



STATE OF CALIFORNIA  
**FRANCHISE TAX BOARD**  
PO Box 1720  
Rancho Cordova, CA 95741-1720  
Telephone (916) 845-3320  
FAX (916) 845-3648

STEVE WESTLY  
Chair

JOHN CHIANG  
Member

TOM CAMPBELL  
Member

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TAM Author: Benjamin F. Miller  
Phone Number: (916) 845-3320  
Fax Number: (916) 845-3648

### **QUESTION PRESENTED**

How should the audit and legal staffs implement the decision of the court of appeal in *Fujitsu IT Holdings, Inc. v. Franchise Tax Board* (2004), 120 Cal.App.4th 459, pending consideration of proposed amendments to regulation sections 24411 and 25106.5-1?

### **CONCLUSIONS**

1. We will allow the receipt of United Kingdom ACT related payments to be treated as dividends regardless of whether they come from the United Kingdom government or the recipient's subsidiary.
2. Dividends described in IRC section 959(b) will be excluded from the numerator of the inclusion ratio of section 25110(a)(6) in determining the amount of income of a controlled foreign corporation that is included in the combined report.
3. Dividends described in section 25106 will be eliminated from the numerator of the inclusion ratio of section 25110(a)(6).
4. We will not eliminate amounts described in IRC section 959(b) or section 25106 from the denominator (earnings and profits) of the inclusion ratio of section 25110(a)(6).
5. Dividends will be eliminated from the apportionable income base pursuant to section 25106. No reduction in the apportionable income base will be made with respect to dividends describe in IRC section 959(b).
6. We will continue to treat dividends as being paid proportionally from the current year earnings and profits, and then from the next succeeding prior year. Taxpayers should be advised that this position is contrary to the decision of the

court of appeal, but the department has prepared proposed amendments to the regulations to provide clarity with respect to this issue. Taxpayers that wish to obtain the treatment accorded by the court of appeal decision should take appropriate steps to preserve their right to such treatment.

## **ANALYSIS AND DISCUSSION**

The appellate court wrote broadly in this case and without precision. In addition, there appear to be errors in its analysis. We have a number of cases at appeal, protest and audit that might be impacted by this decision. We are attempting to correct what staff believes was the appellate court's misinterpretation of our regulations by amending the regulations. The Franchise Tax Board has directed us to hold a symposium on the proposed clarifying amendments.

The first three items follow the decision of the court in *Fujitsu*.

The fourth item is contrary to dicta in *Fujitsu* but should generally benefit taxpayers. The larger the denominator of the inclusion ratio, the smaller the ratio will be. The discussion of the court in this area is both inconsistent with the IRC section 964's definition of earnings and profits referenced by section 25110(a)(6) and with the very concept of earnings and profits which are determined without regard to taxability.

The fifth item may also be inconsistent with what the court said in dicta in *Fujitsu*. But other than for the purposes of the inclusion ratio of section 25110(a)(6), IRC section 959(b) does not describe a circumstance that exists under California law. Dividends, unless declared, are not in the California income base. Therefore, no deduction is required to prevent double taxation. Section 25106 provides the appropriate relief for dividends paid from income previously considered in the combined report.

The sixth item arises because of what we believe was a misinterpretation of our regulations by the *Fujitsu* court. The opinion in *Fujitsu* clearly rejected our position that dividends are paid proportionally from each component of a year's earnings and profits. In addition, it can also be read as disregarding the requirement that dividends are to be treated as being paid from the most recent earnings and profits determined on an annual basis.

We have proposed that the regulations be amended to address this misinterpretation. Until there is a decision as to whether to adopt the proposed amendments, we will continue to apply the regulations as we believe they would have applied if properly interpreted by the court. That is, dividends are to be treated as paid proportionally from the earnings and profits of the most current year. **Taxpayers should be notified of the court decision and that our treatment is inconsistent with that decision so they can protect their rights by filing a protest, appeal or claim for refund.**

It should be noted that for years ending on or before December 1, 1999, the taxpayer will be allowed a 100% dividend received deduction as the result of the holding in *Farmer Bros. Co. v. FTB* (2003), 108 Cal.App.4th 976. For such an income year, the tax effect for that year of

allowing a 100% 24402 deduction will be at least the same as elimination under section 25106. It may be even more beneficial to the taxpayer if the dividend payor has earnings and profits arising from activity not included in the combined report.

The only immediate tax effect for the 1999 and earlier years might arise from the allocation of expenses to income that is not included in the measure of tax pursuant to section 24425. *Farmer Bros.* dividends are subject to such an allocation, but dividends eliminated pursuant to section 25106 are not.

The question of whether dividends are treated as being first eliminated pursuant to section 25106, without regard to the year, may have consequences for other years because the reservoir of earnings and profits attributable to income included in a combined report may be exhausted so that section 25106 relief will not be available in subsequent years. If the taxpayer requests, we should agree that the source of dividend payments may be adjusted in subsequent years to reflect the final determination with respect to the proposed amendments to the regulations.

Counsel, Multistate Tax Affairs