DRAFT PROPOSED AMENDMENTS TO REGULATIONS 24411 AND 25106.5-1(f)

STAFF REPORT REGARDING THE COURT'S DECISION IN
*Fujitsu IT Holdings, Inc. v. Franchise Tax Board* (2004) 120 Cal.App.4th 459

Pursuant to Board action at its meeting on February 9, 2005, staff held a symposium on proposed amendments to California Code of Regulations, title 18, sections 24411 and 25106.5-1(f) to receive public comment. The proposed amendments are in response to the Court of Appeal's decision in *Fujitsu IT Holdings, Inc. v. Franchise Tax Board* (2004) 120 Cal.App.4th 459. On June 15, 2005, the Board received a staff report regarding the symposium that was held on April 4, 2005.

At the June 15, 2005, meeting of the Franchise Tax Board, based on comments received from the public during the meeting, staff was directed to provide a report to the Board addressing the extent of the statutory construction contained in the portion of the *Fujitsu* opinion that addresses the ordering of distributions issue. Attached is the staff report. In addition, the report addresses a statutory construction argument raised in an additional comment received by staff following the June 15, 2005, Board meeting.

Staff is not asking for Board action at this time. In view of the complexity of this issue and the differing views regarding the draft regulations, staff recommends no action on the draft regulations at this time in order to provide ample opportunity for consideration of the attached report by the Board and the public and for interested parties to provide comment with respect to the report. Staff will provide to the Board at a subsequent meeting any comments received and will, at that time, seek direction from the Board regarding the draft proposed regulations.

September 7, 2005

STAFF REPORT REGARDING STATUTORY CONSTRUCTION IN THE "ORDERING OF DISTRIBUTIONS" PORTION OF *FUJITSU IT HOLDINGS V. FRANCHISE TAX BOARD* AND IN A WRITTEN COMMENT RECEIVED AFTER THE JUNE BOARD MEETING

The "Ordering of Distributions" Discussion, *Fujitsu IT Holdings v. Franchise Tax Board* (2004) 120 Cal.App. 4th 459, 479-480.

The ordering of distributions issue in *Fujitsu* involves the treatment of dividends that are paid from one member of a combined reporting group to another member of the group. The ordering question arises where the dividend paying entity has earnings and profits derived from income that was included in the combined report of the unitary group, and earnings and profits that were derived from income that was not included in the combined report of the unitary group. The appellate court held that dividends are paid first from earnings and profits derived from income included in the combined report or otherwise qualifying for a deduction, and that they are not paid *pro rata* from earnings and profits. The court's opinion does not address the question, except *sub silentio,* as to whether the source of dividends is determined in relation to the earnings and profits of any particular set of years.[1] The current regulation under section 24411 and the draft proposed amendments address both questions: 1) whether dividends are paid first from income that would give rise to a deduction or elimination and 2) whether the source of dividends is determined first by reference to the current year and thereafter for each immediately preceding year until the earnings and profits for any particular year are exhausted.

The court identifies three statutory provisions in the text associated with that portion of its opinion entitled "Ordering of Distributions," sections 24411,[2] 25106, and 25110. It also discusses section 24402 in a footnote. It does not quote the language of any of these statutes. Instead, it describes generally the operation of these statutes and how they are different from one another. The appellate court also sets forth its understanding of the decision and rationale of the trial court. Stating that statutes, regulations, or administrative pronouncements provide no clear guidance, the appellate court describes regulations adopted under sections 24411 and 25106.5, but appears to have limited the applicability of the regulation under section 24111.[3] It also suggests a

[1] It appears that the appellate court assumed dividends are paid from the collective earnings and profits. This is because the opinion is silent with respect to the question of whether dividends are paid from total earnings and profits without regard to the year in which the earnings and profits arise and because the opinion describes an example in the regulations under section 25106.5 (Cal. Code Regs., tit. 18, § 25106.5-1, subd. (f)(2)). That example does not make this differentiation.
[2] All statutory references are to the California Revenue and Taxation Code.
[3] The court limits regulations under section 24411 (Cal. Code Regs., tit. 18, § 24411) to 1989 and later years. This regulation actually related back to income years beginning on or after January 1, 1988, which is the period that the water's-edge legislation was originally operative. Under section 19503, all regulations are applied retroactively unless the Franchise Tax Board provides otherwise. There was no such limitation, and such a limitation would not have been appropriate since those regulations were adopted to provide direction as to the application of an innovative method of filing in California, i.e., water's-edge. The regulations under section 25106.5-1 are applicable to intercompany transactions occurring on or after January 1, 2001. (Cal. Code Regs., tit. 18, § 25106.5-1, subd. (k))

seeming inconsistency between those two regulations**.** Relying on the reasons discussed and those relied on by the trial court, the appellate court states its conclusion regarding the ordering of distributions.

Since the appellate court relied, in part, on the reasoning of the trial court, this report also examines the trial court's use of statutory construction in its consideration of the ordering of distributions issue. The trial court stated " . . . more significantly for this case, 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."[4] The trial court then states Amdahl's position that "pro-ration is neither required nor suggested by the statutes, and that it unduly burdens foreign commerce, contrary to the Commerce Clause of the U.S. Constitution."[5] The trial court then resolves the issue by stating a principle that " . . . statutes should be interpreted to the extent possible in a manner that harmonizes their terms and avoids unconstitutional infirmities. In view of that principle, the Court holds that RTC § 25106 should be applied . . . 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."[6]

However, in the portion of the trial court's Statement of Decision immediately following its discussion regarding the ordering of distributions, the trial court concluded that section 24411's allowance of a partial deduction for foreign dividends is not unconstitutional.

The question of whether the appellate court's conclusion with respect to the ordering of distributions is grounded in statutory construction may be open to question. The discussion segment of the appellate court's opinion is broken down into seven parts designated A through G. In part C, entitled "Computation of the Inclusion Ratio,"[7] it is clear that the court is engaging in statutory construction. In part D, entitled "Ordering of Distributions," the appellate court sets forth maxims of statutory construction, but it does not engage in a protracted analysis of the operative statutes relating to the ordering of distributions issue or an analysis of the language of the statutes. The appellate court does rely on the reasoning of the trial court with respect to this issue. But the trial court also does not engage in any protracted analysis of the statutes at issue. The trial court does appear to rest its decision on the need to harmonize statutes, in this case sections 24411 and section 25106, in an effort to avoid the risk of an unconstitutional result. The appellate court also cites a similar rule of statutory construction regarding constitutional concerns. However, both courts put to rest the constitutional concerns raised with respect to section 24411.

In staff's view the appellate court grounded its decision in its conclusion that there is an "absence of any clear and controlling guidance." With respect to the regulation section

[4] *Amdahl Corp. v. Franchise Tax Board* (Super. Ct. S.F. City and County, 2002, No. 321296).
[5] *Amdahl Corp. v. Franchise Tax Board, supra*.
[6] *Amdahl Corp. v. Franchise Tax Board, supra*.
[7] *Fujitsu IT Holdings v. Franchise Tax Board, supra,* 120 Cal.App. 4th 459, 475-479.

24411 and subdivision (f)(2) of regulation section 25106.5-1,[8] the appellate court suggested they were in conflict. However, relying on an absence of clear guidance, the court indicated its "construction is to favor the taxpayer rather than the government."[9] Therefore, staff concludes that the "Ordering of Distributions" portion of the appellate court's opinion grounds its analysis primarily in <u>regulatory</u> construction, not <u>statutory</u> construction. Staff believes that this regulatory construction arises from the court's misinterpretation of the example in regulation section 25106.5-1(f)(2). The draft proposed amendments would clarify the regulations and eliminate any potential further conflict.

<u>Additional Public Comment on Statutory Construction</u>

At the June Board meeting a member of the public made an oral comment that the resolution of the ordering of distributions in *Fujitsu* involved statutory construction. To ensure consideration of all relevant arguments regarding this issue, staff invited the person making the comment to submit a letter setting forth his views. Following the June 15th meeting, staff received a letter from that person.

In the letter, the author points out that section 24411 specifically allows for a 75% deduction "to the extent not otherwise allowed as a deduction or eliminated from income." It is the author's opinion that this language in section 24411 specifically provides that "[d]ividends are to be eliminated first before applying the 75 percent deduction." The taxpayer in *Fujitsu* did not advance this argument, nor was it reflected in the decision of the trial court or the appellate court.

The author's construction of the language is one possible construction of that language but it is not the only construction possible. Staff believes that an alternative construction -- that this language is a safeguard against a double deduction (a construction not inconsistent with proration) -- is a better construction and is supported by the history of the language.

The language referred to in section 24411, that the 75% dividend deduction will only apply "to the extent not otherwise allowed as a deduction or eliminated from income," was added to section 24411 by Senate Bill 85, (Stat.1988, ch. 989). This bill was "clean-up" legislation to the original "water's-edge" election bill enacted in 1986, effective for income years beginning on or after January 1, 1988.

In staff's view, this language was added to prevent a double deduction from occurring. Staff believes that what that phrase provides is that if a dividend from a foreign affiliate to a member of the water's-edge group can be deducted pursuant to another statute, e.g., section 24402 or section 25106, then the same dividend cannot also be deducted once again under section 24411. The language precludes a double deduction. It does not prohibit the prorating of dividends between those that are paid from income that has

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[8] All regulatory references are to the California Code of Regulations, title 18.
[9] *Fujitsu IT Holdings v. Franchise Tax Board, supra,* 120 Cal.App.4th 459, 480.

been previously subject to California taxation and those that are paid from income that has not been previously subject to California taxation.

The requirement of proration is a long-established principle of California law. The ordering of dividend distributions was a significant issue under section 24402. That section, although unconstitutional because it discriminates against interstate commerce, allowed a dividends-received deduction to the extent dividends were paid from earnings and profits derived from income previously taxed by California. In administering section 24402 it was necessary to determine what portion of a dividend was paid from income previously taxed by California when a taxpayer had only a portion of its income taxed by California. The department has always treated dividends as being paid *pro rata* from all of the earnings of a year. This treatment was acknowledged and accepted by the California Supreme Court in *Safeway Stores, Inc. v. Franchise Tax Board*, (1970) 3 Cal 2nd 745. There is no evidence that a different result was intended in the context of section 24411.

Staff's view as to the intent of the amendment is also consistent with contemporaneous legislative history regarding this revision, which states that the language in question was inserted to prevent any attempt to claim a concurrent deduction under section 24411 and any other statute.[10]

In addition, less than five months after SB 85 was signed into law, regulation section 24411, which interprets section 24411, was adopted. These regulations were first proposed and noticed for hearing during January 1988. From the time the regulations under section 24411 were first noticed they contained the provision stating that the source of dividends is determined through the use of proration. Accordingly, the regulation under section 24411 is both a contemporaneous interpretation of the statute, and an interpretation of the statute that was in the public realm at the time the "clean-up" legislation was adopted by the Legislature and signed by the Governor.

This regulation has always provided for prorating dividends. Specifically, Example 4 under subdivision (e)(4) of regulation section 24411 provides for the prorating of dividends between those that are paid from income that has been previously subject to California taxation and those that are paid from income that has not been previously subject to California taxation. This rule was included in regulation section 24411 that became effective on February 2, 1989, and applicable for income years beginning on or after January 1, 1988.

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[10] Assembly Revenue & Taxation Committee Analysis of SB 85, dated May 18, 1987. Department of Finance Analysis of SB 85, dated July 3, 1987. FTB Legislative Change No. 88-23, Senate Bill no. 85, dated October 10, 1988. FTB letter to Commerce Clearing House re: SB 85, dated October 25, 1988. (Attached).

[Nos. A101101, A102558. First Dist., Div. Two. July 7, 2004.]

FUJITSU IT HOLDINGS, INC., Plaintiff and Respondent, v.
FRANCHISE TAX BOARD, Defendant and Appellant.
[No. A101203. First Dist., Div. Two. July 7, 2004.]

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

SUMMARY

A multinational corporation filed a tax refund suit against the Franchise Tax Board (FTB) for four separate tax years, alleging that the FTB improperly assessed taxes against it based on its erroneous treatment of dividends distributed by the corporation's first-tier and second-tier subsidiaries. The corporation and its subsidiaries were treated as engaged in a single unitary business. The corporation, as the parent company of the unitary group, made a water's edge election effective for each of the tax years at issue. Accordingly, the corporation filed a water's edge combined income tax return for each of the relevant tax years that included combined income of its unitary group members incorporated in the U.S. as well as income of its controlled foreign subsidiaries that earned Subpart F income. (Rev. & Tax Code, § 25110, subd. (a)(6).) Dividends declared and paid by the corporation's (United Kingdom) subsidiaries triggered a tax liability—a U.K. tax known as the Advance Corporation Tax (ACT)—one-half of which was refunded to the U.K. subsidiaries' sole shareholder pursuant to the terms of a U.S.-United Kingdom tax treaty. The corporation characterized the ACT refund it received from the U.K. subsidiary under the tax treaty as a dividend on its water's edge combined return while the FTB treated it as nondividend income. The State Board of Equalization (SBE) found in favor of the FTB. The trial court found in favor of the corporation on all issues relevant in the action except the corporation's constitutional challenge to California's treatment of dividends from foreign subsidiaries, and awarded tax refund amounts for each of the relevant tax years. (Superior Court of the City and County of San Francisco, No. 321296, Thomas Mellon, Judge.)

The Court of Appeals affirmed. The court held that the ACT refund must be treated as dividends for California tax purposes. Treating the ACT credit refunds as dividends would effect the intent of the tax treaty—that the ACT refund paid by the U.K. to a U.S. corporation should be treated as a dividend for U.S. tax credit purposes. The court also held 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 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). California incorporates the federal definition of Subpart F income through Rev. & Tax. Code, § 25110, subd. (a)(6) and Cal. Code Regs., tit. 18, § 25110, subd. (d)(2)(F)(1). For purposes of defining the inclusion ratio under Rev. & Tax. Code, § 25110, subd. (a)(6), federal exclusions including distributions of previously taxed income under Int.Rev. Code, § 959(b), are considered part of California's definition of Subpart F income. Additionally, Rev. & Tax. Code, § 25106, forbids second-tier dividends at issue from being included in the inclusion ratio. The court concluded 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 § 25106, with (2) any excess paid out of earnings eligible for partial deduction under Rev. & Tax. Code, § 24411. The court held that California's water's edge method of apportionment of income does not facially discriminate against foreign commerce. The court also concluded that the corporation's action of seeking a refund for one of the relevant tax years was timely filed. The FTB could not take advantage of its own failure to process according to statutory mandate a tax payment made by the corporation, to invoke a statute of limitations defense against the corporation. Finally, the court held that the trial court properly awarded to the corporation attorney fees under Rev. & Tax. Code, § 19717. (Opinion by Ruvolo, J., with Kline, P. J., and Haerle, J., concurring.)

## HEADNOTES

Classified to California Digest of Official Reports

(1) **Corporations § 57—Taxation—Franchise Tax—Franchise Tax Board.**—The Franchise Tax Board (FTB) is the state agency empowered to determine the California tax liability of multistate or multinational corporations (Rev. & Tax. Code, § 23001 et seq.) The FTB has the authority to audit the operations of such corporations. (Rev. & Tax. Code, § 26423.)

(2) **Corporations § 59—Taxation—Apportionment of Unitary Business—Test to Determine Whether Business Is Unitary.**—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.

(3) **Corporations § 59—Taxation—Apportionment of Unitary Business—Water's-Edge Method.**—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.

(4) **Corporations § 59—Taxation—Apportionment of Unitary Business—Water's-Edge Method.**—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 case. The relevant exception, Rev. & Tax. Code, § 25110, subd. (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.

(5) **Corporations § 57—Taxation—Franchise Tax—Foreign Source Income from Foreign Affiliates—Portion Includible in Water's-Edge Group's Combined Income.**—Subpart F income gets its name from Subpart F of the Internal Revenue Code, as defined in Int.Rev. Code, § 952. It includes certain forms of passive income earned by affiliates controlled by foreign corporations (CFC)—for example, dividends, income from bank accounts, and stock investments. 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.

(6) **Appellate Review § 144—Scope of Review—Questions of law and Fact.**—On appeal, the appellate court applies the substantial evidence test to the trial court's factual findings, but reviews legal determinations independently.

(7) **Taxation § 3—Construction of Taxation Legislation.**—Ambiguities in governing statutes are resolved in favor of the taxpayer.

(8) **Administrative Law § 9—Powers and Functions of Administrative Agencies—Delegation of Functions—State Board of Equalization.**—The Legislature has delegated to the State Board of Equalization (SBE) the duty of hearing and determining appeals from actions of the Franchise Tax Board (FTB). (Rev. & Tax. Code, §§ 19045–19048.)

(9) **Administrative Law § 35—Administrative Actions—Legislation or Rule Making—Effect and Validity of Rules and Regulations—Construction and Interpretation of Rules and Regulations—Judicial Deference.**—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.

(10) **Administrative Law § 35—Administrative Actions—Legislation or Rule Making—Effect and Validity of Rules and Regulations—Construction and Interpretation of Rules and Regulations.**—The fact that an agency changes its interpretation of a statute is not evidence that either interpretation was legally impermissible.

(11) **Corporations § 55—Taxation—Foreign Tax—Advance Corporation Tax.**—Under United Kingdom (U.K.) 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 (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.)

(12) **Corporations § 55—Taxation— Tax Treaty Between the United States and the United Kingdom.**— 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.

(13) **Corporations § 55—Taxation—Tax Treaty Between the United States and the United Kingdom.**—Under a tax treaty between the U.S. and the United Kingdom (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) commonly referred to as the "Income Tax Treaty Between the United Kingdom and the United States", 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 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.

(14) **Corporations § 57—Taxation—Franchise Tax—Advance Corporation Tax Refund—Characterization as Dividend.**—A refund to the foreign subsidiaries of a multinational corporation according to the terms of a U.S.-United Kingdom (U.K.) tax treaty of one half of a particular tax assessed by the U.K., was required to be treated as a dividend for purposes of California taxes assessed against the multinational corporation. Treating the refunds as dividends effected the intent of the tax treaty that when a portion of the U.K. tax is refunded directly to a U.S. shareholder, that refund is to be treated as an additional dividend distribution for U.S. tax purposes.

[9 Witkin, Summary of Cal. Law (9th ed. 1989) Taxation, § 291.]

(15) **Corporations § 57—Taxation—Franchise Tax—Foreign Source Income from Foreign Affiliates—Includible in Combined Income—Inclusion Ratio.**— To determine the includable portion of a controlled foreign corporation's Subpart F foreign source income in the water's-edge report, Rev. & Tax Code, § 25110, subd. (a)(6), sets out a computation formula.

(16) **Corporations § 57—Taxation—Franchise Tax—Foreign Source Income from Foreign Affiliates—Includible in Combined Income—Inclusion Ratio.**—The income of a controlled foreign corporation (CFC) 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 Rev. & Tax Code, § 25110, subd. (a)(6).

(17) **Corporations § 57—Taxation—Franchise Tax—Foreign Source Income from Foreign Affiliates.**—With certain exceptions, California incorporates the federal definition of Subpart F income through Rev. & Tax Code, § 25110, subd. (a)(6), and Cal. Code Regs. tit. 18, § 25110, subd. (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., tit. 18, § 25110, subd. (d)(2)(F)(3).) In the case of dividends that are received by foreign subsidiaries from lower tier foreign subsidiaries, Int.Rev. Code, § 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 § 959(b).

(18) **Corporations § 57—Taxation—Franchise Tax—Foreign Source Income from Foreign Affiliates—State Incorporation of Federal Standard.**—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 the purpose of calculating the inclusion ratio defined in Rev. & Tax Code, § 25110, subd. (a)(6), absent clear language in the statute or in administrative regulations refusing to do so, a reviewing court may assume California has adopted into its definition of Subpart F income the federal exclusions, including distributions of previously taxed income under Int.Rev. Code, § 959(b).

(19) **Corporations § 57—Taxation—Franchise Tax—Combined Income of Unitary Group.**—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.

(20) **Statutes § 21—Construction—Legislative Intent.**— 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.

(21) **Corporations § 57—Taxation—Franchise Tax—Dividends Paid Out of Unitary Income of Lower-Tier Subsidiaries—Inclusion Ratio.**—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 § 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). This was the only conclusion possible from the plain and unambiguous language of Rev. & Tax. Code, § 25106.

(22) **Corporations § 57—Taxation—Franchise Tax—Dividends Received by Water's-Edge Group from a Foreign Affiliate—Order of Distributions.**—Rev. & Tax. Code, § 24411, subd. (a), provides that 75 percent of dividends received by the water's-edge group, and not eliminated by 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, i.e., § 25106 (100 percent deduction for earnings previously included in a California combined return) or Rev. & Tax. Code, § 24411, subd. (a), (75 percent "dividends received" deduction).

(23) **Corporations § 57—Taxation—Franchise Tax—Dividends Received by Water's-Edge Group from a Foreign Affiliate—Order of Distributions.**—Dividends paid by first-tier subsidiaries from current year earnings should be treated as paid (1) first out of earnings eligible for elimination under Rev. & Tax. Code, § 25106, with (2) any excess paid out of earnings eligible for partial deduction under Rev. & Tax. Code, § 24411. In the case of a subsidiary controlled by a 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 above.

(24) **Constitutional Law § 1—Commerce Clause—In General.**—The U.S. Constitution's foreign commerce clause provides that "Congress shall have Power . . . to regulate Commerce with foreign Nations." (U.S. Const., art. I, § 8, cl. 3.) The term "commerce" includes the flow of dividends from a foreign subsidiary to its parent company.

(25) **Constitutional Law § 1—Commerce Clause—Powers Given to Congress.**—U.S. Const., art. I, § 8, cl. 3, 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. The dormant aspect of U.S. Const., art. I, § 8, cl. 3, 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.

(26) **Corporations § 59—Taxation—Apportionment of Unitary Business—Water's-Edge Method—Commerce Clause.**—California's water's-edge method of apportionment of income does not facially discriminate against foreign commerce.

(27) **Taxpayers' Remedies § 9—Recovery of Taxes Paid—Taxes Paid Under Protest.**—Rev. & Tax. Code, § 19335, provides that a taxpayer may pay a tax under protest, before the Franchise Tax Board acts on a claim or the 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.

(28) **Taxpayers' Remedies § 9—Recovery of Taxes Paid—Taxes Paid Under Protest.**—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 Rev. & Tax. Code, § 19384, statute of limitations regarding claims for refund.

(29) **Taxpayers' Remedies § 6—Recovery of Taxes Paid—Recovery of Reasonable Litigation Costs.**—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.

(30) **Taxpayers' Remedies § 6—Recovery of Taxes Paid—Recovery of Reasonable Litigation Costs.**—Where a lawsuit consists of related claims and the taxpayer has won substantial relief, a trial court has discretion to award the taxpayer attorney fees for discrete issues under 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 the extent that an award of attorney fees will act as a disincentive to the Franchise Tax Board (FTB) to take positions that it cannot substantially justify, an award is well within the court's discretion. Thus, in a tax refund action in which a multinational corporation sought a refund alleging that the FTB improperly assessed taxes against it based on its erroneous treatment of dividends distributed by the corporation's first-tier and second-tier subsidiaries, the trial court did not err in awarding to the corporation attorney fees under Rev. & Tax. Code, § 19717.

COUNSEL

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OPINION

**RUVOLO, J.—**

## I.

### INTRODUCTION

Amdahl Corporation (Amdahl),[1] 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 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[2] to dividends received from Amdahl's foreign subsidiaries.[3] 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" method of apportioning the combined income of a unitary business group for tax purposes improperly discriminates against foreign subsidiaries in favor of domestic

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[1] 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.

[2] All further undesignated statutory references are to the Revenue and Taxation Code.

[3] 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.

subsidiaries, in violation of the commerce clause of the United States Constitution (U.S. Const., art. I, § 8).

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.

**(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 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].) **(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

Cal.2d 664 [111 P.2d 334].) 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.)

In 1986, California passed legislation permitting taxpayers to make a "water's-edge" election. **(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.)-based affiliated entities. **(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 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)[4] if all or part of their income is "Subpart F" income.

**(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 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.

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

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 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

**(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, 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].) **(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 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. **(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.)

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.

**(9)** 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. (*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].)

**(10)** As the FTB emphasizes, 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 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 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 elimination under section 25106 or deduction under section 24411, subdivision (a). This issue concerns only the Amdahl subsidiaries incorporated in the U.K.—Amdahl International Management Services (AIMS) and Amdahl (U.K) Ltd.[5]

**(11)** For the tax years relevant here, 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 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.)

**(12)** However, 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.

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. **(13)** 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 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.

[5] 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.

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 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 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 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.

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: "the aggregate of the amount or value of the dividend and the [ACT refund] paid by the United Kingdom to 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, 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] ["[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 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 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. **(14)** Accordingly, we agree with the trial court that the ACT refunds must be treated as dividends for California tax purposes.

### C. Computation of the Inclusion Ratio

**(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)[6] sets out a computation formula, or what the trial court 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.[7] The FTB challenges this conclusion on appeal. **(16)**

As previously noted, 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:

$$\frac{\text{CFC's Subpart F Income}}{\text{CFC's Earnings and Profits}}$$

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."[8] The resulting fraction may not be less than zero nor more than one.

[6] 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.

[7] 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.)

[8] Section 25110, subdivision (a)(6) provides, in pertinent part, "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

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."

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.

**(17)** As noted, with certain exceptions not relevant here, 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 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

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."

§ 959 or its principles, and the exclusion in that Treasury regulation therefore has no application for California tax purposes."

We disagree with this conclusion. **(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), 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: "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 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.)

The Legislature could hardly have chosen words with a clearer meaning. **(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 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 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. **(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. (*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]; *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"].)

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 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.)

**(21)** For the foregoing reasons, 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 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 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.

**(22)** The importance of this distinction stems from the fact that, 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: "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.[9]

The superior court reached its result in order to "harmonize[] [the statutes] and avoid[] constitutional infirmities." The court came to the conclusion that

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[9] 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.

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. 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).)

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].)

**(23)** 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, with 2) any excess paid out of earnings eligible for partial deduction under section 24411. In the case of a CFC that is *partially* included in a unitary group, the CFC will be able to move amounts that have been included in the combined income of the unitary group without tax incident only by adopting the ordering rule described above.

### 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 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 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 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 is 100 percent included on the combined report. Relying on this reasoning, the FTB argues that section 24411 does not discriminate against foreign commerce. We agree.

(24) The United States Constitution's foreign commerce clause provides that "Congress shall have Power . . . to regulate Commerce with foreign Nations." (U.S. Const., art. I, § 8, cl. 3.) The term "commerce" includes the flow of dividends from a foreign subsidiary to its parent 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*).)

(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 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* involved a separate entity tax return of a parent company.[10] 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

[10] 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.

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.)

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 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*), 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 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: "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 scheme in *Kraft*." (*Id.* at pp. 87–88.)

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 OhioSt.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.)

**(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 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 commerce on this basis.[11]

### 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. The statute of limitations applicable to tax refund suits is section 19384, which provides: "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."

[11] 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).

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 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" to a claim for refund by section 19335. **(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 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 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 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 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. **(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.[12] As the Legislature

[12] Section 19041.5, subdivision (a) provides, in pertinent part, that "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: [¶] (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. [¶] (2) The deficiency assessed becomes due and payable in accordance with Section 19049."

recognized, section 19041.5 simply "[c]odifies existing . . . [FTB] practice . . . ."

### 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.[13] 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.

**(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 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."

"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 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

[13] 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.

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 2000. Nevertheless, adopting its untenable position that Amdahl's claims with respect to the 1988 tax year were time-barred, the 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.

**(30)** Where a lawsuit consists of related claims and the taxpayer has won substantial relief, we believe a trial court has discretion 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.

## IV.

### DISPOSITION

The judgment is affirmed.

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

ENDORSED
FILED
San Francisco County Superior Court

OCT - 3 2002

GORDON PARK-LI, Clerk
BY: DAN MACDUFF
Deputy Clerk

SUPERIOR COURT OF THE STATE OF CALIFORNIA

CITY AND COUNTY OF SAN FRANCISCO

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|---|---|
| AMDAHL CORPORATION, a Delaware corporation,<br>Plaintiff,<br>v.<br>FRANCHISE TAX BOARD, an agency of the State of California,<br>Defendant. | Case No. 321296<br>**STATEMENT OF DECISION** |

This action was tried to the Court largely on stipulated facts, which were supplemented by testimony of witnesses and documents admitted into evidence at the hearings on May 29, and July 8, 2002. At the commencement of and during the the trial, the parties submitted very substantial written briefs and argument. After consideration of the evidence and arguments, the Court orally announced its proposed resolution of each of the several issues raised. In order to facilitate a cogent statement of decision, the parties agreed to jointly undertake an effort to prepare an agreed Proposed Statement of Decision. which while it might be approved by each of them as to form, would waive none of the rights of either party to challenge the Judgment which would be made. The submission of the Proposed Statement of Decision was somewhat delayed by scheduling issues of counsel and the Court, but has now been submitted. After review, the Court adopts, with some modifications that Proposed Statement as the Court's Statement of Decision .

## 1. AMDAHL'S CLAIM WITH RESPECT TO 1988 IS NOT TIME-BARRED

During the pendency of its administrative protest against a proposed deficiency for the 1988 year, Amdahl made a payment of $2 million with respect to the 1988 tax year. The FTB argues that (i) by virtue of Revenue and Taxation Code ("RTC") § 19335, the payment converted Amdahl's administrative protest into a claim for refund, (ii) after the decision by the State Board of Equalization ("SBE") upholding the FTB's denial of the protest, Amdahl's subsequent claim for refund was a nullity, and (iii) Amdahl's suit for refund with respect to 1988 is untimely, since it was not filed within 90 days of the SBE's decision. Amdahl presented evidence that its payment was intended to cover liabilities other than the taxes being protested, that the FTB consistently treated Amdahl's administrative action as a protest against a proposed assessment, rather than being a claim for refund, and that both the FTB and SBE treated Amdahl's subsequent appeal as an appeal of a proposed assessment, rather than as an appeal of the denial of a claim for refund. Amdahl also argued that its claim for refund had broader scope than the protest against the proposed deficiency.

RTC § 19335 provides that:

> If, with or after the filing of a protest ...a taxpayer pays the tax protested before the Franchise Tax Board acts upon the protest, ... the Franchise Tax Board ... shall treat the protest ... as a claim for refund ... under this article.

This provision directs the FTB to treat a protest as a claim for refund if the taxpayer has paid the tax protested. Leaving aside the question of whether Amdahl had in fact paid the tax protested, the simple fact is that the FTB did not treat the protest as

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a claim for refund. In fact, the evidence produced by the FTB itself shows that Amdahl's payment was applied to the protested taxes only after the SBE's decision on the appeal. 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.

## 2. THE ACT CREDIT MANDATED BY THE U.S.-U.K. INCOME TAX TREATY IS DIVIDEND INCOME TO THE RECEIVING U.S. SHAREHOLDERS

Under a treaty with the United Kingdom (the "U.S.-U.K. Income Tax Treaty", or the "Treaty"), U.S. corporations that own 10% or more of the stock of a U.K. corporation are entitled, when the U.K. corporation pays a dividend, to a payment from the United Kingdom of an amount equal to one-half of the amount of the tax credit that an individual U.K. shareholder holding the same number of shares would receive with respect to the dividend. For the years at issue, a U.K. corporation that paid a dividend to its shareholders was required to pay an Advance Corporation Tax ("ACT"), computed according to the amount of the dividend. Individual U.K. shareholders received a tax credit equal to the amount of the corporation's ACT (pro-rated by percentage ownership), and were subject to U.K. personal income taxes not only on the dividend received, but also on the amount of the tax credit, as if the tax credit were an additional amount of dividend. The U.K. corporation also received a credit in the amount of the ACT against its corporate income tax liability. In the context of a U.K. shareholder, there is, therefore, a double credit for a single tax payment.

Amdahl contends that the tax credit payment ("ACT Credit") that it received with respect to dividends from its U.K. subsidiaries should be taxable as additional

Edge election. The effect of the Water's Edge election is to take into account the income and apportionment factors generally only of affiliates incorporated in the United States, with a number of exceptions, one of which is at issue in this case. The relevant exception, in RTC § 25110(a)(6)[1], adds to the Water's Edge group a portion of the income and apportionment factors of affiliates that are "controlled foreign corporations", as defined in the Internal Revenue Code ("IRC"), if all or part of their income is "Subpart F income" – a category that includes most types of passive income and that is defined in IRC § 952.

The statutory language of RTC § 25110(a)(6) requires the inclusion in the income of the Water's Edge group (subject to apportionment) of that fraction of the controlled foreign corporation's income that is represented by the ratio (which we may call the "inclusion ratio") of the Subpart F income (computed under federal principles) to the corporation's earnings and profits for the year (also computed under federal principles). Consistent with the legislative history of RTC § 25110(a)(6), which makes clear its intent to ensure that Subpart F income is captured in the Water's Edge return, 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. The issue upon which the parties are in dispute is how to compute the inclusion ratio in the case of a controlled foreign corporation that receives dividends from an affiliate that is also a controlled foreign corporation (a "lower-tier subsidiary").

Amdahl makes two arguments with respect to the computation of the inclusion ratio of RTC § 25110(a)(6): first, that dividends paid out of "previously taxed income under [IRC] § 959(b)" are excluded from Subpart F income pursuant to U.S. Treasury Regulations under IRC § 959; and, second, that taking into account dividends paid out of income that was included in the combined income of a unitary group when computing the inclusion ratio would violate RTC § 25106.

[1] Current RTC § 25110(a)(6) was originally numbered RTC § 25110(a)(3), then changed to RTC § 25110(a)(7), before having its current numbering.

dividend income (and, accordingly, eligible for elimination under RTC § 25106 or a partial deduction under § 24411). In the alternative, Amdahl contends that, if the ACT Credit is not dividend income, then it is not income, but is a contribution to capital by a non-shareholder. The FTB, on the other hand, claims that the ACT Credit is non-dividend income of the U.S. corporate shareholder.

The characterization of the ACT Credit that is mandated by the U.S.-U.K. Income Tax Treaty involves the nature of the ACT system in the U.K. The legislative history of the Treaty reveals that the U.S. Treasury Department viewed the ACT system as giving U.K. shareholders the benefit of a lower corporate tax rate on distributed earnings. In other words, under the ACT system, when a U.K. corporation distributed a portion of its earnings as a dividend, the U.K. shareholders were in the same position as if the corporation's tax liability had been lowered (by the amount of the ACT), and the dividend to the shareholders was correspondingly increased. The Treaty was intended partly to mitigate the disparity in treatment between U.K. and U.S. investors by providing U.S. direct investors with a payment equal to one-half of the tax credit. This payment was not refunded to the dividend-paying U.K. corporation, but was paid only to the U.S. shareholders. In effect, the shareholders received a \$1 offset for every \$2 of ACT paid by the U.K. corporation with respect to dividends.

From the above considerations, the Court concludes that the most reasonable interpretation of the ACT Credit is that it is additional dividend income to the U.S. shareholders. Because of the disposition of this issue, the Court need not reach Amdahl's alternative argument.

3. <u>IN COMPUTING THE PORTION OF INCOME OF A CONTROLLED FOREIGN CORPORATION THAT IS INCLUDED IN A WATER'S EDGE RETURN UNDER RTC 25110(a)(6), RTC 25106 REQUIRES THE COMPLETE ELIMINATION OF DIVIDENDS PAID OUT OF INCOME OF THE WATER'S EDGE GROUP</u>

Under RTC §§ 25110-25115 (the "Water's Edge" provisions), a qualified taxpayer can elect to determine its California taxable income pursuant to a Water's

The FTB disputes both of these claims. First, the FTB argues that IRC § 959(b) is not incorporated into California law and that, accordingly, the exclusion in the U.S. Treasury Regulation that references IRC § 959(b) should not be applied to RTC § 25110(a)(6). Second, the FTB argues that RTC § 25106, which pre-dates the Water's Edge provisions, was not intended to be applied to the computation of the inclusion ratio, which is merely a measure of how much income of the controlled foreign corporation is included (subject to apportionment) in the Water's Edge return.

RTC § 25106 provides that dividends paid out of unitary income of a lower tier subsidiary shall "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 the unitary group. If the phrase "in any other manner" is to be given full effect, 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). This conclusion harmonizes and gives effect to express terms of both RTC § 25106 and RTC § 25110(a)(6) and carries out the intent of the statutory scheme.

As to Amdahl's first argument that U.S. Treasury regulations exclude, for California tax purposes, dividends paid out of previously taxed income under IRC § 959(b), the Court agrees with the FTB that, in using the federal definition of Subpart F income in IRC § 952, California did not adopt IRC § 959 or its principles, and the exclusion in that Treasury regulation therefore has no application for California tax purposes.

4. IN APPLYING RTC 25106 TO DIVIDENDS FROM CORPORATIONS THAT ARE PARTIALLY INCLUDED IN A UNITARY GROUP UNDER THE WATER'S EDGE PROVISIONS, DISTRIBUTIONS ARE DEEMED TO BE MADE FIRST FROM INCOME OF THE UNITARY GROUP, TO THE EXTENT THEREOF, AND THEN FROM NON-UNITARY INCOME

When a controlled foreign corporation, part of whose income and apportionment factors are taken into account under the Water's Edge provisions, pays a dividend to its parent corporation, a portion of that dividend may be paid out of income of the unitary group (and, therefore, eliminated under RTC § 25106) and a portion may be paid out of other income. The latter portion would not be eliminated under RTC § 25106, but would be eligible for a partial deduction under RTC § 24411. The question put at issue by the parties is how the source of a dividend should be apportioned between income of the unitary group and other income.

The question of the source of such dividends is related in two ways to Amdahl's challenge to the constitutionality of the partial (75%) deduction under RTC § 24411. First, the source of dividends would largely be moot if dividends from non-unitary income were eligible for 100% deduction, since there is little difference between elimination and complete deduction. Second, and more significantly for this case, 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.

When a lower-tier subsidiary whose income and factors are fully included in the combined return of a Water's Edge group under RTC § 25110 pays a dividend to a controlled foreign corporation, which, in turn, distributes the amount received as a dividend to its shareholder, the FTB argues that the latter dividend should be deemed to be paid only partially (that is, pro rata) out of income of the unitary group (*i.e.*, to the extent of the inclusion ratio of the controlled foreign corporation) and partially out of non-unitary income (*i.e.*, to the extent of the remainder). Amdahl argues that such a pro-ration is neither required nor suggested by the statutes, and that it unduly burdens foreign commerce, contrary to the Commerce Clause of the U.S. Constitution.

In resolving this issue, the 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 that principle, the Court holds that RTC § 25106 should be applied to dividends from controlled foreign corporations that are partially included in a 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.

In light of the decision on this issue, we turn to Amdahl's facial challenge to the constitutionality of RTC 24411.

5. <u>THE FTB'S TREATMENT OF AMDAHL'S FOREIGN DIVIDENDS IS CONSTITUTIONAL</u>

Amdahl claims that, in allowing only a partial deduction for dividends paid out of non-unitary income of a Water's Edge group, RTC § 24411 discriminates against foreign commerce in violation of the Foreign Commerce and Due Process Clauses of the United States Constitution. Amdahl alleges that unconstitutional discrimination occurs because dividends paid from domestic subsidiaries' income (which is included on the water's-edge group's combined report) are fully eliminated under Revenue and Taxation Code ("RTC") §25106, but foreign subsidiaries' dividends (paid from income not included on the combined report) are

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only 75% excluded by §24411.[2] However, Amdahl's argument overlooks two significant facts: (1) that California's corporate tax system has the effect of including 100% of domestic subsidiaries' income on the combined report, *and*, under Amdahl's water's-edge election, allows a deduction of 75% for foreign subsidiary dividends, and (2) as to dividends paid from income included on the combined report by RTC §25110(a)(6), foreign source dividends are, pursuant to RTC §25106, eliminated in the same manner and to the same extent as dividends paid by domestic subsidiaries. Thus, this scheme actually provides better tax treatment for foreign subsidiaries' income.

Amdahl cites the United States Supreme Court's decision in *Kraft General Foods, Inc. v. Iowa Department of Revenue* (1992) 505 U.S. 71 for the proposition that dividends received from foreign and domestic subsidiaries must not be treated differently. Amdahl also cites *Hunt-Wesson, Inc. v. Franchise Tax Board* (2000) 528 U.S. 458 for the proposition that reducing the deduction available for foreign subsidiary dividends is, in effect, a discriminatory tax. However, unlike the facts in *Kraft* and *Hunt-Wesson*, Amdahl's water's-edge election creates a form of "taxing symmetry," which actually includes only a portion of a foreign subsidiary's income, and *all* of a domestic subsidiary's income, in the water's-edge group's combined report.

The Iowa corporate tax system struck down in *Kraft* was very different from the California system. See, *Kraft*, 505 U.S. at 74 fn.9. Under Iowa law, each corporation taxable in the State was required to file a separate return, and there was

[2]. When a domestic subsidiary pays dividends from earnings and profits from operations that are not unitary with the operations of the parent, those dividends are not eliminated by §25106. Only dividends paid from unitary earnings and profits, and that are included on the combined report, are entitled to elimination under §25106. *Willamette Ind. Inc v. Franchise Tax Bd.* (1995) 33 Cal.App. 4th 1242, 1248. Thus, in the water's-edge context, under the joint operation of RTC §§25110(a)(6) and 25106, foreign source dividends are fully eliminated to the extent they are paid out of unitary income that is included on the combined report of the water's-edge group. As the opinion in *Willamette Industries* demonstrates, the same fate befalls dividends from domestic subsidiaries that are paid out of earnings and profits not included on the combined report. Because, under the water's-edge election, non Subpart F foreign subsidiary income is not included in the combined report, RTC §24411 grants a 75% deduction for foreign subsidiaries' dividends paid from such income. |

no intercompany apportionment of income. Because Iowa relied on federal taxable income as a starting point for computing Iowa taxable income, all dividends paid to the taxpayer by domestic (U.S.) subsidiaries were eliminated. However, because the U.S. government subjected foreign source dividends paid to U.S. taxpayers to taxation, all foreign source dividends were included by Iowa in the measure of its tax. Unlike the federal government, however, Iowa did not allow a credit for foreign taxes on, or measured by, income. Thus, Iowa allowed 100% of the income earned and dividends paid by domestic subsidiaries to escape taxation, while objecting 100% of foreign source dividends to taxation.[1]

Under 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 domestic dividends are eliminated, 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.

For those dividends not eliminated by §25106, California provides a 75% "dividends received" deduction under RTC § 24411. Therefore, only 25% of those dividends are subject to apportionment, and only that percentage of the dividends equal to the California apportionment percentage of the water's-edge group will actually be subjected to tax by California. Thus, while Iowa taxed none of the domestic subsidiaries' income and 100% of the foreign dividends, California

[1]. In *Hunt-Wesson* the Supreme Court held that California's computation of a deduction from unitary income, based upon the amount of nonunitary income received by the taxpayer, amounted to an impermissible tax on nonunitary income. *Hunt-Wesson*, 528 U.S. at 464-465. Here, RTC §24411 does not tax nonunitary income; the dividends received from foreign subsidiaries are, in fact, taxable income to the unitary group. Thus, *Hunt-Wesson* does not support Amdahl's argument.

subjects only 25% of the foreign dividends to apportionment while subjecting 100% of the domestic income to apportionment.

In *E.I. Du Pont De Nemours & Co. v. State Tax Assessor* (Me. 1996) 675 A.2d 82, the Supreme Judicial Court of Maine upheld Maine's water's-edge combined reporting method, which is substantially similar to California's, distinguishing it from Iowa's single entity reporting method at issue in *Kraft.* Quoting at times from the Kansas Supreme Court's opinion in *Appeal of Morton Thiokol* (1993) 254 Kan. 23, 864 P.2d 1175, 1186 the *Du Pont* Court said:

> "*Kraft* does not address the taxation of foreign dividends by domestic combination states. . . . In *Kraft,* the Supreme Court considered the constitutionality only of Iowa's single entity reporting system. (Citation). Pursuant to this taxing method Iowa directly taxed neither the income nor the dividends of a domestic subsidiary if the subsidiary did not do business within the state. Iowa, however, did tax the dividends paid by the foreign subsidiary to the domestic parent. . . . In contrast, the combined reporting method by definition includes within the amount apportioned to Maine part of the income earned by the unitary business's domestic subsidiaries. . . . With respect to dividends of foreign subsidiaries, however, Maine's use of the water's edge combined reporting method limits the State to the nation's boundaries in calculating corporate income, and hence no income of foreign subsidiaries is apportioned to Maine. . . . Far from discriminating against foreign commerce, Maine's water's edge combined reporting method provides at 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 scheme in *Kraft.* Thus, Maine's use of a water's edge combined reporting method distinguishes Maine's taxing scheme from the scheme invalidated by the United States Supreme Court in *Kraft*". 675 A.2d at 87-88.

See, *Conoco, Inc. v. Taxation and Revenue Dept. of New Mexico* (N.M. 1997) 122 N.M. 736, 742, 931 P.2d 730, 736 (distinguishing *Thiokol* and *DuPont* from *Kraft*).

See also, *Emerson Electric Co. v. Tracy* (Ohio 2000) 90 Ohio St. 3d 157, 160-161, 735 N.E.2d 445, 448-449; *Caterpillar Fin. Services v. Whitley* (Ill.App.1997) 288 Ill. App. 3d 389, 397-399, 680 N.E.2d 1082, 1086-1089; *Dart Industries, Inc. v. Clark* (R.I. 1995) 657 A.2d 1062, 1065.

Like *Du Pont*, 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 group's combined report. See, RTC §25110. 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.

Likewise, Amdahl's reliance on *Ceridian Corp. v. Franchise Tax Bd.* (2001) 85 Cal.App. 4th 875 is misplaced. In that case the Court of Appeal held unconstitutional under the U.S. Constitution's dormant Commerce Clause a tax on dividends paid by insurance companies to major corporate stockholders. The statute in question, RTC §24410, allowed a deduction for "dividends received by a corporation commercially domiciled in California during the income year from an insurance company . . . ." That Court found that the statute's limitation of the deduction to dividends "paid from income from California sources" unconstitutionally "favors domestic corporations over their foreign competitors in raising capital among California corporations, and tends, at least, to discourage domestic corporations from plying their trade in interstate commerce, from purchasing property or hiring employees in other states, and from purchasing subsidiary insurance corporations that do so." *Id.* at 887. Here, California's water's-edge application of RTC 24411 actually favors, rather than discourages, foreign commerce. Thus, *Ceredian* has no application here; California's water's-edge reporting method does not unconstitutionally discriminate against foreign commerce. Finally, Amdahl's reference to the Los Angeles County Superior Court's ruling on RTC §24402 in *Farmer Bros. Co. v. Franchise Tax Bd.*. No. BC 237663, is not persuasive. The lack of precedential effect of any Superior Court decision must be humbly acknowledged, but the force of its reasoning may be compelling. Here, the reasoning of the *Farmer Bros*. Decision is not pertinent. As in the case of Amdahl's *Ceredian* argument, the statute at issue here, RTC §24411, grants deductions for dividends which actually favor, rather than discriminate against, foreign commerce.

For all these reasons, the Court finds Amdahl's constitutional challenge to RTC §24411 to be without merit. The Court's disposition of this matter makes it unnecessary to address the FTB's argument that the contractual nature of Amdahl's water's-edge election prevents it from raising a constitutional challenge to the application of California's water's-edge legislation.

Plaintiff shall prepare a judgment consistent with this Statement of Decision.

Dated: October 2, 2002

Judge of the Superior Court

## CERTIFICATE OF SERVICE BY MAIL

I, DAN MACDUFF, a deputy clerk of the Superior Court for the City and County of San Francisco, hereby certify that:

I am not a party to this action.

On the date appearing below, I served the attached

STATEMENT OF DECISION

By placing a copy thereof in a sealed envelope, addressed as follows:

David Lester Larson, Esq.
MCDERMOTT, WILL & EMERY
3150 Porter Dr.
Palo Alto, CA 94304

ATTORNEY GENERAL
455 Golden Gate Ave., Rm. 11000
San Francisco, CA 94102

FENWICK & WEST
Two Palo Alto Square, Ste. 800
Palo Alto, CA 94306

and,

I then placed the sealed envelope in the outgoing mail at 400 McAllister Street, San Francisco, CA, 94102 on the date indicated below for collection, attachment of required postage and mailing on that date, following standard court practices.

DATE: October 3, 2002

GORDON PARK-LI, Clerk

by: 
Dan MacDuff, Deputy

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Mr. Craig Swieso
State of California
Franchise Tax Board - Legal Department
P.O. Box 1720
Rancho Cordova, CA 95741-1720

July 11, 2005

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

Dear Mr. Swieso:

At the recent FTB Board meeting held on June 15, 2005, I testified against the Staff's request to notice the proposed amendments to Reg. section 24411. Subsequent to that meeting, I was requested to put into writing one of the comments that I made so that the Staff can respond to it.

Proposed amendment to Reg. section 24411 would impose an ordering rule for distributions that differs from that announced by the Court of Appeal in *Fujitsu It Holdings, Inc. v. Franchise Tax Board* (2004), 120 Cal.App.4$^{th}$ 459. Under this proposed amendment, dividends are considered, on a pro-rata, last-in, first-out basis, paid out of earnings and profits that are eligible for a dividend elimination treatment under California Revenue and Taxation Code ("CRTC") Section 25106 and from earnings and profits that are eligible for a dividend received deduction under CRTC Section 24402, etc. Such a position is in direct conflict with the holding in *Fujitsu* where the Court of Appeal in a final, published opinion held that such distributions shall be considered first paid of earnings and profits eligible for a dividend elimination treatment under CRTC Section 25106 before being considered paid out of earnings and profits that are eligible for a dividend received deduction under CRTC Section 24402, etc.

As further support for this proposition, I noted that CRTC Section 24411 adopts a similar ordering rule for dividends paid to taxpayers electing to file under the water's edge combined report basis. This section provides a 75 percent deduction for qualifying dividends "to the extent not otherwise allowed as a deduction or eliminated from income." The language of the statute is quite clear. Dividends are to be eliminated first before applying for the 75 percent deduction. The proposed amendment is in conflict with this clear direction.

Very truly yours

Barry Weissman

Barry Weissman
Director
Tax

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

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION
JOHAN KLEHS, CHAIR

SB 85 (Alquist) - As Amended: May 13, 1987

ASSEMBLY ACTIONS:

| COMMITTEE ____ VOTE ____ | COMMITTEE ____ VOTE ____ |
|---|---|
| Ayes: | Ayes: |
| Nays: | Nays: |

SUBJECT: Unitary Apportionment: Revises Provisions Of 1986 Unitary Reform Legislation

DIGEST

Majority Vote Required. Tax Levy. Fiscal Committee.

Current law imposes a tax on the net income of banks and corporations at a 9.6% rate. In order to determine the California portion of the total net income of a multinational corporation, California uses an apportionment formula with a combined unitary return. In this combined return, generally all affiliates of a corporation are combined and treated as one unitary corporation.

Legislation passed in 1986 (SB 85, Alquist) permits taxpayers a choice of:

1) Worldwide combination (where all affiliated corporations worldwide are combined and treated as one) or

2) Water's edge combination (where certain affiliated domiciled overseas are not combined with domestic corporations for California tax purposes).

Corporations incorporated in the United States but with less than 20 percent of their average property, payroll and sales in the United States (known as 80-20 corporations) are included in a water's edge combination, because they are incorporated in the United States.

Taxpayers electing a "water's edge" apportionment may exclude from taxation 75 percent of the base dividends they receive from qualified affiliates.

Base dividends are the highest dividends received in any one of three taxable years ending before January 1, 1987. Dividends received in excess of base

- continued -

dividends may be wholly taxable, partially taxable, or wholly exempt, depending on the ratio of their foreign payroll to their USA payroll. If foreign payroll goes up, more dividends will be wholly taxable; if foreign payroll goes down, more dividends will be wholly exempt.

Taxpayers making a "water's edge" election must make the election for a 10 year period and pay an election fee of .03% of the sum of current sales and historic property and payroll in California. The election fee base may be reduced permanently by the amount expended for investment in new plants in California and the amount expended for new employees in California beginning on January 1, 1988. However, in no event may the election fee drop below .01 percent of current property, payroll and sales.

This bill makes a number of changes in the unitary apportionment reform bill of 1986, which are generally technical and clean-up in nature, by:

1) Excluding specifically from the "water's edge" group corporations electing under Section 936 of the Internal Revenue Code (possessions corporations).

2) Providing treatment of corporations parallel to the "deemed subsidiary" treatment for banks and requiring such such banks and corporations to include income only from sources within the United States as defined by federal income tax law.

3) Clarifying that the references to "Subpart F" income and total earnings and profits mean those for the current income year.

4) Revising the election and the "election fee" as follows:

   a) Taxpayers are given an option to make a 5 year election and pay an election fee of .03 percent of current sales and historical property and payroll in California or a 10 year election and pay an election fee of .015 percent of current sales and historical property and payroll in California.

   b) New investment in California in 1987 (as well as in 1988 and thereafter) may be deducted from the election fee base.

   c) Intangibles are not included in the property factor for the minimum election fee (since they are not included in the property factor for the regular election fee).

   d) A mechanism is added to correct the computation of the election fee where corporate reorganizations occur after the base period is established.

- continued -

e) The election fee will not apply if there is no net income subject to tax in California and the corporation is only liable for the $200 minimum tax.

f) The election fee is deductible from the bank and corporation tax (which codifies FTB staff administrative practice).

g) The definition of new plant can include a new plant built for the taxpayer by someone else.

5) Revising the dividend exclusion as follows:

a) References to "taxpayer" are changed to references to "water's edge" group.

b) The dividend exclusion is restricted to dividends which are not otherwise excluded from taxation.

c) The computation of the dividend exclusion can not be less than zero (which would result in a tax increase).

d) References to the payroll factor inside and outside of the United States are clarified.

6) Clarifying the domestic spreadsheet requirements, as follows:

a) A domestic spreadsheet is not required if a corporation is not required to file a federal return.

b) The domestic spreadsheet is to be filed 6 months after the federal return is filed, rather than 3 months after the state return is filed.

c) Corporations with less than $500,000 of property, payroll and sales in the United States will not be subject to the spreadsheet requirement.

d) The foreign property, payroll or sales test for the requirement for filing of a spreadsheet is increased from $1 million to $10 million.

- continued -

## FISCAL EFFECT

State: Unknown.

Local: None.

## COMMENTS

1. The Purpose Of This Bill Is To "Clean-up" Technical Problems In The Unitary Apportionment Reform Bill Of 1986

   Since the passage in 1986 of the unitary apportionment reform bill (SB 85), numerous minor policy and technical concerns have surfaced. This bill is intended to be a vehicle for such changes and corrections.

2. Should The Length Of The Election Period Be Shortened?

   Over the past decade, a number of corporations and foreign governments have leveled charges that California's worldwide combination unitary apportionment system is unfair. Even the federal government got into the act by asking the state to switch to a "water's edge" apportionment system.

   Responding to this criticism, California enacted legislation in 1986 which permitted taxpayers to file on a "water's edge" basis. The purpose of this change was to give taxpayers who believed the worldwide combination system to be unfair an alternative. The change was not made just to give companies a tax planning device. To discourage such tax planning, the law required companies to stay on a water's edge system for 10 years after making an election.

   Some companies are now complaining that the 10 year period is too long and would like to see a much shorter election period.

   This raises the issue: Was the change to water's edge election made to provide taxpayers who believe worldwide combination unfair an alternative or was the change for the purpose of tax planning, permitting taxpayers to shift back and forth frequently to minimize tax liability?

   This bill seeks to minimize the use of the unitary reform bill as a tax planning device by providing a lower election fee for taxpayers willing to make a 10 year election.

- continued -

SB 85
Page 4

3) The Domestic Spreadsheet Legislation Is To Be Carried By Assemblyman Vasconcellos

Although this bill makes some minor changes in the domestic spreadsheet requirement, it is our understanding the an agreement has been reached whereby Assemblyman Vasconcellos will carry the legislation which makes the filing of the spreadsheet only applicable to corporations electing water's edge treatment. This bill, AB 559, has already been approved by the Assembly Committee on Revenue and Taxation. The minor changes in this bill are consistent with the Vasconcellos proposal. Since this bill must amend the provisions of law which include the spreadsheet, the intent is to have the Vasconcellos bill chapter out the provisions of this bill relating to spreadsheets.

David R. Doerr
322-3730
arevtax

SB 85
Page 5

Honorable Alfred E. Alquist
Member of the Senate
State Capitol, Room 5100
Sacramento, CA 95814

| DEPARTMENT | AUTHOR | BILL NUMBER |
|---|---|---|
| Finance | Alquist | SB 85 |
| **SPONSORED BY** | **RELATED BILLS** | **AMENDMENT DATE** |
| | SB 85 (1986) | June 23, 1987 |

BILL SUMMARY

BANK & CORPORATION TAX: UNITARY APPORTIONMENT

Provides technical clean-up to the Bank & Corporation Tax Law with respect to unitary apportionment and the "Water's edge" election.

COMMENTS

Chapter 660 of the Statutes of 1986 (SB 85) provided for a "water's edge" election for certain corporations. In addition, these provisions provided for an election fee to be used for infrastructure and economic development. This bill provides clarification and technical clean-up to that law.

FISCAL SUMMARY--STATE LEVEL

| Code/Department Agency or Revenue Type | SO LA CO RV | FC | 1987-88 | FC | 1988-89 | FC | 1989-90 | Code Fund |
|---|---|---|---|---|---|---|---|---|
| | | (Fiscal Impact by Fiscal Year) (Dollars in Thousands) | | | | | | |
| 1104 - Bank and Corporation Tax | RV | U | -$8,000 | U | -$26,000 | U | -$30,000 | 001 General |

Impact on State Appropriations Limit--Yes

ANALYSIS

A. Specific Findings

Current Law

Under the Bank & Corporation law corporations are required to use an income apportionment formula in all cases where the business operations within and without California are "unitary in nature". The formula factors consist of property, payroll, and sales. An apportionment percentage is determined by (1) computing the ratio of property, payroll and sales in California to property, payroll and sales everywhere for each factor, and (2) averaging the three ratios (percentages). This average percentage is then applied to total business income to determine the amount subject to the California franchise tax.

(Continued)

POSITION: Department Director Date

Neutral

| Principal Analyst | Date | Program Budget Manager | Date | Governor's Office |
|---|---|---|---|---|
| (722) A. B. Moss | 7/3/87 | (700) Susanne Morgan | | Position noted |
| | | | | Position approved |
| | | | | Position disapproved |
| | | | | by: date: |

BILL ANALYSIS/ENROLLED BILL REPORT--(Continued) Form DF-43

| AUTHOR | AMENDMENT DATE | BILL NUMBER |
|---|---|---|
| Alquist | June 23, 1987 | SB 85 |

ANALYSIS

A. Specific Findings (Continued)

Chapter 660 of the Statutes of 1986 (SB 85) provided that a bank or corporation taxpayer could determine taxable income pursuant to a "water's edge" election rather than by world-wide unitary apportionment. A water's edge election is valid for 10 years after a notice of non-renewal is given by the taxpayer.

Corporations electing the water's edge option must pay an election fee of 30/1000 of 1 percent of property, payroll and sales in California. This fee could be reduced, in part, by the cumulative amount expended for investment in new plants and new employment in California. The election fee is special fund revenue and is designated for the support of various organizations and activities related to California infrastructure and economic development.

Chapter 660 contains considerable detail as to which corporations are eligible for the water's edge election and the treatment of income. One involved and controversial aspect relating to the treatment of income revolves around the inclusion/exclusion of foreign sourced dividends.

Proposed Law

This bill would provide technical clean-up and clarification. These include:

1. Clarification that the provision for the dividend deduction (exclusion) does not provide for a double deduction (under other provisions of the law) and that this deduction applies to dividends received by all members of the water's edge group whose income and apportionment factors are used to determine the California taxpayer's income.

2. Provides that the dividend exclusion formula may not result in a negative number.

3. Clarifies that the ratio of U.S. to foreign payroll used in the dividend exclusion calculation includes the payroll of both the water's edge group and corporations which would have been combined with the group had the election not been made.

4. Provides that possessions corporations (e.g., Virgin Islands) are excluded from the water's edge group.

5. Provides that certain banks and corporations which are treated as "deemed subsidiaries" shall include income only from sources within the U.S. as defined by Federal income tax law.

BILL ANALYSIS/ENROLLED BILL REPORT--(Continued) Form DF-43

| AUTHOR | AMENDMENT DATE | BILL NUMBER |
|---|---|---|
| Alquist | June 23, 1987 | SB 85 |

ANALYSIS

A. Specific Findings (Continued)

6. Provides that in the case of a controlled foreign corporation whose income and factors are included in the combination only to the extent of the ratio of "Subpart F income" to total earnings and profits, the references to Subpart F income and earnings mean those for the current income year. (Note: Subpart F refers to provisions in the Federal law).

7. Provides that the election fee provisions will be based on a full year's experience ending in 1986.

8. Provides that the amount that the election fee may be reduced for new plant and employment shall begin in 1987 rather than 1988.

9. Provides a rule for the determination of the 1986 factors in cases of corporate reorganization.

10. Provides for various reorganization of the law.

11. Instead of a single 10 year election, this bill provides for a 5 year and 10 year option. Corporations selecting the 5 year option would continue to pay the current law fee of 30/1000 of 1 percent. Corporations selecting the 10 year option would have a reduced fee of 15/1000 of 1 percent.

B. Fiscal Analysis

The FTB estimates a General Fund revenue loss of $8 million in 87-88 and $26 million in 88-89. The Unitary Fund revenue is expected to remain unchanged although there are both revenue gains and losses attributable to various factors.

FR:0833F

State of California

Franchise Tax Board
(916) 369-4326

# MEMORANDUM

To: Legislative Change Personnel

Date: October 28, 1988

File No.: 530:L-5

From: Carol Horowitz

Subject: 1988 Legislative Changes (LC 88-23)

Attached is Legislative Change No. 88-23 for Senate Bill 85.

Carol Horowitz

Director,
Legislative Services Bureau

Attachment

cc: Legislative File

LEGISLATIVE CHANGE NO. 88-23
SENATE BILL NO. 85

Author: Alquist
Subject: Water's Edge Election
Laws Affecting Franchise Tax Board: Sections 24411, 25110, 25111, 25112, 25113, 25114, 25115, and 25401d of the Revenue and Taxation Code
Date Filed with Secretary of State: September 20, 1988
Chapter Number: 88-989

## SUMMARY

Section 24411, as amended.

Current law allows a 75% deduction for qualifying dividends in the amount of similar dividends received in any of three base period years. The amendments clarify that only 12 month income years shall be considered in determining the base period and that a double deduction is not available under both Section 24411 and any other code section. They also specify that the deduction applies to dividends received by all members of the water's edge group whose income and apportionment factors are used to determine the California taxpayer's income, and make other technical changes.

In addition this act allows a deduction equal to 100% of the dividends attributable to construction projects the location of which is beyond the taxpayer's control.

Section 25110, as amended.

The act amends Section 25110 to state specifically that corporations electing under IRC Section 936 (possessions corporations) are excluded from the water's edge group, (unless they have 20% or more of their activities in the U.S.) and that certain banks and corporations which are treated as "deemed subsidiaries" shall include income only from sources within the United States as defined by federal income tax law. In the case of a controlled foreign corporation whose income and factors are included in the combination only to the extent of the ratio of "Subpart F income" to total earnings and profits, the bill clarifies that the references to Subpart F income and total earnings and profits mean those for the current income year.

A "qualified taxpayer" for purposes of making the election must consent to the taking of depositions from key domestic corporate individuals and to the acceptance of subpoenas duces tecum. This act clarifies that the consent relates only to issues of service and jurisdiction and does not otherwise waive any defenses a taxpayer might have. The act also provides for the taking of depositions at a mutually convenient time and location.

The definition of "affiliated corporation", for purposes of both Article 1.5 and Section 24411, is amended to include corporations which are owned by an individual and to include brother/sister corporations.

Subsection (d) is moved to subdivision (c), Section 25111. Subdivision (b) (4) is redenominated Section 25114.

State of California

FRANCHISE TAX BOARD
Sacramento, California 95867
(916) 369-4326

October 25, 1988

Commerce Clearing House
One Thorndale Drive, CS 4900
San Rafael, California 94903

Dear Mr. Kovitz:

Re: SB 85 Information Previously Sent to You

On September 29, 1988 we sent you a letter with some information relating to Senate Bill 85 in response to your request. Since that time, an error has been noted in the summary that was attached to that letter.

The phrase "key domestic corporate individual" was mistakenly referred to as "key individuals in domestic corporations" (see paragraph four on the first page of the summary).

On October 25, Elois Blakley of my staff attempted to reach you by phone to bring this error to your attention. You were unavailable so Mrs. Blakley spoke with Cheryl Wicklas instead.

Attached is a corrected copy of the summary for your records.

We regret any inconvenience this error may have caused for you.

Sincerely,

Carol Horowitz

Director, Legislative Services Bureau

Attachment

Senate Bill 85
Ch. No. 989, Stats. 1988

## SUMMARY

This bill amends Section 24411 and Article 1.5 of Chapter 17 of the Revenue and Taxation Code, enacted in 1986, which allows qualified taxpayers to determine their income and apportionment factors pursuant to a water's edge combination, and to deduct a specific percentage of qualifying dividends, as defined.

Amendments to Section 24411 which provide for the deduction of qualifying dividends allow a 100% deduction for dividends received from construction projects the location of which is beyond the taxpayer's control. A 75% deduction is allowed for qualifying dividends in the amount of similar dividends received in any of three base period years. The amendments clarify that only 12 month income years shall be considered in determining the base period. The amendments to Section 24411 also clarify that a double deduction is not available under both Section 24411 and any other code section. They also specify that the deduction applies to dividends received by all members of the water's edge group whose income and apportionment factors are used to determine the California taxpayer's income, and make other technical changes.

With respect to Article 1.5 of Chapter 17, the bill amends Section 25110 to state specifically that corporations electing under IRC Section 936 (possessions corporations) are excluded from the water's edge group, (unless they have 20% or more of their activities in the US) and that certain banks and corporations which are treated as "deemed subsidiaries" shall include income only from sources within the United States as defined by federal income tax law. In the case of a controlled foreign corporation whose income and factors are included in the combination only to the extent of the ratio of "Subpart F income" to total earnings and profits, the bill clarifies that the references to Subpart F income and total earnings and profits mean those for the current income year.

A "qualified taxpayer" for purposes of making the election must consent to the taking of depositions from key domestic corporate individuals and to the acceptance of subpoenas duces tecum. The bill clarifies that the consent relates only to issues of service and jurisdiction and does not otherwise waive any defenses a taxpayer might have. The bill also provides for the taking of depositions at a mutually convenient time and location.

The definition of "affiliated corporation", for purposes of both Article 1.5 and Section 24411, is amended to include corporations which are owned by an individual and to include brother/sister corporations.

Section 25111 which provides for the mechanics of the election is amended to remove the requirement that all affiliates of electing taxpayers consent to the election and to provide instead that all members of the water's edge group must elect. A single corporation which engages in more than one unitary business would be permitted to elect separately for each business.

The amendments to Section 25111 also provide that an electing taxpayer may change the election prior to the expiration of the election period if it is acquired by a corporation which alone, or together with its affiliates in its combined report, is larger than the taxpayer as measured by equity capital. The amendments would also provide for a change of election if the taxpayer's business activities become solely domestic as a result of reorganization or if the Franchise Tax Board substantially changes the composition of the water's edge group at audit. In the latter case the change of election could first be made for the year in which the audit occurred.

The amendments to Section 25111 include moving of subdivision (d) of 25110 relating to the Franchise Tax Board's disregard of an election to subdivision (c) of 25111, with the following changes: An election may be disregarded upon the taxpayer's willful failure to retain and produce certain documents. The bill would require the FTB to provide 90 days notice of its intention to disregard an election and for judicial review of that intention to disregard the election. The amendments also change the requirement that a taxpayer comply with "reasonable requests for discovery" to a requirement that a taxpayer comply with "reasonable requests for information", and specify that upon FTB's request certain information must be prepared and made available rather than requiring the information be prepared, whether or not requested, and made available upon request.

Section 25112 provides inter alia, that in the event the taxpayer, without reasonable cause fails to produce documents in response to an FTB formal document request, the court shall upon motion by FTB in a subsequent court proceeding prohibit the introduction of any documents covered by that request. Amendments to Section 25112 would make the prohibition discretionary with the court. Section 25112 also provides that, for purposes of the above described prohibition on introduction of documents in a court proceeding, the fact that a foreign jurisdiction would impose civil or criminal penalties on a taxpayer for disclosure of the requested documents is not reasonable cause. This bill would amend Section 25112 to allow for a court finding of reasonable cause in such circumstances after in camera review of the documents.

Section 25113 which provides for the introduction of various documents in court proceedings and which is duplicative of existing law would be repealed.

Section 25114 which requires taxpayers to file a domestic disclosure spreadsheet is amended and renumbered to Section 25401 (d) to place it with other general administrative provisions in the code. The amendments include a limitation of the filing requirement to electing taxpayers, which would file every three years rather than annually unless there is a substantial change in the taxpayer's business activity. The amendments would also provide for review by the Auditor General of the utility of the spreadsheet with a preliminary report to the Legislature in 1991 and a final report in 1994. The amendments also change the due date for filing the spreadsheet from three months after the filing of the federal return to six months after filing the California return; raise the threshold test for determining whether a spreadsheet must be filed from $1 million to $10 million in foreign payroll, property and sales; and waive the filing requirement for any years in which the taxpayer has less than $500,000 each in payroll, property, and sales in the United States.

Section 25110(b)(4), providing for audit procedures, is renumbered as Section 25114.

Section 25115 which prescribes the election period and election fee is amended to require a five (5), rather than ten (10) year election. It is also amended to provide specifically for refunds and deductibility of the fee, to allow reduction of the fee base for new investment in California after January 1, 1987 rather than January 1, 1988 and to allow reduction of the fee base for investment in new tangible personal property acquired after January 1, 1987.

Amendments provide rules for determination of the fee base in the event of corporate reorganizations and also exclude intangibles from the property factor for purposes of the minimum fee.

In addition, there are various technical corrections and several subdivisions are reordered within the Article to provide better placement and continuity.

Current State Law

Beginning in 1988 a qualified taxpayer will be permitted to elect to determine its income and apportionment factors on the basis of a water's edge combination. Taxpayers so electing will be permitted to exclude specified portions of their qualifying dividends, as defined.

Current Federal Law

No federal counterpart exists.

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

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

(b) Definitions.

(1) Qualifying dividends.

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

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

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

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

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

(c) Computation of amount allowable.

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

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

(d) Dividends derived from construction projects.

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

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

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

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

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

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

(4) Examples:

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

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

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

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

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

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

(e) Classification of distributions.

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

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

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

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

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

(4) Examples:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Staff Proposed Amendments to Regulation § 25106.5-1
(Only those subsections proposed to be amended are set forth)
Additions in 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~~3 dividend is not eliminated under section 25106 or ~~deducted~~deductible under sections 24402, 24110, ~~or~~ 24411 or any other provision of the Revenue and Taxation Code, P's dividend income will be treated as current apportionable business income in Year ~~1~~3. The intercompany distribution is not included in the sales factor in Year ~~1~~3, to the extent attributable to dividends eliminated from income under section 25106.

Example 3: Deferred intercompany stock accounts.

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

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

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

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

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