

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 out 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 ~~66.7%~~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 \times \$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 ($\$30 \times 75\%$).

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~~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 1988Year 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 1988Year 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 amountthe 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%).