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TECHNICAL ADVICE MEMORANDUM 2011-02

Requested by:	Multistate Audit
Requested Date:	December 15, 2010
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Subject: Ordering of Dividend Distributions.

QUESTION PRESENTED

Should the staff continue to apply the Last-In-First-Out (LIFO) and the proration approaches to order dividend distributions from subsidiaries partially included in a water's-edge combined report?

CONCLUSIONS

The LIFO ordering approach determines the years of earnings from which dividends are distributed. Within each year's distribution, dividends are deemed first distributed from that year's unitary earnings, until those earnings are depleted, with the remaining dividends deemed distributed from non-unitary earnings.

ANALYSIS AND DISCUSSION

Background

RTC section 25106 provides that dividends paid from one member of a unitary group to another member of the group are eliminated from the recipient's income if the dividends are paid from income that was already included on the combined report. RTC section 24411 provides a 75 percent deduction for dividends received by a member of the water's edge group if those dividends are not otherwise deducted under section 25106. A problem arises as to what to do with dividends that are paid by a controlled foreign corporation (CFC) that is partially included in a water's-edge combined report. Because the CFC's dividends are paid from income which is partially included in, and partially excluded from, the water's-edge combined report, to what extent are the dividends eligible for elimination under section 25106 or a partial deduction under section 24411?

The California Court of Appeal in *Fujitsu IT Holdings, Inc. v. Franchise Tax Board* (2004) 120 Cal.App.4th 459 (*Fujitsu*) held that dividends paid from current year earnings consisting of a mix of included and excluded income[1] should be treated as paid (1) first out of earnings eligible for elimination under RTC section 25106, with (2) any excess paid out of earnings eligible for partial deduction under RTC section 24411. *Fujitsu* did not address the question of which years the dividends are paid from when distributions are made from multiple years of earnings.

On March 7, 2005, the FTB Legal Division issued TAM 2005-1 to provide audit and legal staff with guidance on how to implement the *Fujitsu* decision. TAM 2005-1 reflected the FTB's position in sourcing dividend distributions using a LIFO approach and a proration approach. Specifically, TAM 2005-1 read, in part:

> 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....

The State Board of Equalization (SBE) agreed with the FTB's LIFO and proration approaches in sourcing dividend distributions. In the *Appeal of Apple Computer, Inc.*, 2006-SBE-002, November 20, 2006, the SBE concluded that,

> to the extent a CFC pays dividends from accumulated earnings, those dividends are deemed paid from the current year's earnings until those earnings are exhausted, and thereafter from the most recent years' earnings, exhausting each year's earnings in turn. We further conclude that, to the extent a CFC pays dividends from a year in which it is partially included in the water's-edge combined report, those dividends are deemed paid from included income and excluded income in the ratio that included and excluded income bear to total income.

Apple, Inc. filed a suit for refund in San Francisco Superior Court after the SBE's decision in *Appeal of Apple Computer, Inc.* became final. During the trial, the FTB continued to assert the LIFO approach, but not the proration method. The superior court judge observed that *Fujitsu* did not reach the issue of how to order distributions when they are made from more than a single year's earnings and noted that the holding of *Fujitsu* on the distributions ordering issue was limited to dividends paid by first–tier subsidiaries from "*current year earnings.*" Accordingly, the superior court judge sided with the FTB on the LIFO ordering approach, but did not rule on the proration method since that issue was not before it.

Guidance has been sought on the proper approach in ordering dividend distributions in light of the above courts' and SBE decisions.

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[1] "Included income" refers to income that was included in a combined report and "excluded income" refers to income that was not included in a combined report.

Discussion

Fujitsu is a published and precedential Court of Appeal decision. The decisions of an administrative agency such as SBE are not binding on the courts as precedent and thus do not trump precedential court of appeal decisions. See *A.M. Castle & Co. v. Franchise Tax Board* (1995) 36 Cal. App. 4^{th} 1794, 1808 (administrative tribunals such as the State Board of Equalization do not make precedents that are binding on this court).

1. LIFO Ordering Applies Among Years: Because *Fujitsu*'s holding regarding the ordering of dividend distributions applies to dividends paid from "current year earnings", the Court did not expressly address the LIFO ordering issue. Arguably, the Court of Appeal in *Fujitsu* must have applied the LIFO approach, even though it did not specifically address the ordering of dividends paid from multiple years of earnings, because it applied the LIFO rule in determining that the entire dividend at issue must be paid out of current year earnings. *Fujitsu* either does not address, or implicitly endorses, the use of LIFO ordering. Therefore, staff shall continue to apply the LIFO ordering to determine the order of year(s) from which the dividend distributions are made, starting with the current year, and after that year's earnings are depleted, moving to the next most recent year.

2. Ordering Of Distributions Within A Year: The court in *Fujitsu* rejected the FTB's position that dividends are paid proportionally from each component of a year's earnings and profits, in favor of an approach that deems the dividends are paid first out of the earnings and profits that were included in the combined report of a unitary business and eligible for complete elimination under RTC section 25106. Therefore, under *Fujitsu,* staff shall treat dividend distributions within a year as paid first from that year's earnings eligible for elimination under RTC section 25106, until those earnings are depleted, then from earnings eligible for deduction under other provisions of the Corporation Tax Law, until that year's earnings are depleted.