Explanation of the Discussion Draft
California Code of Regulations, Title 18,
Sections 24411 and 25106.5

Ordering of Dividends

Attached is a discussion draft of proposed amendments to the above regulations that address the ordering of dividends paid from earnings and profits that are, in part or in whole, eligible for deduction, exclusion, elimination, or are wholly taxable. In general, the regulations would apply the ordering rules of section 316 of the Internal Revenue Code (IRC), incorporated into California law under Revenue and Taxation Code (RTC) section 24451. IRC section 316 requires that a distribution with respect to stock is to be considered paid first from current year's earning and profits, and then from the most recently accumulated earnings and profits.

The regulation also provides that if a distribution from a given year's earnings and profits is not sufficient to exhaust the earnings and profits of that year, the distribution will be considered paid, on a pro rata basis, from each class of potential dividend within the earnings and profits of that year. The principle of prorating dividend payments against all of the earnings and profits of a taxable year is a long established principle in California law. The issue arose under RTC section 24402, which allowed a dividends-received-deduction to the extent a dividend was paid out of earnings previously taxed by California. The source of dividends reflects both the apportionment of income and the allocation of nonbusiness income and, for purposes of RTC section 24402, dividends were treated as being paid proportionately from California source and non-California source income. The California Supreme Court in *Safeway Stores Inc. v. Franchise Tax Board* (1970) 3 Cal 3rd 745, 753, acknowledged and endorsed this principle. "The method employed in the present case would be a section 8, subdivision (h) [the predecessor to RTC section 24402], deduction for each dividend in the ratio that the earnings and profits of each payor attributable to California bears to its total earnings and profits. No error is shown." *Safeway* itself involved the method for extending this principle in a combined report setting.

This regulation clarifies the department's regulations that were considered in *Fujitsu IT Holdings, Inc. v. Franchise Tax Board*[1] (2004) 120 Cal.App.4th 459. In that case, the First District Court of Appeals determined that the present versions of California Code of Regulations, title 18, sections 24411(e) and 25106.5(f)(2), Example 2, were in conflict, and construed that conflict against the department. Thus, notwithstanding regulation section 24411(e), the court held that when a corporation issues a dividend, earnings and profits that are eligible for elimination under RTC section 25106 should be considered distributed before other earnings and profits. However, regulation section 25106.5 was not in effect for the years in controversy in the case, so it could not have been in conflict with regulation section 24411(e). In addition, regulation section 25106.5(f)(2), Example 2, was wholly consistent with the operation of IRC section 316, as described above. The regulation example did not deal with a situation where a distribution from

[1] At earlier levels of the proceedings of this case, the case was referred to as *Amdahl Corporation v. Franchise Tax Board*.

the earnings and profits of a given year is not sufficient to exhaust all of the earnings and profits of that year.

Technical amendment to regulation section 25106.5. The current version of regulation section 25106.5 indicates that taxable dividends (i.e., those dividends that are not eliminated from income under RTC section 25106) paid between unitary members should be disregarded in the sales factor. Taxable dividends are, by definition, not subject to elimination under RTC section 25106 and are thus paid from income *other than* income that was included in a combined report. Because they are paid from activities that are not part of the combined report activity of the shareholder and its subsidiary, they should not be eliminated from the sales factor. The attached regulation amendments reflect that change.

Technical amendment to regulation section 24411. Clarifying amendments are added to regulation section 24411 to a) provide that the deduction provided by RTC section 24411 applies even if a dividend distribution is from earnings and profits of a year before the year for which water's edge election was made and b) explicitly state that dividends attributable to construction projects are not allowed as a deduction under RTC section 24411 to the extent otherwise allowed as a deduction or eliminated from income.