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SUBJECT: Election Under AB 263 With Respect to Dividends From Eighty Percent or More Owned Insurance Companies

On September 29, 2004, Governor Arnold Schwarzenegger signed into law AB 263 (Stats. 2004, ch. 868). In general, this law allows a deduction for certain dividends received by a corporation from insurance subsidiaries that are 80% or more owned. In addition, the law allows taxpayers to make an election for tax years ending on or after December 1, 1997, and beginning before January 1, 2004, ("open years") to claim a similar deduction for dividends received from an 80% or more owned insurance company with respect to those years. The election for open years must be made by March 28, 2005. The purpose of this notice is to inform taxpayers how to make that election.

For "open years" AB 263 provides the following:

1. A corporate taxpayer may elect a dividends received deduction of 80% of qualified dividends received from an insurance subsidiary in which the corporation owns at least 80% of all classes of stock.
2. The taxpayer makes the election by filing a return for any one year of the open years expressly stating that it is making the election provided for by AB 263.
3. The election must be made and any amounts due pursuant to the election must be paid by March 28, 2005.
4. The election for any one-year constitutes an election for all open years.

Qualified dividends are defined in AB 263. The amount of dividends that qualify for the dividends received deduction may be reduced if, under AB 263, the insurance company is overcapitalized. A phase-out ratio of insurance premiums to total income (as defined) is used to calculate the amount of overcapitalization.

The following procedures will aid taxpayers in making the election under AB 263 for open years:

1. The taxpayer may make the election on an original return or an amended return.
 - a. For taxable years for which a return has already been filed, the taxpayer will file an amended return (Form 100X) to make the election. For ease of

processing, the taxpayer should type or print "AB 263 Election" on the top of side 1 of Form 100X. On side 2 of Form 100X, Part V, Line 2 (which requests an explanation of the changes to the prior filed return), the taxpayer should type or print a statement that they are making the dividends received deduction election in accordance with AB 263. The taxpayer should attach supplementary schedules as necessary to compute the deduction.

- b. In the case of an original return (Form 100), the election may be made by typing or printing "AB 263 Election" on the top of the front page of the tax return with a statement attached indicating that the taxpayer is making the dividends received deduction election in accordance with AB 263. The taxpayer should attach supplementary schedules as necessary to compute the deduction.
2. AB 263 requires that all additional amounts due pursuant to the election, if any, be paid by March 28, 2005. Additional amounts due include taxes, interest and any applicable penalties. In the case of taxes, it is the amount of additional tax shown as due on the return, amended return, or schedule as a result of the election that must be paid. Interest is the amount of statutory interest from the due date of the return, as computed in good faith by the taxpayer, on the additional tax and penalties shown as due on the return, amended return, or schedules. Penalties are those penalties that were assessed, either by the taxpayer on the original return, or by the department as reflected in a notice of proposed assessment or notice of tax due for a year issued prior to the date of the amended return, such as a late filing penalty. Failure to pay all additional amounts due as a result of the election by March 28, 2005, invalidates the election.
3. It will facilitate administration for the taxpayer to file amended returns for each open year. The statute, however, does not require it. AB 263 provides that the taxpayer may make the election by filing one return to elect for all of the open years. If the taxpayer makes the election by filing only one return, it must include supplemental schedules identifying the same information as required on Form 100X for every year to which the election applies. The schedule must identify all amounts due by year in order to insure that all amounts are properly posted to the taxpayer's account and paid by March 28, 2005.
4. Taxpayers in a refund position based on the election for any year must file a claim for refund for each open year for which the statute of limitations for filing a claim has not expired. AB 263 does not change the statute of limitations or the requirement to file a claim for refund.
5. If the taxpayer already has a refund claim filed with respect to any of the open years based upon the deductibility of dividends received from an insurance

company, the making of the election for any open year shall be treated as an amendment of that claim to conform it to the terms of the election.

6. For taxpayers making the election for taxable years in which proposed assessments have been issued and are in the protest or appeal process, the taxpayer must still file an amended return reflecting the AB 263 election. All amounts due pursuant to the election must be paid by March 28, 2005, for the election to be valid. The protest hearing officer or appeals attorney should be informed of the amended return filing.

Filing a return and computing the tax due pursuant to the method allowed by AB 263 is not sufficient to constitute an election. A return must be filed containing an express statement that the election allowed by AB 263 is being made. An accuracy related penalty may be assessed if the taxpayer files a return computing the tax due pursuant to the method allowed by AB 263 without making the election. The only authority for the deduction provided by AB 263 for tax years ending on or after December 1, 1997, and beginning before January 1, 2004, is by making the election and being bound by the terms of AB 263 for those years.

The principal author of this notice is Karen Smith of the Franchise Tax Board, Legal Department. For further information regarding this notice, contact Karen Smith at the Franchise Tax Board, Legal Department, P.O. Box 1720, Rancho Cordova, CA 95741-1720.