Request for Permission to Proceed with Formal Regulation Process
For Proposed Amendments to
Regulation Sections 24411 and 25106.5-1,
Ordering of Dividend Payments

On February 9, 2005, staff received authorization from the Franchise Tax Board to proceed with a symposium on the proposed amendments to Regulation sections 24411 and 25106.5-1. A symposium to discuss the proposed amendments to the existing regulations was held on April 4, 2005. A report on the symposium is included in the Board's materials. (Attachment A.) Written comments were received from the public prior to the symposium. The written comments are also included in the Board's materials. (Attachment B.) As a result of the symposium, no change was made to the language in staff's original discussion draft proposal. A copy of the proposed amendment to the existing regulations is included in the Board's materials. (Attachment C.)

Staff now requests permission to proceed to the formal public hearing process under the Administrative Procedure Act.

The proposed amendments to the regulations are in response to an appellate decision, *Fujitsu It Holdings, Inc. v. Franchise Tax Board* (2004) 120 Cal.App. 4th 459. Staff is proposing amendments to Regulation sections 24411(e) and 25106.5-1(f)(2), not to change their substance, but to definitively set forth the rule for the ordering of dividends that are paid from income that has been included in a unitary combined report and from income that has not been included in a unitary combined report.

Many of the commentators complained that the proposed amendments will over-rule the holding of the Court of Appeal in *Fujitsu* and that the Board does not have the power to do that or should not do that. Staff believes that the Court of Appeal's decision was premised on a misinterpretation of the existing regulations and that clarifying the existing regulations, without changing them substantively, is an appropriate response to the court's decision. It should be noted that one of statutes, Revenue and Taxation Code section 25106.5, which the regulations implement, contains a direct legislative delegation of authority to regulate. Staff believes the Board has the power to clarifying its existing regulations to correct a misinterpretation of those regulations by the courts.

A second issue raised by several commentators was whether the proposed amendments should be prospective only. Staff believes that the proposed amendments should be applied retroactively, without limitation, as they are only clarifying in nature. Staff accepts that proposed regulations, or amendments to them, which result in a substantive change in the law should generally operate prospectively. Revenue and Taxation Code section 19503, the statute generally authorizing the Franchise Tax Board to adopt regulations, formerly provided the Board with the authority to determine the extent to which regulations would operate without retroactive effect. That statute was amended in 1997 to provide that, with limited enumerated exceptions, regulations relating to statutory provisions enacted after January 1, 1998, would only apply to taxable years subsequent to Franchise Tax Board notice substantially describing the expected contents of any regulations having been given. These 1997 amendments do not apply to the statutes involved in these regulations.

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

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

(b) Definitions.

(1) Qualifying dividends.

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

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

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

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

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

(b) Definitions. For purposes of this regulation:

(1) Intercompany transactions.

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

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

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

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

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

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

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

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

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

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

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

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

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

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.

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

(c) Computation of amount allowable.

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

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

(d) Dividends derived from construction projects.

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

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

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

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

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

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

(4) Examples:

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

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

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

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

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

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

(e) Classification of distributions.

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

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

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

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

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

(4) Examples:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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March 31, 2005
State of California
Franchise Tax Board Legal Department
Attn. Colleen Berwick
PO BOX 1720
Rancho Cordova, CA 95741-1720

Subject: FTB Notice 2005-1

Dear Sirs:

On behalf of Hewlett-Packard Company, I would like to offer the following comments on the approach for amending regulations outlined in FTB Notice 2005-1:

1. Administrative Burden. The proposed regulation changes would require taxpayers to track California E&P pools by year for computing the tax on dividends. There is no justification for imposing on taxpayers the burden of complex computations that are different than the federal requirements and that might have to be tracked for decades. In addition, there is no reason to have the FTB audit such complex calculations.

2. Precedent. The Amdahl decision cannot be disregarded by changing the regulations because the Amdahl decision interpreted the statute, which has not been changed.

3. Prospective vs. Retrospective. These proposals do not provide retrospective relief that must be available from the Amdahl decision.

4. Permanent loss to taxpayers. Under the proposed approach, some of the previous California E&P pools would never be available to provide tax relief. This could cause a permanent loss to taxpayers. It would not be just a timing difference.

Regards,

Michael Buczek
Senior Tax Manager
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Ms. Colleen Berwick
Franchise Tax Board
Legal Department
P.O. Box 1720
Rancho Cordova, CA 95741-1720

April 4, 2005

Re: Draft Proposed Amendments to Reg. Secs. 24411 and 25106.5

Dear Ms. Berwick:

In FTB Notice 2005-1, March 4, 2005 ("Notice"), the Franchise Tax Board Staff ("Staff") announced that it had prepared a discussion draft of proposed amendments to the existing regulations adopted under Revenue and Taxation Code ("CRTC") Sections 24411 and 25106.5-1. The proposed amendments would add provisions that address the ordering of dividends paid from earnings and profits that are, in part or in whole, eligible for deduction, exclusion, elimination, or are wholly taxable. The proposed amendments would also relate to the sales factor treatment of business dividends not eliminated under CRTC Section 25106 as well as to construction dividends eligible for the 100% deduction under CRTC Section 24411. The Notice invited the public to provide any written comments before the formal regulatory process with respect to adoption of these proposed amendments begins. On behalf of PricewaterhouseCoopers LLP, we submit the following comments.

THE STAFF'S PROPOSAL TO IMPOSE AN ORDERING RULE FOR DISTRIBUTIONS CONTRADICTS THE CLEAR HOLDING BY THE COURT OF APPEAL IN *FUJITSU IT HOLDINGS, INC. v. FRANCHISE TAX BOARD* AND THUS IS INVALID

The Proposed Amendment to Reg. Sec. 24411(e) states that it will apply the ordering rules of Internal Revenue Code ("IRC") Sec. 316 by requiring that a distribution with respect to stock is to be considered first paid from current year's earnings and profits, and then from the most recently accumulated earnings and profits by year thereafter. The proposed regulation would also provide that if a distribution from a given year's earnings and profits is not sufficient to exhaust the earnings and profits of that year, the distribution would be considered paid, on a pro rata basis, from each class of potential dividend within the earnings and profits of that year. Thus, based upon the Staff's proposal, if

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April 4, 2005

VIA FACSIMILE

Ms. Colleen Berwick
Franchise Tax Board Legal Department
P.O. Box 1720
Rancho Codova, CA 95741-1720

RE: COMMENTS ON DISCUSSION DRAFT OF PROPOSED CHANGES TO CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTIONS 24411 AND 25106.5

Dear Ms. Berwick:

Please accept the following comments to the Franchise Tax Board ("FTB") in response to its Request for Public Comment (FTB Notice 2005-1), issued on March 4, 2005.

A. Background

In FTB Notice 2005-1, the FTB proposes to amend certain regulations adopted under Revenue and Taxation Code ("RTC") §§ 24411 and 25106. The amendments seek to add provisions that address the ordering of dividends paid from various classes of earnings and profits. Specifically, the proposed amendments would apply the ordering rules of Internal Revenue Code ("IRC") § 316 (*i.e.*, "if a distribution from a given year's earnings and profits are not sufficient to exhaust the earnings and profits of that year, the distribution will be considered drawn from each class of potential dividend on a pro rata basis").

The justification for these amendments is explained by the FTB in "Request to Amend Regulations 24411 and 25106.5-1: Dividend Ordering Rules and the *Fujitsu* (*Amdahl*) Case"[1] (the "FTB Explanation"). The FTB Explanation focuses on the fact that the Court of Appeal "misconstrued" an example provided in the Cal. Code Regs., tit. 18, § 25106.5-1.[2] Later, the FTB Explanation more pointedly states:

> Because the *Fujitsu* court's holding was based on a misconstruction of a regulation, which by its terms was not applicable to the year in question and by its

[1] Franchise Tax Board, February 9, 2005.
[2] *See* FTB Explanation, *supra* note 1, at 1.

> example didn't apply to the issue presented to the court, and because of the court's open disregard of a regulation which it acknowledged was on point, the court's holding appears to be in error.[3]

As will be explained in greater detail below, this description of the Court of Appeal decision in *Fujitsu IT Holdings, Inc. v. Franchise Tax Board* ("*Fujitsu*"),[4] itself completely misconstrues the basis for that court's holding.

B. *Fujitsu*: Superior Court and Court of Appeal Decisions

1. Superior Court[5]

The reasoning underlying the Superior Court holding on the ordering of distributions is important because, as discussed in greater detail below, it is explicitly incorporated into the Court of Appeal decision.[6]

The Superior Court describes the relevant issue as "how the source of a dividend should be apportioned between income of the unitary group and other income." The court identified that constitutional considerations were very important in resolving this issue: "[T]he burden on foreign commerce that Amdahl alleges is lesser or greater depending on whether dividends are treated as coming first or last from income of the unitary group." The court goes on to explain:

> [T]he Court is cognizant of the principle that statutes should be interpreted to the extent possible in a manner that harmonizes their terms and avoids constitutional infirmities. In view of this principle, the Court holds that RTC § 25106 should be applied to dividends from controlled foreign corporations that are partially included in the Water's Edge group under RTC § 25110(a)(6) in a manner that deems dividends to be distributed first from income that has already been included in the unitary group, to the extent thereof, and then from non-unitary income.

These statements make it clear that the ordering of distributions cannot be seen as a mere administrative computation. Instead, the treatment of distributions from foreign unitary income must, at a minimum, meet the standards imposed by the U.S. Constitution's Foreign Commerce

[3] *See* FTB Explanation, *supra* note 1, at 3.
[4] 120 Cal.App.4th 459 (2004).
[5] *Amdahl Corporation v. Franchise Tax Board*, California Superior Court for San Francisco, No. 321296, October 3, 2002.
[6] *Fujitsu*, 120 Cal.App.4th at 480 ("For the reasons indicated above, *including those relied on by the trial court*, we conclude that the dividends paid by first-tier subsidiaries from current year earnings should be treated as paid (1) first our of earnings eligible for elimination under section 25106, with (2) any excess paid out of earning eligible for partial deduction under section 24411.") (emphasis supplied).

Clause.[7] Perhaps most important for this commentary, woven into the court's holding and analysis is the implication that the "pro rata" rule advocated by the FTB in both *Fujitsu* and the currently proposed regulations, would *not* satisfy the standards imposed by the Foreign Commerce Clause.

Critically, the Superior Court mentions neither Cal. Code Regs., tit. 18, §§ 24411 nor 25106.5-1 in its analysis. Its holding is based solely on constitutional considerations.

2. Court of Appeal

The FTB Explanation focuses on the Court of Appeal's examination of an example in Cal. Code Regs., tit. 18, § 25106.5-1(f)(2) and whether the example was properly construed. The Court of Appeal does look to this example and, moreover, acknowledges that there is no "clear guidance" on the proper ordering of distributions. Perhaps, if the Court of Appeal decision ended by pointing only to the lack of administrative clarity, the FTB's proposed amendments in FTB Notice 2005-1 may have some basis. However, the Court of Appeal went on to note that "wherever possible, 'we will interpret a statute as consistent with applicable constitutional provisions, seeking to harmonize Constitution and statute.'"[8] Moreover, the Court of Appeal *explicitly* adopts the reasoning set forth by the Superior Court on this issue, which, as described above, was based wholly on constitutional considerations.[9]

C. Analysis

1. The Court of Appeal's holding on the ordering of distributions was based almost wholly on constitutional grounds.

As amply demonstrated above, FTB Notice 2005-1 oversimplifies the Court of Appeal's holding in *Fujitsu*. This is not a situation in which a court misapplied or misunderstood a piece of administrative guidance. Constitutional concerns where the *sole basis* for the Superior Court's holding (adopted explicitly by the Court of Appeal) and a substantial factor in the Court of Appeal's holding. The key factor in this analysis is not, however, whether constitutional considerations were the only factor considered in the courts' holdings or one of many factors. Instead, it is the mere fact that constitutional considerations supported some portion of the Court of Appeal's reasoning that limits the FTB's ability to engage in rule-making that contradicts the Court of Appeal's decision.

---

[7] *See e.g., Kraft Gen. Food, Inc. v. Iowa Dept. of Revenue and Finance*, 505 U.S. 71 (1992); *Japan Line, Ltd. V. County of Los Angeles*, 441 U.S. 434 (1979). We would be happy to supplement our comments with a discussion of how the ordering of distributions from unitary income included in the group's combined report versus income not included in the combined report raises Foreign Commerce Clause implications. However, as appropriate to the current discussion, the important issue is the mere fact that these arguments were the basis of the Superior Court holding and the Court of Appeal holding.

[8] *Fujitsu*, 120 Cal.App.4th at 480 (citations omitted).

[9] *Id.* at note 6.

The FTB's reliance on the fact that IRC § 316 is explicitly incorporated into California law by RTC § 24451 does nothing to address the potential constitutional infirmities of the ordering rules set forth in IRC § 316 as applied in the state tax context. That is, while Congress may be permitted to discriminate against foreign commerce in the context of federal tax legislation, the dormant Commerce Clause prohibits states from taking similar action.

2. **The FTB is not permitted to use its rule-making authority to circumscribe a court's interpretation of the Constitution.**

The FTB argues that, in proposing amendments to Cal. Code Regs., tit. 18, §§ 24411 and 25106.5-1, it is merely clarifying regulations that were misinterpreted by the Court of Appeal. The FTB is permitted to propose such amendments, the reasoning goes, because the basis for the Court of Appeal's decision in *Fujitsu* was regulations, the promulgation and amendment of which fall within the ambit of FTB powers. As discussed above, however, the holdings of the Superior Court and the Court of Appeal in *Fujitsu* were based squarely in constitutional principles. As such, to amend the regulations in a way that contradicted *Fujitsu* would be tantamount to allowing the FTB to ignore a court's interpretation of the mandates of the U.S. Constitution. Not only does this most certainly exceed the authority granted to the FTB by the California legislature, it conflicts with basic separation of power principles.[10]

D. Conclusion

For the foregoing reasons, we assert that the FTB does not have the authority to propose the regulations referenced in FTB Notice 2005-1 and, as such, they should be withdrawn.

****

Sincerely,

John G. Ryan

Kimberley M. Reeder

JGR/kc

[10] *Mandel v. Myers*, 29 Cal.3d. 531 (1981). Under basic separation of powers principles, "the powers of state government are legislative, executive and judicial. Persons charged with the exercise of one power may not exercise either of the others except as permitted by this Constitution." Cal. Const. art. III, § 3.

a corporation had earnings and profits a distribution from which would qualify under CRTC Sec. 25106 as well as earnings and profits a distribution from which would qualify under CRTC Sec. 24402, 24411, etc. a distribution by the corporation would be considered distributed pro rata from both types of earnings and profits and hence eligible for treatment under both CRTC 25106 and 24402, 24411.

First, the Staff incorrectly quotes IRC Sec. 316, finding an ordering rule where none exists. IRC Sec. 316 is only concerned with whether a distribution will constitute a dividend; return of capital, etc. and not with whether the distribution qualifies for any dividend deductions, etc. which are provided for in different IRC sections.

In addition, in *Fujitsu IT Holdings, Inc. v. Franchise Tax Board,* (2004) 120 Cal. App.4th 459, the California Court of Appeal set forth a different ordering rule from that suggested by the Staff. The Court of Appeal clearly held that dividends 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. Id at 480.

The Staff attempts to justify its proposed ordering rule by assuming that the Court reached its conclusion relying on an example found in the FTB regulations under section 25106.5 (example (2) of Reg. Sec. 25106.5(f)(2)) which were not in effect for the years in controversy in this case. In doing so, the Staff ignores the Court's reliance upon and favorable discussion of CRTC Sec. 25106. The Court noted:

> Section 25106 provided the following for the years at 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.*" (Italics in original opinion.)
>
> 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 the unitary group without tax consequences. 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 taxed twice—once as earnings of the issuing subsidiary, and once as separate income to the unitary business from receipt of the dividend. " Id at 477.

The Court commented favorably on the lower court's ruling and rationale. It noted:

> The superior court's decision directs that: 'RTC § 25106 should be applied to dividends from [CFCs] that are partially included in the Water's Edge group under RTC § 25110(a)(6) in a manner that deems dividends to be distributed first from income that has already been included in the unitary group, to the extent thereof, and then from the non-unitary income.' Consequently, 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.
>
> The superior court reached its result in order to 'harmonize [ ] [the statutes] and avoid [ ] constitutional infirmities.' The court came to the conclusion that the FTB's pro rata ordering of such dividends might raise a constitutional concern about section 24411, subdivision (a) because 'the burden on foreign commerce that Amdahl alleges is lesser or greater depending on whether dividends are treated as coming first or last from income of the unitary group.' Id at 479-480.

The Court noted that no statute, regulation or other administrative pronouncement provided clear guidance on this question. Further, while the Court observed that for 1989 and later years, the FTB promulgated regulations under section 24411 as well as new unitary combined reporting intercompany transaction regulations in 2001, the Court in no way relied upon these regulations in reaching its conclusion. The observation regarding these other regulations must be considered dicta and not the basis for the Court's decision. Other than to acknowledge the existence of these regulations, the Court did not discuss these regulations. Further, nowhere in the opinion did the Court expressly state that it relied upon example (2) of Reg. Sec. 25106.5(f)(2) as the Staff asserts. Rather, the Court based its holding on as follows:

> In the absence of any clear and controlling guidance on this question, our 'construction is to favor the taxpayer rather than the government.' (*Edison California Stores v. McColgan* (1947) 30 Cal.2d 472, 476, 183 P.2d 16.) 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.' [Citations omitted.] "And, wherever possible, 'we will interpret a statute as consistent with applicable constitutional provisions, seeking to harmonize Constitution and statute.' [Citation omitted.]

Thus, it is clear from the foregoing language that the Court relied upon CRTC Sec. 25106 and the Legislative intent with respect to this section to avoid double taxation at the corporate level for dividends paid out of unitary income, and not on an example in the FTB's combined reporting intercompany transaction regulations, as its basis for holding that dividends should be considered as coming out of 25106 earnings and profits first before coming out of any other earnings and profits. The Staff's assertion that the Court relied upon Reg. Sec. 25106.5 which was not in effect during the years at issue in this case is in error. Accordingly, the Staff's attempt to clarify the department's regulations cannot be reconciled with the actual reading of this decision and thus is invalid.

STAFF'S ATTEMPT TO OVERRIDE THE COURT OF APPEAL DECISION IS INVALID

By proposing this amendment, the Staff is attempting to override by regulation a published decision by the Court of Appeal. Such action is unprecedented. To the extent that the Staff wishes to apply this proposed regulation retroactively, it lacks the necessary authority to do so. The Court's decision in *Fujitsu* became final on October 20, 2004 when the California Supreme Court denied the FTB's petition for review. The FTB is bound to follow all final decisions of the California Court of Appeal as well as the California Supreme Court whether it likes the decision or not.

Further, CRTC Sec. 19503 provides that no regulation shall apply to any taxable year ending before the date on which any notice substantially describing the expected contents of any regulation is issued to the public. An exception provided in CRTC Sec. 19503(b)(4) that allows for the retroactive application of a regulation that corrects a procedural defect in the issuance of any prior regulation is not applicable since the Staff has not asserted (nor could they if they wanted to) that this proposed amendment is necessary to correct a procedural defect in a prior regulation. Any defect if it existed was not procedural but rather technical in nature.

Even if the Staff were to propose to apply this proposed amendment only a prospective basis, the Staff would still be seeking to override the clear holding of the *Fujitsu* decision. The FTB may prescribe rules and regulations necessary for the enforcement of the income tax laws. See CRTC Sec. 19503. However, regulations must be in harmony with and not in conflict with existing statutes. The FTB does not have the authority to issue a rule or regulation that alters or enlarges the terms of a legislative enactment. See *Whitcomb Hotel, Inc. v. California Employment* Commission, 24 Cal. 2d. 753,757 (1944); *County of Los Angeles v. State Department of* Health, 158 Cal. App. 2d 425, 438 (1958). The validity of a regulation depends upon whether the regulation is consistent with the governing statute. See, e.g., *Ontario Community Foundation, Inc. v. State Board of* Equalization, 35 Cal. 3d 811, 816 (1984); *Appeal of Standard Oil Co. of* California, Cal. St. Bd. Of Equal., Mar. 2, 1983, CCH Calif. Tax Rptr. ¶ 400-383. Unless and until such time as the California Legislature either amends CRTC 24411 to provide an ordering rule suggested by the Staff or the California Legislature amends CRTC 25106, the Staff's proposed amendments to the regulations under CRTC Sec. 24411 clearly are in conflict with existing statutes and thus are invalid.

THE STAFF'S PROPOSED ORDERING RULE MISAPPLIES FEDERAL AUTHORITIES IT CITES

Proposed Amendment to Reg. Sec. 24411(e)(1) provides that 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. Thus, the Staff proposes to use a LIFO approach for determining which year's earnings and profits a distribution is deemed paid out of. If a distribution exceeds the earnings and profits for the current taxable year, then the Staff would consider the distribution as next coming out of the first year preceding the current taxable year, and, if necessary, then from the second year preceding the current taxable year, etc. As authority for this proposition, the Staff cites IRC Sec. 316 which it notes is incorporated in CRTC Sec. 24451.

Despite the Staff's assertion, neither IRC Sec. 316 nor any of the regulations promulgated thereunder support the notion of a LIFO approach as suggested by Staff. Federal regulations provide that distributions are first considered paid out of current year's earnings and profits and then from earnings and profits accumulated since February 28, 1913 for purposes of determining whether a distribution is a dividend or return of capital. See, for example, Treas. Reg. Secs. 1.316-1 and 1.316-2. All years earnings and profits before the current taxable year are accumulated together. There is no segregation of the earnings and profits by year other than for the current year. Accordingly, if the Staff seeks to use an ordering rule and relies upon federal precedent as its authority, then it must amend the proposed amendment to aggregate all years earnings and profits (other than the current year) together when determining the source of a distribution.

Very truly yours

Barry Weissman

Barry Weissman
Director
Tax

cc: Mr. Douglas Anderson, PricewaterhouseCoopers LLP, Sacramento
Mr. Michael Herbert, PricewaterhouseCoopers LLP, San Francisco
Mr. Matt Stolte, PricewaterhouseCoopers LLP, San Francisco
Mr. Chris Whitney, PricewaterhouseCoopers LLP, Orange County
Ms. Ligia Machado, PricewaterhouseCoopers LLP, Sacramento
Ms. Kathleen Freeman, PricewaterhouseCoopers LLP, Sacramento

STAFF REPORT ON
SYMPOSIUM ON PROPOSED AMENDMENTS
TO REGULATION SECTIONS 24411 AND 25106.5-1
(ORDERING OF DIVIDEND PAYMENTS)
APRIL 4, 2005

On March 4, 2005, staff issued a notice advising the public of the scheduling of the symposium for April 4, 2005. Copies of the proposed amendments to the regulations were attached to the notice. Furthermore, the notice and the proposed amendments to the regulations were posted on the department's website. The symposium was held at 10:00 A.M. on April 4, 2005, at the Franchise Tax Board's central office in Sacramento, California. The facilitators were Benjamin F. Miller, Counsel Multistate Tax Affairs, and Craig Swieso, Tax Counsel III.

Prior to the symposium, staff received written comments from Michael Buczek, who is a senior tax manager with Hewlett-Packard Company. On the day of the symposium, comments were received from Barry Weissman, who is a Tax Director with PriceWaterhouseCoopers and John Ryan and Kimberley Reeder, who are with McDermott, Will & Emery. (Comments attached)

There were 12 non-FTB attendees at the symposium, including Michael Buczek and Barry Weissman. Many comments and suggestions were proffered, which will be discussed below.

Additionally, Dave Doerr and Teresa Casazza from CalTax attended. An article about the symposium appeared in the April 8, 2005, online version of the CalTaxLetter. (Copy attached.)

On July 7, 2004, the First Appellate District Court of Appeal issued its opinion in <u>Fujitsu It Holdings, Inc. v. Franchise Tax Board</u> (2004) 120 Cal.App. 4^{th} 459. Among the issues addressed by the Court was the proper ordering of dividends between those that were paid from income that had been included in a unitary combined report and those paid from income that had not been included in a unitary combined report. (See <u>Fujitsu</u>, pp. 479-480.)

The proposed amendments are intended to address the Court of Appeals' misinterpretation of the regulations that are being amended. The comments made at the symposium were directed to those amendments. Staff does not believe any changes are required as a result of the comments.

While these regulations are being amended, this also presents an opportunity to make additional technical amendments to Regulations sections 24411 and 25106.5. No comments were provided with respect to the technical changes.

II. Written Comments

A. *Michael Buczek's Comments*

1. The proposed amendments to the regulations would require taxpayers to keep track of California earnings and profits pools. There is no justification for imposing on taxpayers the burden of complex computations that are different than federal requirements and that might have

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May 31, 2005

Re: Proposed Amendments to Reg. sections 24411 and 25106.5-1(f)

Dear Mr. Swieso:

I have reviewed the draft status report you prepared on the symposium held on April 4, 2005 on Proposed Amendments to Regulation sections 24411 and 25106.5-1(f) and have the following comments to make relating to the comments I provided and your proposed response:

1. *The staff's proposal to impose an ordering rule for distribution contradicts the clear holding by the Court of Appeal in Fujitsu IT Holdings, Inc. v. Franchise Tax Board, (2004) 120 Cal. App.4th 459.*

The *Fujitsu* Court clearly held that dividends are first considered paid out of income that has been included in a unitary combined report and thus eliminated before being considered paid out of income not included in a unitary combined report. The Court based its holding on the clear legislative intent embodied in California Revenue and Taxation Code ("CRTC") Section 25106 not to tax unitary earnings twice at the corporate level. Despite this clear ruling, Staff continues to hold to the mistaken belief that somehow the Court was confused and saw conflicts between existing regulations when no such conflict existed and that, by clarifying its existing regulations through this proposed regulation, all will be well. No matter how the Staff seeks to spin it, the bottom line is the Staff is seeking to overrule by regulation a valid, final decision by the Court of Appeal.

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2. *The proposed amendment references IRC section 316. IRC section 316 is only concerned with whether a distribution will constitute a dividend. It does not provide an ordering rule.*

The report did not accurately reflect our written comment. On page 2 of our comments we stated:

"First, the Staff incorrectly quotes IRC Sec. 316, finding an ordering rule where none exists. IRC Sec. 316 is only concerned with whether a distribution will constitute a dividend; return of capita; etc. and not with whether the distribution qualified for any dividend deductions, etc. which are provided for in other IRC Sections."

3. *The Court of Appeal set forth a different ordering rule from that suggested by staff. In doing so, staff ignores the court's reliance upon and favorable discussion of section 25106.*

On page 2 of our comments we quoted language from the court's decision regarding CRTC Section 25106 and the Legislature's intent 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." While this quote was taken from the court's discussion of the CFC Inclusion ratio issue, the quotation is nevertheless applicable to the ordering rule discussion. The Court in the ordering rule discussion (starting on page 480) noted that the superior court's decision directs that CRTC section 25106 should apply in a manner that deems dividends to be distributed first from income that has already included in the unitary group and then from the non-unitary income. Such a ruling stems from the afore-mentioned Legislative intent regarding CRTC Section 25106. The Court stated:

> For the reasons indicated above, **including those relied on by the trial court**, we conclude that dividends 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 . . . (emphasis added.),

The citation is appropriate.

4. *The staff's proposed ordering rule misapplies federal authorities it cites.*

Proposed amendment to Reg. Sec. 24411(e)(1) provides that 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**. While the proposed amendment tracks the wording of Treas. Reg. Sec. 1.316-2(a), it adds the bold language. Federal regulations clearly provide that a distribution is paid either out of current year's earnings and profits or from accumulated earnings and profits. There is no segregation of the earnings and profits by year other than for the current year. Since Staff cites IRC Sec. 316 which it notes is incorporated in CRTC Section 24451, it overreached when it sought to include the bolded language.

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Very truly yours

Barry Weissman

Barry Weissman
Director
Tax

cc: Mr. Christopher Whitney, PricewaterhouseCoopers LLP, Orange County

*120 Cal. App. 4th 459, *; 15 Cal. Rptr. 3d 473, **;*
*2004 Cal. App. LEXIS 1084, ***; 2004 Cal. Daily Op. Service 6085*

FUJITSU IT HOLDINGS, INC., Plaintiff and Respondent, v. FRANCHISE TAX BOARD, Defendant and Appellant. FUJITSU IT HOLDINGS, INC., Plaintiff and Appellant, v. FRANCHISE TAX BOARD, Defendant and Respondent.

A101101, A101203 & A102558

COURT OF APPEAL OF CALIFORNIA, FIRST APPELLATE DISTRICT, DIVISION TWO

120 Cal. App. 4th 459; 15 Cal. Rptr. 3d 473; 2004 Cal. App. LEXIS 1084; 2004 Cal. Daily Op. Service 6085; 2004 Daily Journal DAR 8243

July 7, 2004, Filed

SUBSEQUENT HISTORY: Time for Granting or Denying Review Extended Fujitsu It Holdings, Inc. v. Franchise Tax Board, 2004 Cal. LEXIS 9881 (Cal., Oct. 13, 2004)
Review denied by, Request denied by Fujitsu It Holdings v. Franchise Tax Bd., 2004 Cal. LEXIS 10228 (Cal., Oct. 20, 2004)

PRIOR HISTORY: [*1]** Superior Court of the City and County of San Francisco, No. 321296, Thomas Mellon, Judge.

DISPOSITION: The judgment is affirmed.

CASE SUMMARY:

PROCEDURAL POSTURE: Defendant California Franchise Tax Board (FTB) challenged a decision of the San Francisco County Superior Court (California), which (1) ruled in favor of plaintiff corporate taxpayer on its claims related to assessments by the FTB, except for the taxpayer's claim that Cal. Rev. & Tax. Code § 24411(a) violated U.S. Const. art. I, § 8, and (2) granted the taxpayer attorney fees. The taxpayer cross-appealed the constitutional issue.

OVERVIEW: The taxpayer, as the parent company of its unitary group, made a water's-edge election effective for certain tax years. The taxpayer objected to certain tax assessments by the FTB. The taxpayer then filed a tax refund action, and the trial court ruled in its favor, except for the taxpayer's constitutional challenge to California's treatment of dividends from foreign subsidiaries. On appeal, the court affirmed. The court agreed that refunds of a United Kingdom tax called the Advance Corporation Tax (ACT) had to be treated as dividends for California tax purposes, given the definition of dividend income in Cal. Rev. & Tax. Code § 24451 and former Cal. Rev. & Tax. Code § 24495. The court endorsed the trial court's conclusion that the legislative scheme contemplated that dividends paid out of unitary income of lower-tier subsidiaries were to be excluded from all the factors used in the computation of the amount included under Cal. Rev. & Tax. Code § 25110(a)(6). The court affirmed the ruling that California's water's-edge reporting method did not unconstitutionally discriminate against foreign commerce, and the taxpayer was properly awarded fees under Cal. Rev. & Tax. Code § 19717.

OUTCOME: The court affirmed.

CORE TERMS: dividend, subsidiary, refund, water, edge, combined, taxation, protest, earnings, shareholder, inclusion, ratio, unitary business, dividends received, unitary group, franchise tax, foreign commerce, domestic, dividends paid, tax credit, foreign subsidiaries, apportionment, recipient, tax year, affiliate, discriminate, substantially justified, eliminated, reporting, taxed

LexisNexis(R) Headnotes

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations

HN1 The California Franchise Tax Board (FTB) is the state agency empowered to determine the California tax liability of multistate or multinational corporations. Cal. Rev. & Tax. Code § 23001 et seq. The FTB has the authority to audit the operations of such corporations. Cal. Rev. & Tax. Code § 26423.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations

HN2 A unitary business has been judicially defined as one in which the following factors are present: (1) unity of ownership; (2) unity of operations, as evidenced by central accounting, purchasing, advertising, and management divisions; and (3) unity of use in a centralized executive force and general system of operation. A unitary business is one that receives income from or attributable to sources both within and without the state. Cal. Rev. & Tax. Code § 25101. If a unitary business exists, taxes are apportioned based on property, payroll, and sales to allocate to California for taxation its fair share of the taxable values of the taxpayer.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Tax Law > International Tax > Americans Operating Abroad > Controlled Foreign Corporations (IRC secs. 951-964)

HN3 In 1986, California passed legislation permitting taxpayers to make a "water's-edge" election. Under the water's-edge method, qualified taxpayers determine their income derived from or attributable to California by including only a formula-based allocation of the income from California and United States-based affiliated entities. Essentially, California's water's-edge method is an accepted accounting method using the United States as the jurisdictional boundary. Thus, generally speaking, the effect of a water's-edge election is for the taxpayer to account only for the income and apportionment factors of affiliates incorporated in the United States, subject to a number of exceptions for certain types of income produced by foreign affiliates. The relevant exception, Cal. Rev. & Tax. Code § 25110(a)(6), adds to the water's-edge group a portion of the income and apportionment factors of affiliates that are controlled by foreign corporations if all or part of their income is "Subpart F" income.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Tax Law > International Tax > Americans Operating Abroad > Controlled Foreign Corporations (IRC secs. 951-964)

HN4 Subpart F income gets its name from Subpart F of the Internal Revenue Code, as defined in I.R.C. § 952. It includes certain forms of passive income earned by controlled foreign corporations (CFCs)--for example, dividends, income from bank accounts, and stock investments. Subpart F of the Internal Revenue Code (I.R.C. §§ 951-964) was enacted to deter taxpayers from using foreign subsidiary corporations to accumulate earnings in countries that impose no taxes on accumulated earnings. Thus, under the water's edge method of taxation, a portion of the income of CFCs that have Subpart F income (that which is not taxed in the foreign countries in which it is earned) is included in the water's-edge group's combined income.

Civil Procedure > Appeals > Standards of Review > Substantial Evidence Rule
Governments > Legislation > Interpretation
Civil Procedure > Appeals > Standards of Review > De Novo Review

HN5 On appeal, the appellate court applies the substantial evidence test to the trial court's factual findings, but reviews legal determinations independently. In the appellate court's review, the appellate court is mindful of the California Supreme Court's declaration that ambiguities in the governing statutes are resolved in favor of the taxpayer.

Tax Law > State & Local Tax > Administration & Proceedings
HN6 The legislature has delegated to the California State Board of Equalization (SBE) the duty of hearing and determining appeals from actions of the California Franchise Tax Board. Cal. Rev. & Tax. Code §§ 19045-19048. It has been judicially recognized that the SBE has accumulated a body of experience and informed judgment in the administration of the business tax law to which the courts and litigants may properly resort for guidance.

Administrative Law > Judicial Review > Standards of Review > Standards Generally
HN7 The level of deference due to an agency's statutory and regulatory interpretation turns on a legally informed, common sense assessment of its merit in the context presented. An agency's consistent maintenance of the interpretation under scrutiny, especially if it is long-standing, is a circumstance which weighs in favor of judicial deference. This rule is supported by practical considerations. When an administrative interpretation is of long standing and has remained uniform, it is likely that numerous transactions have been entered into in reliance thereon, and it could be invalidated only at the cost of major readjustments and extensive litigation.

Administrative Law > Agency Rulemaking > Rule Application & Interpretation
HN8 The fact that an agency changes its interpretation of a statute is not evidence that either interpretation was legally impermissible. In the general case, of course, an administrative agency may change its interpretation of a statute, rejecting an old construction and adopting a new. Put simply, an administrative agency is not disqualified from changing its mind.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Tax Law > International Tax
HN9 Under United Kingdom tax law, a U.K. corporation that paid a dividend to its shareholders was required to pay the Advance Corporation Tax (ACT) to the U.K.'s taxing authority, U.K. Inland Revenue. Also under U.K. law, the ACT was deemed an advance payment in partial or full satisfaction of the paying corporation's general U.K. corporate income tax, and the paying corporation used the ACT to reduce its corporate tax liability on its taxable profits. The ACT was also deemed a payment of tax if the recipient of the dividend was a U.K. resident. Thus, the U.K. resident recipient of such a dividend received a tax credit from the U.K. taxing authority for the amount of the ACT payment made by the corporation that related to the dividend received by the resident. The tax credit was refundable to the dividend recipient, if the recipient's tax owed was less than the credit.

Tax Law > International Tax > Americans Operating Abroad > Foreign Tax Credits (IRC secs. 901-908)
HN10 Under United Kingdom domestic law, the tax credit attached to a dividend paid by a U.K. company is not generally available to a shareholder who is not a U.K. resident. Thus, in the absence of an income tax treaty, a nonresident shareholder of a U.K. company receiving a dividend would suffer double taxation--once in the U.K. at the corporate level (the Advance Corporation Tax payment) and once in his or her home country at the shareholder level.

Tax Law > International Tax > Americans Operating Abroad > Foreign Tax Credits (IRC secs. 901-908)
Tax Law > International Tax > Americans Operating Abroad > Tax Treaties (IRC secs. 894, 6114)

HN11 Effective in 1980, the United States and the United Kingdom entered into a treaty commonly referred to as the Income Tax Treaty, Dec. 31, 1975, as amended by an Exchange of Notes, signed on Apr. 13, 1976, and Protocols, signed on Aug. 26, 1976, Mar. 31, 1977, and Mar.15, 1979, U.S-U.K., which imputes some of the benefits of the U.K. system to U.S. shareholders. Under the Tax Treaty, the U.S. parent corporation will generally be entitled (assuming it owns at least 10 percent of the voting stock of the U.K. company) to a payment from the U.K. Inland Revenue of a tax refund (not a tax credit) equal to one-half the tax credit which would be received by a U.K. individual shareholder, less an amount not exceeding five percent of the aggregate of the dividend and the tax credit.

Tax Law > International Tax > Americans Operating Abroad > Foreign Tax Credits (IRC secs. 901-908)
Tax Law > International Tax > Americans Operating Abroad > Tax Treaties (IRC secs. 894, 6114)

HN12 The United Kingdom Inland Revenue has allowed many U.K. corporations with United States shareholders to pay the additional tax refund directly to their U.S. shareholders, thereby avoiding the need for the U.S. shareholders to claim a refund from Inland Revenue. Under this arrangement, the U.K. company also pays a correspondingly lesser amount of the Advance Corporation Tax (ACT) on the dividend to Inland Revenue (the amount Inland Revenue would refund directly to the non-resident shareholder under the Income Tax Treaty, Dec. 31, 1975, as amended by an Exchange of Notes, signed on Apr. 13, 1976, and Protocols, signed on Aug. 26, 1976, Mar. 31, 1977, and Mar.15, 1979, U.S-U.K.), although the U.K. corporation is given credit for the full amount of the ACT. Overall, through the mechanism of the Treaty, a U.S. shareholder of a U.K. corporation gains some relief by receiving a tax refund (either from Inland Revenue or the corporation directly) for a portion of the ACT payable by the U.K. corporation to Inland Revenue.

Tax Law > International Tax > Americans Operating Abroad > Foreign Tax Credits (IRC secs. 901-908)
Tax Law > International Tax > Americans Operating Abroad > Tax Treaties (IRC secs. 894, 6114)

HN13 See Income Tax Treaty, Dec. 31, 1975, as amended by an Exchange of Notes, signed on Apr. 13, 1976, and Protocols, signed on Aug. 26, 1976, Mar. 31, 1977, and Mar.15, 1979, U.S-U.K., art. 10(2)(a)(iii).

Tax Law > International Tax > Americans Operating Abroad > Foreign Tax Credits (IRC secs. 901-908)

HN14 The Income Tax Treaty, Dec. 31, 1975, as amended by an Exchange of Notes, signed on Apr. 13, 1976, and Protocols, signed on Aug. 26, 1976, Mar. 31, 1977, and Mar.15, 1979, U.S-U.K., envisions that the Advance Corporation Tax part of the United Kingdom corporate tax would be refunded directly to the United States shareholder and, for U.S. tax purposes, be treated as an additional dividend distribution to be added to the shareholder's dividend income.

Tax Law > International Tax > Americans Operating Abroad > Foreign Tax Credits (IRC secs. 901-908)
Tax Law > Federal Taxpayer Groups > C Corporations > Dividends (IRC secs. 316, 561-565)
Tax Law > International Tax > Americans Operating Abroad > Tax Treaties (IRC secs. 894,

6114)

HN15 The tax treaties into which the United States has entered do not generally cover the taxing activities of subnational governmental units such as states. However, the characterization of the Advance Corporation Tax (ACT) refund by the Income Tax Treaty, Dec. 31, 1975, as amended by an Exchange of Notes, signed on Apr. 13, 1976, and Protocols, signed on Aug. 26, 1976, Mar. 31, 1977, and Mar.15, 1979, U.S-U.K., as additional dividend income to the taxpayer appears to be the result most supported by both the mechanics of the ACT refund system and California's definition of dividend income, which tracks the federal definition. Former Cal. Rev. & Tax. Code § 24495 and Cal. Rev. & Tax. Code § 24451 directly incorporate the federal definition of dividends from I.R.C. § 316.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Tax Law > International Tax > Americans Operating Abroad > Controlled Foreign Corporations (IRC secs. 951-964)

HN16 To determine the includable portion of a controlled foreign corporation's Subpart F foreign source income in the water's-edge report, Cal. Rev. & Tax. Code § 25110 (a)(6) sets out a computation formula.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Tax Law > International Tax > Americans Operating Abroad > Controlled Foreign Corporations (IRC secs. 951-964)

HN17 The income of controlled foreign corporations (CFCs) in a water's-edge group that has Subpart F income is potentially subject to California tax. The portion of the CFCs' income to be included in the group's combined income is determined by the inclusion ratio set forth in Cal. Rev. & Tax. Code § 25110(a)(6). The inclusion ratio is defined as the following fraction: CFC's Subpart F income over CFC's earnings and profits.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Tax Law > International Tax > Americans Operating Abroad > Controlled Foreign Corporations (IRC secs. 951-964)

HN18 Cal. Rev. & Tax. Code § 25110(a)(6) defines Subpart F income as income defined in I.R.C. § 952 of Subpart F, and earnings and profits as defined in I.R.C. § 964. The resulting fraction may not be less than zero nor more than one. The controlled foreign corporation's (CFC) subsidiary's inclusion ratio is then multiplied by its net income to obtain the amount of the CFC's income to be included in the water's-edge group's combined income. This statutory formulation results in the inclusion of Subpart F income, increased (or decreased, as the case may be) by a pro-rata share of California adjustments.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Tax Law > International Tax > Americans Operating Abroad > Controlled Foreign Corporations (IRC secs. 951-964)

HN19 See Cal. Rev. & Tax. Code § 25110(a)(6).

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Tax Law > International Tax > Americans Operating Abroad > Controlled Foreign Corporations (IRC secs. 951-964)

HN20 California incorporates the federal definition of Subpart F income though Cal. Rev. & Tax. Code § 25110(a)(6) and Cal. Code Regs. tit. 18, § 25510(d)(2)(F)(i). Additionally, in determining whether a corporation has Subpart F income for a given year, certain federal exclusions and special rules apply. Cal. Code Regs. tit. 18, § 25510, subd. (d)(2)(F)(iii).) In the case of dividends that are received by foreign subsidiaries from lower tier foreign subsidiaries, I.R.C. § 959(b) excludes from gross income such dividends to the extent that they are, or have been included in the gross income of a U.S. shareholder under Subpart F. Under U.S. Treasury Regulations, Subpart F income excludes distributions of previously taxed income under I.R.C. § 959(b). 26 C.F.R. § 1.954-2(b)(1)(i) (renumbered § 4.954-2(b)(1)(i)).

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Tax Law > International Tax > Americans Operating Abroad > Controlled Foreign Corporations (IRC secs. 951-964)

HN21 It is clear that California has chosen to measure Subpart F income by incorporating the federal definition--a standard that implies California's willingness to follow the federal lead. In defining Subpart F income for purpose of calculating the inclusion ratio defined in Cal. Rev. & Tax. Code § 25110(a)(6), absent clear language in the statute or in administrative regulations refusing to do so, the court may assume California has adopted into its definition of Subpart F income the federal exclusions, including distributions of previously taxed income under I.R.C. § 959(b). 26 C.F.R. § 1.954-2(b)(1)(i) (renumbered § 4.954-2(b)(1)(i)).

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations

HN22 See Cal. Rev. & Tax. Code § 25106.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations

HN23 The legislature could hardly have chosen words with a clearer meaning. Simply put, Cal. Rev. & Tax. Code § 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 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 taxed twice--once as earnings of the issuing subsidiary, and once as separate income to the unitary business from receipt of the dividend.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Governments > Legislation > Interpretation

HN24 It is elementary that the objective of statutory interpretation is to ascertain and effectuate legislative intent. The first step in determining that intent is to scrutinize the actual words of the statute, giving them a plain and common sense meaning. If there is no ambiguity in the statutory language, a court must presume that the legislature meant what it said, and the plain meaning of the statute governs. Because the language of Cal. Rev. & Tax. Code § 25106 is clear and unambiguous, it would be improper for the court to refer to extrinsic evidence in an attempt to create an ambiguity from which the court could construe the statute to mean something other than what it says.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations

HN25 The court must presume that the legislature was well aware of the rules governing intercompany dividends, including Cal. Rev. & Tax. Code § 25106, when it enacted Cal. Rev. & Tax. Code § 25110(a)(6). Consequently, the court assumes that, at the time it enacted § 25110(a)(6), the legislature was aware that Cal. Rev. & Tax. Code § 25106 made intercompany dividends paid from unitary income nontaxable and provided such dividends shall not be taken into account in any manner in determining the tax of any member of the group.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations

HN26↓The court endorses the trial court's conclusion that the legislative scheme contemplates that dividends paid out of unitary income of lower-tier subsidiaries should be excluded from all the factors used in the computation of the amount included under Cal. Rev. & Tax. Code § 25110(a)(6): that is, such dividends should be excluded from the numerator (Subpart F income), the denominator (earnings and profits), and the amount to which the inclusion ratio is applied (the income of the controlled foreign corporation). The court is persuaded that is the only conclusion possible from the plain and unambiguous language of Cal. Rev. & Tax. Code § 25106.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
HN27↓Generally speaking, Cal. Rev. & Tax. Code § 24411(a) provides that 75 percent of dividends received by the water's-edge group, and not eliminated by Cal. Rev. & Tax. Code § 25106, can be deductible for purposes of computing the taxable income for the combined report. The ordering determines whether the dividend elimination or dividend deduction provision applies, that is, § 25106 (100 percent deduction for earnings previously included in a California combined return) or Cal. Rev. & Tax. Code § 24411(a) (75 percent "dividends received" deduction).

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Tax Law > International Tax > Americans Operating Abroad > Controlled Foreign Corporations (IRC secs. 951-964)
HN28↓Cal. Rev. & Tax. Code § 25106 should be applied to dividends from controlled foreign corporations (CFCs) that are partially included in the water's-edge group under Cal. Rev. & Tax. Code § 25110(a)(6) in a manner that deems dividends to be distributed first from income that has already been included in the unitary group, to the extent thereof, and then from the non-unitary income. Consequently, under this ruling, such dividends would be deemed to have been paid first out of already taxed, unitary group income (subject to elimination under Cal. Rev. & Tax. Code § 25106), and only after the § 25106 income had been exhausted would they be taxed at the 25 percent rate remaining after application of Cal. Rev. & Tax. Code § 24411(a)'s 75 percent dividends received deduction.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
HN29↓A taxpayer may be eligible for a deduction under Cal. Rev. & Tax. Code § 24402. Section 24402 provides that, even in the absence of a unitary business, where the payor corporation was subject to California tax, the recipient corporation may deduct from its gross income dividends that were declared from income already included in the measure of California franchise tax imposed upon the payor corporation. The purpose of this deduction is to avoid double taxation. In order for the recipient corporation to claim the California deduction, however, the payor corporation must have had income from sources in California so that the payor corporation was subject to California tax.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
HN30↓For 1989 and later years, regulations under Cal. Rev. & Tax. Code § 24411(a) provided that dividends paid by partially included corporations would be treated as prorated between amounts eligible for Cal. Rev. & Tax. Code § 25106 elimination and amounts eligible for partial deduction under Cal. Rev. & Tax. Code § 24411. However, commencing in 2001, the California Franchise Tax Board's new unitary combined reporting intercompany transaction regulations seem to indicate that, when a dividend is paid out of a mix of previously included and non-previously included income, any earnings previously included in the unitary group are deemed to be distributed first, dollar-for-dollar. Cal. Code Regs. tit. 18, § 25106.5-1(f)(2).

Governments > Legislation > Interpretation

HN31↓In the absence of any clear and controlling guidance on the question, the court's construction is to favor the taxpayer rather than the government. Furthermore, the court 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, wherever possible, the court will interpret a statute as consistent with applicable constitutional provisions, seeking to harmonize Constitution and statute.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Tax Law > International Tax > Americans Operating Abroad > Controlled Foreign Corporations (IRC secs. 951-964)

HN32↓The court concludes that dividends paid by first-tier subsidiaries from current year earnings should be treated as paid (1) first out of earnings eligible for elimination under Cal. Rev. & Tax. Code § 25106, with (2) any excess paid out of earnings eligible for partial deduction under Cal. Rev. & Tax. Code § 24411. In the case of a controlled foreign corporation (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.

Constitutional Law > Congressional Duties & Powers > Commerce Clause

HN33↓See U.S. Const. art. I, § 8, cl. 3.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Constitutional Law > Congressional Duties & Powers > Commerce Clause

HN34↓The term "commerce" includes the flow of dividends from a foreign subsidiary to its parent company.

Constitutional Law > Congressional Duties & Powers > Commerce Clause

HN35↓The foreign Commerce Clause not only grants Congress the authority to regulate commerce between the United States and foreign nations, it also directly limits the power of the states to discriminate against foreign commerce. This is commonly referred to as the dormant or negative aspect of the foreign commerce clause. The dormant aspect of the foreign Commerce Clause serves two related purposes. First, it prevents states from promulgating protectionist policies. Second, it restrains the states from excessive interference in foreign affairs, which are the domain of the federal government. Because matters of concern to the entire nation are implicated, the constitutional prohibition against state taxation of foreign commerce is broader than the protection afforded to interstate commerce.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Constitutional Law > Congressional Duties & Powers > Commerce Clause

HN36↓A court limited the holding in case law to states that do not use a combined water's edge or domestic combination reporting method. The court reasoned that a combined reporting state (that is, water's edge) does not discriminate against foreign subsidiaries. While the foreign subsidiaries' dividend payments to the unitary business are taxed, its total income is not included in the unitary business overall income. Conversely, while a domestic subsidiary's dividend payments to the unitary business is not taxed, its total income is included in the unitary business overall income. Thus, no discrimination against foreign commerce occurs.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations

HN37 Far from discriminating against foreign commerce, Maine's water's edge combined reporting method provides a type of taxing symmetry that is not present under the single entity system. Because the income of the unitary domestic affiliates is included, apportioned, and ultimately directly taxed by Maine as part of the parent company's income, the inclusion of dividends paid by foreign subsidiaries does not constitute the kind of facial discrimination against foreign commerce that caused the invalidation of Iowa's tax scheme in case law.

Tax Law > State & Local Tax > Income Tax > Corporations & Unincorporated Associations
Constitutional Law > Congressional Duties & Powers > Commerce Clause
HN38 The court finds the rationales of other courts to be persuasive and holds that California's water's-edge method of apportionment of income does not facially discriminate against foreign commerce. In the case of California's water's-edge reporting method, foreign subsidiaries' dividends are partially included, while the entirety of domestic subsidiaries' income is included, in the water's-edge combined report. In addition, California gives those included foreign subsidiary dividends a 75 percent dividends received deduction from the water's-edge group's combined income pursuant to Cal. Rev. & Tax. Code § 24411. Thus, the same kind of taxing symmetry present in case law is present here. Therefore, the holding in other case law does not apply to these facts. The court affirms the ruling that California's water's-edge reporting method does not unconstitutionally discriminate against foreign commerce on this basis.

Governments > Legislation > Statutes of Limitations > Time Limitations
Tax Law > State & Local Tax > Administration & Proceedings
HN39 The statute of limitations applicable to tax refund suits is Cal. Rev. & Tax. Code § 19384.

Governments > Legislation > Statutes of Limitations > Time Limitations
Tax Law > State & Local Tax > Administration & Proceedings
HN40 See Cal. Rev. & Tax. Code § 19384.

Tax Law > State & Local Tax > Administration & Proceedings
HN41 Cal. Rev. & Tax. Code § 19335 provides that a taxpayer may pay a tax under protest, before the California Franchise Tax Board acts on a claim or the California State Board of Equalization acts on an appeal, in which case the protest is treated as a claim for a refund or an appeal from the denial of a claim for refund.

Governments > Legislation > Statutes of Limitations > Time Limitations
Tax Law > State & Local Tax > Administration & Proceedings
HN42 Cal. Rev. & Tax. Code § 19041.5 allows the taxpayer to make a payment to stop the accrual of interest or to cover non-protested tax without having those funds considered a payment of taxes that would trigger the Cal. Rev. & Tax. Code § 19384 statute of limitations regarding claims for refund. As the legislature recognized, Cal. Rev. & Tax. Code § 19041.5 simply codifies existing California Franchise Board practice.

Tax Law > State & Local Tax > Administration & Proceedings
HN43 See Cal. Rev. & Tax. Code § 19041.5(a).

Civil Procedure > Costs & Attorney Fees > Litigation Costs
Civil Procedure > Costs & Attorney Fees > Attorney Fees
Tax Law > State & Local Tax > Administration & Proceedings
HN44 Cal. Rev. & Tax. Code § 19717 provides that a party who brings a civil proceeding against the state to recover franchise taxes may recover reasonable litigation

costs, including attorney fees, if: (1) the suit is brought in a California court; (2) the party has exhausted its administrative remedies under the applicable tax laws; (3) the party establishes that the position of the state was not substantially justified; and (4) the party substantially prevails.

Civil Procedure > Costs & Attorney Fees > Attorney Fees
Tax Law > State & Local Tax > Administration & Proceedings
Evidence > Procedural Considerations > Burdens of Proof

HN45 California cases have defined a substantially justified position to mean one which is justified to a degree that would satisfy a reasonable person, or has a reasonable basis both in law and fact. The use of the word "reasonable" in explaining "substantially justified" implies an objective standard that does not depend on an analysis of the subjective motivations of the government in taking the position it did. In this regard, the court stresses that the California Franchise Tax Board's position need not be the one accepted by the trier of fact. So long as the position is one that a reasonable person could think is correct, it may be substantially justified even in the face of conflicting evidence. Finally, the burden of showing substantial justification is on the Board, not the taxpayer. Cal. Rev. & Tax. Code § 19717(c)(2)(B)(ii).

Civil Procedure > Costs & Attorney Fees > Attorney Fees
Tax Law > State & Local Tax > Administration & Proceedings

HN46 Where a lawsuit consists of related claims and the taxpayer has won substantial relief, the court believes a trial court has discretion to award the taxpayer attorney fees for discrete issues under Cal. Rev. & Tax. Code § 19717, even if the issues for which fees are awarded do not represent the bulk of the amount in controversy or the most significant issues in the case. To hold otherwise would allow the government free rein to adopt positions and argue issues that are not substantially justified so long as the issues are less significant than other issues in the case. To the extent that an award of attorney fees will act as a disincentive to the California Franchise Tax Board to take positions that it cannot substantially justify, the court believes such an award is well within the trial court's discretion.

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JUDGES: Opinion by Ruvolo, J., with Kline, P. J., and Haerle, J., concurring.)

OPINIONBY: RUVOLO

OPINION: [476] RUVOLO, J.--**

I.

Introduction

Amdahl Corporation (Amdahl), n1 a multinational business, sought a refund of $ 3,390,388 in taxes arising from assessments by the Franchise Tax Board (FTB) for the tax years 1988, 1989, 1991 and 1992. In the underlying tax refund action, Amdahl alleged that the FTB improperly assessed taxes against it for these years based on its erroneous treatment of dividends distributed by Amdahl's first-tier and second-tier subsidiaries. Specifically, Amdahl claimed that the FTB: 1) incorrectly treated tax credit payments from Amdahl's United Kingdom subsidiaries as nondividend income; 2) incorrectly computed the inclusion ratio used to determine how much of the income of Amdahl's **[***2]** foreign subsidiaries should be included in the combined income of the "water's-edge" group; and 3) incorrectly applied Revenue and Taxation Code sections 25106 and 24411 n2 to dividends received from Amdahl's foreign subsidiaries. n3 Amdahl also alleged that the FTB erred in concluding that its tax refund action, as it relates to tax year 1988, was not timely filed. Finally, Amdahl claimed that California's "water's-edge" **[**477]** method of apportioning the combined income of a unitary business group for tax purposes improperly discriminates against foreign subsidiaries in favor of domestic **[*468]** subsidiaries, in violation of the commerce clause of the United States Constitution (U.S. Const., art. I, § 8).

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n1 Amdahl Corporation has changed its name to Fujitsu IT Holdings, Inc. For convenience, however, we will continue to refer to Amdahl, as it was known throughout the tax years at issue.

n2 All further undesignated statutory references are to the Revenue and Taxation Code.

n3 The parties, for purposes of this case, have stipulated to the dollar amounts involved in each of these disputed issues and have provided the court with detailed calculations to illustrate the differences between each party's position in this case. We will not add to the length of this opinion by reprinting these calculations, but assure the parties that they have been considered in resolving the issues presented.

- - - - - - - - - - - - End Footnotes- - - - - - - - - - - - - - **[***3]**

After the State Board of Equalization (the SBE) rejected Amdahl's arguments, it filed the underlying action in the superior court. The matter was tried to the court largely on stipulated facts. Amdahl prevailed on each issue except for its constitutional claim.

We now consider three consolidated appeals. In Appeal No. A101101, the FTB appeals from the superior court judgment in the underlying action; in Appeal No. A102558, the FTB appeals from a post-judgment order granting Amdahl attorney fees; and in Appeal No. A101203, Amdahl has cross-appealed the constitutional issue. We affirm in all respects.

II.

Facts and Procedural History

Amdahl, headquartered in Sunnyvale, California, is a Delaware corporation engaged in the business of providing integrated computer solutions to meet the needs of many of the largest users of information technology in the world. Amdahl operates extensively throughout the United States, Europe, and Asia, often through various subsidiaries and holding companies.

HN1 *CA(1)* **(1)** The FTB is the state agency empowered to determine the California tax liability of multistate or multinational corporations, such as Amdahl. (§ 23001 et seq.) The FTB has the authority **[***4]** to audit the operations of such corporations. (§ 26423; *Franchise Tax Board v. Firestone Tire & Rubber Co.* (1978) 87 Cal. App. 3d 878 [151 Cal. Rptr. 460].)

The issues in this case may be more easily understood if Amdahl's corporate structure and several rather esoteric tax terms are first explained. During 1988 through 1992, the tax years at issue, Amdahl and its subsidiaries, including Amdahl International Corporation (AIC); Amdahl (U.K.) Ltd.; Amdahl International Management Services (AIMS); Amdahl Ireland, AOCC; Amdahl Lease BV; and Amdahl Netherlands BV, were treated as engaged in a single unitary business. (See §§ 25101, 25102; *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472, 479 [183 P.2d 16].) *HN2*CA(2)**(2)** A unitary business has been judicially defined as one in which the following factors are present: (1) unity of ownership; (2) unity of operations, as evidenced by central accounting, purchasing, advertising, and management divisions; and (3) unity of use in a centralized executive force and general system of operation. (*Dental Ins. Consultants, Inc. v. Franchise Tax Bd.* (1991) 1 Cal.App.4th 343 [1 Cal. Rptr. 2d 757]; *Butler Brothers v. McColgan* (1941) 17 **[*469]** Cal.2d 664 [111 P.2d 334].) **[***5]** A unitary business is one that receives income "from or attributable to sources both within and without the state ... ." (§ 25101.) If a unitary business exists, taxes are apportioned based on property, payroll, and sales to allocate to California for taxation "its fair share of the taxable values of the taxpayer ... ." (*Butler Brothers v. McColgan*, *supra*, 17 Cal.2d at pp. 667-668.)

*HN3*In 1986, California passed legislation permitting taxpayers to make a "water's-edge" election. *CA(3)***(3)** Under the water's-edge method, qualified taxpayers determine their income derived from or attributable to California by including only a formula-based allocation of the income from California and United States (U.S.)- **[**478]** based affiliated entities. *CA(4)***(4)** Essentially, California's water's-edge method is an accepted accounting method using the United States as the jurisdictional boundary. Thus, generally speaking, the effect of a water's-edge election is for the taxpayer to account only for the income and apportionment factors of affiliates incorporated in the United States, subject to a number of exceptions for certain types of income produced by foreign affiliates, one of which is at issue in this **[***6]** case. The relevant exception, section 25110, subdivision (a)(6), adds to the water's-edge group a portion of the income and apportionment factors of affiliates that are controlled by foreign corporations (CFCs) n4 if all or part of their income is "Subpart F" income.

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n4 A CFC, generally, is organized in a foreign country and is more than 50 percent owned by U.S. shareholders.

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*HN4*CA(5)**(5)** Subpart F income gets its name from Subpart F of the Internal Revenue Code (IRC), as defined in IRC section 952. It includes certain forms of passive income earned by CFCs--for example, dividends, income from bank accounts, and stock investments. "Subpart F of the Internal Revenue Code (sections 951-964) was enacted to deter taxpayers from using foreign subsidiary corporations to accumulate earnings in countries that impose no taxes on accumulated earnings. [Citations.]" (*R.E. Dietz Corp. v. U.S.* (2nd Cir. 1991) 939 F.2d 1, 6.) Thus, as discussed more fully in a later section of this opinion, under the water's-edge method **[***7]** of taxation, a portion of the income of CFCs that have Subpart F income (that which is not taxed in the foreign countries in which it is earned) is included in the water's-edge group's combined income.

Amdahl, as the parent company of its unitary group, made a water's-edge election effective for each of the tax years at issue, and signed an agreement consenting to taxation under the water's-edge regime. Accordingly, Amdahl filed a water's-edge combined income tax return for each of the relevant tax years that included the combined income of its unitary group members incorporated in the U.S.--Amdahl Corporation and AIC--as well as income of its controlled foreign subsidiaries that earned Subpart F income. **[*470]**

Amdahl objected to certain tax assessments by the FTB for the tax years 1988, 1989, 1991 and 1992. The FTB rejected those objections. In administrative proceedings, the SBE determined all issues in the FTB's favor. Having paid the taxes in question, Amdahl filed the underlying tax refund action. The action was tried to the court largely on stipulated facts, supplemented by the testimony of witnesses and documentary evidence.

The trial court ruled in Amdahl's favor on all of the **[***8]** issues in this action, except Amdahl's constitutional challenge to California's treatment of dividends from foreign subsidiaries. Consequently, Amdahl was awarded tax refunds in the following amounts: $ 1.26 million for tax year 1988; $ 1.396 million for tax year 1989; and $ 254,000 for tax year 1992, for a total judgment of $ 2.676 million. This appeal and cross-appeal followed.

III.

Discussion

A. Standard of Review

HN5 *CA(6)* **(6)** On appeal, we apply the substantial evidence test to the trial court's factual findings, but review legal determinations independently. (*Metropolitan Life Ins. Co. v. State Bd. of Equalization* (1982) 32 Cal.3d 649, 658 [186 Cal. Rptr. 578, **[**479]** 652 P.2d 426]; *Parsons v. Bristol Development Co.* (1965) 62 Cal.2d 861, 865 [44 Cal. Rptr. 767, 402 P.2d 839]; *Southern Pacific Pipe Lines, Inc. v. State Bd. of Equalization* (1993) 14 Cal.App.4th 42, 54 [17 Cal. Rptr. 2d 345].) *CA(7)* **(7)** In our review, we are mindful of our Supreme Court's declaration that ambiguities in the governing statutes are resolved in favor of the taxpayer. (*Agnew v. State Bd. of Equalization* (1999) 21 Cal.4th 310, 326 [87 Cal. Rptr. 2d 423, 981 P.2d 52].)

As noted, in the earlier administrative proceedings, the SBE **[***9]** determined all issues in the FTB's favor. The parties dispute the degree of judicial deference owed to the SBE's decision in the underlying litigation between the FTB and Amdahl. *HN6* *CA(8)* **(8)** The Legislature has delegated to the SBE the duty of hearing and determining appeals from actions of the FTB. (§§ 19045-19048.) It has been judicially recognized that the SBE has accumulated a " 'body of experience and informed judgment' in the administration of the business tax law 'to which the courts and litigants may properly resort for guidance.' [Citation.]" (*Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 14 [78 Cal. Rptr. 2d 1, 960 P.2d 1031] (*Yamaha Corp.*).) Accordingly, the FTB claims we must accord "great weight" to the SBE's interpretation of the statutes and regulations at issue in this litigation. (*Id.* at pp. 12-13.) **[*471]**

Amdahl claims that the authoritative strength of the SBE's decision in this litigation is severely weakened by the fact that in several key issues in this case, the SBE has subsequently reevaluated its position and changed its mind. We agree with Amdahl on this point.

HN7 *CA(9)* **(9)** The level of deference due to an agency's statutory and regulatory interpretation **[***10]** turns on a legally informed, common sense assessment of its merit in the context presented. (*Yamaha Corp., supra*, 19 Cal.4th at p. 14.) An agency's consistent maintenance of the interpretation under scrutiny, " 'especially if [it] is long-standing, ...' " is a circumstance which weighs in favor of judicial deference. (*Id.* at p. 13, quoting *Culligan Water Conditioning v. State Bd. of Equalization* (1976) 17 Cal.3d 86, 93 [130 Cal. Rptr. 321, 550 P.2d 593].) This rule is supported by practical considerations. "When an administrative interpretation is of long standing and has remained uniform, it is likely that numerous transactions have been entered into in reliance thereon, and it could be invalidated only at the cost of major readjustments and extensive litigation. [Citations.]" (*Whitcomb Hotel, Inc. v. Cal. Emp. Com.* (1944) 24 Cal.2d 753, 757 [151 P.2d 233].)

CA(10) **(10)** As the FTB emphasizes, HN8 the fact that an agency changes its interpretation of a statute is not evidence that either interpretation was legally impermissible. (*Henning v. Industrial Welfare Com.* (1988) 46 Cal.3d 1262, 1269-1270 [252 Cal. Rptr. 278, 762 P.2d 442].) " 'In the general case, of **[***11]** course, an administrative agency may change its interpretation of a statute, rejecting an old construction and adopting a new. [Citations.] Put simply, "[a]n administrative agency is not disqualified from changing its mind ... ." [Citation.]' " (*Californians for Political Reform Foundation v. Fair Political Practices Com.* (1998) 61 Cal.App.4th 472, 488 [71 Cal. Rptr. 2d 606].) However, the fact that the SBE has vacillated in its decision on several key points entitles us to give its administrative decision only limited deference in deciding this case.

B. Characterization of ACT Refund for California Tax Purposes

Amdahl claims the FTB improperly assessed tax liability arising from refunds of **[**480]** a United Kingdom (U.K.) tax called the Advance Corporation Tax (ACT). The FTB characterized the ACT refunds as "nondividend gross income." Amdahl's position on this issue, which was accepted by trial court, was that the ACT refunds received by the U.S. parent of a U.K. subsidiary are "dividends" for California tax purposes, and are therefore subject to **[*472]** elimination under section 25106 or deduction under section 24411, subdivision (a). This issue concerns only the Amdahl subsidiaries **[***12]** incorporated in the U.K.--Amdahl International Management Services (AIMS) and Amdahl (U.K) Ltd. n5

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n5 AIC is a California corporation that is a wholly owned subsidiary of Amdahl operating as a U.S. holding company for foreign subsidiaries of Amdahl. AIMS, a U.K. corporation, is a wholly owned subsidiary of AIC. AIMS owns all of the shares of Amdahl (U.K.) Ltd., a U.K. corporation.

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CA(11) **(11)** For the tax years relevant here, HN9 under U.K. tax law, a U.K. corporation that paid a dividend to its shareholders was required to pay the ACT to the U.K.'s taxing authority, U.K. Inland Revenue (Inland Revenue). Also under U.K. law, the ACT was deemed an advance payment in partial or full satisfaction of the paying corporation's general U.K. corporate income tax, and the paying corporation used the ACT to reduce its corporate tax liability on its taxable profits. The ACT was also deemed a payment of tax if the recipient of the dividend was a U.K. resident. Thus, the U.K. resident recipient of such a dividend received a tax credit from **[***13]** the U.K. taxing authority for the amount of the ACT payment made by the corporation that related to the dividend received by the resident. (The tax credit was refundable to the dividend recipient if the recipient's tax owed was less than the credit.)

CA(12) **(12)** However, HN10 under U.K. domestic law, the tax credit attached to a dividend paid by a U.K. company is not generally available to a shareholder who is not a U.K. resident. Thus, in the absence of an income tax treaty, a nonresident shareholder of a U.K. company receiving a dividend would suffer double taxation--once in the U.K. at the corporate level (the ACT payment), and once in his or her home country at the shareholder level.

HN11 Effective in 1980, the U.S. and the U.K. entered into a treaty commonly referred to as the "Income Tax Treaty Between the United Kingdom and the United States" (United States-United Kingdom Income Tax Convention, Dec. 31, 1975, as amended by an Exchange of Notes, signed on April 13, 1976, and Protocols, signed on Aug. 26, 1976, March 31, 1977, and March 15, 1979, eff. April 25, 1980) (the Tax Treaty), which imputes some of the benefits of the U.K. system to U.S. shareholders. CA(13) **(13)** Under the Tax Treaty, the U.S. parent **[***14]** corporation will generally be entitled (assuming it owns at least 10 percent of the voting stock of the U.K. company) to a payment from the Inland Revenue of a tax refund (not a tax credit) equal to one-half the tax credit which would be received by a U.K. individual shareholder, less an amount not exceeding 5 percent of the aggregate of the dividend and the tax credit. **[*473]**

HN12 Inland Revenue has allowed many U.K. corporations with U.S. shareholders to pay the additional tax refund directly to their U.S. shareholders, thereby avoiding the need for the U.S. shareholders to claim a refund from Inland Revenue. Under this arrangement, the U.K. company also pays a correspondingly lesser amount of the ACT on the dividend to Inland Revenue (the amount Inland Revenue would refund directly to the non-resident shareholder under the Tax Treaty), although the U.K. corporation is given credit for the full amount of the ACT. Overall, through the **[**481]** mechanism of the Tax Treaty, a U.S. shareholder of a U.K. corporation gains some relief by receiving a tax refund (either from Inland Revenue or the corporation directly) for a portion of the ACT payable by the U.K. corporation to Inland Revenue.

As shown in documentary **[***15]** evidence submitted to the trial court, dividends declared and paid by Amdahl's U.K. subsidiaries, AIMS and Amdahl (U.K.) Ltd., triggered an ACT liability, one-half of which was refunded to AIMS's sole shareholder, AIC, a California corporation, pursuant to the terms of the U.S.-U.K. Tax Treaty. For example, Amdahl's U.K. subsidiaries paid $ 41.104 million in dividends to AIC in 1988. The ACT on the $ 41.104 million in dividends was $ 14,380,018. Pursuant to established procedures of Inland Revenue with respect to ACT refunds, AIMS actually paid only one-half of the ACT, or $ 7,190,009, directly to Inland Revenue. The other one-half of the ACT was paid directly by AIMS to AIC, less the 5 percent dividend withholding tax.

Amdahl treated the ACT refund as a dividend from AIMS to AIC on its federal tax returns for 1988 and 1991, and the IRS accepted such treatment. However, when Amdahl treated this ACT refund as a further dividend from AIMS to AIC in its California water's-edge combined returns, the FTB took the position that the refunded portion of the ACT received by AIC was nondividend gross income of AIC from the U.K. government. Amdahl asserts that treating the ACT refund as additional **[***16]** income is inconsistent with the language and purpose of the Tax Treaty, which clearly mandates that ACT refunds are to be treated as dividends to the U.S. recipient.

The SBE rejected Amdahl's appeal of the FTB's denial of its protest on the ACT refund issue in April 2000 (*Appeal of Amdahl Corp.* 9A-0054 (Apr. 6, 2000) Case Nos. 89002459110 & 29780, 2000 WL 781986). Nevertheless, in September 2000, less than six months later, the SBE reconsidered the identical issue of the treatment of ACT refunds for California franchise tax purposes in conjunction with another taxpayer's appeal and held that such refunds should be characterized as dividends (*Appeal of Thomas & Betts Corporation* (Sept. 15, 2000) Case No. 32822, 2001 WL 236812). This decision certainly represents a reversal by the SBE on this issue. **[*474]**

On balance, we find Amdahl's argument on this issue is more persuasive. Treating the ACT credit refunds as dividends, as Amdahl urges, will effect the purpose of the Tax Treaty. The salient Tax Treaty provision, as stipulated by the parties, reads: HN13 "the aggregate of the amount or value of the dividend and the [ACT refund] paid by the United Kingdom to **[***17]** the United States corporation or other resident (without reduction for the 5 or 15 percent deduction, as the case may be, by the United Kingdom) *shall be treated as a dividend for United States tax credit purposes*." (Tax Treaty, Art. 10(2)(a)(iii).) As the italicized language indicates, *HN14*the Tax Treaty envisions that the ACT part of the U.K. corporate tax would be refunded directly to the U.S. shareholder and, for U.S. tax purposes, be treated as an additional dividend distribution to be added to the shareholder's dividend income.

The FTB emphasizes that California is not bound by the Tax Treaty's pronouncements. (See *Container Corp. v. Franchise Tax Board* (1983) 463 U.S. 159, 196 [77 L. Ed. 2d 545, 103 S. Ct. 2933] *HN15*["[T]he tax treaties into which the United States has entered do not generally cover the taxing activities of subnational governmental units such as States ... ." (Fn. omitted.)].) However, the Tax Treaty's characterization **[**482]** of the ACT refund as additional dividend income to the taxpayer appears to be the result most supported by both the mechanics of the ACT refund system and California's definition of dividend income, which tracks the federal definition. (See **[***18]** former § 24495 and current § 24451, both of which directly incorporate the federal definition of dividends from section 316 of the IRC.)

We reject the FTB's argument that the ACT refund cannot be a California dividend because the refund is a payment from the U.K. government and Amdahl is not a shareholder in the U.K. government. This argument does not withstand close scrutiny because it ignores the U.K. government's role as that of a pass-through or agent that is legally obligated to forward the payment to a third party. In fact, in this case, consistent with its role as an intermediary or agent, the U.K. government did not even go through the formality of collecting the full amount of the ACT from the U.K. company, but permitted the ACT refund payment to be made directly to the U.S. parent by the U.K. subsidiary. *CA(14)***(14)** Accordingly, we agree with the trial court that the ACT refunds must be treated as dividends for California tax purposes. **[*475]**

C. Computation of the Inclusion Ratio

*HN16CA(15)***(15)** To determine the includable portion of a CFC's Subpart F foreign source income in the water's-edge report, section 25110, subdivision (a)(6) n6 sets out a computation formula, or what the trial court **[***19]** called "the inclusion ratio." In the case of Amdahl's first-tier CFCs (Amdahl Ireland, ANBV, and AIMS), the parties are in dispute as to whether or how dividends received by each of these first-tier subsidiaries from the corresponding second-tier subsidiary (AOCC, Amdahl Lease, and Amdahl U.K.) are taken into account in the determination of the inclusion ratio of the first-tier subsidiary. The trial court found that in its water's-edge combined report, Amdahl could completely exclude from this ratio the dividends paid out of income already included in the combined income of the group. n7 The FTB challenges this conclusion on appeal.

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n6 Current section 25110, subdivision (a)(6) was originally numbered section 25110, subdivision (a)(8), and then changed to section 25110, subdivision (a)(7), before receiving its current numbering.

n7 In a subsequent ruling involving another taxpayer, the SBE reversed the position it took in Amdahl's administrative appeal, and interpreted section 25110, subdivision (a)(6) in the same manner as the trial court. In other words, the SBE held that dividends paid out of included income of a lower-tier CFC should not taken into account in the determination of the inclusion ratio. (See Appeal of Baxter Healthcare Corp. (Aug. 1, 2002, rehg. denied Dec. 19, 2002), SBE Case No. 150881.)

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As previously noted, HN17 the income of CFCs in a water's-edge group that has Subpart F income is potentially subject to California tax. The portion of the CFCs' income to be included in the group's combined income is determined by the inclusion ratio set forth in section 25110, subdivision (a)(6). The inclusion ratio is defined as the following fraction:

CFC's Subpart F Income

CFC's Earnings and Profits HN18

Section 25110, subdivision (a)(6) defines Subpart F income as "income ... defined in Section 952 of Subpart F of the Internal Revenue Code ...," and earnings and profits "as defined in Section 964 of the Internal Revenue Code." n8 The resulting **[**483]** fraction may not be less than zero nor more than one. **[*476]** The CFC subsidiary's inclusion ratio is then multiplied by its net income to obtain the amount of the CFC's income to be included in the water's-edge group's combined income. As the trial court noted, "this statutory formulation results in the inclusion of Subpart F income, increased (or decreased, as the case may be) by a pro-rata share of California adjustments."

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n8 Section 25110, subdivision (a)(6) provides, in pertinent part, HN19 "Any affiliated corporation which is a 'controlled foreign corporation,' as defined in Section 957 of the Internal Revenue Code, if all or part of the income of that affiliate is defined in Section 952 of Subpart F of the Internal Revenue Code ('Subpart F income'). The income and apportionment factors of any affiliate to be included under this paragraph shall be determined by multiplying the income and apportionment factors of that affiliate without application of this paragraph by a fraction (not to exceed one), the numerator of which is the 'Subpart F income' of that corporation for that taxable year and the denominator of which is the 'earnings and profits' of that corporation for that taxable year, as defined in Section 964 of the Internal Revenue Code."

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The court went on to note that "[t]he issue upon which the parties are in dispute is how to compute the inclusion ratio in the case of a [CFC] that receives dividends from an affiliate that is also a [CFC] (a 'lower-tier subsidiary')." The court found that when a CFC receives a dividend that was paid by a lower-tier CFC out of earnings that were wholly included in the combined income of the water's-edge group, such dividend is excluded and is not taken into account in applying the inclusion ratio of section 25110, subdivision (a)(6) to the recipient CFC. While we agree with the trial court's result, we do not altogether adopt its reasoning.

CA(17) **(17)** As noted, with certain exceptions not relevant here, HN20 California incorporates the federal definition of Subpart F income through section 25110, subdivision (a)(6) and California Code of Regulations, title 18, section 25110, subdivision (d)(2)(F)(1). Additionally, in determining whether a corporation has Subpart F income for a given year, certain federal exclusions and special rules apply (Cal. Code Regs., § 25110, subd. (d)(2)(F)

(3).) In the case of dividends that are received by foreign subsidiaries from lower **[***22]** tier foreign subsidiaries, IRC section 959(b) excludes from gross income such dividends to the extent that they "are, or have been" included in the gross income of a U.S. shareholder under Subpart F. Under U.S. Treasury Regulations, Subpart F income *excludes* "distributions of previously taxed income under [IRC §] 959(b)." (26 CFR § 1.954-2(b)(1)(i); later renumbered § 4.954-2(b)(1)(i).)

Significantly, both Amdahl and the FTB agree that under the foregoing statutory and regulatory scheme, the dividends at issue here are excluded from Subpart F income under the federal definition. Nevertheless, the FTB argues that "[t]he fact that the dividends would be excluded for federal purposes as a result of the operation of IRC § 959(b) does not remove them from the 'Subpart F income' used to compute the inclusion ratio of the payee under the California Revenue and Taxation Code." The trial court agreed with this portion of the FTB's argument, finding that "in using the federal definition of Subpart F income in IRC § 952, California did not adopt IRC **[*477]** § 959 or its principles, and the exclusion in that Treasury regulation therefore has no application for California tax purposes." **[***23]**

We disagree with this conclusion. *HN21* *CA(18)* **(18)** It is clear that California has chosen to measure Subpart F income by incorporating the federal definition--a standard that implies California's willingness to follow the federal lead. In defining Subpart F income for purpose of calculating the inclusion ratio defined in section 25110, subdivision (a)(6), **[**484]** absent clear language in the statute or in administrative regulations refusing to do so, we may assume California has adopted into its definition of Subpart F income the federal exclusions, including "distributions of previously taxed income under [IRC §] 959(b)." (26 CFR § 1.954-2(b)(1)(i); later renumbered § 4.954-2(b)(1)(i).)

Nevertheless, there is a separate and distinct reason why the second-tier dividends at issue here must not be included in the inclusion ratio--section 25106 forbids it. Section 25106 provided the following for the years at issue in this case: *HN22* "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 corporations **[***24]** 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*." (Italics added.)

HN23 The Legislature could hardly have chosen words with a clearer meaning. *CA(19)* **(19)** 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 the 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 taxed twice--once as earnings of the issuing subsidiary, and once as separate income to the unitary business from receipt of the dividend.

The FTB acknowledges "there is no regulation which squarely addresses the question of whether [Revenue and Taxation Code (RTC)] section 25106 applies in computing **[***25]** the 'inclusion ratio' required by RTC section 25110(a)(6)." Nevertheless, by delving into the legislative history and purpose of section 25106, the FTB argues that section 25106 was never intended to be applied to the computation of the inclusion ratio, which is merely a measure of how much income of the CFC is included (subject to apportionment) in the water's-edge return. In making its point, the FTB emphasizes **[*478]** that "section 25106 was enacted in 1967, when Subpart F income and water's-edge tax reporting were unknown to the Revenue and Taxation Code."

The FTB has not provided us with a compelling reason to disregard the clear statutory language of section 25106. HN24 CA(20) **(20)** It is elementary that the objective of statutory interpretation is to ascertain and effectuate legislative intent. The first step in determining that intent is to scrutinize the actual words of the statute, giving them a plain and common sense meaning. (*Hughes v. Board of Architectural Examiners* (1998) 17 Cal.4th 763, 775 [72 Cal. Rptr. 2d 624, 952 P.2d 641].) If there is no ambiguity in the statutory language, a court must presume that the Legislature meant what it said, and the plain meaning of the statute governs. **[***26]** (*Lennane v. Franchise Tax Bd.* (1994) 9 Cal.4th 263, 268 [36 Cal. Rptr. 2d 563, 885 P.2d 976].) Because the language of section 25106 is clear and unambiguous, it would be improper for us to refer to extrinsic evidence in an attempt to create an ambiguity from which we could construe the statute to mean something other than what it says. (See *Hartford Fire Ins. Co. v. Macri* (1992) 4 Cal.4th 318, 326 [14 Cal. Rptr. 2d 813, 842 P.2d 112]; **[**485]** *Solberg v. Superior Court* (1977) 19 Cal.3d 182, 198 [137 Cal. Rptr. 460, 561 P.2d 1148]; *Farnow v. Superior Court* (1990) 226 Cal. App. 3d 481, 486 [276 Cal. Rptr. 275] ["a court may not rewrite a law, supply an omission or give words an effect different from the plain and direct import of the terms used"].)

HN25 We must also presume that the Legislature was well aware of the rules governing intercompany dividends, including section 25106, when it enacted section 25110, subdivision (a)(6). (See *Fermino v. Fedco, Inc.* (1994) 7 Cal.4th 701, 720 [30 Cal. Rptr. 2d 18, 872 P.2d 559]; *Building Industry Assn. v. City of Livermore* (1996) 45 Cal.App.4th 719, 730 [52 Cal. Rptr. 2d 902]; *Bailey v. Superior Court* (1977) 19 Cal.3d 970, 977-978 [140 Cal. Rptr. 669, 568 P.2d 394] [Legislature is presumed to **[***27]** have enacted legislation with existing law in mind].) Consequently, we assume that at the time it enacted section 25110, subdivision (a)(6), the Legislature was aware that section 25106 made intercompany dividends paid from unitary income nontaxable and provided such dividends "*shall not be taken into account ... in any ... manner in determining the tax of any member of the group*." (Italics added.)

CA(21) **(21)** For the foregoing reasons, HN26 we endorse the trial court's conclusion that the legislative scheme contemplates that "dividends paid out of unitary income of lower-tier subsidiaries should be excluded from all the factors used in the computation of the amount included under RTC § 25110(a)(6): that is, such dividends should be excluded from the numerator (Subpart F income), the denominator (earnings and profits) and the amount to which the inclusion ratio is applied (the income of the controlled foreign corporation)." Like the **[*479]** trial court, we are persuaded that is the only conclusion possible from the plain and unambiguous language of section 25106.

D. Ordering of Distributions

A question remains, however, as to how dividends received by the **[***28]** unitary group from a CFC should be treated where part of the CFC's income is Subpart F income and thus included in the unitary group's tax return, and some is not. Amdahl argued, and the trial court adopted as correct, the view that such dividends should be deemed paid *first* out of included income. The FTB, on the other hand, claims that the dividend should be *prorated* between earnings that have been included in the combined income of the water's-edge group and excluded income.

CA(22) **(22)** The importance of this distinction stems from the fact that, HN27 generally speaking, section 24411, subdivision (a) provides that 75 percent of dividends received by the water's-edge group, and not eliminated by section 25106, can be deductible for purposes of computing the taxable income for the combined report. The ordering determines whether the dividend elimination or dividend deduction provision applies, i.e., section 25106 (100 percent deduction for earnings previously included in a California combined return) or section

24411(a) (75 percent "dividends received" deduction).

The superior court's decision directs that: HN28 "RTC § 25106 should be applied to dividends from [CFCs] **[***29]** that are partially included in the Water's Edge group under RTC § 25110(a)(6) in a manner that deems dividends to be distributed first from income that has already been included in the unitary group, to the extent thereof, and then from the non-unitary income." Consequently, 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 **[**486]** 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. n9

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n9 HN29 A taxpayer may also be eligible for a deduction under section 24402. Section 24402 provides that even in the absence of a unitary business, where the payor corporation was subject to California tax, the recipient corporation may deduct from its gross income dividends that were declared from income already included in the measure of California franchise tax imposed upon the payor corporation. The purpose of this deduction is to avoid double taxation. (*Safeway Stores, Inc. v. Franchise Tax Board* (1970) 3 Cal.3d 745, 749-750 [91 Cal. Rptr. 616, 478 P.2d 48].) In order for the recipient corporation to claim the California deduction, however, the payor corporation must have had income from sources in California so that the payor corporation was subject to California tax.

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The superior court reached its result in order to "harmonize[] [the statutes] and avoid[] constitutional infirmities." The court came to the conclusion that **[*480]** the FTB's pro rata ordering of such dividends might raise a constitutional concern about section 24411, subdivision (a) because "the burden on foreign commerce that Amdahl alleges is lesser or greater depending on whether dividends are treated as coming first or last from income of the unitary group."

No statute, regulation or other administrative pronouncement provides clear guidance on this question. HN30 For 1989 and later years, regulations under section 24411, subdivision (a) provided that dividends paid by partially included corporations would be treated as prorated between amounts eligible for section 25106 elimination and amounts eligible for partial deduction under section 24411. However, commencing in 2001, the FTB's new unitary combined reporting intercompany transaction regulations seem to indicate that when a dividend is paid out of a mix of previously included and non-previously included income, any earnings previously included in the unitary group are deemed to be distributed first, dollar-for-dollar. (Cal. Code Regs., tit. 18, § 25106.5-1(f)(2) **[***31]** .)

HN31 In the absence of any clear and controlling guidance on this question, our "construction is to favor the taxpayer rather than the government." (*Edison California Stores v. McColgan* (1947) 30 Cal.2d 472, 476 [183 P.2d 16].) 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." [Citation.]' [Citation.]" (*Torres v. Parkhouse Tire Service, Inc.* (2001) 26 Cal.4th 995, 1003 [111 Cal. Rptr. 2d 564, 30 P.3d 57].) "And, wherever possible, 'we will interpret a statute as consistent with applicable constitutional provisions, seeking to harmonize Constitution and statute.' [Citation.]" (*People v. Superior Court (Zamudio)* (2000) 23 Cal.4th 183, 193 [96 Cal. Rptr. 2d 463, 999 P.2d

686].)

CA(23)↑**(23)** For the reasons indicated above, including those relied on by the trial court, *HN32*↑we conclude that dividends 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 **[***32]** 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. **[**487]**

E. Discriminatory Treatment of Foreign Dividends

Turning to Amdahl's cross-appeal, Appeal No. A101203, Amdahl argues that section 24411, subdivision (a)'s deduction limitation for foreign source **[*481]** dividends unconstitutionally discriminates against foreign commerce in violation of the United States Constitution's foreign commerce clause. As seen, section 24411, subdivision (a) provides that dividends received by the water's-edge group from a foreign subsidiary, to the extent not eliminated by some other provision such as section 25106, are only 75 percent deductible. In its cross-appeal, Amdahl claims that similar dividends received from a U.S. subsidiary are, through various provisions, 100 percent eliminated or deductible. Thus, Amdahl alleges that section 24411, subdivision (a), to the extent that it taxes foreign subsidiary dividends more heavily than domestic subsidiary dividends, discriminates **[***33]** against foreign commerce in violation of the commerce clause of the United States Constitution.

The trial court rejected Amdahl's constitutional challenge. Among other things, the court pointed out that section 25106, acting in conjunction with section 24411, posits its different treatment of dividends *not* on whether the dividends are paid from a foreign or domestic subsidiary, but on whether or not the income from which the dividends are paid has been included in the water's-edge combined report. Thus, if a subsidiary's dividend has been fully included in the combined report, it is eliminated pursuant to section 25106, *whether the subsidiary is foreign or domestic*. If the subsidiary's dividends are paid out of earnings and profits that have not been included on the combined report, it is nevertheless eligible for the 75 percent "dividends received" deduction found in section 24411, subdivision (a).

Consequently, the trial court found that California's water's-edge system actually favors foreign commerce, rather than discriminating against it, because it subjects *less* of foreign subsidiaries' income to tax when compared to domestic subsidiaries. The court reasoned: "Under **[***34]** California law, 100% of the income of domestic unitary subsidiaries is included in the combined report, and is subject to interstate and intercorporate apportionment. Thus, while the domestic dividends are eliminated [by section 25106], the income from which they are paid is included 100% on the combined report, which renders that income subject to apportionment and taxation. Similarly, foreign source dividends paid from income included on the combined report are eliminated in exactly the same manner as domestic dividends. It is only when the income of a foreign subsidiary has been excluded from the combined report by Amdahl's water's-edge election under RTC § 25110 that dividends paid by a foreign subsidiary are not eliminated by RTC § 25106."

The trial court went on to explain, "For those dividends not eliminated by § 25106, California provides a 75% 'dividends received' deduction under RTC § 24411." Consequently, the trial court found that California's water's-edge system actually subjected less of a foreign subsidiary's income to taxation when compared to that of domestic subsidiaries, which **[***35]** is 100 **[*482]** percent included on the combined report. Relying on this reasoning, the FTB argues that section 24411 does not discriminate against foreign commerce. We agree.

CA(24) **(24)** The United States Constitution's foreign commerce clause provides that *HN33* "Congress shall have Power ... to regulate Commerce with foreign Nations." (U.S. Const., art. I, § 8, cl. 3.) *HN34* The term "commerce" includes the flow of dividends from a foreign subsidiary to its parent **[**488]** company. (*Kraft Gen. Foods, Inc. v. Iowa Dept. of Revenue and Finance* (1992) 505 U.S. 71, 76 [120 L. Ed. 2d 59, 112 S. Ct. 2365] (*Kraft*).)

HN35 *CA(25)* **(25)** The foreign commerce clause not only grants Congress the authority to regulate commerce between the United States and foreign nations, it also directly limits the power of the states to discriminate against foreign commerce. (*Wardair Canada v. Florida Dept. of Revenue* (1986) 477 U.S. 1, 7-8 [91 L. Ed. 2d 1, 106 S. Ct. 2369].) This is commonly referred to as the "dormant" or "negative" aspect of the foreign commerce clause. The dormant aspect of the foreign commerce clause serves two related purposes. First, it prevents states from promulgating protectionist policies. Second, it restrains the states from excessive interference **[***36]** in foreign affairs, which are the domain of the federal government. (*Japan Line, Ltd. v. County of Los Angeles* (1979) 441 U.S. 434, 448-451 [60 L. Ed. 2d 336, 99 S. Ct. 1813]; *National Foreign Trade Council v. Natsios* (1999) 181 F.3d 38, 66.) Because matters of concern to the entire nation are implicated, "the constitutional prohibition against state taxation of foreign commerce is broader than the protection afforded to interstate commerce ... ." (*Kraft*, *supra*, 505 U.S. at p. 79.)

The United States Supreme Court applied these principles in *Kraft*, a case relied upon by Amdahl. In *Kraft*, Iowa allowed a deduction from base taxable income for dividends paid to a parent company by a domestic subsidiary not doing business in Iowa, while it did not allow a deduction from base income for dividends paid to a parent company by a foreign subsidiary not doing business in Iowa. The Supreme Court held that the fact that dividends received from a unitary business' foreign subsidiaries were always treated less favorably than dividends received from its domestic subsidiaries constituted an unconstitutional discrimination under the foreign commerce clause.

Kraft **[***37]** involved a separate entity tax return of a parent company. n10 The court pointed out that Iowa was not applying unitary combination. The court wrote an important footnote, as follows: "If one were to compare the **[*483]** aggregate tax imposed by Iowa on a unitary business which included a subsidiary doing business throughout the United States (including Iowa) with the aggregate tax imposed by Iowa on a unitary business which included a foreign subsidiary doing business abroad, it would be difficult to say that Iowa discriminates against the business with the foreign subsidiary. Iowa would tax an apportioned share of the domestic subsidiary's entire earnings, but would tax only the amount of the foreign subsidiary's earnings paid as a dividend to the parent. ..." (*Kraft*, *supra*, 505 U.S. at p. 80, fn. 23.)

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n10 As the term "separate entity" implies, states using that method of reporting income treat the various subsidiaries of a multi-jurisdictional enterprise as separate from one another and the income of those entities not doing business in the state are not considered in the income of the single entity.

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Relying on this rationale, the FTB argues that the single-entity reporting system involved in *Kraft* raises constitutional concerns that are not present under California's combined water's-edge method of apportioning the combined income of a unitary business group for tax purposes. The FTB claims *Kraft* should have no application within a combined unitary group, because each member's income and apportionment factors are included in the return equally, regardless of place of incorporation or country of operation. The **[**489]** FTB's argument finds substantial support in the case law.

Since *Kraft* was issued, several other courts have been asked to determine whether a given state's tax system discriminates against foreign commerce in a manner prohibited by *Kraft*. In *In re Morton Thiokol, Inc.* (1993) 254 Kan. 23 [864 P.2d 1175] (*Thiokol*), *HN36*the court limited the holding in *Kraft* to states that do not use a combined water's-edge or domestic combination reporting method. The *Thiokol* court reasoned that a combined reporting state (i.e., water's-edge) does not discriminate against foreign subsidiaries. While the foreign subsidiaries' dividend payments to **[***39]** the unitary business are taxed, its total income is not included in the unitary business overall income. Conversely, while a domestic subsidiary's dividend payments to the unitary business is not taxed, its total income is included in the unitary business overall income. Thus, no discrimination against foreign commerce occurs.

Following the lead of *Thiokol*, the Supreme Court of Maine in *E.I. Du Pont de Nemours & Co. v. State Tax Assessor* (Me. 1996) 675 A.2d 82 (*Du Pont*), held that combined water's-edge reporting saved the Maine income tax statute from the fate of the Iowa statute in *Kraft*. The *Du Pont* court reasoned: *HN37*"Far from discriminating against foreign commerce, Maine's water's edge combined reporting method provides a type of 'taxing symmetry' that is not present under the single entity system. ... Because the income of the unitary domestic affiliates is included, apportioned, and ultimately directly taxed by Maine as part of the parent company's income, the inclusion of dividends paid by foreign subsidiaries does not constitute the kind of facial discrimination against foreign commerce that caused the Supreme Court to invalidate Iowa's tax **[***40]** scheme in *Kraft*." (*Id.* at pp. 87-88.) **[*484]**

Other courts have found the rationale of the *Thiokol* and *Du Pont* courts to be persuasive and have determined that the taxation of foreign-source income is not invalid under *Kraft* where the consolidated or combined methodology is used. (See *Caterpillar, Inc. v. Commissioner of Revenue* (Minn. 1997) 568 N.W.2d 695 [interest and royalty payments by foreign subsidiary]; *Caterpillar, Inc. v. Dept. of Rev. Admin.* (1999) 144 N.H. 253 [741 A.2d 56] [interest and royalty payments by foreign subsidiary]; see also *Emerson Elec. Co. v. Tracy* (2000) 90 Ohio St. 3d 157 [735 N.E.2d 445, 448-449]; *Caterpillar Financial Services Corp. v. Whitley* (1997) 288 Ill. App. 3d 389 [680 N.E.2d 1082, 1086-1089, 223 Ill. Dec. 879]; *Dart Industries, Inc. v. Clark* (R.I. 1995) 657 A.2d 1062, 1065.)

HN38 *CA(26)* **(26)** We find the rationale of these courts to be persuasive, and hold that California's water's-edge method of apportionment of income does not facially discriminate against foreign commerce. As explained by the trial court, "Like *Du Pont*, in the **[***41]** case of California's water's-edge reporting method, foreign subsidiaries' dividends are partially included, while the entirety of domestic subsidiaries' income is included, in the water's-edge combined report. ... In addition, California gives those included foreign subsidiary dividends a 75% 'dividends received' deduction from the water's-edge group's combined income pursuant to RTC § 24411. Thus, the same kind of 'taxing symmetry' present in *Du Pont* is present here. Therefore, the holding in *Kraft* does not apply to these facts." We affirm the trial court ruling that California's water's-edge reporting method does not unconstitutionally discriminate against foreign **[**490]** commerce on this basis. n11

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n11 The court's disposition of Amdahl's constitutional challenge to section 24411, subdivision (a) makes it unnecessary to address the FTB's additional argument that Amdahl's voluntary water's-edge election prevents it from raising a constitutional challenge to the application of section 24411, subdivision (a).

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[*42]**

F. Timeliness of Action with Respect to 1988 Tax Year

The FTB claims the trial court erred in finding Amdahl's action seeking a refund for the 1988 tax year was timely filed. *HN39*The statute of limitations applicable to tax refund suits is section 19384, which provides: *HN40*"The action ... shall be filed within four years from the last date prescribed for filing the return or within one year from the date the tax was paid, or within 90 days after (a) notice of action by the Franchise Tax Board upon any claim for refund, or (b) final notice of action by the State Board of Equalization on an appeal from the action of the Franchise Tax Board on a claim for refund, whichever period expires later." Relying on section 19384, the FTB argues "[S]ince this action was not filed within 90 days of the SBE's April 6, 2000 denial of Amdahl's appeal, as it relates to 1988 taxes, this action is time barred." **[*485]**

In rebuttal, Amdahl argues that its claim for refund did not ripen until July 31, 2000, when the FTB formally notified Amdahl how it would apply various payments and credits for various tax years to the 1988 tax liability. Having paid the tax, Amdahl filed its administrative claims for **[***43]** refund in a timely manner in two parts on August 30, 2000.

In the administrative proceedings below, the FTB rejected Amdahl's claim for refund of the 1988 tax year based on the assertion that Amdahl's earlier protest had been " 'converted' to a claim for refund three years earlier." The FTB took the position that because the earlier protest had actually become a claim for refund, Amdahl's time for filing suit for refund had already expired (90 days after the April 6, 2000 SBE decision). In challenging this ruling below, Amdahl claimed that prior to the FTB's rejection of its administrative protest, there was no evidence that Amdahl's tax protest was being treated as a claim for refund nor was Amdahl ever notified that the FTB was treating its tax protest as a claim for refund, or that it considered the 1988 protested taxes to have been paid.

At the center of this controversy is the legal of effect of Amdahl's wire-transferred payment of $ 2 million to the FTB in January 1998, during the pendency of its administrative protest against the FTB's proposed assessment for the 1988 tax year. By this payment, the FTB asserts that Amdahl's earlier protest was converted "by operation of law" **[***44]** to a claim for refund by section 19335. *HN41**CA(27)***(27)** Section 19335 provides that a taxpayer may pay a tax under protest, before the FTB acts on a claim or the SBE acts on an appeal, in which case the protest is treated as a claim for a refund or an appeal from the denial of a claim for refund. Relying on section 19335, the FTB claims that, having paid the taxes in question during pendency of the administrative proceedings, Amdahl missed the 90-day statutory deadline to file a tax refund action.

Amdahl does not dispute the fact that it made a $ 2 million payment to the FTB in January 1998, although it adamantly denies the payment was made to satisfy its 1988 tax obligation. Instead, Amdahl claims that by making this payment, it was paying unprotested taxes and potential but unassessed 1988 taxes. Furthermore, as of January 1998, with ongoing federal and **[**491]** state audits and likely proposed adjustments and assessments coming, Amdahl wanted to stop interest from accruing on unpaid amounts.

The trial court concluded that Amdahl's action with respect to its 1988 taxes was timely.

After considering documentary and testimonial evidence, the trial court made the following findings of fact: 1) the disputed **[***45]** payment by Amdahl in January 1998 was not applied to the liability for the protested tax until *after* the SBE's denial of Amdahl's appeal in April 2000; 2) at no time **[*486]** during the pendency of Amdahl's protest did the FTB treat the protest as a claim for refund; and 3) at no time during the pendency of Amdahl's appeal from the denial of the protest did the SBE or the FTB treat the appeal as the appeal from the denial of a refund. The trial court reasoned: "Had the FTB acted in the manner which the Statute mandates, Amdahl would have had ample notice of the FTB's position and could have commenced this action in what the FTB would necessarily concede to be a timely fashion. The FTB cannot now take advantage of its own failure to follow the statute, that is, the FTB cannot now invoke RTC § 19335 to divest Amdahl of its right to due process on its refund. The Court holds, therefore, that Amdahl's refund claim with respect to the 1988 year is not time-barred."

We conclude Amdahl introduced evidence sufficient to sustain the findings in its favor on the theory enunciated by the trial court. The record in this case shows that Amdahl sent a letter dated January 23, 1998, accompanying **[***46]** the $ 2 million payment, stating: "The payment represents a combination of additional franchise tax owed on certain audit adjustments made during the franchise tax field audit and additional franchise tax owed due to potential audit adjustments for 1988. ... *Certain other proposed FTB audit adjustments for 1988 are currently being protested by Amdahl Corp. To prevent additional interest from accruing Amdahl decided to make a payment at this time*." (Italics added.) The FTB never treated the protest as a claim for refund and never informed Amdahl that its protest had been converted into a claim for refund until February 2001, over a year *after* the 90-day statute of limitations had allegedly run. On the contrary, the FTB consistently treated the protest, logically enough, as a protest.

The FTB argues that to endorse the trial court's factual findings in this case would be opening the door to both the piecemeal litigation of tax claims, and tolerating the evasion of the Legislature's strict rules for the filing of tax refund actions. However, we note that in 1999 the Legislature enacted section 19041.5, which expressly authorizes the procedure employed by Amdahl herein. **[***47]** *HN42* *CA(28)* **(28)** Section 19041.5 allows the taxpayer to make a payment to stop the accrual of interest or to cover non-protested tax without having those funds considered a payment of taxes that would trigger the section 19384 statute of limitations regarding claims for refund. n12 As the Legislature **[*487]** recognized, section 19041.5 **[**492]** simply "[c]odifies existing ... [FTB] practice ... ."

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n12 Section 19041.5, subdivision (a) provides, in pertinent part, that *HN43* "any amount paid as a tax or in respect of a tax that is paid after the mailing of a notice of proposed deficiency assessment and designated by the taxpayer as a deposit in the nature of a cash bond made to stop the running of interest, shall not be considered a payment of tax for purposes of filing a claim for refund pursuant to Section 19306 or an action pursuant to Section 19384 until either of the following occurs: [P] (1) The taxpayer provides a written statement to the Franchise Tax Board specifying that the deposit shall be a payment of tax for purposes of Section 19306, 19335, or 19384. [P] (2) The deficiency assessed becomes due and payable in accordance with Section 19049."

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[*48]**

G. Award of Attorney Fees with Respect to Time-Bar Issue

In Appeal No. A102558, the FTB appeals from the post-judgment order awarding Amdahl $ 20,000 in attorney fees under section 19717. n13 Invoking that section, the trial court found that the FTB's position on the time-bar issue was not "substantially justified," thus entitling Amdahl to an award of attorney fees for its defense of that issue.

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n13 While Amdahl prevailed on all of the primary issues in this case, Amdahl sought and was granted attorney fees only in connection with the statute of limitations issue for which it believed the FTB's position had no substantial justification.

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HN44 *CA(29)* **(29)** Section 19717 provides that a party who brings a civil proceeding against the state to recover franchise taxes may recover reasonable litigation costs, including attorney fees, if: (1) the suit is brought in a California court; (2) the party has exhausted its administrative remedies under the applicable tax laws; (3) the party establishes that the position of the **[***49]** state was not substantially justified; and (4) the party substantially prevails. (See *Lennane v. Franchise Tax Bd.* (1996) 51 Cal.App.4th 1180, 1183-1184 [59 Cal. Rptr. 2d 602] [statute quoted at fn. 1]; *McDonnell Douglas Corp. v. Franchise Tax Bd.* (1994) 26 Cal.App.4th 1789, 1797 [33 Cal. Rptr. 2d 129].) The FTB urges this court to reverse the award because its position on the time-bar issue was "substantially justified" and Amdahl did not "substantially prevail."

HN45 "California cases have defined a 'substantially justified' position to mean one which is justified to a degree that would satisfy a reasonable person, or ' "has a ' "reasonable basis both in law and fact." ' " ' ..." (*Wertin v. Franchise Tax Bd.* (1998) 68 Cal.App.4th 961, 977 [80 Cal. Rptr. 2d 644], citing *Lennane v. Franchise Tax Bd., supra,* 51 Cal.App.4th at pp. 1188-1189.) "[T]he use of the word 'reasonable' in explaining 'substantially justified' implies an objective standard that does not depend on an analysis of the subjective motivations of the government in taking the position it did." (*Wertin, supra*, 68 Cal.App.4th at p. 978.) In this regard, we stress that the FTB's position need not be the one accepted **[***50]** by the trier of fact. So long as the position is one that a reasonable person could think is correct, it may be substantially justified even in the face of conflicting evidence. Finally, the burden of showing substantial justification is on the FTB, not the taxpayer. (§ 19717, subd. (c)(2)(B)(ii).)

Applying these principles to the case at bar leads to the conclusion that the FTB's position, when viewed from the totality of the circumstances, was not **[*488]** substantially justified. While section 19335--which transforms a protest by law into a claim for refund upon the payment of the tax--provided the FTB with a reasonable legal basis for the theory it propounded, there was virtually no factual support for the legal theory advanced. On appeal, the FTB does not challenge the superior court's factual findings or even attempt to meet the requirements of the substantial evidence standard of review. Nor does it explain how Amdahl could have paid the protested tax during the pendency of the protest, given the documentary evidence attesting to the fact that the FTB did not apply Amdahl's $ 2 million payment to the 1988 tax liability until *after* the SBE's rejection of Amdahl's appeal in April **[***51]** 2000. Nevertheless, adopting its untenable position that Amdahl's claims with respect to the 1988 tax year were time-barred, the **[**493]** FTB forced Amdahl into lengthy administrative proceedings to develop the record on this point before final vindication of its right to bring an action with respect to the 1988 tax year. The FTB has simply not shown how it was substantially justified in advancing this argument.

Additionally, the FTB claims Amdahl cannot be considered a prevailing party because the single issue for which attorney fees were awarded--the time-bar issue for the 1988 tax year--was not the most significant issue in the case. In making its point, the FTB emphasizes that the amount of the refund attributable for the 1988 tax year was only 30 percent of the total refund sought by Amdahl.

Regardless of the relative importance of the time-bar issue, Amdahl unquestionably was the prevailing party below, having prevailed on almost every significant issue at trial and having been awarded $ 2.676 million, which was all but $ 714,000 out of the refunds sought.

HN46 *CA(30)* **(30)** Where a lawsuit consists of related claims and the taxpayer has won substantial relief, we believe a trial court has discretion **[***52]** to award the taxpayer attorney fees for discrete issues under section 19717, even if the issues for which fees are awarded do not represent the bulk of the amount in controversy or the most significant issues in the case. To hold otherwise, as pointed out by Amdahl, would allow "the government free rein to adopt positions and argue issues that are not substantially justified so long as the issues are less significant than other issues in the case." To the extent that an award of attorney fees will act as a disincentive to the FTB to take positions that it cannot substantially justify, we believe such an award is well within the court's discretion. **[*489]**

IV.

Disposition

The judgment is affirmed.

Kline, P. J., and Haerle, J., concurred.

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HEADLINE: #8 2005 STT 88-8 COMMENTS ON THE CALIFORNIA FTB'S PROPOSED REG ON DIVIDEND DISTRIBUTIONS. (Release Date: MAY 03, 2005) (Doc 2005-9327)

ABSTRACT: Kimberley Reeder, with McDermott, Will & Emery LLP-Silicon Valley, and John G. Ryan, with McDermott, Will & Emery LLP, Palo Alto, Calif., wrote to the California Franchise Tax Board, saying FTB Notice 2005-1 oversimplified the California Court of Appeal's decision in Fujitsu regarding dividend distributions.

SUMMARY:

Published by Tax AnalystsTM

Kimberley Reeder, with McDermott, Will & Emery LLP-Silicon Valley, and John G. Ryan, with McDermott, Will & Emery LLP, Palo Alto, Calif., wrote to the California Franchise Tax Board, saying FTB Notice 2005-1 oversimplified the California Court of Appeal's decision in Fujitsu regarding dividend distributions. The court's decision was based almost entirely on constitutional grounds, the authors say.

AUTHOR: Reeder, Kimberley;
Ryan, John G.
McDermott, Will & Emery LLP

GEOGRAPHIC: California ; United States

REFERENCES:
Subject Area:
  Individual income taxation;
  Corporate taxation

TEXT:

Comments on the California FTB's Proposed Reg on Dividend Distributions

Release Date: MAY 03, 2005

Published by Tax AnalystsTM

by Kimberley Reeder and John G. Ryan

Kimberley Reeder, counsel with McDemott, Will & Emery LLP- Silicon Valley, and John G. Ryan, partner with McDermott, Will & Emery LLP-Palo Alto. Calif., submitted these comments to the California Franchise Tax Board on April 4. Ryan was counsel in the Amdahl/Fujitsu case. For the California Court of Appeal's Fujitsu, see Doc 2004-14091 or 2004 STT 33-8.

* * * * *

April 4, 2005

Ms. Colleen Berwick
Franchise Tax Board Legal Department
P.O. Box 1720
Rancho Codova, CA 95741-1720

RE: COMMENTS ON DISCUSSION DRAFT OF PROPOSED CHANGES TO CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTIONS 24411 AND 25106.5

Dear Ms. Berwick:

Please accept the following comments to the Franchise Tax Board ("FTB") in response to its Request for Public Comment (FTB Notice 2005-1), issued on March 4, 2005.

A. Background

In FTB Notice 2005-1, the FTB proposes to amend certain regulations adopted under Revenue and Taxation Code ("RTC") sections 24411 and 25106. The amendments seek to add provisions that address the ordering of dividends paid from various classes of earnings and profits. Specifically, the proposed amendments would apply the ordering rules of Internal Revenue Code ("IRC") section 316 (i.e., "if a distribution from a given year's earnings and profits are not sufficient to exhaust the earnings and profits of that year, the distribution will be considered drawn from each class of potential dividend on a pro rata basis").

The justification for these amendments is explained by the FTB in "Request to Amend Regulations 24411 and 25106.5-1: Dividend Ordering Rules and the Fujitsu (Amdahl) Case"/1/ (the "FTB Explanation"). The FTB Explanation focuses on the fact that the Court of Appeal "misconstrued" an example provided in the Cal. Code Regs., tit. 18, section 25106.5-1./2/ Later, the FTB Explanation more pointedly states:

> Because the Fujitsu court's holding was based on a misconstruction of a regulation, which by its terms was not applicable to the year in question and by its example didn't apply to the issue presented to the court, and because of the court's open disregard of a regulation which it acknowledged was on point, the court's holding appears to be in error./3/

As will be explained in greater detail below, this description of the Court of Appeal decision in Fujitsu IT Holdings, Inc. v. Franchise Tax Board ("Fujitsu"),/4/ itself completely misconstrues the basis for that court's holding.

B. Fujitsu: Superior Court and Court of Appeal Decisions

1. Superior Court/5/

The reasoning underlying the Superior Court holding on the ordering of distributions is important because, as discussed in greater detail below, it is explicitly incorporated into the Court of Appeal decision./6/

The Superior Court describes the relevant issue as "how the source of a dividend should be apportioned between income of the unitary group and other income." The court identified that constitutional considerations were very important in resolving this issue: "[T]he burden on foreign commerce that Amdahl alleges is lesser or greater depending on whether dividends are treated as coming first or last from income of the unitary group." The court goes on to explain:

> [T]he Court is cognizant of the principle that statutes should be interpreted to the extent possible in a manner that harmonizes their terms and avoids constitutional infirmities. In view of this principle, the Court holds that RTC section 25106 should be applied to dividends from controlled foreign corporations that are partially included in the Water's Edge group under RTC section 25110(a)(6) in a manner that deems dividends to be distributed first from income that has already been included in the unitary group, to the extent thereof, and then from non-unitary income.

These statements make it clear that the ordering of distributions cannot be seen as a mere administrative computation. Instead, the treatment of distributions from foreign unitary income must, at a minimum, meet the standards imposed by the U.S. Constitution's Foreign Commerce Clause./7/ Perhaps most important for this commentary, woven into the court's holding and analysis is the implication that the "pro rata" rule advocated by the FTB in both Fujitsu and the currently proposed regulations, would not satisfy the standards imposed by the Foreign Commerce Clause.

Critically, the Superior Court mentions neither Cal. Code Regs., tit. 18, sections 24411 nor 25106.5-1 in its analysis. Its holding is based solely on constitutional considerations.

2. Court of Appeal

The FTB Explanation focuses on the Court of Appeal's examination of an example in Cal. Code Regs., tit. 18, section 25106.5-1(f)(2) and whether the example was properly construed. The Court of Appeal does look to this example and, moreover, acknowledges that there is no "clear guidance" on the proper ordering of distributions. Perhaps, if the Court of Appeal decision ended by pointing only to the lack of administrative clarity, the FTB's proposed amendments in FTB Notice 2005-1 may have some basis. However, the Court of Appeal went on to note that "wherever possible, 'we will interpret a statute as consistent with applicable constitutional provisions, seeking to harmonize Constitution and statute.'"/8/ Moreover, the Court of Appeal explicitly adopts the reasoning set forth by the Superior Court on this issue, which, as described above, was based wholly on constitutional considerations./9/

C. Analysis

1. The Court of Appeal's holding on the ordering of distributions was based almost wholly on constitutional grounds.

As amply demonstrated above, FTB Notice 2005-1 oversimplifies the Court of Appeal's holding in Fujitsu. This is not a situation in which a court misapplied or misunderstood a piece of administrative guidance. Constitutional concerns were the sole basis for the Superior Court's holding (adopted explicitly by the Court of Appeal) and a substantial factor in the Court of Appeal's holding. The key factor in this analysis is not, however, whether constitutional considerations were the only factor considered in the courts' holdings or one of many factors. Instead, it is the mere fact that constitutional considerations supported some portion of the Court of Appeal's reasoning that limits the FTB's ability to engage in rule-making that contradicts the Court of Appeal's decision.

The FTB's reliance on the fact that IRC section 316 is explicitly incorporated into California law by RTC section 24451 does nothing to address the potential constitutional infirmities of the ordering rules set forth in IRC section 316 as applied in the state tax context. That is, while Congress may be permitted to discriminate against foreign commerce in the context of federal tax legislation, the dormant Commerce Clause prohibits states from taking similar action.

2. The FTB is not permitted to use its rule-making authority to circumscribe a court's interpretation of the Constitution.

The FTB argues that, in proposing amendments to Cal. Code Regs., tit. 18, sections 24411 and 25106.5-1, it is merely clarifying regulations that were misinterpreted by the Court of Appeal. The FTB is permitted to propose such amendments, the reasoning goes, because the basis for the Court of Appeal's decision in Fujitsu was regulations, the promulgation and amendment of which fall within the ambit of FTB powers. As discussed above, however, the holdings of the Superior Court and the Court of Appeal in Fujitsu were based squarely in constitutional principles. As such, to amend the regulations in a way that contradicted Fujitsu would be tantamount to allowing the FTB to ignore a court's interpretation of the mandates of the U.S. Constitution. Not only does this most certainly exceed the authority granted to the FTB by the California legislature, it conflicts with basic separation of power principles./10/

D. Conclusion

For the foregoing reasons, we assert that the FTB does not have the authority to propose the regulations referenced in FTB Notice 2005-1 and, as such, they should be withdrawn.

Sincerely,

Kimberley M. Reeder
John G. Ryan

FOOTNOTES

/1/ Franchise Tax Board, February 9, 2005.

/2/ See FTB Explanation, supra note 1, at 1.

/3/ See FTB Explanation, supra note 1, at 3.

/4/ 120 Cal.App.4th 459 (2004).

/5/ Amdahl Corporation v. Franchise Tax Board, California Superior Court for San Francisco, No. 321296, October 3, 2002.

/6/ Fujitsu, 120 Cal.App.4th at 480 ("For the reasons indicated above, including those relied on by the trial court, we conclude that the dividends paid by first-tier subsidiaries from current year earnings should be treated as paid (1) first our of earnings eligible for elimination under section 25106, with (2) any excess paid out of earning eligible for partial deduction under section 24411.") (emphasis supplied).

/7/ See e.g., Kraft Gen. Food, Inc. v. Iowa Dept. of Revenue and Finance, 505 U.S. 71 (1992); Japan Line, Ltd. V. County of Los Angeles, 441 U.S. 434 (1979). We would be happy to supplement our comments with a discussion of how the ordering of distributions from unitary income included in the group's combined report versus income not included in the combined report raises Foreign Commerce Clause implications. However, as appropriate to the current discussion, the important issue is the mere fact that these arguments were the basis of the Superior Court holding and the Court of Appeal holding.

/8/ Fujitsu, 120 Cal.App.4th at 480 (citations omitted).

/9/ Id. at note 6.

/10/ Mandel v. Myers, 29 Cal.3d. 531 (1981). Under basic separation of powers principles, "the powers of state government are legislative, executive and judicial. Persons charged with the exercise of one power may not exercise either of the others except as permitted by this Constitution." Cal. Const. art. III, section 3.

END OF FOOTNOTES

to be tracked for decades. This would create an administrative burden, both for the FTB and taxpayers.

Response – Both federal law and California law require taxpayers to keep track of earnings and profits in order to determine whether a distribution qualifies as a dividend. The federal law does not have a counterpart to section 25106. Taxpayers are required to keep track of California earnings and profits for purposes of determining the elimination under section 25106. This is a separate record-keeping requirement from that required for federal purposes. Neither the current regulations, nor the amendments which only clarify the current regulations, create any new administrative burdens. Even if the Court of Appeal's interpretation of the current regulations were correct there would still be a requirement to track earnings and profits and determine the source of corporate distributions to ascertain if the distributions qualify as dividends and whether such distributions qualify for elimination under section 25106. Moreover, the Court of Appeal's interpretation might exacerbate the problem because under a correct application of the law, dividends are treated as being paid from the current year's earnings and profits and, only if those earnings and profits are exhausted, from the next preceding year's earnings and profits. Therefore, the proposed amendments clarify the existing law and do not create any new or additional burdens apart from those that might currently exist.

Recommendation – No change required.

2. Fujitsu cannot be disregarded by amending the regulations since the Court's opinion interpreted the statute, which has not been changed.

Response - Staff does not believe this is a correct reading of the court's opinion. The court's analysis is premised on its statement that "No statute, regulation or other administrative pronouncement provides clear guidance on this question." It finds this lack of clarity by perceiving a conflict between two existing regulations. Without this perceived conflict there would have been clear direction. From the opinion it appears that the court's inquiry would have ended. The opinion does discuss section 25106 but that statute is silent with respect to the ordering of dividend distributions. The ordering of dividend distributions is controlled by IRC section 316 and California's conformity to that section. The Court of Appeal does make reference to the reasoning of the trial court and states that reasoning also supports its conclusion. The trial court expressed concerns about a possible constitutional challenge to providing a preference for section 24411 dividends. The Court of Appeal, however, in another part of its opinion (See Fujitsu at 480-484), disposed of that constitutional challenge, thereby contradicting its statement of reliance.

Recommendation – No change required.

3. The proposed amendments do not provide for retroactive relief that must be available from the Fujitsu opinion.

Response – The proposed amendments do not make a substantive change in the underlying regulations. There is no basis or need for "retroactive relief."

Recommendation – No change required.

4. Under the proposed amendments, it is possible that some of the previous California earnings and profits pools that reflect income previously included in a unitary combined report might never be available to provide tax relief. This could cause a permanent loss to taxpayers, not just a timing loss.

Response – The only reason that the California earnings and profits pools would not be "used up" is if the taxpayer did not distribute all of its earnings and profits. If the taxpayer declares sufficient dividends, all earning and profit pools would be exhausted. This can occur regardless of how the ordering rules are applied. The current regulations, along with the proposed clarifying amendments, do not cause this result.

Recommendation – No change required.

B. *Barry Weissman's Comments*

1. The staff's proposal to impose an ordering rule for distributions contradicts the clear holding by the Court of Appeal in <u>Fujitsu IT Holdings, Inc. v. Franchise Tax Board</u>. Thus, it is invalid.

Response – The proposed amendments provide clarity to the existing regulations; they do not cause a substantive change. The current regulations, correctly interpreted, demonstrate that there was no conflict between the existing regulations, contrary to the holding of the Court of Appeal in <u>Fujitsu</u>.

> a. The proposed amendment references IRC section 316. IRC section 316 is only concerned with whether a distribution will constitute a dividend. It does not provide an ordering rule.
>
> **Response –** IRC 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 is an ordering rule.
>
> Treasury Regulation section 1.316-2(a) provides further guidance as to the source of dividends and applies the last in – first out (LIFO) methodology.
>
> **Recommendation –** No change required.
>
> b. The Court of Appeal set forth a different ordering rule from that suggested by staff. In doing so staff ignores the court's reliance upon and favorable discussion of section 25106.

Response –Mr. Weissman presents several citations from the Fujitsu opinion to support his argument. The first cite that he presents for this proposition is from page 477 of the opinion, but that actually relates to the part of the opinion where the court is discussing the inclusion ratio issue. The court's discussion of the ordering question is specifically segregated by the court from its discussion of the inclusion ratio and does not begin until page 480. Therefore, this cite does not support his argument since it does not relate to the ordering of dividends issue.

The next two paragraphs cited merely reiterate how the trial court decided the issue. This portion of the opinion precedes the Court of Appeal's own analysis. The Court of Appeal, after conducting its own analysis, reaches its conclusion for its own reasons. It then adds as reasons for its decision, "and including those relied upon by the trial court." (See Fujitsu at 480.) However, the holding of the Court of Appeal that section 24411 is constitutional is a rejection of one of the primary reasons given by the trial court for its holding on the ordering of dividends.

The final cite presented is a string of cites of other cases dealing with statutory construction. It reads as follows:

> In the absence of any clear and controlling guidance on this question, our "construction is to favor the taxpayer rather than the government". 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 wherever possible, "we will interpret a statute as consistent with applicable constitutional provisions, seeking to harmonize Constitution and statute." (Fujitsu at 480.) (Internal citations omitted.)

As pointed our in response to Mr. Buczek's second comment, the Court contradicts itself in finding that there is "an absence of clear and controlling guidance" and then, immediately follows this with a statement that regulation 24411(a) provides for proration. There is nothing in section 25106 that speaks to the ordering of dividend distributions. However, section 25106.5 is a legislative grant of authority to the Franchise Tax Board to establish rules for accounting for transactions occurring in a combined report group. The payment of dividends between members of a combined reporting group out of income included in the combined report is such a transaction. The FTB's regulations regarding the ordering of dividends are accomplished under this legislative grant of authority.

Recommendation – No change required.

c. The Court's observations about the regulations must be considered dicta and not a basis for its decision.

Response – The Court of Appeal's decision was premised on the lack of "any clear and controlling guidance." It found this absence of authority only because in misinterpreting Regulation section 25106.5-1(f)(2), the court found it inconsistent with regulation section 24411(a), a subdivision that it stated required proration. The court indicated the uncertainty of its decision by stating that the later regulation "*seemed to indicate* that when a dividend is paid out of a mix of previously included and non-previously included income, any earnings previously included in the unitary group are deemed to be distributed first, dollar-for-dollar". (Emphasis added.) Ibid. Based on this comment it is clear that the court supported its opinion by reliance on Regulation section 25106.5-1(f)(2) . The court's comments about the regulation are more than mere dicta.

Recommendation – No change required.

2. Staff's attempt to override the Court of Appeal decision is invalid.

Response – The proposed amendments provide clarity with respect to the existing regulations; they do not make a substantive change. As previously demonstrated, the Court of Appeal's decision was premised upon its erroneous conclusion that "[n]o statute, regulation or other administrative pronouncement provides clear guidance on this question". To the extent the proposed amendments provide clarity with respect to the regulations upon which the Court of Appeal based its decision, it appears that they would lead the court to a different conclusion.

Recommendation – No change required.

3. The staff's proposed ordering rule misapplies federal authorities it cites. The proposed amendment to Regulation section 24411(e) proposes a LIFO rule for the ordering of which earnings and profits pool a dividend is paid from. Staff references IRC section 316 to support this treatment. However, IRC section 316 does not provide for a LIFO rule.

Response – The language in Regulation section 24411(e) that provides for a LIFO rule is preexisting. It is not part of the proposed amendments. IRC 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 is an ordering rule, clearly requiring earnings and profits to be drawn in reverse order, backwards in time.

Treasury Regulation section 1.316-2(a) provides further guidance as to the source of dividends and applies a LIFO rule. Therefore, IRC section 316 supports a LIFO rule for the ordering of which earnings and profits pool a dividend is paid from.

Recommendation – No change required.

(On May 31, 2005, Mr. Weissman submitted additional comments that generally reiterated the comments he originally submitted. A copy of the additional comments is attached.)

C. *John Ryan's and Kimberley Reeder's Comments*

1. The Court of Appeal's holding on ordering of distributions was based almost wholly on constitutional grounds.

Response – The court's analysis is premised on its statement that "No statute, regulation or other administrative pronouncement provides clear guidance on this question." The Court of Appeal does make reference to the reasoning of the trial court. The trial court expressed concerns about a possible constitutional challenge to providing a preference for section 24411 dividends. The Court of Appeal, in another part of its opinion, disposed of that constitutional challenge. (See Fujitsu at 480-484.)

The purported constitutional concern apparently relates to the fact that pursuant to section 24411, dividends paid from a foreign affiliate of a water's-edge group are only 75% deductible, while dividends paid from income that was previously included in a unitary combined report are completely eliminated. However, the reason for this disparate treatment is not due to the fact that the section 24411 dividends are paid from a foreign entity. By definition, in a water's-edge context, but for the inclusion ratio or effectively connected income, the income of a foreign entity is not included in a unitary combined report. The reduced deduction relates to the fact that the foreign entity's earnings may not have been included in a unitary combined report. This is why they are only 75% deductible rather than being 100% eliminated. This means that the limited deduction is predicated on the fact that the foreign entity's income may not have been included in the unitary combined report, not because of the fact that it is a non-U.S. company. Therefore, no constitutional issue exists.

Recommendation – No change required.

2. The FTB is not permitted to use its rule-making authority to circumscribe a court's interpretation of the Constitution. The Court of Appeal's decision was based squarely in constitutional principles.

Response – The Court of Appeal's holding, to the extent it considered the constitutionality of the statutes, upheld them. There is no part of the opinion dealing with the ordering question that relies on constitutional analysis, except for the reference to the concerns of the trial court in deciding that issue. In a subsequent portion of the opinion the appellate court concludes there are no constitutional infirmities in section 24411, the section cited to by the trial court in its ordering discussion.

Recommendation – No change required.

III. Comments During the Symposium

A. *Comments by Barry Weissman representing PriceWaterhouseCoopers.*

1. The proposed amendments cannot be applied retroactively because section 19503 specifically provides that regulations should be applied prospectively.

Response – Section 19503(b) provides that "Except as otherwise provided in this subdivision, no regulation . . . shall apply to any taxable year ending before the date on which any notice substantially describing the expected contents of any regulation is issued to the public." It then contains a list of seven exceptions to the general rule of non-retroactivity. In the instant case the proposed amendments to the regulations are clarifying of the existing regulations and do not have substantive effect. As such there is no apparent reason that they should not operate on a retroactive basis. There are, however, only seven exceptions to the general rule of non-retroactivity in subdivision (b), but not one addresses the circumstance of clarification.

Section 19503(c) provides that the amendments to section 19503 (generally requiring regulations to be made prospective, with exceptions) applies to statutory provisions enacted on or after January 1, 1998. Sections 24411, 25106 and 25106.5 were all enacted prior to January 1, 1998. No statutory provisions have been added to sections 24411 or section 25106.5, and the only amendment to section 25106 that occurred after January 1, 1998, was related to removal of deadwood language regarding litigation that was pending at the time of the original enactment of section 25106. Thus, no statutory provision has been enacted on or after January 1, 1998, that relates to the subject matter of these regulations. Prior to amendment, section 19503 read:

> The Franchise Tax Board shall prescribe all rules and regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.7 (commencing with Section 21001), Part 11 (commencing with Section 23001), and this part and may prescribe the extent to which any ruling or regulation shall be applied without retroactive effect.

Section 19503, prior to amendment, authorized retroactive amendment of regulations, unless the Franchise Tax Board exercised discretion to apply the regulations prospectively. As the regulations here at issue are clarifying regulations, and are wholly consistent with the current provisions of section 24411, the amendments are appropriately applied on a retroactive basis.

Recommendation – Staff recommends that the proposed amendments to the regulation be applied retroactively. The proposed amendments are clarifying in nature only and do not make a substantive change. Subdivision (b) of section 19503 does not apply. Moreover, staff acted promptly following the publication of the Fujitsu opinion in noticing to the public that there were to be amendments to the relevant regulations. Promptness is a key factor in supporting retroactivity. (See United States v. Carlton (1994) 512 U.S. 28, 32.)

B. *Comments by Teresa Casazza on behalf of Cal-Tax*

1. Staff is seeking to override the clear holding of the Fujitsu opinion.

Response – Staff believes the decision in Fujitsu dealing with the dividend ordering rules was based upon a misinterpretation of the Franchise Tax Board's regulations, and the proposed amendments are intended to clarify the meaning of the current regulations. Correct application of the current regulations lead to a different result than that reached in Fujitsu on the ordering issue. See the response to Mr. Weissman's second comment.

Recommendation – No change required.

2. Taxpayers might have already taken a position on their returns based on the Fujitsu opinion. If the proposed amendments are adopted, those taxpayers will be charged with a deficiency, which would subject them to the Amnesty-related interest penalty.

Response – The Fujitsu opinion was final in October of 2004. The amnesty related penalty applies to income years 2002 and earlier. Timely returns for those years would have been filed on or before October 15, 2003, for calendar year taxpayers, which is well prior to the Fujitsu opinion. No timely original returns could have been filed in reliance on that opinion.

In March of 2005 the staff commenced the process of amending the regulations by announcing this symposium and making available the language of the proposed amendments. All of this occurred prior to the date on which taxpayers had to make any payments to avoid the 50% penalty for amounts that were unpaid as of March 31, 2005, that were ultimately determined to be due. Therefore, taxpayers were on notice that the staff of the Franchise Tax Board did not believe that the Fujitsu opinion would be applicable for taxpayers other than Fujitsu. Furthermore, the hypothetical situation presented is not unique to the proposed amendments. 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. The concerns expressed by Ms. Casazza relate to the Amnesty program and not to proposed amendments to regulations that are only of a clarifying nature.

Recommendation – No change required.

C. *Comments by Rick Richman representing Deloitte & Touche.*

1. Staff is seeking to override the clear holding of the Fujitsu opinion.

Response - Staff believes the decision in Fujitsu dealing with the dividend ordering rules was based upon a misinterpretation of the Franchise Tax Board's regulations and the proposed amendments are intended to clarify the meaning of the current regulations. Correct application of the current regulations lead to a different result than that reached in Fujitsu on the ordering issue. See the response to Mr. Weissman's second comment.

Recommendation – No change required.

2. The proposed amendments to the regulations would require taxpayers to keep track of California earnings and profits pools. This would create an administrative burden, both for the FTB and taxpayers.

Response – Both federal law and California law require taxpayers to keep track of earnings and profits in order to determine whether a distribution qualifies as a dividend. The federal law does not have a counterpart to section 25106. Taxpayers are required to keep track of California earnings and profits for purposes of determining the elimination under section 25106. This is a separate record-keeping requirement from that required for federal purposes. Neither the current regulations, nor the amendments which only clarify the current regulations, create any new administrative burdens. Even if the Court of Appeal's interpretation of the current regulations were correct, there would still be a requirement to track earnings and profits and determine the source of corporate distributions to ascertain if the distributions qualify as dividends and whether such distributions qualify for elimination under section 25106. The Court of Appeal's interpretation might exacerbate the problem because under a correct application of the law, dividends are treated as being paid from the current year's earnings and profits and, only if those earnings and profits are exhausted, from the next preceding year's earnings and profits. Therefore, the proposed amendments clarify the existing law and do not create any new or additional burdens apart from those that might currently exist.

Recommendation – No change required.

3. The proposed amendments are not technical changes, but indicate a policy change by the FTB staff.

Response – The proposed amendments clarify the existing regulation and are consistent with the policy expressed by the Franchise Tax Board in arguing the ordering question in the <u>Fujitsu</u> case, and are consistent with the existing regulations adopted under section 24411. They do not represent a policy change or a substantive change by the Franchise Tax Board. Staff believes that because the proposed changes are only clarifying in nature they could be viewed as "technical changes", but because they do require a different result than was reached in the <u>Fujitsu</u> opinion, they should proceed through the formal regulatory process.

Recommendation – No change required.

4. The proposed amendments should be applied prospectively, but taxpayers should be able to elect to have them applied retroactively. This would insure that no taxpayer would be adversely impacted by the proposed amendments.

Response – Section 19503(b) provides that "Except as otherwise provided in this subdivision, no regulation . . . shall apply to any taxable year ending before the date on which any notice substantially describing the expected contents of any regulation is issued to the public." It then contains a list of seven exceptions to the general rule of non-retroactivity. In the instant case the proposed amendments to the regulations are clarifying of the existing regulations and do not have substantive effect. As such there is no apparent reason that they should not operate on a retroactive basis. There are, however, only seven exceptions to the general rule of non-retroactivity in subdivision (b) but not one addresses the circumstance of clarification.

Section 19503(c) provides that the amendments to section 19503 (generally requiring regulations to be made prospective, with exceptions) applies to statutory provisions enacted on or after January 1, 1998. Sections 24411, 25106 and 25106.5 were all enacted prior to January 1, 1998. No statutory provisions have been added to sections 24411 or section 25106.5, and the only amendment to section 25106 that occurred after January 1, 1998 was related to removal of deadwood language regarding litigation that was pending at the time of the original enactment of section 25106. Thus, no statutory provision has been enacted on or after January 1, 1998 that relates to the subject matter of these regulations. Prior to amendment, section 19503 read:

> The Franchise Tax Board shall prescribe all rules and regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.7 (commencing with Section 21001), Part 11 (commencing with Section 23001), and this part and may prescribe the extent to which any ruling or regulation shall be applied without retroactive effect.

Section 19503, prior to amendment, authorized retroactive amendment of regulations, unless the Franchise Tax Board exercised discretion to apply the regulations prospectively. As the regulations here at issue are clarifying regulations, and are wholly consistent with the current provisions of section 24411, the amendments are appropriately applied on a retroactive basis.

Recommendation – Staff recommends that the proposed amendments to the regulation be applied retroactively. The proposed amendments are clarifying in nature only and do not make a substantive change. Subdivision (b) of section 19503 does not apply. Moreover, staff acted promptly following the publication of the Fujitsu opinion in noticing to the public that there were to be amendments to the relevant regulations. Promptness is a key factor in supporting retroactivity. (See United States v. Carlton (1994) 512 U.S. 28, 32.)

5. Staff should take the opportunity presented by the Fujitsu opinion to propose regulations conforming to the federal treatment of Subpart F income.

Response – The treatment of entities with federal Subpart F income is provided for in section 25110. Conformity to Subpart F of the Internal Revenue Code would require legislation. It cannot be accomplished by regulation.

Recommendation – No change required.

D. *Comments by Kerne Matsubara representing Pillsbury Winthrop*

1. The examples in the proposed amendments do not include fact patterns involving the inclusion ratio, or a dividend that is deductible pursuant to section 24402.

Response – Including an example with a fact pattern involving the inclusion ratio might make it unduly complicated. With respect to the fact pattern involving section 24402, for years after

January of 2000, a deduction is not available. Therefore, there would be no continuing need for that type of fact pattern.

Recommendation – No change required.

E. *Comments by Terry Ryan representing Apple Computer.*

1. According to new federal requirements, publicly-traded corporations must present effective tax rate information in their quarterly financial statements. It is difficult to do this for California purposes because the denominator of the inclusion ratio is based on the foreign entity's earnings and profits, which are not known until the end of the year. The earnings and profits are not known on a quarterly basis. This problem would be rectified if California were to conform to the federal "Subpart F" rules

Response - This comment relates to California's treatment of entities with federal Subpart F income. This is a question that cannot be addressed by a regulation. It is a legislative matter

Recommendation – No change required.

F. *Comments by Michael Buczek representing Hewlett Packard*

1. Will the FTB be issuing guidance as to how taxpayers should conform to the inclusion ratio portion of the Fujitsu opinion?

Response – Portions of the Fujitsu opinion dealing with the calculation of the inclusion ratio for entities with Subpart F income, in particular the holding that an elimination should be made in calculating earnings and profits used as the denominator of the inclusion ratio, appear to be in error. This error does not arise from a misinterpretation of the Franchise Tax Board's regulations and is not involved in the ordering of dividend payments that is the subject of the proposed amendments. An internal Technical Advice Memorandum has been drafted about the subject. It has been distributed to the FTB's Compliance Division. Consideration will be given to issuing an FTB Notice or Legal Ruling.

Recommendation – No change required.