., 2006-SBE-002 (hereinafter *Apple*), it was noted that the decision in *Fujitsu* was inconsistent with the holding of the California Supreme Court in *Safeway Stores Inc. v. FTB* (1970) 3 Cal. 3d 745. The California Supreme Court is a tribunal superior to the California Court of Appeal and under the doctrine of *stare decisis* its decision should be followed.

In addition, at the taxpayer's discretion, the SBE is the initial administrative appellate review body for the FTB's actions and its decisions are precedential for the FTB. The revisions to the regulations are following the authority of what is tantamount as the initial appellate review body for the FTB. The Court of Appeal and California Supreme Court can only reconcile the decisions of the SBE in *Apple* and the Court of Appeal in *Fujitsu*. However, without that reconciliation the state will be whipsawed because a taxpayer can choose the tribunal it wishes to proceed before.

While the SBE might qualify as a tribunal, the FTB certainly does not. Therefore, the doctrine of *stare decisis* does not apply to the FTB's actions in seeking to revise California Code of Regulations, title 18, sections 24411 and 25106.5-1.

Recommendation:

No change to the revisions of the regulations is necessary.

4. California Revenue and Taxation Code (hereinafter CRTC) section 25106 was relied on in *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4^{th} 459 (hereinafter *Fujitsu*) in support of the use of the preferential ordering rule.

Response:

In *Fujitsu*, with respect to the ordering of distributions issue, the only mention of CRTC section 25106 involves the elimination of dividends received from previously included earnings. *Fujitsu* does not rely on CRTC section 25106 to make its determination. Instead, *Fujitsu* focuses upon the application of California Code of Regulations, title 18, sections 24411 and 25106.5-1, and not CRTC section 25106.

Recommendation:

No change to the revisions of the regulations is necessary.

5. The incorporation of Internal Revenue Code section 316 in the revision to California Code of Regulations, Title 18 (hereinafter CCR) section 24411 will provide that only two layers of earnings and profits exist: 1) the current years earnings and profits and 2) the cumulative earnings and profits from all preceding years.

Response:

Internal Revenue Code section 316(a) defines a dividend as a "distribution of property made by a corporation to its shareholders – (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year." It continues "Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits." This last quoted sentence certainly provides that there are year-by-year layers of earnings and profits.

Recommendation:

No change to the revisions of the regulations is necessary.

<u>Oral Comments from John McBeth dated January 16, 2008</u>

1. Based on GAAP rules, double taxation will result if the pro rata rule of allocating distributions from foreign subsidiaries is adopted, while the preferential ordering rule relating to distributions from foreign subsidiaries will not result in double taxation. APB 23 provides that the undistributed earnings from a parent company's foreign subsidiaries will not be required to be reflected in the parent company's income statement, which would result in the accrued tax expense being increased, so long as the parent company has established a policy whereby all of the undistributed earnings of a subsidiary (including foreign subsidiaries) is indefinitely invested back into the subsidiary.

However, because Subpart F income (Internal Revenue Code section 951, et seq. provides the definitions and rules relating to Subpart F income) is deemed to be income of the parent, these amounts are subject to accrual for tax expenses on the income statement and are not removable from the income statement under APB 23. Because the Subpart F earnings are already reflected in the parent's income statement, the foreign subsidiary is able to distribute that portion of its earnings represented by its Subpart F earnings to its parent company without any additional accrued tax expense because the Subpart F earnings are already reflected on the parent company's income statement.

Under this scenario, it is argued that the use of the pro rata method will result in double taxation because the dividend paid by the foreign subsidiary, which for book purposes is deemed to be all subpart F income and therefore does not result in any additional tax accrual expenses, will be subjected to tax expense accrual a second time. This is due to the pro rata method treating the dividend as only partially paid from subpart F income, with the remainder of the dividend paid from other earnings and profits. Additionally, treating a portion of the foreign subsidiary's distribution as being paid from its non-Subpart F earnings will violate APB 23 because it would be a repatriation of previously undistributed earnings that were not previously subject to U.S. tax.

Response:

The arguments about double taxation are based on financial accounting standards, such as APB 23. However, it is a well-established rule of tax law that financial accounting standards and the application of tax principles serve different purposes. (See *Guardian Investment Corp. v. Phinney* (1958) 253 F.2d 326, 330; *Freedman v. U.S.* (1959) 266 F.2d 291, 295; *Thor Power Tool Co. v. Comm. of IRS* (1979) 439 U.S. 522.) Therefore, although the pro rata rule of allocating foreign subsidiary distributions might have an adverse impact on the parent company's income statement by increasing its accrued tax expense, in no way does the use of the pro rata rule result in double taxation for California purposes. Furthermore, despite the commentator's assertions to the contrary, in *Safeway Stores Inc. v. FTB* (1970) 3 Cal. 3d 745, the California Supreme Court held that the pro rata rule of allocating distributions from subsidiaries is the correct methodology. While it may be possible to deem a dividend to be paid only from subpart F income for book purposes, there is no authority for the proposition that this "earmarking" is appropriate for tax purposes.

Recommendation:

No change to the revisions of the regulations is necessary.

2. The FTB should adopt a resolution to have the dividend ordering rules determined through legislation and not through regulations.

Response:

CRTC section 19503, the California Legislature has given the FTB the authority to generally prescribe regulations necessary for the enforcement of the California Corporation Tax Law, which is the relevant tax law for purposes relating to the revisions to CCR, title 18, section 24411. Furthermore, CRTC section 25106.5, grants the FTB specific legislative rulemaking authority to promulgate regulations relating to combined reports, which is the relevant authority for purposes of revising CCR section 25106.5-1. Based on this statutory grant of authority to prescribe regulations, it follows that the Legislature has given the FTB the authority to revise regulations. Therefore, by seeking to revise CCR sections 24411 and 25106.5-1, the FTB is only acting in accordance with the authority given to it by the California Legislature.

Recommendation:

No change to the revisions of the regulations is necessary.

3. The revisions to California Code of Regulations, Title 18, section 24411 and 25106.5-1 should be applied prospectively.

Response:

The proposed amendments are clarifying in nature and do result in a substantive change and therefore they should be applied retroactively to reduce any confusion. Furthermore, the California Legislature enacted CRTC section 19503, which generally provides that regulations are to be applied retroactively.

Recommendation:

No change to the revisions of the regulations is necessary.

<u>Oral Comments from Jeff Vesely dated January 16, 2008</u>

1. *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4^{th} 459 (hereinafter *Fujitsu*) is a final published decision. Under the doctrine of *stare decisis*, the FTB and the SBE must follow the holding in *Fujitsu*.

Response:

Auto Equity Sales, Inc. v. Superior Court (1962) 57 Cal. 2d 450, 455 states: "Under the doctrine of *stare decisis*, all **tribunals** exercising inferior judgment are required to follow decisions of courts exercising superior jurisdiction" (Emphasis added). In the SBE decision in the <u>*Appeal of Apple Computer, Inc.*</u>, 2006-SBE-002 (hereinafter *Apple*), it was noted that the decision in *Fujitsu* was inconsistent with the holding of the California Supreme Court in *Safeway Stores Inc. v. FTB* (1970) 3 Cal. 3d 745 (hereinafter *Safeway*). The California Supreme Court is a tribunal superior to the California Court of Appeal and under the doctrine of *stare decisis* its decision should be followed.

In addition, at the taxpayer's discretion, the SBE is the primary administrative appellate review body for the FTB's actions and its decisions are precedential for the FTB. The revisions to the regulations are following the authority of what is tantamount as the primary appellate review body for the FTB. The Court of Appeal and California Supreme Court can only reconcile the decisions of the SBE in *Apple* and the Court of Appeal in *Fujitsu*. However, without that reconciliation the state will be whipsawed because a taxpayer can choose the tribunal it wishes to proceed before.

While the SBE might qualify as a tribunal, the FTB certainly does not. Therefore, the doctrine of *stare decisis* does not apply to the FTB's actions in seeking to revise CCR, title 18, sections 24411 and 25106.5-1.

Recommendation:

No change to the revisions of the regulations is necessary.

2. In refusing to follow *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*), the FTB violates the separations of powers. Judicial power is vested in the California courts, which cannot be exercised by any other branch of the California government. Furthermore, the FTB cannot usurp the powers of the courts by ignoring *Fujitsu* by seeking to revise California Code of Regulations, Title 18 (hereinafter CCR), sections 24411 and 25106.5-1.

Response:

Pursuant to CRTC section 19503, the California Legislature has given the FTB the authority to generally prescribe regulations necessary for the enforcement of the California Corporation Tax Law, which is the relevant tax law for purposes relating to the revisions to CCR section 24411. Furthermore, CRTC section 25106.5 grants the FTB specific legislative rulemaking authority to promulgate regulations relating to combined reports, which is the relevant authority for purposes of revising CCR section 25106.5-1. Based on this statutory grant of authority to prescribe regulations, it follows that the Legislature has given the FTB the authority to revise regulations. Therefore, by seeking to revise CCR sections 24411 and 25106.5-1, the FTB is only acting in accordance with the authority given to it by the California Legislature and is not attempting to exercise judicial power.

Furthermore, by its actions, the FTB is not ignoring *Fujitsu*. Rather, the FTB is clarifying provisions of the regulations the court in *Fujitsu* interpreted in a manner that is inconsistent with the California Supreme Court's position regarding the pro rata rule of ordering distributions:

> When, as in the present case, the adjustments relate to a large multicorporate [enterprise] which operates through a series of subsidiaries, some of which do business only in California, some of which do business only outside of California and some of which do business both within and without California **and have nonunitary as well as unitary income**, then the computations grow quite involved. **The method employed in the present case would allow a …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.** *Safeway Stores v. FTB* (1970) 3 Cal. 3d 745, 753 (hereinafter *Safeway*). (Emphasis added).

In *Appeal of Apple Computer, Inc.*, 2006-SBE-002, the SBE relied on *Safeway* to make its determination that the appropriate rule for ordering distributions is the pro rata rule.

Moreover, as the California Court of Appeal has stated:

> The adoption of a clarifying regulation after a controversy has arisen cannot be taken as a determination that the former policy was unreasonable or erroneous, but must simply be regarded as a commendable effort to avoid any similar controversy in the future. *Nadler v. California Veterans Board*, (1984) 152 Cal.App.3d 707,719.

The revisions to CCR sections 24411 and 25106.1 must be viewed as an effort by the FTB to avoid any additional controversy brought about by the court in *Fujitsu* relying on the preferential rule of ordering distributions, which is inconsistent with the California Supreme Court's holding in *Safeway*.

Recommendation:

No change to the revisions of the regulations is necessary.

3. The revisions to California Code of Regulations, Title 18 (hereinafter CCR), sections 24411 and 25106.5-1 do not meet the necessity, consistency, and reference standards of the Administrative Procedures Act.

Response:

<u>Necessity</u>:

Government Code section 11349, subdivision (a), defines necessity as follows:

> "Necessity" means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record. For purposes of this standard, evidence includes, but is not limited to, facts, studies, and expert opinion.

The regulatory changes proposed meet this standard because there is currently no clear guidance regarding the proper method for the allocation of distributions such that a taxpayer can determine what amounts are subject to the deduction available under CRTC section 24411. In *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*), at page 480, the Court of Appeal confirmed this lack of guidance when it stated: "No statute, regulation or other administrative pronouncement provides clear guidance on this question." At the same page, the Court stated that CCR section 25106.5-1(f)(2), which did not come into effect until 2001, nine years after the years at issue in *Fujitsu*, "seem[ed] to indicate" that preferential ordering of distributions should be utilized rather than the pro rata rule of allocating distributions. The court's use of the term "seem[ed] to indicate", coupled with the court's admission that there was not guidance on this point, provides the basis for meeting the necessity standard for the revisions to these regulations. The decision of the court in *Fujitsu* also fails to provide a clear interpretation of these provisions because it is inconsistent with the California Supreme Court's earlier decision in *Safeway Stores v. FTB* (1970) 3 Cal. 3d 745 (hereinafter *Safeway*). In *<u>Appeal of Apple Computer, Inc.</u>*, 2006-SBE-002 (hereinafter *Apple*), the preferential ordering of distributions was rejected by the SBE, which relied on *Safeway* in doing so.

Moreover, as the California Court of Appeal has stated:

> The adoption of a clarifying regulation after a controversy has arisen cannot be taken as a determination that the former policy was unreasonable or erroneous, but must simply be regarded as a commendable effort to avoid any similar controversy in the future.
> *Nadler v. California Veterans Board*, (1984) 152 Cal.App.3d 707,719.

Revising CCR sections 24411 and 25106.5-1 is necessary to avoid any additional controversy brought about by the court in *Fujitsu* relying on the preferential rule of ordering distributions, which is inconsistent with the California Supreme Court's holding in *Safeway*.

Consistency:

Government Code section 11349, subdivision (d), defines consistency as follows:

> "Consistency" means being in harmony with, and not in conflict with or contradictory to, existing statutes, court decisions, or other provisions of law.

The proposed regulatory amendments meet this standard because they are consistent with the California Supreme Court's decision in *Safeway*, which set forth the proper dividend ordering rule as being a pro rata method. The proposed amendments are not inconsistent with the Court of Appeal decision in *Fujitsu* because the court in *Fujitsu* did not interpret the statute to require a preferential ordering treatment; rather the court interpreted the regulations to provide for such a method.

The *Fujitsu* opinion does not contain much statutory construction analysis, if any at all. The only statutes that are substantively addressed are CRTC sections 24411 and 25106. The only comments made by the Court with respect to these statutes are to distinguish one from the other. CRTC section 24411 provides for a 75% deduction of the qualifying dividends, while CRTC section 25106 provides for a 100% elimination of qualifying dividends. The court did not rely on statutory construction to make its determination. Instead, the Court focused upon CCR sections 24411 and 25106.5-1. In essence, *Fujitsu* is about regulatory construction and not statutory construction. Consequently, CCR sections 24411 and 25106.5-1 need to be revised because they provide a guide to interpreting CRTC sections 24411 and 25106.5. However, in *Apple*, the SBE was unequivocal about its ability to appreciate the distinctions between the pro rata rule of allocating distributions in contrast to the preferential ordering of distributions. Consequently, the revisions to CCR section 24411 and 25106.5-1 are consistent with the position that the SBE took in *Apple*, which was congruent with the pro rata rule set forth in *Safeway*. Accordingly, the revisions to CCR sections 24411 and 25106.5-1 are consistent with *Safeway*.

Reference:

Government Code section 11349, subdivision (e), defines reference as follows:

> "Reference" means the statute, court decision or other provision of law which the agency implements, interprets, or makes specific by adopting, amending or appealing a regulation.

The revisions to CCR sections 24411 and 25106.5-1 will impart clarity as to how those statutes adhere to the pro rata rule of distributions, as confirmed by *Safeway*.

Recommendation:

No change to the revisions of the regulations is necessary.

4. Proceeding with the revisions to California Code of Regulations, Title 18 (hereinafter CCR), sections 24411 and 25106.5-1 is inappropriate because Apple Computer, Inc. has filed a claim for refund suit challenging the SBE's *Appeal of Apple Computer, Inc.*, 2006-SBE-002 decision.

Response:

Even if Apple Computer, Inc. prevailed in its trial court case, it is likely that the decision would be appealed to obtain clarity. Conversely, if Apple Computer, Inc. did not prevail in its trial court case, it is likely that it would appeal that decision to the California Court of Appeal. Furthermore, the trial court and the California Court of Appeal would not decide whether *Apple* is correct because all of the facts and issues would be addressed de novo. All told, the Apple Computer, Inc. claim for refund suit could conceivably be ongoing for many more years.

With respect to the revisions to CCR sections 24411 and 25106.5-1, a "symposium" (i.e. an "interested parties hearing") and a formal hearing have already been held. Indefinitely delaying the regulation process in order await the dispositive result in Apple Computer, Inc.'s claim for refund suit would be tantamount to beginning the regulation process all over again. Consequently, the efforts of all of the taxpayers and tax practitioners whom have already participated in this regulation process would have been pointless. Revising CCR sections 24411 and 25106.5-1 would eliminate any uncertainty that the pro rata rule is the proper rule for allocating distributions. This would most likely result in less litigation over the matter because potentially affected taxpayers will have guidance with respect to properly filing their returns.

Recommendation:

No change to the revisions of the regulations is necessary.

Oral Comments from Michelle Pielsticker date January 16, 2008

1. The revisions to California Code of Regulations, Title 18 (hereinafter CCR) sections 24411 and 25106.5-1 do not meet the necessity and consistency standards of the Administrative Procedures Act.

Response:

Necessity:

Government Code section 11349, subdivision (a), defines necessity as follows:

> "Necessity" means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record. For purposes of this standard, evidence includes, but is not limited to, facts, studies, and expert opinion.

The regulatory changes proposed meet this standard because there is currently no clear guidance regarding the proper method for the allocation of distributions such that a taxpayer can determine what amounts are subject to the deduction available under CRTC section 24411. In *Fujitsu IT Holdings v FTB* (2004) 120 Cal. App. 4th 459 (hereinafter *Fujitsu*), at page 480, the Court of Appeal confirmed this lack of guidance when it stated: "No statute, regulation or other administrative pronouncement provides clear guidance on this question." At the same page, the Court stated that CCR section 25106.5-1(f)(2), which did not come into effect until 2001, nine years after the years at issue in *Fujitsu*, "seem[ed] to indicate" that preferential ordering of distributions should be utilized rather than the pro rata rule of allocating distributions. The court's use of the term "seem[ed] to indicate", coupled with the court's admission that there was not guidance on this point, provides the basis for meeting the necessity standard for the revisions to these regulations. The decision of the court in *Fujitsu* also fails to provide a clear interpretation of these provisions because it is inconsistent with the California Supreme Court's earlier decision in *Safeway Stores v. FTB* (1970) 3 Cal. 3d 745 (hereinafter *Safeway*). In *Appeal of Apple Computer, Inc.*, 2006-SBE-002 (hereinafter *Apple*), the preferential ordering of distributions was rejected by the SBE, which relied on *Safeway* in doing so.

Moreover, as the California Court of Appeal has stated:

> The adoption of a clarifying regulation after a controversy has arisen cannot be taken as a determination that the former policy was unreasonable or erroneous, but must simply be regarded as a commendable effort to avoid any similar controversy in the future.
> *Nadler v. California Veterans Board*, (1984) 152 Cal.App.3d 707,719.

Revising CCR sections 24411 and 25106.5-1 is necessary to avoid any additional controversy brought about by the court in *Fujitsu* relying on the preferential rule of ordering distributions, which is inconsistent with the California Supreme Court's holding in *Safeway*.

Consistency:

Government Code section 11349, subdivision (d), defines consistency as follows:

> "Consistency" means being in harmony with, and not in conflict with or contradictory to, existing statutes, court decisions, or other provisions of law.

The proposed regulatory amendments meet this standard because they are consistent with the California Supreme Court's decision in *Safeway*, which sets forth the proper dividend ordering rule as being a pro rata method. The proposed amendments are not inconsistent with the Court of Appeal decision in *Fujitsu* because the court in *Fujitsu* did not interpret the statute to require a preferential ordering treatment; rather the court interpreted the regulations to provide for such a method.

The *Fujitsu* opinion does not contain much statutory construction analysis, if any at all. The only statutes that are substantively addressed are CRTC sections 24411 and 25106. The only comments made by the Court with respect to these statutes are to distinguish one from the other. CRTC section 24411 provides for a 75% deduction of the qualifying dividends, while CRTC section 25106 provides for a 100% elimination of qualifying dividends. The court did not rely on statutory construction to make its determination. Instead, the Court focused upon CCR sections 24411 and 25106.5-1. In essence, *Fujitsu* is about regulatory construction and not statutory construction. Consequently, CCR sections 24411 and 25106.5-1 need to be revised because they provide a guide to interpreting CRTC sections 24411 and 25106.5. However, in *Apple*, the SBE was unequivocal about its ability to appreciate the distinctions between the pro rata rule of allocating distributions in contrast to the preferential ordering of distributions. Consequently, the revisions to CCR section 24411 and 25106.5-1 are consistent with the position that the SBE took in *Apple,* which was congruent with the pro rata rule set forth in *Safeway*. Accordingly, the revisions to CCR sections 24411 and 25106.5-1 are consistent with *Safeway*.

Recommendation:

No change to the revisions of the regulations is necessary.

2. Proceeding with the revisions to California Code of Regulations, Title 18 (hereinafter CCR) sections 24411 and 25106.5-1 is inappropriate because Apple Computer, Inc. has filed a claim for refund suit challenging the SBE's *<u>Appeal of Apple Computer, Inc.</u>*, 2006-SBE-002 decision.

Response:

Even if Apple Computer, Inc. prevailed in its trial court case, it is likely that the decision would be appealed to obtain clarity. Conversely, if Apple Computer, Inc. did not prevail in its trial court case, it is likely that it would appeal that decision to the California Court of Appeal. Furthermore, the trial court and the California Court of Appeal would not decide whether *Apple* is correct because all of the facts and issues would be addressed de novo. All told, the Apple Computer, Inc. claim for refund suit could conceivably be ongoing for many more years.

With respect to the revisions to CCR sections 24411 and 25106.5-1, a "symposium" (i.e. an "interested parties hearing") and a formal hearing have already been held. Indefinitely delaying the regulation process in order await the dispositive result in Apple Computer, Inc.'s claim for refund suit would be tantamount to beginning the regulation process all over again. Consequently, the efforts of all of the taxpayers and tax practitioners whom have already participated in this regulation process would have been pointless. Revising CCR sections 24411 and 25106.5-1 would eliminate any uncertainty that the pro rata rule is the proper rule for allocating distributions. This would most likely result in less litigation over the matter because potentially affected taxpayers will have guidance with respect to properly filing their returns.

Recommendation:

No change to the revisions of the regulations is necessary.

January 15, 2008

BY FACSIMILE & U.S. MAIL

Colleen Berwick
Franchise Tax Board, Legal Branch
P. O. Box 1720
Rancho Cordova, CA 95741-1720

Re: Proposed Amendments to Regulations 24411 and 25106.5-1

Dear Ms. Berwick:

This letter is submitted on behalf of Apple Inc. in opposition to the FTB staff's proposed amendments to Regulations 24411 and 25106.5-1.[1] We oppose the FTB staff's attempt to proceed with its proposed amendments, because such amendments are an unlawful and blatant attempt to overturn a binding and precedential decision by the Court of Appeal and are inconsistent with the Revenue and Taxation Code.

The proposed amendments to Regulations 24411 and 25106.5-1 would add provisions that address the ordering of dividends received from income that has been included in a unitary combined report ("included income") and dividends received from income that has not been included in a unitary combined report ("excluded income"). In particular, the Regulations, as amended, would provide that (1) dividends should be treated as being paid from current year's earnings first and the most recent years' earnings thereafter and (2) dividends paid from any given year should be deemed paid part from included income and in part from excluded income on a prorated basis.

The FTB staff's proposed amendments to Regulations 24411 and 25106.5-1 are unlawful and erroneous and should not be adopted.

[1] Unless otherwise indicated, all regulatory references are to Title 18 of the California Code of Regulations.

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1. The Fujitsu Court, in a final, published and precedential decision, has rejected the FTB's position on dividend ordering.

In 2004, the California Court of Appeal issued its decision in Fujitsu IT Holdings, Inc. v. Franchise Tax Board, 120 Cal. App. 4th 459 (2004). In Fujitsu, the Court of Appeal decided the dividend ordering issue and held that dividends should be treated as paid first out of included income, with any excess paid out of excluded income. The Court specifically rejected the FTB's proration position. Thus, the proposed amendments to Regulations 24411 and 25106.5-1 are directly contrary to the Fujitsu Court's holding on the dividend ordering issue.

Fujitsu is a final, published decision and is thus binding on the FTB. Under well-established judicial principles, including *stare decisis*, the Court's holding in Fujitsu on the dividend ordering issue sets forth precedent to which the FTB, the State Board of Equalization ("SBE"), taxpayers and the courts must adhere.[2]

FTB staff's refusal to follow Fujitsu also violates separation of powers. The FTB is an administrative agency of the State of California that is charged with administering and enforcing the California income and franchise tax law, as promulgated by the Legislature.[3] Judicial power is vested in the California courts, and the powers reserved for the judicial branch may not be exercised by the other branches.[4]

The FTB raised its objections to the Fujitsu decision in a petition for rehearing to the Court of Appeal, a petition for review to the California Supreme Court and a request for depublication to the Supreme Court—all of which were denied. The FTB cannot usurp the powers of the courts by ignoring Fujitsu and adopting Regulations which are inconsistent with the Fujitsu decision.

2. The FTB cannot overturn Fujitsu through the regulatory process.

FTB staff believes that Fujitsu was wrongly decided. The proposed amendments to the Regulations are an unlawful and self-serving attempt to support that position. The FTB

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[2] See, e.g., Auto Equity Sales, Inc. v. Superior Court, 57 Cal. 2d 450 (1962).

[3] See Cal. Rev. & Tax. Code § 19501.

[4] Cal. Const. art. III, § 3 and art. VI, § 1; see Mandel v. Myers, 29 Cal. 3d 531 (1981); McHugh v. Santa Monica Rent Control Bd., 49 Cal. 3d 348 (1989).

cannot overturn Fujitsu through the regulatory process. The Administrative Procedure Act ("APA")[5] sets forth specific rules regarding the adoption of administrative regulations in California. In particular, all proposed regulations or amendments thereto must satisfy each of the following standards: necessity, authority, clarity, consistency, reference and nonduplication.[6]

"Necessity" means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record.[7]

"Consistency" means being in harmony with, and not in conflict with or contradictory to, existing statutes, court decisions, or other provisions of law.[8]

"Reference" means the statute, court decision, or other provision of law which the agency implements, interprets, or makes specific by adopting, amending, or repealing a regulation.[9]

FTB staff's proposed amendments to Regulations 24411 and 25106.5-1 fail to satisfy the above standards because they are in conflict with the Court's decision in Fujitsu and are contrary to the statutory provisions under Cal. Rev. & Tax. Code § 24411 ("Section 24411") and § 25106 ("Section 25106").

a. FTB staff's proposed amendments are inconsistent with Fujitsu.

In its Initial Statement of Reasons for the proposed amendments,[10] FTB staff expressly recognizes that the dividend ordering issue that is addressed by the proposed amendments is the same issue that was decided in Fujitsu.

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[5] Cal. Gov't Code § 11340 *et seq.*

[6] Cal. Gov't Code § 11349.1

[7] Cal. Gov't Code § 11349(a) (emphasis added).

[8] Cal. Gov't Code § 11349(d) (emphasis added).

[9] Cal. Gov't Code § 11349(c) (emphasis added).

[10] Initial Statement of Reasons for the Proposed Amendments of California Code of Regulations, Title 18, Sections 24411 and 25106.5-1 (hereinafter, "Initial Statement of Reasons") , p.1.

As discussed above, FTB staff's position on the dividend ordering issue, as reflected in the proposed amendments, is in conflict with the Fujitsu decision. As such, the proposed amendments violate the necessity, consistency and reference standards and cannot be adopted.

b. FTB staff's proposed amendments to the Regulations are contrary to Sections 24411 and 25106.

The proposed amendments also violate the necessity, consistency and reference standards because they are squarely at odds with Sections 24411 and Section 25106.

Section 24411 provides that dividends are deductible under that section, to the extent not otherwise allowed as a deduction (e.g., Section 24402) or eliminated from income (e.g., Section 25106). Section 24411 contains an explicit ordering rule, which states that dividends are first eliminated under Section 25106, then deducted under Section 24402 or other deduction provision, and thereafter deducted under Section 24411.[11] FTB staff's proposed amendments are inconsistent with Section 24411's ordering rule.

In addition, FTB staff's proposed amendments violate the dividend elimination provisions under Section 25106. Section 25106 provides that dividends shall be eliminated, to the extent those dividends are paid out of income that was included in the combined income of the unitary group. As the Fujitsu Court held, Section 25106 prevents dividends from subsidiaries from being taxed twice—once as earnings of the issuing subsidiary and again as separate income to the unitary business in the form of dividends.[12] Section 25106 ensures that amounts included in the combined income of a unitary group can be moved, in the form of dividends, among members of the unitary group without tax consequences.[13] The FTB's proration position, as reflected in the proposed amendments, is inconsistent with Section 25106. The Fujitsu Court has so held.

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[11] FTB staff expressly recognized the ordering rule contained in Section 24411 in the aftermath of Farmer Bros. v. Franchise Tax Board, 108 Cal. App. 4th 976 (2003). In light of Farmer Bros. and consistent with the ordering rule in Section 24411, the FTB announced that dividends would be deducted under Section 24402 and not 24411, to the extent not otherwise eliminated. See FTB Memorandum dated May 17, 2004 from Multistate Audit Program Bureau.

[12] Fujitsu, 120 Cal. App. 4th at 477.

[13] Id.

Thus, FTB staff's proposed amendments wholly fail to satisfy the requisite regulatory standards. The FTB simply does not have the authority to overturn a Court of Appeal decision or alter a statute through the regulatory process. The FTB cannot, and should not be permitted to, legitimize its erroneous position by way of the proposed amendments.

3. The SBE's erroneous decision in Apple cannot provide the support for the adoption of the proposed amendments.

FTB staff seeks to justify its proposed amendments on the basis that they are necessary to conform to the SBE's decision in Appeal of Apple Computer, Inc., 2006-SBE-002 (Nov. 20, 2006).[14] Staff is off base. The SBE's decision in Apple cannot provide the support for the adoption of the proposed amendments because the decision is directly contrary to Fujitsu and cannot supersede the Court of Appeal's holding in that case.

FTB staff recognizes that Apple involved the same issues that were decided in Fujitsu and that are addressed by the proposed amendments.[15] In Fujitsu, the Court held that preferential ordering, not proration, was required under the statute. In Apple, the SBE refused to follow Fujitsu and determined that proration was required. However, under the doctrines of *stare decisis* and separation of powers, the SBE does not have the authority to refuse to follow a published Court of Appeal decision. In short, the FTB cannot rely on the Apple decision to support the adoption of the proposed amendments.

Finally, FTB staff's reliance on the SBE decision in Apple is further misplaced, since the taxpayer in Apple has filed a suit for refund in San Francisco Superior Court challenging that decision. Proceeding with the proposed amendments while the Apple lawsuit is pending is completely inappropriate.

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[14] See Initial Statement of Reasons, p. 1. The FTB also attempts to justify the proposed amendments on the grounds that they are necessary to "clarify" the Regulations and correct the Fujitsu Court's misreading of certain examples in the existing Regulations. The FTB grossly mischaracterizes the Fujitsu decision on the dividend ordering issue as based on a misreading of the Regulations. The Fujitsu Court did much more than simply interpret the FTB's regulations. Rather, it interpreted and harmonized the provisions of the Revenue and Taxation Code.

[15] See Initial Statement of Reasons, p. 1.

In sum, the proposed amendments to Regulations 24411 and 25106.5-1 fail to satisfy the requirements of the Administrative Procedure Act because they are in conflict with Fujitsu and are contrary to Sections 24411 and 25106. The proposed amendments must be rejected.

Very truly yours,

Peter Oppenheimer
Senior Vice President, Chief Financial Officer

cc: Terrence P. Ryan
Jeffrey M. Vesely
Kerne H. O. Matsubara
Annie H. Huang

ORAL AND WRITTEN TESTIMONY AT PUBLIC HEARING ON AMENDMENTS TO REGULATION SECTIONS 24411 AND 25106

The following testimony is provided by John I. McBeth, Senior Tax Counsel, Franklin Templeton Investments on behalf of the Franklin Templeton California unitary group of companies. This testimony concerns proposed amendments to California's Code of Regulations pertaining to the ordering of dividends paid from income that has been or has not been included in a California water's-edge combined report.

My testimony will address several issues that were raised by the Initial Statement of the Reasons for the Proposed Amendments and the proposed regulation amendments. These issues are:

- Whether or not the Proposed Amendments will result in double taxation of income reported by a unitary group filing a water's-edge combined report.
- Whether a statutory interpretation of Revenue & Taxation Code Sections 24411 and 25106 gives precedence to a preferential ordering of dividends.
- Whether or not the effect of this regulation change can be and will be applied retroactively in violation of judicial precedents and a fair reading of these sections.

Double Taxation of Income.

There is no mention in the Notice of Public Hearing or in the Initial Statement of Reasons for the Proposed Amendments of the issue of double taxation. There are, however, conclusory statements in the Notice to the following effect:

a. Significant statewide adverse economic impact directly affecting business including the ability of California businesses to compete with businesses in other states: **None.**

b. Potential cost impact on private persons or businesses affected: **The Franchise Tax Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.**

c. Significant impact on the creation or elimination of jobs, new businesses or the expansion of businesses in the state: **None.**

We challenge these conclusions. As will be shown in the materials that follow, these amendments **WILL RESULT IN SIGNIFICANT DOUBLE TAXATION** of the earnings of controlled foreign corporations that are repatriated to their U.S. parent corporations. These amendments will result in a significant tax increase for larger multinational corporations that file under California's water's-edge legislation. As such, we question whether the Franchise Tax Board has the authority to adopt regulation amendments that will result in a tax increase to a large segment of corporations filing California combined reports. We leave that issue for others to debate and decide.

To analyze the issue of double taxation, let's start with opposing counsel's briefs in the Matter of the Appeal of Apple Computer, Inc. before the State Board of Equalization in late 2006. The Appellant in this appeal, Apple Computer, contended that the Section 24411 ordering rules that allow for a 75% deduction for dividends paid from income not otherwise eliminated under Section 25106, were not applicable because the statutes under both Section 24411 and 25106 gave precedence to the exclusion of income under Section 25106. Further, it stated that this interpretation is not only reasonable, but is the best interpretation of these sections in light of their plain language and purpose, which is to prevent double taxation of dividends.

The respondent, Franchise Tax Board, challenged that interpretation in their Supplemental Brief. I quote in length from that brief:

> III. RESPONDENT'S APPLICATION OF THE LIFO ORDERING RULE AND THE PRORATION OF DIVIDEND DISTRIBUTIONS DOES NOT RESULT IN DOUBLE TAXATION.
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> Under the LIFO ordering rule, dividend distributions are paid first out of the current year's earnings and profits, and thereafter, out of each immediately preceding year's earnings and profits. In addition, for any year where the earnings and profits consist of both income previously included in the unitary combined report and income previously not included in the unitary combined report, the dividend distribution is considered paid out of both earnings and profits pools proportionally. Under this approach, provided by the regulations and applied by respondent, dividends paid from the previously included income pool are eliminated pursuant to section 25106 in the year of distribution. Whether such dividends are distributed and eliminated during the current year, or distributed and eliminated in the subsequent years, the income previously included in the unitary combined report is taxed no more than once when distributed between members of the unitary group. This result is consistent with section 25106.

> The only difference between respondent's approach and appellant's approach is in the timing of the deduction. Under the respondent's approach, because dividend distributions are pro-rated between the previously included income pool and non-previously included income pool, some of the dividends will be allowed a 100 percent deduction under *Farmer Bros.* decision and not eliminated 100 percent under section 25106 until later years. On the other hand, under the appellant's approach, dividends are first eliminated entirely under section 25106 until the unitary income pool is depleted, regardless of when the unitary income is earned.
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> In other words, appellant's approach accelerates the dividends eligible for elimination under section 25106. There would be no timing difference, however, if one single dividend distribution depletes all of the dividend payor's earnings and profits, as the amount of dividends eliminated under section 25106 and amount of dividends eligible for deduction under *Farmer Bros.* decision would be the same under both approaches. There would be no tax difference when multiple dividend distributions made in different years deplete the dividend payor's entire earnings and profits, because in the aggregate, the amounts of dividends eliminated under section 25106 and deducted under *Farmer Bros.* would be the same under both respondent's and appellant's approaches.

First, let me say that my analysis and conclusion would not vary if we substituted Section 24411 for *Farmer Bros.* Then I have to concur with the Franchise Tax Board Staff's conclusion that if ALL current and accumulated earnings and profits are distributed to a member of the water's-edge group, then the tax result will be the same for both methods of allocation: preferential or pro rata. Internal Revenue Code Section 965, the federal repatriation legislation signed into law in American Jobs Creation Act of 2004, created just this situation for most large California-based multinational corporations in that U.S. corporations were allowed to make an election under federal law to repatriate their controlled foreign corporations' accumulated and untaxed foreign earnings and profits with a special 85% dividend-received deduction, subject to certain limitations and requirements. Those water's-edge filers that took advantage of this legislation probably eliminated most if not all of their controlled foreign corporations' earnings and profits and, in so doing, eliminated in the year of their repatriation this dividend ordering rule controversy.

It is the impact of this ordering rule policy on post-Section 965 repatriation years that we are concerned with. We contend that the application of ordering rules to subsequent repatriations is NOT a timing issue, for the reasons that I will now identify.

The federal legislation, when adopted, contained express language in the committee reports and implementing provisions that it was intended to be and will be a one-time event. There is no intent within Congress for subsequent adoptions of such relief legislation. To do so would eviserate the effect of the federal Subpart F taxing regime. The Conference Committee Reports for PL 108-357, the American Jobs Creation Act of 2004, stated as follows:

> *Conference Agreement* The conference agreement follows the House Bill, with modifications. Under the conference agreement, certain dividends received by a U.S. corporation from controlled foreign corporations are eligible for an 85-percent dividends-received deduction. . . . The conferees emphasize that this is a temporary economic stimulus measure, and that there is no intent to make this measure permanent, or to "extend" or enact it again in the future.

A second, significant consideration in this analysis is the impact of financial accounting standards under APB 23: Accounting for Income Taxes – Special Areas. Under this pronouncement (in the section "Undistributed Earnings of Subsidiaries") and other accounting rules, multinational corporations filing consolidated financial statements in accordance with Generally Accepted Accounting Principles (GAAP) are required to currently accrue income taxes on all earnings included in consolidated income under FAS 109, *Accounting for Income Taxes*. Under these rules, any income earned by subsidiaries operating within or outside the United States requires the accrual at the current maximum corporate income tax rate of taxes as a financial statement expense against earnings. The practical effect of this requirement is to strongly encourage multinational corporations with operations outside the United States to find ways to defer or permanently eliminate their income tax expense for U.S. GAAP purposes on their foreign earnings. One such way is the exception language of APB 23, paragraph 12.

> 12. *Indefinite reversal criteria*. The presumption that all undistributed earnings will be transferred to the parent company may be overcome, and no income taxes should be accrued by the parent company, if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be

> remitted in a tax-free liquidation. A parent company should have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely. . . .

The disclosure of Franklin Resources, Inc. in its Form 10-K filed for Fiscal Year Ended September 30, 2007, is typical of the disclosure of California water's-edge combined groups operating within and outside the United States:

> As a multinational corporation, we operate in various locations outside the United States and generate earnings from our non-U.S. subsidiaries. At September 30, 2007, and based on tax laws then in effect, it is our intention to continue to indefinitely reinvest the undistributed earnings of non-U.S. subsidiaries, except for previously taxed foreign subsidiary Subpart F income and the earnings of material consolidated non-U.S. subsidiaries taxed at higher local jurisdiction rates the U.S. income rate. As a result, we have not made a provision for U.S. taxes and have not recorded a deferred tax liability on $2.6 billion of cumulative undistributed earnings recorded by non-U.S. subsidiaries at September 30, 2007. Changes to our policy of reinvesting non-U.S. earnings may have a significant effect on our financial condition and result of operations.

Multinational corporations that choose to avail themselves of the financial statement benefits of paragraph 12 of APB 23 must establish a consistent policy that provides for the indefinite reinvestment overseas of a portion or all of their foreign earnings. Once their policies are established, these corporations are accountable to government regulators and the investing public to abide by their policies. If a corporation were to deviate from its existing policy without substantial justification, it would suffer the consequences of loss of credibility and accountability in its reported financial statements, as well as any additional consequences required by the Securities and Exchange Commission or other federal or state regulatory bodies. Once established, multinational corporations adhere to these APB 23 policies diligently, with changes in their repatriation strategies only upon extreme events such as the passage of the federal AJCA of 2004.

The net effect of these accounting rules is that most multinational corporations establish accounting policies that provide for the repatriation back into the United States of only their income that is already subject to U.S. tax (such as Subpart F income). Some multinational corporations also adopt a policy to repatriate income that is subject to tax in a foreign jurisdiction at a rate higher than the United States, and use the foreign taxes paid on this income as a credit on their federal consolidated income tax return.

The impact of pro rata dividend ordering rules in this environment is obvious. The only way for multinational corporations filing water's-edge California returns to avoid double taxation on a portion of their included income is for the corporation to avoid the application of the ordering rules by repatriating ALL of their CFC foreign E&P, thereby substantially increasing their federal income tax and decreasing their financial accounting net income. And to avoid problems with APB 23, they must do this consistently. Any vacillations in their indefinite reinvestment policy will cause the deferral to be voided, resulting in a substantial, material impact on their current financial statement earnings and the loss of confidence by the investment community in the value of their traded shares. The net effect of a policy to repatriate sufficient earnings (or ALL earnings) to mitigate the impact of double taxation of the repatriated dividends is to lose any benefit from filing as a water's-edge taxpayer. One wonders whether this push for pro rata ordering of dividends is a backdoor effort to move California multinational corporations away from water's-edge filing to worldwide combined reports.

I have attached an example of a corporation that repatriates indefinitely only its Subpart F income. On the last page of the example, I have summarized the net effect of the dividend ordering rules. Under the preferential ordering rule, the CA Parent is able to repatriate all of its previously taxed income without any additional tax under Section 24411. Under the pro rata rule, the CA Parent will never be able to repatriate all of its previously taxed income due to the interaction of APB 23 and this pro rata allocation methodology.

In any given year (whether the current year or in a year with distributions from accumulated earnings and profits), a corporation that distributes only its previously taxed income will have the following percentage of its foreign earnings subject to double taxation:

Item or Effect	**Percentage**				
CA Inclusion Ratio	10	25	50	75	90
Double Taxed Income	22.5	18.75	12.5	6.25	2.5

The Bottom Line

The bottom line is that unless a multinational corporation has a policy to repatriate all or substantially all of its foreign earnings as earned, there will be a significant element of double taxation inherent in the adoption of a pro rata ordering rule for dividends repatriated back into the United States. And APB 23 pretty much guarantees that multinational corporations will defer the financial accounting impacts of large repatriations by adopting an indefinite reinvestment overseas policy under its provisions. The combination of APB 23 and pro rata dividend ordering rules will mean double taxation of their repatriated CFC earnings for multinational corporations on their California water's-edge combined income tax returns and a tax increase for all of these corporations.

Statutory interpretation of Sections 24411 and 25106.

In the Court of Appeal decision in *Fujitsu*, the court in the section on Ordering of Distributions discussed their interpretation of the interaction between these two sections. The court affirmed the superior court's decision that unitary group income must first be subject to elimination under Sec. 25106, and only after it had been exhausted under this section would it be taxed at 25% remaining after the application of section 24411. The appellate court stated that the superior court reached its result in order to "harmonize the statutes and avoid constitutional infirmities." The appellate court affirmed, concluding "Furthermore, we must select the construction that comports most closely with the apparent intent of the Legislature, with a view to promoting rather than defeating the general purpose of the statute, and avoid an interpretation that would lead to absurd consequences. And, whenever possible, we will interpret a statute as consistent with applicable constitutional provisions, seeking to harmonize Constitution and statute." [citations omitted]

We read Section 25106 in a like manner. The express language of this section can only be read and the provision given its intended consequences if previously included income is allowed to be repatriated first.

> **. . . all dividends paid by one to another of those corporations shall, to the extent those dividends are paid out of the income previously described of the unitary business, be eliminated from the income of the recipient and, . . . shall not be taken into account . . . in any other manner in determining the tax of any member of the unitary group.**

We would challenge that this express language can never be given it intended effect under a pro rata dividend ordering rule adopted by regulation. And if the Franchise Tax Board staff continues to demand that it be so interpreted, and if the Board adopts the staff's proposed regulation, the end result will be a constitutional challenge again in a California superior court, appellate court or state supreme court. We would like to question the staff to determine how many of these decisions it will ignore in seeking to have its way in double taxing this income.

We would suggest that if the staff insists on adopting these changes, it should do so legislatively with clear language in Sections 25106 and 24411 that provides for the pro rata ordering of foreign dividends. With legislation, there will no longer be interpretative battles in the California court system and uncertainty among California water's-edge filers.

Retroactive Application of Pro Rata Dividend Ordering Rules

Finally, we would challenge the Franchise Tax Board to remove any doubt and declare that any changes that are to be made by these regulatory amendments be made prospective only. Given the existence of a binding Court of Appeals decision in Fujitsu as authority for preferential dividend ordering, these regulation changes cannot be deemed to be just a clarification of prior law or regulations. Any attempt at making these regulations retroactive will only engender further litigation at great cost to both the State of California and California water's-edge filers.

Example of Interaction between <u>Preferential</u> and <u>Pro Rata</u> Dividend Ordering Rules

Assumptions:

1. Subpart F income is repatriated up to U.S. parent in the year earned.
2. For this illustration, the impacts of the differences between California's inclusion ratio reporting and the federal Subpart F regime on the California apportionment factors of the unitary group have been disregarded.
3. We assume for purposes of this illustration that the Controlled Foreign Corporation (CFC) had no accumulated E&P prior to Year 1.

Year 1:

CFC earns $1,000 in foreign E&P, has $500 in Subpart F income and it does not pay a dividend to its U.S. parent.

Current Year Tax for CA water's-edge group:

CFC has a CA inclusion ratio of 50%. It will have $500 in income included in the water's-edge return.

Carryover to Year 2:

<u>Preferential</u>: CFC has $1,000 in foreign, accumulated E&P:

$500 in previously taxed income in CA
$500 in untaxed foreign earnings

<u>Pro rata</u>: Same as Preferential.

Year 2:

CFC earns $1,000 in foreign E&P, has $100 in Subpart F income and pays a $200 dividend to its U.S. parent.

Current Year Tax for CA water's-edge group:

CFC has a CA inclusion ratio of 10%.

Preferential: U.S. Parent receives a $200 dividend that will be entirely excluded from income as previously taxed income under Sec. 25106 ($100 from the current year and $100 from accumulated previously taxed income in CA).

Pro rata: Because the dividend is less than the current E&P of U.S. Parent, the entire dividend is to be allocated based on current E&P. Includable income is $100; total current E&P is $1,000. Therefore, 1/10 of the dividend is paid out of income taxed in CA ($20) and 9/10 of the dividend is paid out of untaxed income ($180). The latter dividend is subject to a Sec. 24411 deduction: $135 – 75% dividend deduction; $45 - not offset by anything.

Carryover to Year 3: $1,800 in foreign E&P

Preferential :	$ 400 in previously taxed income in CA $1,400 in untaxed foreign earnings
Pro rata:	From Year 2: $ 80 in previously taxed income $720 in untaxed income
	From Year 1: $500 in previously taxed income $500 in untaxed income

Year 3:

CFC earns $1,000 in foreign E&P, has $800 in Subpart F income and pays a $1,200 dividend to its U.S. Parent.

Current Year Tax for CA waters'-edge group:

CFC has an Inclusion Ratio of 80%.

Preferential: U.S. Parent receives a $1,200 dividend that will be entirely excluded from income as previously taxed income under Sec. 25106 ($800 from the current year and $400 from accumulated previously taxed income in CA).

Pro rata: Because the dividend exceeds current E&P of U.S. Parent, the $1,000 of current E&P must be allocated between income included in the CA return ($800) and untaxed income ($200). Then Year 2 accumulated E&P is included to the extent of the additional $200 in dividends: 1/10 ($20) as previously taxed income in CA and 9/10 ($180) as untaxed income

The dividends paid out of untaxed income ($380) is subject to a Sec. 24411 deduction: $285 – 75% dividend deduction; $95 - not offset by anything.

Carryover to Year 4: ($1,600 in accumulated E&P)

Preferential:	$ 0 in previously taxed income $1,600 in untaxed income
Pro rata:	From Year 3: $ 0 in previously taxed income $ 0 in untaxed income
	From Year 2: $ 60 in previously taxed income $540 in untaxed income
	From Year 1: $500 in previously taxed income $500 in untaxed income

Net Effect of Dividend Ordering Methods:

Preferential: U.S. Parent is able to repatriate ALL of its previously taxed income and have that income be subject to tax in its CA combined return only once. Under APB 23 (absent a special federal law on repatriation), it is prohibited from repatriating any additional foreign earnings unless it is willing to have most if not all of its foreign earnings be subject to current reporting in its financial statements. This effect occurs once the CFC's dividends (including catch-up dividends) equal its accumulated previously taxed income in CA.

Pro rata: U.S. Parent will NEVER be able to repatriate ALL of its previously taxed income in CA due to the interaction of APB 23 and these rules, unless federal law again grants a special repatriation deduction and FASB again grants an exception to APB 23 as a relief measure. (NOTE that this is something that the U.S. Congress has said it will never do.) With respect to the income that it's CFCs repatriate, either the income dividends in excess of the CFC's current year E&P will be considered to be a dividend of previously taxed income in CA subject in part to double taxation OR the U.S. Parent will be effectively barred from repatriating a significant portion of its previously taxed income in CA and forced to substitute in its place untaxed income in an equal amount.

Browse Location: United States\Financial Accounting Standards Board (FASB)\Original Pronouncements\Accounting Principles Board Opinions (APB)
Publish Date: 16 May, 2005

APB 23: Accounting for Income Taxes-Special Areas

APB 23 STATUS

Issued: April 1972

Effective Date: For fiscal periods beginning after December 31, 1971

Affects: Deletes ARB 51, paragraph 16

Deletes APB 11, paragraphs 38, 39, and 41

Deletes APB 18, paragraph 19(j) and footnote 11

Affected by: Paragraph 2 amended by FAS 9, paragraph 16

Paragraph 4 deleted by FAS 71, paragraph 26(i)

Paragraph 9 and footnote 9 amended by FAS 96, paragraph 205(e), and FAS 109, paragraph 288(f)

Paragraph 10 amended by FAS 96, paragraph 205(e)

Paragraph 10 replaced by FAS 109, paragraph 288(f)

Paragraphs 11, 14, and 24 replaced by FAS 96, paragraph 205(e), and FAS 109, paragraph 288(f)

Paragraph 13 amended by FAS 96, paragraphs 204 and 205(e), and FAS 109, paragraphs 287 and 288(f)

Paragraphs 21 and 23 amended by FAS 109, paragraph 288(f)

Paragraphs 26 through 30 and footnote 11 deleted by FAS 60, paragraph 62

Footnote 3 deleted by FAS 109, paragraph 288(f)

Footnotes 4, 6, and 10 deleted by FAS 96, paragraph 205(e), and FAS 109, paragraph 288(f)

Footnote 7 amended by FAS 96, paragraph 204, and FAS 109, paragraph 287

Other Interpretive Pronouncements: AIN-APB 23, Interpretation No. 1 (Superseded by FAS 96 and FAS 109)

FIN 22 (Superseded by FAS 96 and FAS 109)

FIN 29 (Superseded by FAS 96 and FAS 109)

FTB 84-2 (Superseded by FAS 96 and FAS 109)

Issues Discussed by FASB Emerging Issues Task Force (EITF)

Affects: No EITF Issues

Interpreted by: Paragraph 12 interpreted by EITF Issue No. 93-16

Related Issues: EITF Issues No. 86-31 and 95-20

INTRODUCTION

APB23, Par. 1

APB23, Par. 1

1. In December 1967 the Accounting Principles Board issued APB Opinion No. 11, *Accounting for Income Taxes*, but deferred modifying the practices of accounting for income taxes in five special areas identified in paragraphs 38 through 41 of that Opinion as requiring further study:

a. Undistributed earnings of subsidiaries

b. Intangible development costs in the oil and gas industry

c. "General reserves" of stock savings and loan associations

d. Amounts designated as "policyholders' surplus" by stock life insurance companies

e. Deposits in statutory reserve funds by United States steamship companies.

APB23, Par. 2

2. The Board has examined the characteristics of the tax consequences of transactions in the three special areas designated (a), (c), and (d) above and sets forth in this Opinion its conclusions on appropriate accounting treatments. The Board also defers conclusions on deposits in capital construction funds or statutory reserve funds by United States steamship companies until regulations covering the provisions of the Merchant Marine Act of 1970 are available; experience under the 1970 Act, which substantially modified the Merchant Marine Act of 1936, is now limited. The Board also expresses in this Opinion its conclusions on accounting for taxes on income from investments in corporate joint ventures accounted for by the equity method in accordance with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock.* APB Opinion No. 24 covers accounting for taxes on income from investments in common stock accounted for by the equity method (other than subsidiaries and corporate joint ventures).

APB23, Par. 3

3. This Opinion supersedes paragraph 16 of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, paragraphs 38, 39, and 41 of APB Opinion No. 11 and paragraph 19(j) of APB Opinion No. 18. Except as stated in the preceding sentence this Opinion does not modify APB Opinion No. 11.

APB23, Par. 4

4. [This paragraph has been deleted. See Status page.]

Discussion

APB23, Par. 5

APB23, Par. 5

5. In APB Opinion No. 11 the Board defined differences between taxable income and pretax accounting income as either timing differences or permanent differences and provided criteria for distinguishing between the differences. Timing differences are "Differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Timing differences originate in one period and reverse or 'turn around' in one or more subsequent periods." Permanent differences are "Differences between taxable income and pretax accounting income arising from transactions that, under applicable tax laws and regulations, will not be offset by corresponding differences or 'turn around' in other periods." The Board also recognized that the tax consequences of a number of other transactions are somewhat similar to those of timing differences; however, the initial differences between taxable income and pretax accounting income related to the transactions may not reverse until indefinite future periods or may never reverse.

APB23, Par. 6

6. A timing difference arises when the initial difference between taxable income and pretax accounting income originates in one period and predictably reverses or turns around in one or more subsequent periods. The reversal of a timing difference at some future date is definite and the period of reversal is generally predictable within reasonable limits. Sometimes, however, reversal of a difference cannot be predicted because the events that create the tax consequences are controlled by the taxpayer and frequently require that the taxpayer take specific action before the initial difference reverses.

UNDISTRIBUTED EARNINGS OF SUBSIDIARIES

APB23, Par. 7

Discussion

APB23, Par. 7

APB23, Par. 7

7. Paragraph 16 of ARB No. 51, *Consolidated Financial Statements*, which is superseded by this Opinion, provided guides for interperiod allocation of income taxes that will be incurred at the date that previously undistributed earnings of subsidiaries are remitted to the parent company. [1] The concept of accruing income taxes for earnings included in consolidated income in accordance with APB Opinion No. 11 has been applied inconsistently. Some believe that the only appropriate method is to accrue related deferred taxes substantially in accordance with paragraphs 36 and 37 of APB Opinion No. 11 while others believe that under the criteria set forth in ARB No. 51 a parent company need accrue related deferred taxes only if the transfer of earnings to the parent company in a taxable distribution is imminent or relatively certain. Disclosure of the accounting for income taxes on undistributed earnings of subsidiaries has often been inadequate. Some believe that the contingent liability for taxes that would be payable if the undistributed earnings of subsidiaries were remitted should be disclosed. In their view changing circumstances, often beyond the control of the parent company, may accelerate distribution of earnings of a subsidiary so that the parent company will incur a tax for which no provision has been made. They believe an inability to determine the exact amount of the tax that might be payable is in itself no justification for not accruing the best current estimate of the contingent liability. Others believe that instead the amount of undistributed earnings of subsidiaries for which a parent company has not accrued income taxes should be disclosed in notes to financial statements. In their view disclosure of a hypothetical tax which would be payable, assuming those earnings were distributed currently, implies a contradiction of the decision that it is not necessary to provide for income taxes on the earnings in the financial statements. They do not believe that such a hypothetical tax is normally a realistic quantification of the contingent taxes that would be incurred even if some portion of the undistributed earnings were remitted.

APB23, Par. 8

8. A domestic or foreign subsidiary remits earnings to a parent company after the parties consider numerous factors, including the following:

a. Financial requirements of the parent company

b. Financial requirements of the subsidiary

c. Operational and fiscal objectives of the parent company, both long-term and short-term

d. Remittance restrictions imposed by governments

e. Remittance restrictions imposed by lease or financing agreements of the subsidiary

f. Tax consequences of the remittance.

Remittance of earnings of a subsidiary may sometimes be indefinite because of the specific long-term investment plans and objectives of the parent company. Even in the absence of long-term investment plans, the flexibility inherent in the United States Internal Revenue Code may permit a parent company to postpone income taxes on the earnings of a subsidiary for an extended period or may permit the ultimate distribution to be taxed at special rates applicable to the nature of the distribution. Other circumstances may indicate that the earnings will probably be remitted in the foreseeable future. However, the parent company may control the events that create the tax consequences in either circumstance.

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Opinion

APB23, Par. 9

APB23, Par. 9

9. The Board concludes that including undistributed earnings of a subsidiary [2] in the pretax accounting income of a parent company, either through consolidation or accounting for the investment by the equity method, results in a temporary difference.

APB23, Par. 10

10. *Temporary Difference.* The Board believes it should be presumed that all undistributed earnings of a subsidiary will be transferred to the parent company. Accordingly, the undistributed earnings of a subsidiary included in consolidated income should be accounted for as a temporary difference unless the tax law provides a means by which the investment in a domestic subsidiary can be recovered tax free. However, for

reasons described in FASB Statement No. 109, *Accounting for Income Taxes,* a deferred tax liability is not recognized for (a) an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary that meets the criteria in paragraph 12 of this Opinion and (b) undistributed earnings of a domestic subsidiary that arose in fiscal years beginning on or before December 15, 1992 and that meet the criteria in paragraph 12 of this Opinion. The criteria in paragraph 12 of this Opinion do not apply to undistributed earnings of domestic subsidiaries that arise in fiscal years beginning after December 15, 1992, and a deferred tax liability shall be recognized if the undistributed earnings are a taxable temporary difference.

[3-4][These footnotes have been deleted. See Status page.]

APB23, Par. 11

11. A deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary in accordance with the requirements of paragraph 34 of Statement 109.

APB23, Par. 12

12. *Indefinite reversal criteria.* The presumption that all undistributed earnings will be transferred to the parent company may be overcome, and no income taxes should be accrued by the parent company, if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation. A parent company should have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely. Experience of the companies and definite future programs of operations and remittances are examples of the types of evidence required to substantiate the parent company's representation of indefinite postponement of remittances from a subsidiary. If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent company, it should accrue as an expense of the current period income taxes attributable to that remittance; income tax expense for such undistributed earnings should not be accounted for as an extraordinary item. If it becomes apparent that some or all of the undistributed earnings of a subsidiary on which income taxes have been accrued will not be remitted in the foreseeable future, the parent company should adjust income tax expense of the current period; such adjustment of income tax expense should not be accounted for as an extraordinary item.

APB23, Par. 13

13. *Change in investment.* An investment in common stock of a subsidiary may change so that it is no longer a subsidiary because the parent company sells a portion of the investment, the subsidiary sells additional stock, or other transactions affect the investment. If the remaining investment in common stock should be accounted for by the

equity method, the investor should recognize income taxes on its share of current earnings of the investee company in accordance with the provisions of FASB Statement No. 109, *Accounting for Income Taxes.* If a parent company did not recognize income taxes on its equity in undistributed earnings of a subsidiary for the reasons cited in paragraph 12 (and the company in which the investment is held ceases to be a subsidiary), it should accrue as a current period expense income taxes on undistributed earnings in the period that it becomes apparent [5] that any of those undistributed earnings (prior to the change in status) will be remitted; the accrual of those income taxes should not be accounted for as an extraordinary item. If a parent company recognizes a deferred tax liability for the temporary difference arising from its equity in undistributed earnings of a subsidiary and subsequently reduces its investment in the subsidiary through a taxable sale or other transaction, the amount of the temporary difference and the related deferred tax liability will change. An investment in common stock of an investee (other than a subsidiary or corporate joint venture) may change so that the investee becomes a subsidiary because the investor acquires additional common stock, the investee acquires or retires common stock, or other transactions affect the investment. A temporary difference for the investor's share of the undistributed earnings of the investee prior to the date it becomes a subsidiary shall continue to be treated as a temporary difference for which a deferred tax liability shall continue to be recognized to the extent that dividends from the subsidiary do not exceed the parent company's share of the subsidiary's earnings subsequent to the date it became a subsidiary.

APB23, Par. 14

14. *Disclosure.* Statement 109 specifies the requirements for financial statement disclosures.

[6][This footnote has been deleted. See Status page.]

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INVESTMENTS IN CORPORATE JOINT VENTURES

APB23, Par. 15

Discussion

APB23, Par. 15

APB23, Par. 15

15. Corporate joint ventures, as defined in APB Opinion No. 18 are of two kinds: (1) those essentially permanent in duration and (2) those that have a life limited by the nature of the venture or other business activity. In APB Opinion No. 18 the Board concluded

that the equity method of accounting best enables an investor in a corporate joint venture to recognize the underlying nature of the investment regardless of duration.

APB23, Par. 16

16. Unless characteristics indicate a limited life, a corporate joint venture has many of the characteristics of a subsidiary. The investors usually participate in the management of the joint venture, consider the factors set forth in paragraph 8 above, and agree (frequently before forming the venture) as to plans for long-term investment, for utilizing the flexibility inherent in the United States Internal Revenue Code, and for planned remittances.

Opinion

APB23, Par. 17

APB23, Par. 17

17. The Board concludes that the principles applicable to undistributed earnings of subsidiaries (paragraphs 9, 10, 11, 12 and 13) also apply to tax effects of differences between taxable income and pretax accounting income attributable to earnings of corporate joint ventures that are essentially permanent in duration and are accounted for by the equity method. [7]

APB23, Par. 18

18. *Disclosure.* The disclosure requirements set forth in paragraph 14 also apply to earnings of corporate joint ventures.

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"BAD DEBT RESERVES" OF SAVINGS AND LOAN ASSOCIATIONS

APB23, Par. 19

Discussion

APB23, Par. 19

APB23, Par. 19

19. Regulatory authorities require both stock and mutual savings and loan associations to appropriate a portion of earnings to general reserves [8] and to retain the reserves as a

protection for depositors. Provisions of the United States Internal Revenue Code permit a savings and loan association to deduct an annual addition to a reserve for bad debts [8] in determining taxable income, subject to certain limitations. This annual addition permitted by the Code generally differs significantly from the bad debt experience upon which determination of pretax accounting income is based. Thus, taxable income and pretax accounting income of an association usually differ.

APB23, Par. 20

20. Although a general reserve determined according to requirements of the regulatory authorities is not directly related to a reserve for bad debts computed according to provisions of the United States Internal Revenue Code, the purposes and restrictions of each reserve are similar. Amounts of bad debt deductions for income tax purposes are includable in taxable income of later years only if the bad debt reserves are used subsequently for purposes other than to absorb bad debt losses.

APB23, Par. 21

21. The term *pretax accounting income*, as used in this section, represents income or loss for a period, exclusive of related income tax expense, determined in conformity with generally accepted accounting principles. The term *taxable income*, as used in this section, represents pretax accounting income (a) adjusted for reversal of provisions for estimated losses on loans and property acquired in settlement of loans, and gains or losses on the sales of such property, and adjusted for events that do not have tax consequences, and (b) after giving effect to the bad debt deduction allowable by the United States Internal Revenue Code assuming the applicable tax return were to be prepared based on such adjusted pretax accounting income.

APB23, Par. 22

22. Some believe that a difference between taxable income and pretax accounting income attributable to a bad debt reserve that is accounted for as part of the general reserve and undivided profits of a savings and loan association has attributes of a permanent or indefinite deferral of tax payments. In their view, a savings and loan association should not accrue income taxes on such differences. Others believe that this difference has the principal attributes of a timing difference as described in paragraphs 36 and 37 of APB Opinion No. 11. In effect, they believe that this difference is a Government sponsored deferral of tax, that the Government has an equity in the savings and loan association to the extent of the deferred tax, and that it is inappropriate to include earnings in stockholders' equity without accruing income taxes which the the association would incur if the earnings were distributed to stockholders or otherwise became subject to tax. In their view the savings and loan association should recognize deferred taxes on the difference.

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Opinion

APB23, Par. 23

APB23, Par. 23

23. As described in Statement 109, a savings and loan association [9] should not provide deferred taxes on taxable temporary differences related to bad-debt reserves for tax purposes that arose in tax years beginning before December 31, 1987 (the base-year amount). However, if circumstances indicate that the association is likely to pay income taxes, either currently or in later years, because of known or expected reductions in the bad debt reserve, income taxes attributable to that reduction should be accrued as tax expense of the current period; the accrual of those income taxes should not be accounted for as an extraordinary item.

APB23, Par. 24

24. *Disclosure.* Statement 109 specifies the requirements for financial statement disclosures.

APB23, Par. 25

25. The disclosure requirements set forth in paragraph 24 also apply to a parent company of a savings and loan association accounting for that investment either through consolidation or by the equity method.

APB23, Par. 26-30

26-30. [The paragraphs have been deleted. See Status page.]

[10-11] [These footnotes have been deleted. See Status page.]

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EFFECTIVE DATE

APB23, Par. 31

APB23, Par. 31

31. This Opinion shall be effective for all fiscal periods beginning after December 31, 1971. However, the Board encourages earlier application of the provisions of this Opinion.

APB23, Par. 32

32. The conclusions of the Board on accounting for income taxes on undistributed earnings of subsidiaries and corporate joint ventures represent a clarification of current practice. Accordingly, this Opinion should be applied retroactively to undistributed earnings of subsidiaries included in consolidated financial statements and to undistributed earnings applicable to unconsolidated subsidiaries and investments in corporate joint ventures accounted for by the equity method in accordance with APB Opinion No. 18. An adjustment resulting from a change in accounting method to comply with this Opinion should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated.

APB23, Par. 33

33. The conclusions of the Board on "bad debt reserves" of savings and loan associations and amounts designated as "policyholders' surplus" by stock life insurance companies agree generally with current practice. If application of this Opinion should result in a change in accounting principle, the adjustment should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated.

The Opinion entitled "Accounting for Income Taxes-Special Areas" was adopted by the assenting votes of fourteen members of the Board, of whom four, Messrs. Halvorson, Hellerson, Norr, and Watt, assented with qualification. Messrs. Bevis, Bows, Broeker, and Burger dissented.

Mr. Halvorson assents to the publication of this Opinion but believes that a company should be permitted to accrue taxes on differences between taxable income and pretax accounting income in any circumstances where management judgment so dictates and that the prohibition thereof expressed by the "should not" injunction in paragraphs 12, 23, and 28 will stifle what could be a desirable development in accounting. He further believes that the disclosure of the cumulative amount of untaxed earnings required by paragraphs 14, 24, and 29 should be coupled with a requirement to disclose the amount of such earnings for each period currently under report.

Mr. Hellerson assents to the issuance of this Opinion as he believes it does clarify and standardize the accounting in the areas encompassed by it. However, he qualifies his assent because of disagreement with the last two sentences of paragraph 12. It is his view that if undistributed earnings of a subsidiary on which income taxes have not been recognized are, in fact, remitted this may be prima facie evidence that the company's plans have changed and a tax on the remainder of the undistributed earnings which have not, in fact, been reinvested should be provided. He also disagrees with the final sentence in paragraph 12 which sanctions the reversal of a tax previously accrued. It is his view that any plans for reinvestment of undistributed earnings should be applied prospectively and not retroactively, i.e., the tax expense for the current and future periods should be affected. Further, it is his understanding that the thrust of the portion of the Opinion pertaining to undistributed earnings of subsidiaries is that all such undistributed earnings give rise to a timing difference for which comprehensive interperiod income tax

Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, *October 1964). Members of the Institute must assume the burden of justifying any such departures.*

APB23 Board Members

Accounting Principles Board (1972)

Philip L. Defliese, *Chairman*
Donald J. Bevis
Albert J. Bows
Milton M. Broeker
Leo E. Burger
Joseph P. Cummings
Robert L. Ferst
Oscar Gellein
Newman T. Halvorson
Robert Hampton, III
Donald J. Hayes
Charles B. Hellerson
Charles T. Horngren
Louis M. Kessler
David Norr
George C. Watt
Allan Wear
Glenn A. Welsch

Cal-Tax
Established 1926

January 16, 2008

Colleen Berwick
Franchise Tax Board
Legal Branch
P.O. Box 1720
Rancho Cordova, CA 95741-1720

Re: Opposition to Proposed Amendments to Reg. Sections 24411 and 25106.5-1

Dear Ms. Berwick:

The California Taxpayers' Association is opposed to the staff proposal to amend the California Code of Regulations, Title 18, Sections 24411 and 25106.5-1. The proposed amendments lack necessity and consistency with existing statutes and court decisions, as required by the Administrative Procedures Act. In addition, we are very concerned that, insofar as the amendments are being proposed as a clarification of existing law, they will retroactively increase taxes on those who have relied on the First District Court of Appeal's decision in *Fujitsu IT Holdings, Inc. v. Franchise Tax Board* (2004) 120 Cal. App.4th 459, which reaches a result that is completely contrary to what the staff proposes.

Under the California Administrative Procedures Act, the Office of Administrative Law must review all regulations proposed to be adopted, amended or repealed for compliance with the standards set forth in Government Code Section 11349.1(a)(1)-(6). These standards are: necessity, authority, clarity, consistency, reference, and nonduplication, all of which are defined by Government Code Section 11349(a)-(f). The proposed amendments are of particular concern with respect to the standards of "necessity" and "consistency."

Section 11349(a) defines "necessity" in relevant part as follows:

> 'Necessity' means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record.

These proposed amendments do not meet the standard of "necessity" because they fail to effectuate the purpose of the statute that the regulation implements, and they also fail to implement the First District Court of Appeal's decision in *Fujitsu*, which interprets that statute.

The *Fujitsu* court stated:

> "[w]e 'must select the construction that comports most closely with the apparent intent of the Legislature, with a view to promoting rather than defeating the general purpose of the statute, and avoid an interpretation that would lead to absurd consequences.'"(citations omitted) "And, wherever possible, 'we will interpret a statute as consistent with applicable constitutional provisions, seeking to harmonize Constitution and statute.'" (citations omitted)[1]

Thus, the court held:

> "[d]ividends paid by first-tier subsidiaries from current year earnings should be treated as paid (1) first out of earnings eligible for elimination under section 25106, with (2) any excess paid out of earnings eligible for partial deduction under section 24411. In the case of a CFC that is *partially* included in a unitary group, the CFC will be able to move amounts that have been included in the combined income of the unitary group without tax incident only by adopting the ordering rule described above."[2]

The decision of the *Fujitsu* court is unequivocally clear. Thus, the staff's proposed amendments lack necessity because the court provided a clear interpretation of the statute and no additional regulation is necessary to effectuate the statute's purpose. Moreover, the proposed amendments' assertion of a pro-rata rule for dividend ordering contradicts the court of appeal, resulting in a lack of consistency for purposes of the Administrative Procedures Act.

Section 11349(d) defines the standard of "consistency" as "being in harmony with, and not in conflict with or contradictory to, existing statutes, court decisions, or other provisions of law." The proposed regulations fail the test of consistency because the *Fujitsu* court explicitly rejected the Franchise Tax Board's position regarding pro rata dividend ordering in favor of its two-step approach: Dividends are paid first out of earnings eligible for elimination under Section 25106, and second out of earnings eligible for partial elimination under Section 24411.

Franchise Tax Board staff has asserted that the regulations are necessary to implement the State Board of Equalization's (SBE) decision in the *Appeal of Apple Computer, Inc.*, Cal. St. Bd. of Equal., November 20, 2006, 2006-SBE-002, which rejected the appellate court's decision in *Fujitsu*. If staff sought to "eliminate any confusion occasioned by the different result of the decisions in *Fujitsu* and *Apple*," as claimed in the notice of the proposed amendments to the dividend ordering regulations, then deference should have been given to the appellate court, rather than the SBE, a quasi-judicial body.

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[1] *Fujitsu IT Holdings, Inc.*, 120 Cal. App. 4^{th} at 471.
[2] *Id.*

The difference in a taxpayer's tax liability under the differing rules of the *Fujitsu* court and the SBE in *Apple Computer* is substantial. If the FTB staff is permitted to go forward with the proposed amendments as a "clarification of existing law," then the proposed amendments presumably will be retroactively applied to increase the tax liability of those taxpayers who have relied on *Fujitsu* in calculating their tax liability.

Retroactive application of the proposed amendments is inappropriate for two reasons. First, the proposed amendments are so contradictory to existing law that they would result in a retroactive regulatory tax increase unauthorized by statute. Tax increases require a 2/3 vote of both houses of the Legislature to pass muster under Article XIIIA of the California Constitution, but this tax increase would be accomplished by regulation without a vote of any legislative body. Moreover, according to the Fifth District Court of Appeal in *City of Modesto v. National Med., Inc.*, (2005) 128 Cal. App. 4^{th} 518 "As noted by Justice Sandra Day O'Connor, concurring in *United States v. Carlton*, [citation omitted], a period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise serious constitutional issues."

On a more fundamental level, retroactively changing the regulations in a manner that is contrary to settled law simply is unfair.

For the foregoing reasons, we request that you decline to permit the proposed amendments to the California Code of Regulations, Title 18, Sections 24411 and 25106.5-1 to move forward.

Respectfully submitted,

Teresa Casazza

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January 16, 2008

Colleen Berwick
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Legal Branch
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Rancho Cordova, CA 95741-1720

Re: Proposed Amendments to Reg. Sections 24411 and 25106.5-1

Dear Ms. Berwick:

On behalf of Chevron Corporation, we are submitting the following comments on the above-mentioned proposed amendments.

General Comments

In its Initial Statement of Reasons for the Proposed Amendments to California Code of Regulations, Title 18, Sections 24411 and 25106.5-1, the Staff of the Franchise Tax Board ("Staff") notes that the proposed amendments are intended to address potential confusion as to how dividends received from income that has been included in a unitary combined report and dividends received from income that has not been included in a unitary combined report should be treated for California franchise tax purposes. This confusion, according to the Staff, arises in part from two inconsistent decisions: one, the Court of Appeal decision in *Fujitsu IT Holdings, Inc. v. Franchise Tax Board* (2004) 120 Cal. App.4th 459 and two, the State Board of Equalization (SBE) decision in the *Appeal of Apple Computer, Inc.*, Cal. St. Bd. of Equal., November 20, 2006, 2006-SBE-002. Staff states that the proposed amendments to the regulations are in response to the appellate court decision in *Fujitsu.* The proposed amendments are intended to conform the regulations to be consistent with the decision and analysis of the SBE in *Apple*.

Rather than clearing up the confusion that exists between these two decisions, the Staff's proposal will only add to the confusion that already exists. By conforming the regulations to the decision rendered in *Apple* rather than the Court of Appeal's decision in *Fujitsu*, Staff is attempting to elevate the status of the ruling in *Apple* in direct contradiction to established law in California. Instead, the Staff should be following the ruling in *Fujitsu.* Staff should propose amendments that are consistent with the *Fujitsu* decision.

In *Fujitsu,* the Court of Appeal held that dividends should be treated as paid: (1) first out of earnings eligible for elimination under California Revenue and Taxation Code [CRTC] § 25106; with any excess paid out of earnings eligible for partial deduction under CRTC § 24411. However, the SBE in *Apple* chose not to follow the ruling in *Fujitsu,* opting not to give a preference to dividends that qualify for elimination first but instead treating dividends as paid "pro-rata" from dividends that qualify for elimination as well as from dividends that qualify for the deduction.

Notwithstanding the SBE's decision in *Apple,* the Court of Appeal's decision in *Fujitsu* is still valid. The Court of Appeal denied Staff's petition for a rehearing. When the California Supreme Court denied the Staff's petition for review in *Fujitsu,* as well as the Staff's request to depublish the Court of Appeal's decision, it affirmed the validity of the Court of Appeal's ruling. Taxpayers are entitled to rely upon a valid, final Court of Appeal decision.

When reviewing Franchise and Income Tax Appeals, the SBE has long held that it acts as a "quasi-judicial body." See *Appeal of Vortox Manufacturing Company,* Cal. St. Bd. of Equal., Aug. 4, 1930; *Appeal of Wilfred and Gertude Winkenbach, et al.,* Cal. St. Bd. of Equal., Dec. 16, 1975. Because the SBE acts in a "quasi-judicial" capacity, it has said that it is "bound to apply judicially accepted doctrines." *Id.*

One such judicially accepted doctrine is the requirement that lower courts follow the decisions of higher courts. In *Auto Equity Sales,* the California Supreme Court held:

> "Under the doctrine of *stare decisis,* **all tribunals exercising inferior jurisdiction are required to follow decisions of courts exercising superior jurisdiction**. Otherwise, doctrine of *stare decisis* makes no sense. The decisions of this court are binding upon and must be followed by all the state courts of California. Decisions of every division of the District Courts of Appeal are binding upon all the justice and municipal courts and upon all the superior courts of this state, and this is so whether or not the superior court is acting as a trial or appellate court. **Courts exercising inferior jurisdiction must accept the law declared by courts of superior jurisdiction. It is not their function to attempt to overrule decisions of a higher court.**[1]

There can be no question that the SBE is a quasi-judicial body exercising inferior jurisdiction or that the Court of Appeal is a court exercising superior jurisdiction. Based upon the holding of the California Supreme Court in *Auto Equity Sales*, it is clear that the holding in *Fujitsu* must

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[1] *Auto Equity Sales, Inc. v. The Superior Court of Santa Clara County* (1962) 57 Cal.2d 450, 455.

take precedence over the SBE's decision in *Apple*. Further, any proposed regulations suggested by Staff must be consistent with the *Fujitsu* decision.

If Staff desires a result different from that reached by the Court of Appeal in *Fujitsu*, its remedy is not to revise its regulations; instead it should go to the legislature and seek a statutory change. Until such action is taken by the Staff and adopted by the Legislature, it should follow the edict set forth by the highest court to address this issue.

Staff's attempt to justify its proposed amendments on the basis of Necessity must fail. It claims that the regulation amendments are necessary in order to clarify the regulations to ensure that they will not be misconstrued in the future and to conform to the SBE decision in *Apple*. However, as explained above, it is Staff that is creating more confusion with the proposed amendments since such amendments contradict the clear and precise holding by the Court of Appeal in *Fujitsu*. Rather than clear up any confusion, these amendments not only add to the confusion but are contrary to the current state of the law as set forth in *Fujitsu*.

Specific Comments

Contrary to the Proposed Amendment's Pro-Rata Approach, Preference must be given to Dividends that Qualify for Elimination before Dividends that Qualify for a Deduction

In *Fujitsu*, the Court of Appeal held that dividends should be treated as paid: (1) first out of earnings eligible for elimination under CRTC § 25106; with (2) any excess paid out of earnings eligible for partial deduction under CRTC § 24411.

In reaching its conclusion, the Court of Appeal relied extensively on CRTC § 25106 which provided the following for the years in issue in this case:

> In any case in which the tax of a corporation is or has been determined under this chapter with reference to the income and apportionment factors of another corporation with which it is doing or has done a unitary business, all dividends paid by one to another of such corporation shall, to the extent such dividends are paid out of such income of such unitary business, be eliminated from the income of the recipient and *shall not be taken into account under Section 24344 or in any other manner in determining the tax of any such corporation.*

In finding that CRTC § 25106 should be applied first prior to the application of CRTC § 24411, the Court of Appeal was persuaded by the Legislative intent embodied in this section not to subject the distribution of corporate earnings to double taxation. The Court stated:

> The Legislature could hardly have chosen words with a clearer meaning. Simply put, section 25106 ensures that amounts included in the combined income of a unitary group can be moved (in the form of dividends) among members of a unitary group without tax consequence. The reason for this is also clear. In a

> combined unitary group, the subsidiaries' apportioned earnings are taxed as income of the unitary business. Because the state has already taxed the earnings out of which dividends are paid, the dividends themselves are not subject to taxation. This prevents dividends from subsidiaries from being taxes twice—once as earnings of the issuing subsidiary, and once as separate income to the unitary business from receipt of the dividend.[2]

The Court of Appeal also noted that the superior court's decision also rested on CRTC § 25106 with respect to the ordering of distributions. The Court stated that: "under the superior court's ruling, such dividends would be deemed to have been paid first out of already taxed, unitary group income (subject to elimination under section 25106) and only after the section 25106 income had been exhausted would they be taxed at the 25 percent rate remaining after application of section 24411, subdivision (a)'s 75 percent 'dividends received' deduction."[3] The Court concluded:

> "In the case of a CFC that is *partially* included in a unitary group, the CFC will be able to move amounts that have been included in the combined income of the unitary group without tax incident only by adopting the ordering rule described above."[4]

A careful reading of the Court of Appeal's opinion leads to only one inescapable conclusion, namely that the Court heavily relied upon CRTC § 25106 and the Legislative intent embodied therein in concluding that distributions must first be deemed paid out of unitary group income that is eligible for elimination under CRTC § 25106 before applying any other section.

The Court of Appeal's decision became final after it denied Staff's petition for rehearing and the California Supreme Court denied the Staff's petition for review. If the conclusions reached by the Court of Appeal were in error, either the Court of Appeal or certainly the California Supreme Court would have granted Staff's petition and reversed the Court of Appeal's holding. Since neither Court did so, the Court of Appeal's decision is binding and must be followed. Further, in the preceding section, we have discussed the California Supreme Court's mandate that a ruling by a court of superior jurisdiction, such as the Court of Appeal's decision in *Fujitsu,* must be followed by a court of lower jurisdiction, such as the SBE. To the extent that the Staff ignores the *Fijutsu* Court's holding (which holding is well founded in law) and chooses to follow the SBE's decision in *Apple*, it does so in contradiction to the clear mandate of the California Supreme Court. Thus, any proposed amendments relying upon the SBE's decision must be rejected.

The Inclusion of the Reference to IRC § 316 Calls Into Question the "Last-in, First-Out" (LIFO) Method for Identifying The Particular Year a Distribution is Made

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[2] *Fujitsu IT Holdings v. Franchise Tax Board* (2004) 120 Cal.App.4th 459, 477.
[3] Id. at 479.
[4] Id. at 480.

According to the Staff's explanation of the various amendments, the original version of Reg. Section 24411(e)(2)(A) provided that dividends are paid out of earnings and profits on a last-in, first-out basis. As Staff has previously explained, this meant that dividends were first paid out the current year's earnings and profits, then from the year preceding the current year, then the year preceding that year and so forth each time going back one year as needed to cover the distribution. However, the Staff now states that the amendment in subsection (e)(2)(A) now cites to IRC § 316 as authority that supports that proposition.

Chevron submits that this change, rather than support the Staff's position, does just the opposite. Rather than providing for more than two layers of earnings and profits from which a distribution can be made, this change would mean that there can be only two layers from which the distribution can be drawn. IRC § 316(a) very clearly provides that there are two sources of earnings and profits, the current year's earnings and profits and all other years (post February 28, 1913) earnings and profits aggregated together. By now citing IRC § 316, the Staff adopts the federal approach. If Staff proceeds with these amendments, it must revise the proposed regulations to make clear that there can only be two layers of earnings and profits from which the distribution can be drawn.

Staff's Proposed Amendments Support the Position that Priority Must be given to Dividends that can be Eliminated under CRTC § 25106 Over Dividends that are Deductible Pursuant to CRTC § 24411

Staff's proposed amendments to subsections (a) and (c) provide that no deduction is allowed under CRTC § 24411 with respect to dividends that can be eliminated from net income or deducted under another provision of the Revenue and Taxation Code. These changes actually lend further support to the notion that priority must be given to dividends that can be eliminated under CRTC § 25106 before any dividends are deducted under CRTC § 24411 as the Court in *Fujitsu* held.

Very truly yours,

Barry Weissman

Barry Weissman

cc: Susan Silvani

STATE OF CALIFORNIA

FRANCHISE TAX BOARD

PUBLIC HEARING

ON THE PROPOSED AMENDMENTS OF CALIFORNIA CODE OF REGULATIONS

TITLE 18, SECTIONS 24411 AND 25106.5-1

WEDNESDAY, JANUARY 16, 2008

FRANCHISE TAX BOARD

9646 BUTTERFIELD WAY

TOWN CENTER GOLDEN STATE ROOM

SACRAMENTO, CALIFORNIA

2:00 P.M.

REPORTED BY: SANDRA VON HAENEL
CSR No. 11407

APPEARANCES

HEARING OFFICER:

Craig Swieso

FRANCHISE TAX BOARD STAFF:

Colleen Berwick
Pat Bitner
Ed Campion
Carl Joseph
Patrick Kusiak
Benjamin Miller
Brian Miller
Marguerite Mosnier
Carole Rouin
Ira Rubinoff
Karen Smith
John Su
Michael Vigil
Geoff Way

PARTICIPANTS:

Jeff Margolis	- Currently representing Betty Yee, State Board of Equalization
John McBeth	- Franklin Templeton Investments
Michelle Pielsticker	- Cal-Tax
Barry Weissman	- Chevron
Jeffrey Vesely	- Apple Computer, Inc.

TELEPHONIC PARTICIPANT:

Amanda Le	- Franchise Tax Board

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SACRAMENTO, CALIFORNIA

WEDNESDAY, JANUARY 16, 2008, 2:00 P.M.

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THE HEARING OFFICER: My name is Craig Swieso. I am a Tax Counsel IV for the Franchise Tax Board, and I will be acting as hearing officer for the revisions to California Code of Regulations, Title 18, sections 24411 and 25106.5-1, relating to the ordering of dividends paid from income that has been included in a combined report and income that has not been included in a combined report.

Anyone who desires to make an oral presentation at the hearing may do so in a few moments. In addition, anyone who desires to submit written comments regarding revisions to the regulations may submit such comments to the Franchise Tax Board Legal Department, to the attention of Colleen Berwick, at P.O. Box 1720, Rancho Cordova, 95741-1720.

The more mail Colleen gets, the more she likes it.

Or fax their comments to (916)845-3648 by today, by 5:00 p.m. today. Any questions you have regarding the submission of written comments should be directed to Ms. Berwick at area code (916)845-3306.

Do you like getting phone calls?

MS. BERWICK: Fine with me.

THE HEARING OFFICER: There is a register here to my

right that will become part of the record of this hearing. If you haven't done so, we request that you sign in. And we would also appreciate it if you would leave your business cards.

And for purposes of the record, would those who are on the telephone that are listening in on a conference call, would you please identify yourself and spell your name, and indicate who you're representing or what firm you're with, please.

MS. BERWICK: Is anybody on the phone?

MS. LE: I'm sorry. It's Amanda Le, Franchise Tax Board.

THE HEARING OFFICER: Amanda Le?

MS. BERWICK: She's with FTB.

THE HEARING OFFICER: Okay. Anyone else?

MS. BERWICK: There is no one else.

THE HEARING OFFICER: As required by the California

Administrative Procedure Act, on November 30th, 2007, a Notice of Hearing was mailed to the members of the public requesting notice of the FTB regulation changes under Government Code 11346.4. And the notice was published in the Office of Administrative Law's register of proposed rulemaking actions. The notice and the proposed revisions to the regulations will also appear on the FTB's website.

The purpose of this formal regulatory hearing is to

receive comments from the public regarding the revisions to the regulations. Each comment then will receive a formal written response from the FTB as provided in the provisions of the Administrative Procedure Act.

Because a formal record of the hearing is being made, we will ask each of you who desires to make comments to come to the microphone so we can record them. When doing so, please identify yourself, spell your name, as well as identifying which law or accounting firm that you're affiliated with or whom you represent.

If you just have a question and you just want to ask it from the audience, I'm going to go ahead, and then I will repeat the question in order that it can be made part of the formal record.

Also -- well, since we don't have -- not to diminish your role -- but since there isn't anybody from the outside, there's an FTB employee -- unless, Amanda, do you want to make comments during this?

Well, I'm going to assume she doesn't.

The hearing is being held pursuant to Government Code 11346.8, to allow members of the public to submit both oral and written statements. Comments received today will be considered as part of the formal regulatory process. Any comments received, oral or written, will become part of the record and will be considered by the FTB staff, and

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addressed by publication on the FTB website, www.ftb.ca.gov, no later than 15 days before submission to the Office of Administrative Law, and will be included in the rulemaking file submitted to the Office of Administrative Law as provided by the Administrative Procedure Act.

As of currently, as of right now, we have received four written comments regarding the revisions.

At this time I'll open it up. Is there anybody who would like to make any comments?

Come on up, Barry.

MR. WEISSMAN: Barry Weissman from Chevron, W-e-i-s-s-m-a-n. I have a general comment to make, and then specific comments regarding the Regulation 24411.

Specifically regarding the general comment, the regulation is based upon the Board of Equalization decision in the Appeal of Apple Computer, which ignored the ruling of the Court of Appeal in Fujitsu.

Rather than clearing up any confusion that's been created by these decisions, the regulation is actually creating more confusion by its promulgation. Fujitsu very clearly held that priority should be given to those distributions that qualify for elimination under Revenue Tax Code Section 25106 before distributions that qualify for deduction under the Revenue and Tax Code Section 24411.

Apple failed to recognize this priority when it held

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that distributions shall be considered pro rata from both classes of E and P as well as using the LIFO approach.

Now, aside from the Board of Equalization's decision in Fujitsu -- in Apple, Fujitsu still remains a viable, binding, valid opinion. The Court of Appeal's decision was not overruled by the Board of Equalization, nor could it possibly be.

Staff had several changes to try to have the result in Fujitsu changed, first when they filed their petition for rehearing, which the Court of Appeal rejected, then when it filed its petition for review of the California Supreme Court, which the California Supreme Court rejected.

Finally, when it asked the California Supreme Court to depublish the opinion of Fujitsu, the California Supreme Court again denied the staff's request. As a result, Fujitsu is a valid, binding decision.

Now, the California Supreme Court has made it very clear that lower courts are bound to follow decisions of the higher court. The Board of Equalization has acknowledged in the past it is actually a quasi-judicial body and that it is bound to follow judicially accepted decisions. One such decision is stare decisis, where the obligation to follow precedent has been established.

The California Supreme Court in Auto Equity Sales had held that it's not the function of a lower court such as the

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Board of Equalization to attempt to overrule decisions of the higher court such as the Court of Appeal.

Now, if staff wants to propose a regulation, we suggest that the regulation should therefore be based upon the holding in Fujitsu, not upon the holding in the Appeal of Apple Computer. Staff is trying to justify their actions on the basis of necessity. He claims that the amendments are necessary in order to clarify the regulation to ensure there is no misinterpretation in the future, as well as to conform to the Board of Equalization's decision in Apple.

However, as I indicated earlier, rather than making the matter clearer, it's actually confusing things, because as long as Fujitsu is still a valid, binding decision, taxpayers are entitled to rely upon it, and they will do so.

Further, the misinterpretation the staff suggests occurs in Fujitsu is incorrect. While the Fujitsu court did note the 2001 intercompany transaction regulations in its decision, to say that the basis of the court -- saying that it does so is to overlook the essence of the court's ruling.

A proper reading of the Fujitsu decision leads to the conclusion that the Court of Appeal did not rely upon this 2001 regulation, but instead relied upon Revenue and Tax Code Section 25106 and the legislative intent that was embodied in this section to reach its ruling.

To say that an item that has been mentioned only once

in passing by the court, which is more aptly referred to as a dicta, is wrong. The court referenced 25106 approximately twenty different times throughout its decision, and to ignore this fact and state that the basis was a misinterpretation of a 2001 regulation that was just mentioned once in passing is not to accurately reflect what the court held.

I'd like to turn to some specific comments about the regulation. Having established with Fujitsu that the priority should be given to distributions under 25106 before taking them under 24411, the regulation needs to be revised to reflect this priority that the courts have established.

Secondly, the regulation now references IRC Section

316, which, when you look at the federal rules, provides only two classes of being possibly E and P: current year E and P and accumulated E and P for all taxable years after February 28, 1913. The regulation doesn't clearly make this point, and so it's very important that, should this reg still go forward, that a year-by-year approach other than as I described is not the way to go.

Finally, I would suggest that the proposed amendments still use priority to 25106 over the deductions section when it says that that applies after the other section applies.

Thank you.

THE HEARING OFFICER: Thank you, Barry.

John.

MR. McBETH: Good afternoon. I'm John McBeth, that's M-c-B-e-t-h, senior tax counsel for Franklin Templeton Investments.

I've given to the staff a copy of my written testimony which you now have. I'd like to make some brief oral comments. The written testimony includes a narrative as well as some examples that illustrate the impact of pro rata and preferential dividend ordering rules, and a copy of the Accounting Pronouncement APB 23, which I will explain, has an impact on this in the oral testimony.

I will address three issues. First, how the staff's insistence on using a pro rata dividend ordering rule will result in double taxation. Two, why a reasoned interpretation of the statutes gives precedence to the preferential, not pro rata, dividend ordering rule. And, three, why any change should be a prospective legislative change, not a retroactive regulatory change.

In my written testimony, I've extracted from the Notice of Public Hearing staff's conclusions that there will be no economic impact from these regulatory changes. We challenge this conclusion. The use of pro rata dividend ordering rules will result in significant double taxation of the earnings of controlled foreign corporations repatriated to U.S. parents and, as such, will result in a tax increase

to these corporations over the method currently in use for reporting these dividends.

In the written materials that I've given you, I've quoted at length from the briefs of appellants and respondents in the matter of Apple Computer that Barry just described. This is a case before the State Board of Equalization. The substance of these comments is the allegation by appellants that the use of pro rata dividend ordering results in double taxation and the response by the state Attorney General that there is no double taxation.

We agree with the Attorney General and the Franchise Tax Board staff that in situations where all of the current and accumulated income of controlled foreign corporations is dividended up to a U.S. parent corporation, that there is no double taxation. However, in situations where only a part of the income is so repatriated, pro rata dividend ordering rules will result in double taxation.

Let us look at Accounting Pronouncement APB 23, accounting for income taxes - special uses. All multinational corporations that have stock traded on U.S. exchanges, and most other large corporations, report the results of their operations using generally accepted accounting principles, or GAAP. Multinational corporations have traditionally sought to indefinitely reinvest the earnings of their offshore subsidiaries, or CFCs, by

electing under APB 23 to have those earnings be indefinitely reinvested overseas. In so doing, these earnings will not be subject to current financial statement reporting in the United States.

For an indefinite reinvestment policy to be effective, however, it must be clearly publicly stated and must be consistently applied. When put into effect, offshore earnings remain offshore.

I've given you in the written materials an extract from Franklin Resources' fiscal year ended September 30th, 2007 financial statements detailing our indefinite reinvestment policy of repatriating only Subpart F and high-taxed income. This statement is an example of what multinational corporations do in their financial statement reporting.

Multinational corporations that have such policies -- and, clearly, most multinational corporations do -- for a variety of reasons, repatriate only a part of their foreign earnings. In the examples I have attached, I show a typical multinational corporation repatriating only its Subpart F income.

When this happens, if the ratio of Subpart F income to foreign earnings and profits is low, the percentage of double-taxed income will approach 25 percent. If the ratio of Subpart F income is high, the percentage of double-taxed

income will be lower. But it is absolutely clear that there will be double-taxed income.

The presence of this double-taxed income raises in our minds constitutional questions that must be addressed by the staff and by the Board before these regulations are adopted to provide for pro rata allocations.

I'd like to then turn to the statutory interpretations that I also address in my written comments. In our written materials, we also question whether a fair reading of the language of sections 24411 and 25106 leads to the conclusion that Section 25106 must be given precedence over the regulations under 24411. This is the unmistakable conclusion that the superior and appellate courts arrived at in Fujitsu. We believe that this reading of the statutes is compelled -- not optional, is compelled -- and that the State Board of Equalization was in error in adopting a different interpretation in the Apple Computer appeal.

Finally, on the issue of retroactive application, on the issue of retroactive application, together with our reading of the above statutes, we would strongly urge the staff to recommend and the Franchise Tax Board to adopt a resolution to have any changes to the dividend ordering rules be made legislatively, and not through regulations or regulatorily, and to be made prospectively, not retroactively as this proposal seeks to do.

Thank you.

THE HEARING OFFICER: Jeff.

MR. VESELY: Good afternoon. My name is Jeff Vesely. I'm with Pillsbury Winthrop Shaw Pittman, and I'm here representing Apple Computer -- Apple, Inc.

Earlier today we submitted written comments regarding proposed amendments. I will briefly summarize those comments.

We oppose staff's attempt to proceed with the proposed amendments to regulations 24411 and 25106.5-1, because such amendments are an unlawful and blatant attempt to overturn Fujitsu versus FTB, a binding and precedential Court of Appeal decision. We also oppose the proposed amendments on the basis that they're inconsistent with the Revenue and Taxation Code.

In 2004, the California Court of Appeal issued its decision in Fujitsu. In Fujitsu, the Court of Appeal decided the dividend ordering issue, and held that the dividend should be treated as paid first out of income that has been previously included in a unitary combined report, with any excess paid out of income which has not been previously included in such report, the so-called preferential ordering approach.

The court specifically rejected the FTB's proration approach, the approach which is set forth in the proposed

amendments to Regulation 24411 and 25106.5-1. The proposed amendments are directly contrary to the Fujitsu court's holding on the dividend ordering issue.

Fujitsu is a final published decision and is thus binding on the FTB. Under well established judicial principles, including stare decisis, the court's holding in Fujitsu on the dividend ordering sets forth precedent to which the FTB, the State Board of Equalization, the taxpayers, as well as the courts, must adhere.

Staff's refusal to follow Jujitsu also violates separation of powers. The FTB is an administrative agency of the State of California that is charged with administering and enforcing the California corporation tax law as promulgated by the Legislature. Judicial power is vested in the California courts, and the powers reserved in the judicial branch may not be exercised by other branches.

The FTB raised its objections to the Fujitsu decision, as Mr. Weissman indicated, in a petition for re-hearing to the Court of Appeal, a petition for review to the California Supreme Court, and request for depublication to the Supreme Court, all of which were denied. The FTB cannot usurp the powers of the courts by ignoring Jujitsu and adopting regulations which are inconsistent with that decision.

FTB staff believes Fujitsu was wrongly decided. However, the FTB cannot overturn Fujitsu through the

regulatory process. California law does not give an administrative agency such power. The California Administrative Procedure Act sets forth specific rules regarding the adoption of regulations in California. Specifically, all proposed regulations or amendments thereto must satisfy each of the following standards: necessity, authority, clarity, consistency, reference, and nonduplication.

The proposed amendments to Regulation 24411 and 25106.5-1 fail to satisfy at least three of these standards -- necessity, consistency, and reference -- because the proposed amendments are in conflict with Fujitsu and are contrary to Revenue and Taxation Code Section 24411 and 25106. As such, the proposed amendments cannot be adopted without violating the California Administrative Procedure Act. In short, the FTB simply does not have the authority to overturn a published Court of Appeal decision or to alter a statute through the regulatory process.

Staff seeks to justify the proposed amendments on the basis that they are necessary to conform to the SBE's

November 20, 2006 decision in the Appeal of Apple Computer. Staff is off base. The SBE's decision in Apple cannot provide the support for adoption of the proposed amendments because the decision is directly contrary to Fujitsu and cannot supersede the Court of Appeal's decision in that

case.

Staff recognizes that Apple involved the same issues that were decided in Fujitsu and that now are addressed by the proposed amendments. In Fujitsu, the court held that preferential ordering, not proration, was required under the statutes. In Apple, the SBE refused to follow Fujitsu, and determined that proration was required. However, under the doctrine of stare decisis, the separation of powers, the SBE does not have the authority to refuse to follow a published Court of Appeals decision.

Simply stated, the FTB cannot rely on the Apple decision to support the adoption of the proposed amendments.

Finally, staff's reliance on the Apple decision is further misplaced since, earlier today, we filed, on behalf of Apple, a suit for refund in the San Francisco Superior Court, the same court that decided Fujitsu, challenging the SBE decision. Proceeding with the proposed amendments while the Apple lawsuit is pending is completely inappropriate.

In closing, the proposed amendments to Regulation 24411 and 25106.5-1 fail to satisfy the requirements of the California Administrative Procedure Act because they are in conflict with Fujitsu and because they are contrary to the Revenue and Taxation Code sections 24411 and 25106.

The proposed amendments must not go forward.

Thank you.

THE HEARING OFFICER: Any further comments?
Michelle.
MS. PIELSTICKER: Michelle Pielsticker, P-i-e-l-s-t-i-c-k-e-r, California Taxpayers' Association.
We are opposed to the proposed amendments. We concur with the comments of the other witnesses. And in the interest of brevity, we would like to refer staff to our written comments, and I will briefly summarize those.
First of all, the proposed regulation is unnecessary, thus failing to meet the standard of necessity, insofar as the appellate court in Fujitsu provided clear guidance as to the appropriate method for dividend ordering.
Second, the proposed regulation lacks consistency with existing law as prior witnesses have testified, because it is contrary to the Fujitsu court's holding. Continuing with a regulation, moreover, that seeks to codify the Apple decision may result in a waste of taxpayer dollars.
As of today, the Apple decision is being appealed, and it would be unwise to spend taxpayer dollars on a regulatory process to codify a decision that ultimately may be reversed.
Accordingly, we would ask that the proposed regulations be held at this point without moving forward.
Thanks.
THE HEARING OFFICER: Anyone else?

Since there are no more comments, we will close the hearing.
It's now approximately 2:30.
Thank you.
The SBE people are here.

MR. MARGOLIS: Jeff Margolis with Betty Yee's office, Board of Equalization.

I just have a question. I haven't looked at the written comments from people, but if it's -- it sounds like most people here are saying that FTB does not have the authority to make these changes. It doesn't look like they will be made.

But have you addressed in your written comments, if there is authority, you know, with respect to -- you mentioned double taxation and you mentioned ways around that -- if you want to make changes that might improve this, assuming that it does go forward?

MR. McBETH: The way around it is to order dividends on a preferential basis, which eliminates double taxation by allowing dividends to come forward.

It was interesting, in the Interested Parties Meeting yesterday, the Franchise Tax Board was willing to adopt the federal rule of dividend ordering when dealing with the Subpart F issue, but was not willing to adopt a preferential ordering rule with respect to this issue.

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I don't understand the inconsistency. But the way to solve the double taxation problem is preferential dividend ordering.

THE HEARING OFFICER: Anyone else have any other substantive changes that -- you know, problems with the actual -- with the authority of the FTB to do this, rather than getting the approval of the amendments themselves?

MR. WEISSMAN: Well, I said in my comments that if they wanted the reg, base it on Fujitsu.

MR. MARGOLIS: Okay. That's all I have.

Thank you.

THE HEARING OFFICER: Thank you, Jeff.

Any further comments?

Okay. It's still approximately 2:30 p.m.

Thank you for your participation, and good afternoon.

(At 2:32 p.m. the hearing was concluded.)

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REPORTER'S CERTIFICATE

STATE OF CALIFORNIA)
) ss.
COUNTY OF SACRAMENTO)

I, SANDRA VON HAENEL, certify that I was the official Court Reporter for the proceedings named herein, and that as such reporter, I reported in verbatim shorthand writing the named proceedings;

That I thereafter caused my shorthand writing to be reduced to typewriting, and the pages numbered 1 through 20, inclusive, constitute a complete, true, and correct record of said proceedings:

IN WITNESS WHEREOF, I have subscribed this certificate at Sacramento, California, on the 31st day of January, 2008.

SANDRA VON HAENEL
CSR No. 11407

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Section 24411 is amended to read:

§ 24411. Deduction for Certain Dividends.

(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 <u>(or any other section of the Revenue and Taxation Code that provides that a dividend is not included in net income),</u> 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. <u>(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.</u>

(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)<u>, paragraphs </u>(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. <u>(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).)</u>

(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 <u>of that portion</u> 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%).

(f) This regulation applies to taxable years beginning on or after January 1, 1996 except as otherwise specifically provided.

Note: Authority cited: Section ~~26422~~19503, Revenue and Taxation Code.
Reference: Section 24411, Revenue and Taxation Code.

Section 25106.5-1 is amended to read:

§ 25106.5-1. Intercompany Transactions.

(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, 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.

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. <u>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,</u> 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~~ <u>Year 3</u>, S declares and makes a dividend distribution of the land to P. P also uses the land in the unitary business. <u>S has no earnings and profits from its ordinary business operations in Year 3.</u> 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~~ <u>4</u>, 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. <u>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</u>

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.

Note: Authority cited: Sections 19503 and 25106.5, Revenue and Taxation Code.
Reference: Section 25106.5, Revenue and Taxation Code.

STATE OF CALIFORNIA — DEPARTMENT OF FINANCE

ECONOMIC AND FISCAL IMPACT STATEMENT

(REGULATIONS AND ORDERS)

STD. 399 (Rev. 2-98) *See SAM Section 6600 - 6680 for Instructions and Code Citations*

DEPARTMENT NAME	CONTACT PERSON	TELEPHONE NUMBER
FRANCHISE TAX BOARD	COLLEEN BERWICK	(916)845-3306
DESCRIPTIVE TITLE FROM *NOTICE REGISTER* OR FORM 400: REGULATION SECTION 24411 - DEDUCTIONS FOR CERTAIN DIVIDENDS		NOTICE FILE NUMBER: Z

ECONOMIC IMPACT STATEMENT

A. ESTIMATED PRIVATE SECTOR COST IMPACTS *(Include calculations and assumptions in the rulemaking record.)*

1. Check the appropriate box(es) below to indicate whether this regulation:

- [x] a. Impacts businesses and/or employees
- [ ] b. Impacts small businesses
- [ ] c. Impacts jobs or occupations
- [ ] d. Impacts California competitiveness
- [ ] e. Imposes reporting requirements
- [ ] f. Imposes prescriptive instead of performance
- [ ] g. Impacts individuals
- [ ] h. None of the above (*Explain below. Complete the Fiscal Impact Statement as appropriate.)*

h. *(cont.)* ______

(If any box in Items 1 a through g is checked, complete this Economic Impact Statement.)

2. Enter the total number of businesses impacted: less than 10 Describe the types of businesses *(Include nonprofits)*: Water's edge corporations with CFC members, Subpart F income, and intercompany dividend distributions.

Enter the number or percentage of total businesses impacted that are small businesses: likely 0

3. Enter the number of businesses that will be created: 0 eliminated: 0

Explain: Proposal affect the treatment of intercompany dividend distributions only.

4. Indicate the geographic extent of impacts: [x] Statewide [ ] Local or regional *(list areas)*: ______

5. Enter the number of jobs created: 0 or eliminated: 0 Describe the types of jobs or occupations impacted: ______

6. Will the regulation affect the ability of California businesses to compete with other states by making it more costly to produce goods or services here?

[ ] Yes [x] No If yes, explain briefly: ______

B. ESTIMATED COSTS *(Include calculations and assumptions in the rulemaking record.)*

1. What are the total statewide dollar costs that businesses and individuals may incur to comply with this regulation over its lifetime? $0.00

a. Initial costs for a small business: $______ Annual ongoing costs: $______ Years: ______

b. Initial costs for a typical business: $______ Annual ongoing costs: $______ Years: ______

c. Initial costs for an individual: $______ Annual ongoing costs: $______ Years: ______

d. Describe other economic costs that may occur: ______

ECONOMIC AND FISCAL IMPACT STATEMENT *cont. (STD. 399, Rev. 2-98)*

2. If multiple industries are impacted, enter the share of total costs for each industry: ______

3. If the regulation imposes reporting requirements, enter the annual costs a typical business may incur to comply with these requirements. *(Include the dollar costs to do programming, record keeping, reporting, and other paperwork, whether or not the paperwork must be submitted.)*: $______

4. Will this regulation directly impact housing costs? ☐ Yes ☑ No If yes, enter the annual dollar cost per housing unit: ______ and the number of units: ______

5. Are there comparable Federal regulations? ☐ Yes ☑ No Explain the need for State regulation given the existence or absence of Federal regulations: ______

   Enter any additional costs to businesses and/or individuals that may be due to State - Federal differences: $0.00

C. ESTIMATED BENEFITS *(Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.)*

1. Briefly summarize the benefits that may result from this regulation and who will benefit: This proposal clarifies existing rules regarding the deductions of certain intercompany dividends.

2. Are the benefits the result of : ☑ specific statutory requirements, or ☐ goals developed by the agency based on broad statutory authority?

   Explain: ______

3. What are the total statewide benefits from this regulation over its lifetime? $______

D. ALTERNATIVES TO THE REGULATION *(Include calculations and assumptions in the rulemaking record. Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.)*

1. List alternatives considered and describe them below. If no alternatives were considered, explain why not: This proposal clarifies existing rules regarding the deductions of certain intercompany dividends.

2. Summarize the total statewide costs and benefits from this regulation and each alternative considered:

Regulation:	Benefit: $ Negligible	Cost: $ Negligible
Alternative 1:	Benefit: $______	Cost: $______
Alternative 2:	Benefit: $______	Cost: $______

3. Briefly discuss any quantification issues that are relevant to a comparison of estimated costs and benefits for this regulation or alternatives: ______

4. Rulemaking law requires agencies to consider performance standards as an alternative, if a regulation mandates the use of specific technologies or equipment, or prescribes specific actions or procedures. Were performance standards considered to lower compliance costs? ☐ Yes ☑ No

   Explain: ______

E. MAJOR REGULATIONS *(Include calculations and assumptions in the rulemaking record.)*
Cal/EPA boards, offices and departments are subject to the following additional requirements per Health and Safety Code section 57005.

ECONOMIC AND FISCAL IMPACT STATEMENT *cont. (STD. 399, Rev. 2-98)*

1. Will the estimated costs of this regulation to California business enterprises exceed $10 million ? ☐ Yes ☑ No *(If No, skip the rest of this section)*

2. Briefly describe each equally as effective alternative, or combination of alternatives, for which a cost-effectiveness analysis was performed:

   Alternative 1: ______________________

   Alternative 2: ______________________

3. For the regulation, and each alternative just described, enter the estimated total cost and overall cost-effectiveness ratio:

Regulation:	$ ____________	Cost-effectiveness ratio: $ ____________
Alternative 1:	$ ____________	Cost-effectiveness ratio: $ ____________
Alternative 2:	$ ____________	Cost-effectiveness ratio: $ ____________

FISCAL IMPACT STATEMENT

A. FISCAL EFFECT ON LOCAL GOVERNMENT *(Indicate appropriate boxes 1 through 6 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years)*

☐ 1. Additional expenditures of approximately $____________ in the current State Fiscal Year which are reimbursable by the State pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code. Funding for this reimbursement:

☐ a. is provided in ____________ ,Budget Act of ____________) or (Chapter ____________ ,Statutes o ____________

☐ b. will be requested in the ____________ (FISCAL YEAR) Governor's Budget for appropriation in Budget Act of ____________

☐ 2. Additional expenditures of approximately $____________ in the current State Fiscal Year which are not reimbursable by the State pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code because this regulation:

☐ a. implements the Federal mandate contained in ____________

☐ b. implements the court mandate set forth by the ____________

court in the case of ____________ vs. ____________

☐ c. implements a mandate of the people of this State expressed in their approval of Proposition No. ____________ at the ____________ (DATE) election;

☐ d. is issued only in response to a specific request from the ____________

____________ , which is.are the only local entity(s) affected;

☐ e. will be fully financed from the ____________ (FEES, REVENUE, ETC.) ____________ authorized by Section

____________ of the ____________ Code;

☐ f. provides for savings to each affected unit of local government which will, at a minimum, offset any additional costs to each such unit.

☐ 3. Savings of approximately $____________ annually.

☐ 4. No additional costs or savings because this regulation makes only technical, non-substantive or clarifying changes to current law regulations.

ECONOMIC AND FISCAL IMPACT STATEMENT *cont. (STD. 399, Rev. 2-98)*

- [x] 5. No fiscal impact exists because this regulation does not affect any local entity or program.
- [ ] 6. Other.

B. FISCAL EFFECT ON STATE GOVERNMENT *(Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)*

- [ ] 1 . Additional expenditures of approximately $__________ in the current State Fiscal Year. It is anticipated that State agencies will:
  - [ ] a. be able to absorb these additional costs within their existing budgets and resources.
  - [ ] b. request an increase in the currently authorized budget level for the __________ fiscal year.
- [ ] 2. Savings of of approximately $__________ in the current State Fiscal Year.
- [ ] 3. No fiscal impact exists because this regulation does not affect any State agency or program.
- [x] 4. Other. see attachment

C. FISCAL EFFECT ON FEDERAL FUNDING OF STATE PROGRAMS *(Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)*

- [ ] 1 . Additional expenditures of approximately $__________ in the current State Fiscal Year.
- [ ] 2. Savings of of approximately $__________ in the current State Fiscal Year.
- [x] 3. No fiscal impact exists because this regulation does not affect any federally funded State agency or program.
- [ ] 4. Other.

SIGNATURE		TITLE
[signature]		Executive Officer
AGENCY SECRETARY [1] APPROVAL/CONCURRENCE	[signature]	DATE 11/1/07
DEPARTMENT OF FINANCE [2] APPROVAL/CONCURRENCE	PROGRAM BUDGET MANAGER	DATE

1. *The signature attests that the agency has completed the STD. 399 according to the instructions in SAM sections 6600-6680, and understands the impacts of the proposed rulemaking. State boards, offices, or department not under an Agency Secretary must have the form signed by the highest ranking official in the organization.*

2. *Finance approval and signature is required when SAM sections 6600-6670 require completion of Fiscal Impact Statement in the STD. 399.*

Amended Regulation Section 24411

Attachment

This amendment seeks to clarify the rules regarding the deduction for certain intercompany dividends in response to the decision of the court of appeal in Fujitsu IT Holdings, Inc. v. Franchise Tax Board (2004). In "Fujitsu," the court of appeal adopted an interpretation of the existing regulation that was inconsistent with analogous provisions of the Internal Revenue Code and traditional tax policy. In the Appeal of Apple Computer, Inc. "Apple" (2006), the State Board of Equalization, in a published opinion, rejected the analysis of the court in Fujitsu and interpreted the existing regulation in a manner consistent with the proposed amendments. The year involved in Apple was the tax year ended September 30, 1989. The proposed amendment provides clarity as to the application of Section 24411 and its interaction with other sections of the Revenue and Taxation Code and set forth an interpretation that is consistent with the most recent published authority.

(a) No deduction is allowed under this section for dividends that are allowed to be deducted or eliminated from net income elsewhere.
(b) On the issue of the assignment of dividends among the earnings and profits from various years, dividends shall be considered to be paid out of the current year's earnings and profits to the extent of current year's earnings and profits. Any dividends above this amount are considered to be paid out from the most recently accumulated earnings and profits for prior years.
(c) On the issue of sourcing of dividends among unitary and nonunitary corporations, 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, then the amount of dividend deduction shall be determined on a pro rata basis based on the ratio of included earnings and profits over total earnings and profits.

This proposed amendment is expected to have an insignificant revenue impact in the retroactive as well as the prospective tax years. For the retroactive tax years, the Fujitsu decision was issued three years ago, 2004. Since then, we know of only one taxpayer who claimed a refund based on this decision. The refund request was denied by the State Board of Equalization in the Appeal of Apple Computer, Inc. (2006). Similarly, there does not appear to have been any taxpayers that have filed their original returns on an aggressive basis, based on the Fujitsu decision. Although there may be additional refund requests or aggressively filed returns for years through 2006, our experience to date suggests that such filings are unlikely. Furthermore, it is expected that any such refund requests will be rejected.

In future tax years, without the above amendment, some taxpayers would file aggressively based on the Fujitsu decision to minimize their tax liability. If the amount of taxes at stake was immaterial, these tax returns probably would not be audited for this issue. Tax returns for which the amount of understatement of tax was material would probably be audited. The audit would generally result in an additional assessment. In these cases the receipt of the tax payment may not occur until the NPA has been issued and the taxpayer's protest has been denied. As such, promulgation of this regulatory amendment would induce an acceleration of revenue. With this regulatory amendment, the tax payments would likely be received by the return due date. Without it, the payments may be delayed for two years or more.

For the above reasons, the proposed amended regulation is expected to accelerate cash flows and increase corporate tax payments in future tax years. The amounts of accelerated cash flows and increased tax payments are estimated to be insignificant, less than $250,000 per year. However, it is possible that the impact might be higher, in the millions of dollars, due to unexpected cases.

STATE OF CALIFORNIA — DEPARTMENT OF FINANCE

ECONOMIC AND FISCAL IMPACT STATEMENT

(REGULATIONS AND ORDERS)

STD. 399 (Rev. 2-98)

See SAM Section 6600 - 6680 for Instructions and Code Citations

DEPARTMENT NAME	CONTACT PERSON	TELEPHONE NUMBER
FRANCHISE TAX BOARD	COLLEEN BERWICK	(916)845-3306
DESCRIPTIVE TITLE FROM *NOTICE REGISTER* OR FORM 400		NOTICE FILE NUMBER
REGULATION SECTION 25106.5-1 - INTERCOMPANY TRANSACTIONS		Z

ECONOMIC IMPACT STATEMENT

A. ESTIMATED PRIVATE SECTOR COST IMPACTS *(Include calculations and assumptions in the rulemaking record.)*

1. Check the appropriate box(es) below to indicate whether this regulation:

- [x] a. Impacts businesses and/or employees
- [ ] b. Impacts small businesses
- [ ] c. Impacts jobs or occupations
- [ ] d. Impacts California competitiveness
- [ ] e. Imposes reporting requirements
- [ ] f. Imposes prescriptive instead of performance
- [ ] g. Impacts individuals
- [ ] h. None of the above (*Explain below. Complete the Fiscal Impact Statement as appropriate.)*

h. *(cont.)*______________________________

(If any box in Items 1 a through g is checked, complete this Economic Impact Statement.)

2. Enter the total number of businesses impacted: less than 10 Describe the types of businesses *(Include nonprofits)*: Water's edge corporations with CFC members, Subpart F income, and intercompany dividend distributions.

Enter the number or percentage of total businesses impacted that are small businesses: likely 0

3. Enter the number of businesses that will be created: 0 eliminated: 0

Explain: Proposal affect the treatment of intercompany dividend distributions only.

4. Indicate the geographic extent of impacts: [x] Statewide [ ] Local or regional *(list areas)*: ______________________________

5. Enter the number of jobs created: 0 or eliminated: 0 Describe the types of jobs or occupations impacted: ______________________________

6. Will the regulation affect the ability of California businesses to compete with other states by making it more costly to produce goods or services here?

[ ] Yes [x] No If yes, explain briefly: ______________________________

B. ESTIMATED COSTS *(Include calculations and assumptions in the rulemaking record.)*

1. What are the total statewide dollar costs that businesses and individuals may incur to comply with this regulation over its lifetime? $0.00

a. Initial costs for a small business: $______ Annual ongoing costs: $______ Years: ____

b. Initial costs for a typical business: $______ Annual ongoing costs: $______ Years: ____

c. Initial costs for an individual: $______ Annual ongoing costs: $______ Years: ____

d. Describe other economic costs that may occur: ______________________________

ECONOMIC AND FISCAL IMPACT STATEMENT *cont. (STD. 399, Rev. 2-98)*

2. If multiple industries are impacted, enter the share of total costs for each industry: ____________

3. If the regulation imposes reporting requirements, enter the annual costs a typical business may incur to comply with these requirements. *(Include the dollar costs to do programming, record keeping, reporting, and other paperwork, whether or not the paperwork must be submitted.)*: $____________

4. Will this regulation directly impact housing costs? ☐ Yes ☑ No If yes, enter the annual dollar cost per housing unit: ________ and the number of units: ________

5. Are there comparable Federal regulations? ☐ Yes ☑ No Explain the need for State regulation given the existence or absence of Federal regulations: ____________

Enter any additional costs to businesses and/or individuals that may be due to State - Federal differences: $ 0.00

C. ESTIMATED BENEFITS *(Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.)*

1. Briefly summarize the benefits that may result from this regulation and who will benefit: This proposal clarifies existing rules regarding the deductions of certain intercompany dividends.

2. Are the benefits the result of : ☑ specific statutory requirements, or ☐ goals developed by the agency based on broad statutory authority?

Explain: ____________

3. What are the total statewide benefits from this regulation over its lifetime? $ ________

D. ALTERNATIVES TO THE REGULATION *(Include calculations and assumptions in the rulemaking record. Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.)*

1. List alternatives considered and describe them below. If no alternatives were considered, explain why not: This proposal clarifies existing rules regarding the deductions of certain intercompany dividends.

2. Summarize the total statewide costs and benefits from this regulation and each alternative considered:

Regulation:	Benefit: $ Negligible	Cost: $ Negligible
Alternative 1:	Benefit: $________	Cost: $________
Alternative 2:	Benefit: $________	Cost: $________

3. Briefly discuss any quantification issues that are relevant to a comparison of estimated costs and benefits for this regulation or alternatives: ____________

4. Rulemaking law requires agencies to consider performance standards as an alternative, if a regulation mandates the use of specific technologies or equipment, or prescribes specific actions or procedures. Were performance standards considered to lower compliance costs? ☐ Yes ☑ No

Explain: ____________

E. MAJOR REGULATIONS *(Include calculations and assumptions in the rulemaking record.)*
Cal/EPA boards, offices and departments are subject to the following additional requirements per Health and Safety Code section 57005.

1. Will the estimated costs of this regulation to California business enterprises exceed $10 million ? ☐ Yes ☑ No *(If No, skip the rest of this section)*

2. Briefly describe each equally as effective alternative, or combination of alternatives, for which a cost-effectiveness analysis was performed:

   Alternative 1: ____________________

   Alternative 2: ____________________

3. For the regulation, and each alternative just described, enter the estimated total cost and overall cost-effectiveness ratio:

   Regulation: $ ____________ Cost-effectiveness ratio: $ ____________

   Alternative 1: $ ____________ Cost-effectiveness ratio: $ ____________

   Alternative 2: $ ____________ Cost-effectiveness ratio: $ ____________

FISCAL IMPACT STATEMENT

A. FISCAL EFFECT ON LOCAL GOVERNMENT *(Indicate appropriate boxes 1 through 6 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years)*

☐ 1. Additional expenditures of approximately $____________ in the current State Fiscal Year which are reimbursable by the State pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code. Funding for this reimbursement:

☐ a. is provided in ____________ ,Budget Act of____________) or (Chapter____________ ,Statutes o____________

☐ b. will be requested in the____________ (FISCAL YEAR) Governor's Budget for appropriation in Budget Act of ____________

☐ 2. Additional expenditures of approximately $____________ in the current State Fiscal Year which are not reimbursable by the State pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code because this regulation:

☐ a. implements the Federal mandate contained in____________

☐ b. implements the court mandate set forth by the ____________

court in the case of____________ vs. ____________

☐ c. implements a mandate of the people of this State expressed in their approval of Proposition No.____________ at the____________ (DATE) election;

☐ d. is issued only in response to a specific request from the ____________

____________ , which is.are the only local entity(s) affected;

☐ e. will be fully financed from the ____________ (FEES, REVENUE, ETC.) authorized by Section

____________ of the____________ Code;

☐ f. provides for savings to each affected unit of local government which will, at a minimum, offset any additional costs to each such unit.

☐ 3. Savings of approximately $____________ annually.

☐ 4. No additional costs or savings because this regulation makes only technical, non-substantive or clarifying changes to current law regulations.

ECONOMIC AND FISCAL IMPACT STATEMENT *cont. (STD. 399, Rev. 2-98)*

[✓] 5. No fiscal impact exists because this regulation does not affect any local entity or program.

[ ] 6. Other.

B. FISCAL EFFECT ON STATE GOVERNMENT *(Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)*

[ ] 1. Additional expenditures of approximately $________ in the current State Fiscal Year. It is anticipated that State agencies will:

- [ ] a. be able to absorb these additional costs within their existing budgets and resources.
- [ ] b. request an increase in the currently authorized budget level for the ________ fiscal year.

[ ] 2. Savings of of approximately $________ in the current State Fiscal Year.

[ ] 3. No fiscal impact exists because this regulation does not affect any State agency or program.

[✓] 4. Other. see attachment

C. FISCAL EFFECT ON FEDERAL FUNDING OF STATE PROGRAMS *(Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)*

[ ] 1. Additional expenditures of approximately $________ in the current State Fiscal Year.

[ ] 2. Savings of of approximately $________ in the current State Fiscal Year.

[✓] 3. No fiscal impact exists because this regulation does not affect any federally funded State agency or program.

[ ] 4. Other.

SIGNATURE		TITLE
(signature)		Executive Officer
AGENCY SECRETARY [1] APPROVAL/CONCURRENCE	(signature)	DATE 11-1-07
DEPARTMENT OF FINANCE [2] APPROVAL/CONCURRENCE	PROGRAM BUDGET MANAGER	DATE

1. *The signature attests that the agency has completed the STD. 399 according to the instructions in SAM sections 6600-6680, and understands the impacts of the proposed rulemaking. State boards, offices, or department not under an Agency Secretary must have the form signed by the highest ranking official in the organization.*

2. *Finance approval and signature is required when SAM sections 6600-6670 require completion of Fiscal Impact Statement in the STD. 399.*

Amended Regulation Section 25106.5-1

Attachment

This amendment makes clarifying changes to two examples in the current Regulation Section 25106.5-1. These changes clarify the ordering rules for determining whether a dividend is paid from earnings and profits arising from income previously included in a combined report so as to be eligible for elimination under section 25106. One example relates to dividends paid from earnings and profit that arose from income that was included in a unitary group's combined report. The other example relates to dividends paid from earnings and profits that arose from income that was not included in a unitary group's combined report.

Without this amendment some taxpayers could file incorrectly and, as a result, pay insufficient taxes. If the amount of taxes at stake was immaterial, these tax returns probably would not be audited for this issue. Tax returns for which the amount of understatement of tax was material would probably be audited. The audit would generally result in an additional assessment. In these cases the receipt of the tax payment may not occur until the NPA has been issued and the taxpayer's protest has been denied. As such, promulgation of this regulatory amendment would induce an acceleration of revenue. With this regulatory amendment, the tax payments would likely be received by the return due date. Without it, the payments may be delayed for two years or more.

This proposed amendment is expected to have no impact on the retroactive tax years because there have been no claims for refund filed with regard to this issue since the Fujitsu decision was made. It is expected to accelerate cash flows and increase corporate tax payments in future tax years. The amounts of accelerated cash flows and increased tax payments are estimated to be insignificant, less than $250,000 per year.