10000 EARNINGS & PROFITS AND DISTRIBUTIONS

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References:

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Internal Revenue Code (IRC) IRC §482

Internal Revenue Code (IRC) IRC §964

Treasury Regulation (Treas. Reg.) §1.964-1

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Revenue Procedure (Rev. Proc.) 75-17, 1975-1 CB 677

10010 Introduction

Congress has never provided a statutory definition of earnings and profits (E&P). Instead, a definition has developed over the years from a collection of administrative practices, court cases, revenue rulings, and adjustments required under IRC §312.

In Henry C. Beck Co. v. Commissioner (1969) 52 TC 1, E&P was defined as an attempt to "approximate a corporation's power to make distributions which are more than just a return of investment."

A correct computation of E&P for federal and California tax purposes is necessary to determine the tax treatment of corporate distributions (e.g., dividend, return of capital, or capital gain).

California generally incorporates, "except as otherwise provided," the provisions of the IRC §§301-385, which relate to corporate distributions and adjustments. (R&TC §24451.)

IRC §316 provides the definition of a dividend. IRC §316(a) states that any distribution of property is a dividend if paid from:

Earnings and profits of the taxable year, or

Earnings and profits accumulated since February 13, 1913

IRC §316(a) also provides for a last-in, first-out (LIFO) ordering rule. IRC §316(a) states, in pertinent part:

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits.

California follows this E&P ordering rule for dividend payments, where dividends are deemed to be paid out of current E&P first, and then layered back on a last-in, first-out (LIFO) basis.

For Federal, the importance of E&P can be demonstrated by the effect it has on items such as:

Dividend income includible in taxable income

Dividend elimination between consolidated return members

Subpart F Income – taxable as a deemed dividend to the extent of the shareholder's pro-rata share of its current E&P. (IRC §951)

Indirect Foreign Tax Credits – E&P is a significant factor used to compute the deemed paid credit under IRC §902 and §960

For California, the importance of E&P can be demonstrated by the effect it has on the following:

Dividend income includible in the California combined report

Dividend elimination – To the extent that the E&P of the dividend payor were included in a combined report that included the dividend recipient (See R & TC §25106.)

Dividend deduction – The source of E&P is necessary to determine the correct amount of dividend-received deductions allowed under R&TC §§24410, and 24411

Controlled Foreign Corporations (CFCs) – Current E&P is a component (denominator) of the inclusion ratio, which is used to determine the income and apportionment factors includible in a water's-edge combined report for CFCs with Subpart F income pursuant to R&TC §25110(a)(2)(A)(ii)

Foreign Investment Interest Offset – For water's-edge taxpayers, E&P is included in the equity investment amounts which are included in the numerator (unassigned foreign investment) and denominator (unassigned total assets) of the ratio that determines the interest expense that is attributable to foreign investments. (CCR §24344(c))

In general, computing the E&P of a corporation included in the California combined report begins with net income after state adjustments (Forms 100 and 100W, page 1, line 18) and by making a series of positive and negative adjustments. For the most part, by incorporation of IRC §316, California follows the federal adjustments to arrive at earnings and profits:

Add nontaxable income (e.g., intercompany dividends)

Add artificially created deductions (e.g., dividend received deductions)

Subtract nondeductible expenses (e.g., federal income tax)

Generally, the federal E&P is similar to the California E&P. The California and federal differences are due to elections and methods adopted in computing the respective taxable income (e.g., difference in basis caused by different elections under IRC §338 (sale of stock treated as asset sale), or IRC §1031 (like-kind exchanges)). For further discussion on differences between federal and California E&P, see section 10040, Calculation of E&P for California Tax Purposes, of this chapter.

10020 E&P To Be Determined On a Separate Basis

Under California law, E&P is determined on a separate entity basis. The computation of a corporation's E&P disregards the unitary attributes. Income apportioned to a member of a unitary group by formula cannot form the basis for determining that corporation's E&P. (*Appeal of Young's Market Company*, 86-SBE-198, November 19, 1986.)

The California Court of Appeals upheld the State Board of Equalization's decision in *Young's Market Company,* supra. However, the Court of Appeals decision is not citable because it is an unpublished decision. The Board of Equalization decision is citable.

Under federal law, every corporation has its own E&P account. For corporations, other than a group of corporations electing to file a federal consolidated return, E&P of a subsidiary does not become E&P of its parent prior to a payment of those earnings to the parent. For corporations included in a consolidated group, the parent is required to adjust its E&P and upon disposition, its basis in subsidiary stock, to account for increases and decreases in the E&P of the subsidiary. (Treas. Reg. §1.1502-33.) Such adjustments are referred to as "tiering adjustments" whereby the E&P of an upper tier corporation includes the E&P of lower tier subsidiaries. (Treas. Reg. §1.1502-33.) As California does not conform to Treas. Reg. §1.1502-33, any "tiering adjustments" (e.g., E&P of lower tier subsidiaries) should be excluded in computing E&P for California tax purposes.

Although E&P is computed on a separate company basis, the methodology provided by Treas. Reg. §1.1502-13 (with exceptions) in deferring income, gain, deduction, and loss of members from intercompany transactions, applies in computing E&P for California. (CCR §25106.5-1.) For further discussions on intercompany transactions and CCR §25106.5-1, see Water's Edge Manual Chapter 17.

10030 Calculation of E&P For Federal Tax Purposes

The primary function of E&P is to provide a measure of the economic income of a corporation available for distribution to its shareholders. E&P is not the same as surplus or taxable income, but it shares characteristics of both. E&P for book income (e.g., retained earnings) rarely equals E&P for tax purposes because of different treatments with respect to reserves, depreciation, and depletion. E&P for tax purposes also rarely equals taxable income because of non-cash deductions (e.g., dividend received deductions) and exclusion of specific items of income (e.g., federal income tax refund) that are allowed in computing taxable income.

In accordance with IRC §316, it is necessary to compute current E&P and accumulated E&P:

Current E&P represents the current economic income computed on an annual basis, without diminution by reason of any distributions made during the taxable year or prior year deficits.

Accumulated E&P represents the sum of each year's current E&P reduced by distributions.

1. Calculation of Current E&P

Current E&P begins with federal taxable income. (Rev. Proc. 75-17.) The computation of E&P can be summarized as follows:

Current year's taxable income/loss

+ Exempt and non-deferred income

+ Deductions not permitted in computing E&P

- Items not deductible in computing taxable income

= Current E&P

The following illustrates the common adjustments made to compute current E&P. It lists items that increase or decrease E&P, but it is not intended to be all inclusive.

Computation of Current E&P:

Taxable Income as Corrected

PLUS: Exempt and non-deferred income (nontaxable income, income per books not on return)

- Tax exempt interest
- Proceeds of officer's life insurance policy
- Increase in cash surrender value – life insurance policy
- Nontaxable portion – bad debt recoveries
- Refund or prior year – federal income taxes (cash basis)
- Gains from dealing in taxpayer's own stock (IRC §1032)
- Miscellaneous nontaxable income

PLUS: Deductions not permitted in computing E&P (noncash deductions, items previously charged to E&P, deductions allowed solely for tax purposes)

- Dividends eliminated or deducted pursuant to R&TC §§25106, 24410, and 24411
- Excess of percentage of depletion over cost depletion (caution: do not duplicate at time of sale)
- Net operating loss (NOL) deduction
- Capital loss carry forwards
- Cancellation of interest owing by accrual basis corporations previously deducted – no tax benefit due to IRC §111
- Charitable contribution carry forwards
- Excess depreciation over straight line

LESS: Items (expenses and losses) not deductible in computing taxable income

- Officer's life insurance premiums
- Amortizable bond premiums on tax exempt bonds
- Fines and penalties
- Political contributions
- Charitable contributions over limitation amount
- Excess capital losses
- Expenses disallowed in audit not of capital nature (e.g., excess compensation)
- IRC §267 losses and expenses
- Current federal income taxes
- State and foreign income taxes
- IRC §78 gross-up and subpart F income

EQUALS: Current Earnings and Profits

2. Specific Adjustments – IRC §312(n)

Additional adjustments are required in computing E&P to accurately reflect economic gain and loss. IRC §312(n) lists specific adjustments to be made in computing E&P:

- Construction period interest
- Intangible drilling costs and mineral exploration and development costs
- Amortization of circulation (IRC §173) and organizational (IRC §248) costs
- LIFO inventory adjustments
- Installment sales
- Completed contract method
- Certain stock redemptions
- Special rules for certain foreign corporations that report less than 20 percent U.S. source income (See section 10060)

3. Accounting Methods

The general rule provides that the method of accounting adopted in computing taxable income should be the same method used to compute E&P. For example, a taxpayer filing its tax return on an accrual basis must determine its E&P on an accrual basis. (Treas. Reg. §1.312-6(a).) There are exceptions to this general rule. For example, the Accelerated Cost Recovery System in computing depreciation (IRC §312(k)) and the installment method (IRC §312(n)(5)) are not allowed in computing E&P. The courts have allowed departures from the adopted income tax methods in the determination of E&P. For example, the Seventh Circuit allowed a cash-basis corporation to accrue federal income taxes for purposes of E&P computations. (Demmon v. U.S., 321 F.2d 203 (7th Cir.1963).)

4. When to Compute Current E&P

Calculate current E&P at the end of the taxable year without regard to distributions made during the year or any E&P deficits from prior years. Once calculated, current E&P is pro ratably applied to distributions made during the taxable year, if any. If the earnings and profits of the taxable year are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. (Treas. Reg. §1.316-2(b).)

5. Calculation of Accumulated E&P

Accumulated E&P is the second source of taxable dividends if distributions made during a tax year exceed current E&P. Accumulated E&P consists of the aggregated E&P accumulated <u>for each tax year</u> from March 1, 1913, up to the beginning of the current tax year that remains available on the date of distribution. (IRC §316(a); Treas. Reg. §1.316-2.)

The following illustrates some common adjustments made to compute accumulated E&P.

Computation of Accumulated E&P (Post 1913):

- Accumulated E&P – Beginning of the Year

PLUS: Corrections of prior years

- Stock splits and stock dividends

- Refund of prior year federal income tax (accrual basis)
- Unauthorized reserves
- E&P of corporations liquidated or merged into taxpayer
- IRS adjustments affecting E&P

LESS: Corrections of prior years

- Additional federal tax on amended returns (accrual)
- Fraud penalty – prior years returns (accrual basis)
- IRS adjustments affecting E&P

= Corrected accumulated E&P – beginning of the year

PLUS: Current year E&P less distributions

EQUALS: Accumulated E&P – end of the year

As discussed in section 10100 of this chapter, "California Tax Treatment of Dividends – Source of E&P," identify and keep track of E&P accumulated for each tax year to determine the character and source of the E&P being distributed (i.e., if E&P relates to income of a unitary or non-unitary business). In such case, apply the above common adjustments to each applicable tax year's E&P in computing each of the layers (E&P by tax year) that make-up accumulated E&P.

6. E&P Deficits

A deficit occurs when deductions exceed income (i.e., net loss) in computing E&P for any tax year. A loss sustained for a year before the current taxable year does not affect the E&P of the current taxable year. However, in determining accumulated E&P, a deficit/loss in a taxable year, including a deficit generated in the current tax year, first reduces E&P accumulated after February 20, 1913. (Reg. § 1.312-6(d).) A deficit in E&P for any taxable year reduces the most recently accumulated E&P for a prior year. If there is no accumulated E&P because of a deficit incurred in a prior year, such deficit must be restored before E&P can be accumulated in a subsequent year. (Rev. Rul. 74-550, 1974-2 C.B. 209; Treas. Reg. §1.243-4.)

A deficit cannot arise from, nor be created by, a distribution in excess of E&P. Distributions in excess of accumulated E&P are considered a return of capital, to the extent of basis in the stock of the distributee. Distributions in excess of basis are considered capital gains. (IRC §301(c).)

An example of applying the above provisions is illustrated below.

Example 1:

Corporation S, a 100% owned subsidiary of Corporation P, made a distribution of $100,000 to Corporation P in tax year ended 2010. The E&P of Corporation S by tax year is listed below.

TYE 2010	$20,000	- Current year E&P - $20,000
TYE 2009	($30,000)	
TYE 2008	$20,000	
TYE 2007	$40,000	Accumulated E&P - $80,000
TYE 2006	($10,000)	
TYE 2005	$50,000	
TYE 2004	$10,000	

With the $20,000 of current E&P and $80,000 of accumulated E&P, the distribution of $100,000 is treated as dividend income and included in gross income of the payer. The $100,000 distribution is made up of the E&P from the following sources:

TYE 2010 - $20,000

TYE 2009 – 0

TYE 2008 – 0 ($20,000 E&P generated minus $20,000 of the $30,000 deficit from 2009)

TYE 2007 - 30,000 ($40,000 E&P generated minus $10,000 of remaining deficit from 2009)

TYE 2006 – 0

TYE 2005 – 40,000 ($50,000 E&P generated minus $10,000 of deficit from 2006)

TYE 2004 – 10,000

Total distribution of E&P - $100,000 treated as a dividend

For further discussion relating to the source and character of E&P that an E&P deficit should be offset against or restored with, please see section 10140 of this chapter.

10040 Calculation of E&P for California Tax Purposes

The method of computing E&P is generally the same under California and federal law.

1. Knowing the Starting Point - Net Income after State Adjustments

The concept underlying the computation of E&P for California tax purposes has always been substantially the same as that for federal tax purposes. However, there are a number of adjustments that should be made if the **starting point** of the California E&P computation is net income after state adjustments (computed on a separate company basis). Examples of such adjustments are discussed below:

a. Dividends eliminated and deducted under R&TC §§ 25106, 24410, and 24411. If starting with California net income after state adjustments, add-back such California eliminations/deductions rather than the federal dividends received deduction which would be added back in computing federal E&P, given federal taxable income was used as the starting point. For both California and federal, no such deductions would apply in computing E&P.

b. State and foreign taxes. Subtract federal income tax liability and state and foreign income taxes from E&P if net income after state adjustments is used as the starting point. In computing federal and California E&P, federal, state and foreign taxes (taxes measured by income) reduce E&P.

2. Factors Causing California and Federal E&P to Differ

E&P may differ between federal and California tax purposes because of the following factors:

a. Different adjusted tax basis under California and federal law. Examples of different basis may be caused by difference in like-kind exchange elections or difference in elections for treatment of sale of stock transactions.

b. Difference between consolidated affiliated group reporting under federal law and combined unitary group reporting under California law. An example of such difference is the "tiering adjustments" required by Treas. Reg. § 1.1502-33, which California has not conformed to.

c. Difference between federal consolidated group and California combined reporting group. An example of such difference is the deferral of the income/gain realized by a seller of property to a unitary affiliate/buyer (both entities being part of the same combined unitary group). For California, such gain is deferred for regular tax and E&P under CCR § 25106.5-1. However, for federal, if the seller and buyer are not part of the federal consolidated group (e.g., U.S. Corporation and CFC), the deferral provided by Treas. Reg. § 1.1502-13 would not apply for regular tax and E&P.

d. Other difference in California and federal law, although minor. For example, unrealized translation gains or losses included in federal E&P of a foreign corporation are not taken into account in computing E&P for California tax purposes. CCR §25106.5-10(a)(2). See section 10060, for further discussion.

10050 Special Items To Consider In Computing E&P

In addition to the adjustments discussed in the previous sections of this chapter, there are additional adjustments to consider when calculating E&P. The following are just a few to be aware of:

- **Life Insurance** – If the corporation pays on life insurance policies, of which it is a beneficiary on the lives of its officers, the payments reduce E&P, but the increase in cash surrender value of the policy increases E&P. For the year the corporation receives proceeds from a policy, its E &P increases by the excess of the proceeds over the cash surrender value. (Rev. Rul. 54-230, 1954-1, C.B. 114, provides, in part, the excess of the insurance proceeds received by the corporation over the aggregate sum of the premiums paid will constitute earnings and profits available for distribution; See also IRS Form 5452, which increases E&P by the excess of insurance proceeds over the cash surrender value.)

- **Depreciation/Gain (Loss)** – Generally, in computing depreciation expense, the period and rate of recovery for E&P purposes often differs from depreciation expense in computing taxable income. For tangible property subject to accelerated cost recovery system (IRC §168) and placed in service after December 31, 1986, the depreciation expense allowable for E&P must be determined under the straight-line alternative depreciation system. (IRC §312(k) (3) (A).) Also, if the corporation deducted amounts under IRC §179, E&P should be reduced by the deduction ratably over a five-year period. (IRC §312(k) (3) (b).)

  Due to differences in depreciation, the adjusted tax basis of such assets for income and E&P purposes will generally differ. As a result of such differences, remember that any gain or loss on the disposition will likely differ when computing taxable income and E&P.

Example:

An asset was purchased at a cost of $40,000 three years ago. For federal income tax, it was depreciated using an accelerated method. The accumulated depreciation expense for federal income tax is $30,000. Accumulated depreciation using straight line, required for E&P, would have been $24,000. The asset was subsequently sold for $15,000. To compute E&P, $6,000 is subtracted from taxable income. The computation follows:

Adjustment to E&P	Tax. Income	E & P
Cost	$40,000	$40,000
Depreciation	$30,000	$24,000
Adjusted Basis	$10,000	$16,000
Sales Price	$15,000	$15,000
Gain (Loss)	$5,000	($1,000)

Adjustment = ($6,000)

The adjustment is a negative $6,000, derived by removing the income tax gain of $5,000 from E&P; then subtracting the E&P loss/deficit of $1,000.

- **Tax Credits** - Since tax credits reduce tax liability, thereby increasing the economic position of the firm, an adjustment for credits must be made. Accordingly, E&P is increased for the credits applied against the tax liability. If a corporation has excess credits for federal that it can carry back and apply to a tax liability in a previous tax year, then E&P increases in the year the credits arise (i.e., the time the corporation receives an economic benefit). When credits are carried forward, the corporation receives an economic benefit only when they are used. (Rev. Rul. 75-153, 1975-1 C.B. 106, modifying Rev. Rul. 66-336, 1966-2 C.B. 110.)

- **Corporate Reorganizations** - When a subsidiary liquidates into its parent company (in a transaction to which IRC §332 applies) or two companies reorganize (in a transaction described in IRC §368 (a)(1)(A), (C), (E), (F), or (G)), the effect is to create one economic enterprise. This concept is reflected by IRC §381 and regulations there under.

Under IRC §381, the acquiring corporation inherits the target or transferor's attributes, such as E&P and NOL carry forwards (although IRC §382 may limit their deductibility). The attributes are considered inherited on the date of the transfer or reorganization.

- **Intercompany Transactions -** Income from an intercompany transaction is not reflected in the seller's E&P until required to be taken into account under the matching or acceleration rules, or if the taxpayer elects to report such income currently. Refer to CCR §25106.5-1 for the timing of recognizing the income, gain, deduction, or loss from intercompany transactions between members of a combined reporting group occurring on or after January 1, 2001. See Water's Edge Manual Chapter 17 for further discussions related to intercompany transactions.

- **Consolidated Returns – "Tiering" Adjustments** - In general, each corporation included in a consolidated federal return (federal Form 1120) must compute its E&P on a separate company basis. However, Treas. Reg. §1.1502-33 requires "tiering" adjustments whereby the E&P of an upper tier corporation will include the E&P of its lower tier subsidiaries. In computing California E&P of a corporation, ignore any "tiering adjustments" included in the corporation's federal E&P.

- **Consolidated Returns – Allocation of federal income tax liability** - Special rules are also available for determining how to allocate the group's federal tax liability in computing federal E&P. (See IRC §1552 and Rev. Ruling 73-605, 1973-2 C.B. 109.) California law does not conformed to IRC §1552. In Private Letter Ruling (PLR) 8524043, the IRS opined that the law relied on in Rev. Rul. 73-605 is a principle of general application and not dependent solely upon the application of the consolidated return regulations. (PLR 8524043 addressed the allocation of a foreign tax liability between foreign subsidiaries of a U.S. company.) In the ruling, the IRS applied the theory underlying Treas. Reg. §1552 to allocate the liability, even though the regulations are inapplicable to foreign subsidiaries. Accordingly, the same reasoning (e.g., IRC §1552 and Rev. Rul. 73-605) in allocating the federal income tax liability should apply in computing California E&P.

Dividend Elimination and Dividend Received Deductions – Intercompany eliminations and dividend received deductions are added back to taxable income to compute E&P, unless the distribution is a return of capital. (IRC §312(f).)

10060 E&P of Foreign Corporations

The determination of E&P of foreign corporations is much the same as for U.S. based corporations. (IRC §964(a).) The main exception to this rule is for corporations with U.S. source income that is less than 20 percent of gross income from all sources (which includes the majority of the foreign corporations). For these corporations, the following adjustments do not apply:

- Depreciation. (IRC §312(k)(4))
- Adjustments for LIFO inventory for E&P layers accumulated prior to 1986. (IRC §312(n)(4))

- Completed contract method of accounting for E&P layers accumulated prior to 1986. (IRC §312(n)(6)
- Adjustments for the installment method for E&P layers accumulated prior to 1987. (IRC §312(n)(5))

(See IRC §312(n)(8)).

For federal, several methods apply in computing E&P of a foreign corporation, each depending on the purpose of the computation. (IRC §§902, 951, 960, 964.)

1. Determining E&P under IRC §964

The CFC's E&P is computed in the same manner as if the corporation were a domestic corporation. In addition to the adjustments provided by IRC §312, the corporation must:

- Prepare a profit and loss (P&L) statement from the books of account regularly maintained by the corporation for accounting to its shareholders. (Treas. Reg. §1.964-1(a)(i).)

- Make adjustments necessary to conform the statement to U.S. accounting standards (GAAP). (Treas. Reg. §1.964-1(a)(ii).)

- Make further adjustments to conform the statement to U.S. tax accounting standards. (Treas. Reg. §1.964-1(a)(iii).)

- Translate the adjusted statements into U.S. dollars. (Treas. Reg. §1.964-1(a)(3); IRC §986(b).

No accounting or tax adjustment, as described above is required, unless it is material. Whether an adjustment is material depends on facts and circumstances. (Treas. Reg. §1.964-1(a)(2).)

The above computation is computed in the foreign corporation's functional currency (determined under IRC §985 and the regulations under that section). (Treas. Reg. §1.964-1(a)(2).) IRC §985 defines "functional currency" as the U.S. dollar except in the case of a qualified business unit when it refers to the currency of the economic environment in which a significant part of that operation's business activities are conducted and which is used in keeping its books and records.

In the case of a foreign corporation with a functional currency other than the U.S. dollar, IRC §986(b) and IRC §989(b) provide rules regarding the time and manner of translating distributions or inclusions of the foreign corporation's earnings and profit into U.S. dollars. (Treas. Reg. §1.964-1(a)(3).)

A. Accounting Adjustments

Generally, profit and loss (P&L) statements of foreign corporations are prepared for the U.S. shareholder based on U.S. generally accepted accounting principles (GAAP). If the statements do not follow this pattern, adjust the statement by applying GAAP standards. Treas. Reg. §1.964-1(b) covers the type of accounting adjustments contemplated, such as:

- **Clear reflection of Income -** Match current income with current expense. For example, make an adjustment when an allocation of current income includes arbitrary reserves. (Treas. Reg. §1.964-1(b)(1)(i).)

- **Historical Cost** – Account for all physical assets, including inventory, at historical costs. Depreciation, depletion, and amortization allowances should be based on the historical cost of the underlying assets. (Treas. Reg. §1.964-1(b)(1)(ii).)

- **Valuation of Assets and Liabilities -** Assets and liabilities may not be under or overvalued, respectively, even when expressly permitted by foreign law. For example, an adjustment would be required where inventory was written down below market. (Treas. Reg. §1.964-1(b)(1)(iii).)

- **Income Equalization –** Adjust the reserves for income or expense equalization that cover more than one accounting period, even though permitted or required under foreign law. (Treas. Reg. §1.964-1(b)(1)(iv).)

- **Foreign Currency –** If transactions effected in a foreign currency other than that in which the books of the corporation are kept are translated into the foreign currency reflected in the books, verify that the transactions are in accordance with IRC §988 and the regulations there under for the translation of foreign currency amounts into U.S. dollars. (Treas. Reg. §1.964-1(b)(1)(v).)

B. Tax Adjustments

Adjust the P&L items to conform to U.S. tax accounting standards according to Treas. Reg. §1.964-1(c), with adjustments that include the following:

- **Accounting Methods –** The method of accounting must reflect the provisions of IRC §446 and regulations there under.

- **Inventories –** Inventories must be taken into account in accordance with IRC §471 (general rule for inventories) and IRC §472 (last-in, first-out inventories) and regulations there under.

- **Depreciation -** For taxable years beginning after June 30, 1972, if 20 percent or more of the gross income from all sources of the corporation is derived from sources within the U.S., then depreciation is computed in accordance with the provisions of IRC §1.312-15, which limits depreciation to non-accelerated methods. If less than 20 percent of the gross income from all sources of the corporation is derived from sources within the U.S., then depreciation is computed in accordance with IRC §167 and the regulations there under.

For taxable years beginning before July, 1, 1972, depreciation is computed in accordance with IRC §167 and the regulations thereunder.

C. Miscellaneous Adjustments

- **Bribes -** E&P of a foreign corporation may not be reduced for the amount of any illegal bribe, kickback, or other similar payments. (IRC §964(a).) Therefore, any amount of bribe, kickback, or illegal payment may not be deducted in computing E&P.

- **Foreign Deferred Compensation Plans -** Deferred compensation plan payments (but not accruals) reduce E&P. Companies in some foreign countries accrue but do not fund deferred compensation plans until later years. Adjust E&P for accruals in excess of payments, since such amounts do not meet the qualifications under IRC §404. (IRC §404A.)

- **Blocked Foreign Income -** Currency or other restrictions or limitations imposed by a foreign country may prevent a CFC from paying dividends to its U.S. shareholders. IRC §964(b) provides relief by reducing the CFC's E&P in determining Subpart F income (IRC §952), withdrawal of previously excluded Subpart F income from qualified investments (IRC §955), and investment of earnings in U.S. property (IRC §956), if the distributions by the CFCs were blocked. Treas. Reg. §1.964-2 contains the rules which determine when a CFC's earnings are blocked. Under the regulations, the restriction must be mandatory, not voluntary, and the shareholders must show that they have either exhausted the country's procedures to distribute the corporation's earnings, or show that the use of such procedures would be futile. Once the restriction is removed, the blocked portion of the E&P is added back for the years in which the earnings were derived. (Treas. Reg. §1.964-2(c)(i).)

D. Functional Currency/Translation to U.S. Dollars

The Tax Reform Act of 1986, which applies to tax years beginning after 1986, added Subpart J (IRC §§985 through 989) and modified the computation of E&P for CFCs (as defined in IRC §957). The purpose of Subpart J was to address certain foreign currency transactions and to provide rules for translating foreign financial statements.

For taxable years beginning after December 31, 1986, a CFC's E&P must be computed using the corporation's "functional currency," as described by IRC §985 and as discussed in more detail in Water's Edge Manual Chapter 12. IRC §989 is the definitional section of Subpart J. IRC §989(b) provides the "appropriate exchange rate" to be used in specific circumstances. Such rates are as follows:

- In the case of an actual distribution of E&P, the spot rate on the date such distribution is included in income;
- In the case of an actual or deemed sale or exchange of stock in a foreign corporation treated as a dividend under IRC §1248, the spot rate on the date the deemed dividend is included in income;
- In the case of any amounts included in income under IRC §951(a)(1)(A) (Subpart F), or IRC §1293(a) (inclusion of income from a Qualified Electing Fund), the average exchange rate for the taxable year of the foreign corporation; or
- In the case of any other qualified business unit of a taxpayer, the average exchange rate for the taxable year of such business unit.

2. Determining E&P of a Foreign Corporation for California – CCR §25106.5-10

For California tax purposes, use regular California rules. In addition to the adoption of the E&P adjustments required by IRC §312 (R&TC §24451), CCR §25106.5-10 provides rules for the determination of income and computation of factors for corporations with operations in foreign countries.

Many of the rules provided are similar to the rules provided in IRC §964. As provided by CCR §25106.5-10, the corporation is required to:

- Prepare P&L statement for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained. (CCR §25106.5-10(b)(1)(A).)

- Adjust the P&L statement to conform it to GAAP, except as modified in the regulation. (CCR §25106.5-10(b)(1)(B).)

- Adjust the P&L statement to conform it to the tax accounting standards required under the corporation tax laws and regulations Division 2, Part 11 of the R&TC. (CCR §25106.5-10(b)(1)(C).)

- Translate the P&L statement into the currency in which the parent company maintains its books and records. (CCR §25106.5-10(b)(1)(D).)

The following exchange rates apply in translating the P&L statement:

- Depreciation, depletion, or amortization are translated at the appropriate exchange rate for the translation period in which the historical cost of the underlying asset was incurred;
- All other items are translated at either the end-of-year exchange rate or at the simple average exchange rate for the translation period. (CCR §25106.5-10(b)(4)(A-B).)

Similar to Treas. Reg. §1.964-1(a)(2), CCR §25106.5-10(b)(3)(C) provides that no accounting or tax adjustments are required unless it is material.

A. Accounting Adjustments – CCR §25106.5-10(b)(3)

The accounting adjustments to conform the P&L statements to those of the U.S., as required by CCR §25106.5-10(b)(3)(A), are similar to the accounting adjustments indicated in Treas. Reg. §1.964-1(b):

- Clear reflection of income – same as Treas. Reg. §1.964-1(b)(1)(i).

- Physical assets, depreciation, etc. – same as Treas. Reg. §1.964-1(b)(1)(ii).

- Valuation of assets and liabilities – same as Treas. Reg. §1.964-1(b)(1)(iii).

- Income equalization - same as Treas. Reg. §1.964-1(b)(1)(iv).

- Currency gains or losses on closed transaction are includible, but no adjustment is made for unrealized gains or losses resulting from revaluation (or restatement) of assets or liabilities to reflect fluctuations in currency values. A closed transaction is one where any foreign exchange position taken by a corporation has been terminated by exchanging the foreign currency for the currency in which the individual corporation maintains its books and normally conducts its business affairs. (CCR §25106.5-10(b)(3)(A)(2).)

Although, Treas. Reg. §1.964-1(b)(1)(v) refers to IRC §988 and the regulations under such section, with respect to the treatment of certain transactions in foreign currency, such provisions also apply for California as well. R&TC §24905 provides the adoption of IRC §988 with the exception of IRC §988(a)(3) relating to the source. See Water's Edge Manual Chapter 12 for further discussions.

B. Tax Adjustments - CCR §25106.5-10(b)(3)(B)

The tax adjustments required by CCR §25106.5-10(b)(3)(B) are similar to the adjustments required by Treas. Reg. §1.964-1(c), as summarized below.

- Accounting Methods – similar to Treas. Reg. §1.964-1(c)(1)(i) which conforms to the provisions of IRC §446.

- Inventories - similar to Treas. Reg. §1.964-1(c)(1)(ii) which conforms to the provisions of IRC §471 (General rule for inventories) and IRC §472 (last-in, first-out inventories).

- Depreciation, depletion, and amortization – computed in accordance with California law.

- Elections required to be made in determining income for all reporting entities are made in accordance with California law.

Note: For California taxpayers electing to file on a water's-edge basis, the federal E&P as determined under IRC §964 is used for determining the:

- Denominator of a CFC's inclusion ratio as set forth in R&TC §25110(a)(2)(A)(ii)
- Foreign investment interest amounts, which include E&P, for purposes of the foreign investment interest offset provisions as set forth in R&TC §24344(c).

10070 IRC Section 482 Adjustments

When adjustments are made under IRC §482 between a foreign subsidiary (FS) and its domestic parent (DP) or between a foreign parent (FP) and a domestic subsidiary (DS), the difference between the actual payment and the arms-length amount can be recharacterized as either a constructive dividend or a capital contribution. (*Sammons v. Commissioner*, 472 F.2d 449 (5th Cir. 1972; See also *Loftin & Woodard, Inc. v. United States*, 577 F.2d 1206 (5th Cir. 1978.) In *Sammons*, the court established a twofold test with regard to constructive dividends, (1) the objective test is whether the transfer caused funds or other property to leave transferor corporation's control and fall under shareholder's control; and (2) the subjective test is whether the primary purpose was to benefit the common shareholder.)

The impact of an IRC §482 adjustment on E&P is explained in the following examples:

Example 1:

DP sells inventory to its FS for $800. The arms-length price is $1,000. FS sells this inventory during the year.

Impact on E&P from an IRC §482 adjustment:

Parent increases its net income and E&P by $200. FS reduces its income and E&P by $200. (Cost of goods sold is increased to reflect the arms-length price.)

DP is deemed to have made a capital contribution to FS of $200. (Since FS saved $200 by not paying the arms-length price, this savings is deemed to be a capital contribution.)

Example 2:

DP buys inventory from its FS for $1,000 when the arms-length price is $800. DP sells the inventory during the year.

Impact on E&P from an IRC §482 adjustment:

DP increases its net income and E&P by $200. (Cost of goods sold is decreased to reflect the arms-length price.) DP is deemed to have made a capital contribution to FS of $200. (Since DP paid FS $200 more than the arm's-length price, the excess payment is deemed to be a capital contribution.)

Example 3:

FP sells inventory to its DS for $1,000 when the arms-length price is $800. DS sells the inventory during the year.

Impact on E&P from an IRC §482 adjustment:

DS's income and E&P are increased by $200. (Cost of goods sold is reduced to reflect the arms-length price.) DS is deemed to have made a $200 constructive dividend to FP. (Since DS distributed $200 more to FP than the arms-length price, the excess distribution is a constructive dividend). DS's E&P is reduced by the constructive dividend. FP's gross receipts are decreased by the $200 reduction in the sales price of the inventory and increased by the $200 constructive dividend.

Example 4:

DP owns DS and FS. FS sells inventory to DS for $1,000 when the arms-length price is $800. DS sells the inventory during the year.

Impact on E&P from an IRC §482 adjustment:

DS increases its net income and E&P by $200. (Cost of goods sold is decreased to reflect the arms-length price.) DS is deemed to have made a $200 constructive dividend to DP for the distribution in excess of the arms-length price. This dividend increases DP's E&P by $200 and reduces DS's E&P. DP is deemed to have made a capital contribution to FS of $200.

Note: The constructive dividend in examples 3 and 4 may be eligible for elimination or deductions under R&TC §25106, §24410, or §24411.

The above examples deal with sales of tangible personal property. However, similar tax consequences will result if non arms-length payments are made for services rendered, use of an intangible, or any other intercompany transaction subject to adjustment under IRC §482. (See Rev. Rul. 78-83, 1978-1 C.B. 79.)

Under certain circumstances the shareholder can obtain relief from the constructive dividend treatment by meeting the requirements of Rev. Proc. 99-32, 1999-2 C.B. 296 (which supersedes Rev. Proc. 65-17). This revenue procedure allows the recipient to set up a receivable to the distributor in the amount of the adjustment. Even when Rev. Proc. 99-32 is followed, E&P still must be adjusted. See Water's Edge Manual Chapter 18 for a detailed discussion of Rev. Proc. 99-32.

1. IRC Section 482 for State Purposes

California taxpayers filing on a water's-edge basis – The recharacterization as either a constructive dividend (*Sammons v. Commissioner*, 472 F.2^{d} 449 (5^{th} Cir. 1972); *Loftin & Woodard, Inc. v. United States*, 577 F.2^{d} 1206 (5^{th} Cir. 1978)) or a capital contribution apply when the transactions are between included and excluded foreign entities from a water's-edge combined report.

California taxpayers filing on a worldwide basis – Even though a federal IRC §482 adjustment is a "wash" in computing California net income during worldwide combined report years, such adjustment will still affect the E&P of the corporations involved.

Therefore, whenever the IRS or the FTB make an IRC §482 adjustment, E&P of the affected parties must be adjusted to reflect the changes to income, tax, and other items.

10080 Impact of Distributions on E&P

1. Distributions that Reduce E&P

Pursuant to IRC §312(a), a corporation's distributions to its shareholders must reduce E&P. The E&P of the corporation must be decreased by the sum of –

- The amount of money
- The principal amount of the obligations of such corporation
- The adjusted basis of the other property distributed

Each type of the above distributions is considered separately, and then combined to produce a net reduction or net increase to E&P.

Distributions of cash or property reduce E&P by the fair market value (FMV) of the property. A corporation that distributes appreciated property to a shareholder will recognize gain (but not a loss) in the amount of the fair market value of the distributed property over its adjusted tax basis. E&P increases by the amount of this gain. The distribution will then decrease E&P by the amount of the FMV of the property. (IRC §§ 311(b) and 312(b).) Any liabilities transferred with the property reduce the reduction to E&P. (IRC §312(c).)

2. Other Distributions

Corporation Issues Own Stock – If a corporation issues stock to its shareholders, E&P is not reduced unless the stock distribution:

- Is in lieu of money or property
- Is a disproportionate distribution
- Results in receipt of preferred stock by some common shareholders and common stock to other common shareholders
- Is a distribution on preferred stock
- Is a distribution of convertible preferred

If one of these conditions is met, the issuance is treated as a distribution of property. (IRC §312(d) and Treas. Reg. §1.312-1(d), which refers to IRC §305(b).)

Bargain Sale Property – If a corporation sells property to a shareholder below its fair market value, treat it as a constructive distribution to the shareholder/purchaser. The excess of the FMV over the sales price is a gain to the corporation (thus increasing E&P) and a dividend to the shareholder (thus reducing E&P). (*L.E. Dellinger v. Commissioner,* 32 TC 1178: Rev. Rul. 69-630, 1969-2 C.B. 112.) The adjustment to E&P should be the difference between the FMV and the sales price. (The difference between the sales price and basis should have already been included in income.)

10090 Characterization of Distribution Received

IRC §316(a) states that any **distribution of property** is a dividend if paid from:

- Earnings and profits of the taxable year, or
- Earnings and profits accumulated since February 13, 1913

Current E&P is calculated at the end of the taxable year without diminution for distributions during the year or any E&P deficit from prior years. Once calculated, current E&P is portably applied to distributions made during the taxable year. Distributions not absorbed by current E&P are applied in a chronological order to the accumulated E&P on a LIFO basis. All distributions of a corporation to its shareholders of money, property, and obligations of the distributing corporation, reduce E&P, but **not below zero**. (IRC §316, Treas. Reg. §§1.316.1 -2.)

A distribution received is treated for tax purposes as follows:

- Dividend – A distribution is first treated as a dividend to the extent of the payor's E&P. (IRC §301(c)(1).)

- Basis reduction – The portion that is not a dividend, as defined in IRC §316, is applied against and reduces the adjusted tax basis of the shareholder's stock as a return of capital and is not taxable. (IRC §301(c)(2).)

Note: California and federal law differ in computing the tax basis of a subsidiary's stock when a consolidated Form 1120 is filed. Federal regulations require the tax basis of the stock of a subsidiary to be adjusted by the E&P of the subsidiary. (Treas. Reg. §1.1502-32(b).) California does not conform to such regulation. Under California law, a parent's basis in its subsidiary's stock will be the parent's original cost, increased by any capital contributions and decreased by any return of capital. (CCR §25106.5-1(d)(3).)

California has adopted Treas. Reg. §1.1502-13 which relates to intercompany transactions effective January 1, 2001. (CCR §25106.5-1.) As provided by CCR §25106.5-1, conformity to Treas. Reg. §1.1502-13 in no way implies conformity to any other regulation under Treas. Reg. §1502.

Under federal law, a U.S. shareholder's basis in a CFC is:

- Increased by the Subpart F amounts included in gross income as if the amounts had been reinvested in the corporation. (IRC §961(a).
- Decreased by any tax free portion distribution as provided under IRC §959. (IRC §961(b)(1). California does not conform to IRC §961 or §959. See also MATM 6095.

- Capital gains – The portion of the distribution that exceeds the adjusted basis of the stock is a capital gain from the sale or exchange of property. (IRC §301(c)(3)(A).) The distribution taxed as a capital gain does not qualify for elimination or deductions under R&TC §§25106, 24410, or 24411.

Example 1:

Allen Corporation had accumulated E&P of $-5,000 (a deficit) on January 1, 2010. For 2010, its current earnings and profits were $5,000. A distribution of $20,000 was made to its sole shareholder on December 31, 2010. The shareholder's tax basis in Allen Corporation stock before the distribution is $20,000. The shareholder's dividend income and return of capital for 2010 is computed as follows:

- Distribution $20,000
- Amount taxable as dividend $5,000 ($5,000 current year E&P + $0 accumulated E&P)
- Return of capital $15,000

After the distribution, the shareholder's new tax basis in Allen Corporation stock is $5,000 ($20,000 - $15,000).

Example 2:

Bacone Corporation is a calendar year cash-basis taxpayer. During 2009, its first year of operations, Bacone Corporation:

- Had California net income after state adjustments of $20,000. (Federal Form 1120, line 28 was $15,000 plus $5,000 tax exempt income.)
- Received tax exempt income in the amount of $5,000.

- Had a federal income tax liability of $2,550. (The tax was paid in 2010).
- Distributed $18,000 to the shareholder on July 1, 2009.
- The adjusted tax basis of the shareholder's stock was $10,000.

	FEDERAL	**CALIFORNIA**
Taxable income	$ 15,000	$ 20,000
Add: Tax Exempt interest	5,000	0
Minus: FIT accrued	0	0
Current E&P	$ 20,000	$ 20,000

For 2009, Bacone Corporation's current E&P is $20,000, and the full distribution of $18,000 is taxed as a dividend to the shareholder. Current E&P is initially computed at the end of the year, without reduction by current year distributions. Thus, the distribution was disregarded. The Federal tax liability was paid in the next year by a cash basis taxpayer; therefore, the payment has no effect on current E&P for 2009.

Example 3:

Same facts as in Example 2 except that Bacone Corporation is an accrual basis corporation. The computations will be:

	FEDERAL	**CALIFORNIA**
Taxable income	$ 15,000	$ 20,000
Add: Tax Exempt interest	5,000	0
Minus: FIT accrued	2,550	2,550
Current E&P	$ 17,450	$ 17,450
Distribution	$ 18,000	

Dividend (limited to current E&P)	17,450
Return of Capital	$550

Example 4:

Caldon Corporation received distributions during 2009 from Mighty Corporation. Other facts include:

Mighty Corporation's current E&P	$15,000
Mighty Corporation's accumulated E&P	$20,000
Cash distribution to Caldon on 6/1/2009	$22,000
Cash distribution to Caldon on 12/31/2009	$26,000
Caldon's adjusted tax basis in Mighty's stock	$10,000

For 2009, Caldon Corporation's dividend, return of capital, and capital gain are:

Taxable Dividend =	$35,000	($15,000 current year E&P + $20,000 accumulated E&P)
Return of Capital =	$10,000	(Basis cannot be reduced below $0)
Capital Gain =	$3,000	(Distribution in excess of E&P and stock basis)

Total Distributions during income year	$48,000
Current E&P	$15,000
Excess of distribution over current E&P	$33,000
Accumulated E&P	$20,000
Excess of distribution over accumulated E&P	$13,000
Adj. Basis of Stock	$10,000
Excess of distribution over basis of Stock	$3,000

10100 California Tax Treatment of Dividends Received - Character and Source of E&P

IRC §316 defines a dividend for income tax purposes as a distribution out of current or accumulated earnings and profits of the distributing corporation. Distributions exceeding E&P reduce stock basis (IRC §301(c)(2), and any excess is treated as a capital gain. (IRC §301(c)(3).)

A distribution described by IRC §301(c)(3) is deferred in a Deferred Intercompany Stock Account (DISA). In general, the DISA income under IRC §301(c)(3) attaches to the stock, and the gain is taken into account if there is a disposition of the stock of the DISA subsidiary. (See CCR §25106.5-1 for more information on DISA.)

It is important to identify the layer (origin) of E&P distributed (e.g., the tax years in which the distributed E&P arose) and whether the E&P is attributable to unitary income or excluded income for purposes of determining intercompany dividends eligible to elimination (R&TC §25106) and dividends eligible for deductions under R&TC §§24410 and 24411.

1. Identify the E&P Distributed from Each Tax Year - LIFO

Apply the LIFO ordering rules. IRC §316(a) provides that dividends are paid from the current year's earnings until exhausted and thereafter from the most recently accumulated E&P, exhausting each year's earnings in turn. California conforms to IRC §316(a). (R&TC §24451.) In addition, CCR §24411(e)(1) also provides similar ordering rules, which reads, in part:

> *For purposes of determining the application of Revenue and Taxation Code sections 24402, 24410, 24411 and 25106, 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.*

The ordering rule provided by IRC §316 and R&TC §24451 is generally referred to as "LIFO" ordering. Distributions treated as dividend income are from current E&P first. Any distribution exceeding current year E&P comes from accumulated E&P on a last-in, first-out (LIFO) basis, starting with the most recent year.

2. Identify the E&P Attributable to Unitary Income and Excluded Income

After application of the LIFO ordering approach in determining the portion of the dividends that are paid from any given year's earnings, determine the amount of dividends paid from unitary earnings, which would qualify for elimination under RT&C §25106, and from "other" pools of earnings, which may qualify for deductions under R&TC §§24410 and 24411. RT&C §25106(a)(1) provides the following, in pertinent parts:

> *In any case in which the income of a corporation is or has been determined under this chapter with reference to the income and apportionment factors of one or more other corporations with which it is doing or has done a unitary business, all dividends paid by one to another of any of those corporations shall, to the extent those dividends are paid out of the income previously described of the unitary business, be eliminated from the income of the recipient,…*

Since dividends are paid out of E&P and not out of "income," the statutory wording referring to "dividends…paid out of the income previously described of the unitary business," reflected in R&TC §25106, should be interpreted to mean that the dividends must be paid out of the E&P that correlate with the unitary business income.

To qualify for elimination under R&TC §25106, a dividend must be paid from "income" of a unitary business, and that "income" must have been determined by reference to the income and apportionment factors of both the dividend payor and the dividend recipient. (R&TC §25106; *Willamette Industries, Inc. v. Franchise Tax Board* (1995) 33 Cal.App.4th 1242.)

When a member of a water's-edge combined group receives a dividend from an affiliate that was partially and/or fully included the combined group of the payer, it determines the portion of the dividend eligible for elimination under R&TC §25106 and the portion eligible for deductions under R&TC §§24410 and 24411.

The key to determining the proper dividend treatment is to identify:

- The amount of each distribution
- The dividend payer and payee
- The current year E&P of the distributing corporation
- The accumulated E&P of the distributing corporation, including E&P calculations for each year
- The character of earnings by identifying earnings attributable to unitary business and earnings attributable to excluded (non-unitary) income.

Example 1:

Parent X acquired 100 percent of the stock of Corporation S on January 1, 2008. For TYE 12/2010, S made a $10,000 cash distribution to X. Prior to January 1, 2008, S was owned by a non-affiliate of Parent X. S' E&P generated is as follows:

TYE 12/2010 - $2,000

TYE 12/2009 - $3,000

TYE 12/2008 - $1,000

TYE 12/2007 - $6,000

Total E&P - $12,000

Following the LIFO ordering rules, S distribution to X is treated as a dividend:

	Available	**Eligible for**	**Distribution from Non-Unitary**
TYE	**E&P**	**Elimination**	**E&P**
12/2010	$2,000	$2,000	$ -
12/2009	3,000	3,000	-
12/2008	1,000	1,000	-
12/2007	6,000	-	4,000
Total		**$6,000**	**$4,000**

The dividend of $6,000 is eligible for elimination under R&TC §25106 because it was paid from unitary earnings. The remaining dividend of $4,000 (TYE 12/2007) is attributable to non-unitary E&P and, therefore, it is NOT eligible for elimination.

Currently, **within each year's** distribution of E&P, dividends are deemed first distributed from that year's earnings attributable to unitary income, qualifying for elimination under R&TC §25106, until those earnings are depleted, with the remaining dividends deemed distributed from excluded/non-unitary earnings, subject to deductions provided by R&TC

§§24410 or 24411. (Technical Advise Memorandum 2011-02, March 15, 2011, *Fujitsu IT Holdings, Inc. v. Franchise Tax Board* (2004) 120 Cal.App.4th 459.)

Example 2 – Water's-edge

For TYE 12/2010, DP received a distribution from its wholly owned foreign subsidiary, CFC1, in the amount of $10,000. CFC1's E&P generated and inclusion ratio is as follows:

TYE 12/2010 – $2,000, 10%

TYE 12/2009 – $4,000, 50%

TYE 12/2008 – $10,000, 50%

The distribution of $10,000 is dividend income. The characterization of the dividend income (distributed E&P) is as follows:

TYE	**Water's-edge Inclusion Ratio**	**Available E&P of CFC1**	**E&P attributable to included income**	**E&P attributable to excluded income**	**E&P used for distribution**	**R&TC §25106**	**R&TC §24411**
12/10	10%	$2,000	$200	$1,800	$2,000	$200	$1,800
12/09	50%	4,000	2,000	2,000	4,000	2,000	2,000
12/08	50%	10,000	5,000	5,000	4,000	4,000	0
Total		$16,000	$7,200	$8,800	$10,000	$6,200	$3,800

CFC1's E&P available for future distributions from 2010 and 2009 is zero ($0), and for 2008 is $6,000 ($1,000 eligible for R&TC §25106 elimination plus $5,000 qualifying for an R&TC §24411 deduction).

This preferential ordering treatment (E&P attributable to unitary income is deemed distributed first) applies to all open tax years. Prior to the preferential ordering treatment, dividends were treated as being paid proportionally from unitary earnings and excluded earnings. For further examples and discussions of such ordering, including the history and evolution of the current preferential treatment, please see MATM 10120

10120 Dividend Received From Foreign Corporations Partially Included In a Water's-Edge Combined Report - Water's Edge

When a member of a water's-edge group receives a dividend from a partially-included entity, it determines the portion of the dividend that will be eligible for elimination under R&TC §25106 and the portion that will be eligible for a deduction under R&TC §24411.

- Intercompany dividend income is eliminated under R&TC §25106 to the extent that the dividend has been paid from E&P attributable to unitary earnings.
- Any remaining dividend income that did not meet the conditions for R&TC §25106 elimination will be subject to the R&TC §24411 foreign dividend deduction (generally a 75% deduction for taxable years beginning on or after January 1, 1996).

  CCR §24411(e)(2)(B) states the following:

  "*Dividends which are considered paid out of earnings and profits of a year in which 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 the earnings and profits attributable to income included in the combined report.*"

  As stated prior, the key to determining the proper dividend treatment is to identify how much of the dividend has been paid from E&P attributable to unitary income and excluded income. If the dividend was paid out of E&P from a year in which the dividend payor was only partially included in the water's-edge combined report, it is necessary to identify how much of the earnings being distributed **from that particular tax year** came from unitary E&P and excluded E&P. The E&P related to unitary income is deemed first distributed with the remaining E&P related to excluded income distributed last.

1. Technical Advice Memorandum (TAM) 2005-01, March 7, 2005 – Water's-Edge

Prior to the issuance of TAM 2011-02 (see discussion below), we treated dividends as being paid proportionally from the current year E&P, and then proportionally from the next succeeding prior year. This standing practice of prorating the dividends among the included and excluded income, was challenged in *Fujitsu IT Holdings, Inc. v. Franchise Tax Board* (2004) 120 Cal. App. 4th (459) (*Fujitsu) (during the litigation, the taxpayer was referred to as Amdahl Corporation).* In *Fujitsu*, the Court ruled that "the dividends paid by first-tier subsidiaries from **current year** earnings should be treated as paid (1) first out of earnings eligible for elimination under section 25106, with (2) excess paid out of earnings eligible for partial deduction under section 24411."

The ruling in *Fujitsu* only provided the ordering of distributions with respect to **current year** E&P. It did not decide how to order distribution from a CFC when the distribution is from earnings generated in multiple years, nor did it reject CCR §24411 as providing guidance on the ordering of distributions made from earnings spanning multiple years (e.g., LIFO ordering).

To implement the decision in *Fujitsu,* the FTB issued TAM 2005-1 (March 7, 2005). This TAM advises audit and legal staff to continue to treat dividends as being paid proportionally from the current year's E&P, and then proportionally from the next succeeding prior year. Specifically, TAM 2005-01, item 6, reads, in part:

1. *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. . .*

Item 6 of this TAM is superseded by TAM 2011-02 as explained below. Except for Item #6, TAM 2005-01 remains in effect and continues to be the department policy.

The following example illustrates this proration approach.

Example 1 (for illustration purposes only)

For TYE 12/2010, CFC1 had Subpart F income of $300, current year E&P of $400, net income of $420. CFC1 paid a dividend of $300 to its U.S. parent. CFC1's income and factors are partially included in the water's-edge combined report. CFC1 inclusion ratio is 75% ($300 Subpart F income divided by $400 current E&P).

The U.S. parent eliminates $225 dividend from its gross income under R&TC §25106 using the proration approach. The computation is as follows:

$300 dividend paid $225 dividend

From current E&P x 75% = elimination

The remaining balance of the distribution, $75, would be included in the U.S. parent's gross income and would qualify for an R&TC §24411 foreign dividend deduction.

2. Technical Advice Memorandum (TAM) 2011-02, March 15, 2011– Water's-Edge

On March 15, 2011, the Franchise Tax Board issued TAM 2011-02. This TAM advises audit and legal staff to:

- Continue to apply the LIFO ordering approach to determine the years of earnings from which dividends are distributed; and
- Treat dividend distributions **within a year** as paid first from:
    - That year's unitary earnings which are eligible for elimination under R&TC §25106, until those earnings are depleted; and
    - Then from earnings excluded from the combined report, which are eligible for deduction under other provisions of the Corporation Tax law, until that year's earnings are depleted.

The TAM 2011-02 reads, in part:

1. *<u>Ordering Of Distributions Within A Year</u>: 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.*

TAM 2011-02 applies to all open years.

The following examples illustrate the holdings in TAM 2011-02.

Example 2:

Using the same facts as in Example 1 above, the dividend eligible for elimination and deduction under the TAM 2011-02 is a follows:

Inclusion Ratio	Current E&P	Earnings in W/E combined Report	Section 25106	Section 24411
75%	$400	$300	$300	$0

CFC1's 2010 E&P attributable to unitary earnings and eligible for R&TC §25106 elimination is $300 ($400 E&P x 75%). The remaining E&P of $100 ($400 E&P - $300 dividend distribution) is attributable to excluded earnings. Thus, the current year dividend of $300 is treated as paid first from the earnings eligible for R&TC §25106 elimination. CFC1's E&P available for future distributions equals $100, qualifying for partial deduction under R&TC §24411.

Example 3:

X, a U.S. Corporation, owns 100 percent of CFC1, a controlled foreign corporation. CFC1's income and apportionment factors are partially included in X's 2007 and 2008 water's-edge combined report. During 2007 and 2008 CFC1 reported the following:

	2008	2007
Subpart F income	$8,000	$12,000
Current E&P	20,000	15,000
Cash dividend	30,000	-

Following the TAM 2011-02, in 2008, X eliminates $18,000 dividend from its gross income under R&TC §25106. The remaining balance of the distribution, $12,000, would be included in the U.S. parent's gross income and would qualify for an R&TC §24411 foreign dividend deduction. The computation is as follows:

Earnings in

	Inclusion Ratio	Current E&P	W/E combined Report	Section 25106	Section 24411
2008	40%	$20,000	$8,000	$8,000	$12,000
2007	80%	15,000	12,000	10,000	-

CFC1's E&P available for future distributions from 2008 is zero ($0), and from 2007 is $5,000, $2,000 E&P eligible for R&TC §25106 elimination plus $3,000 qualifying for partial deduction under R&TC §24411.

10130 Dividends Paid from E&P Attributable to Excluded Income - Worldwide and Water's-Edge

Generally, dividends paid from E&P attributable to excluded income (e.g., nonbusiness income, E&P from an entity not included in the combined report such as a foreign corporation or pre-affiliation) do not qualify for elimination under R&TC §25106. For dividends to qualify for elimination under R&TC §25106, the dividends must correlate with the unitary business income. (*Willamette Industries, Inc. v. Franchise Tax Board* (1995) 33 Cal App 4th 1242;.)

1. Income Excluded from Water's Edge Combined Report

Dividends paid by foreign affiliates, not included in the water's-edge group but previously included in the worldwide combined report, will be considered distributed first from current year's E&P. (IRC §316(a); CCR §24411(e)(1).) These dividends are not eliminated under R&TC §25106 as the distributed E&P is from non-unitary/excluded income. They are considered qualified dividends and eligible for deduction under R&TC §24411. The dividends paid from accumulated E&P attributable to tax years where the foreign affiliates were included in the worldwide combined report, would qualify for elimination under R&TC §25106.

Example 1:

Corporation G and its 100% owned foreign subsidiary H were engaged in a unitary business for many years prior to G's 2007 water's-edge election. H is not an includible entity under R&TC §25110(a). For 2006 and prior when H was included in G's worldwide combined report, H had $1,000 of accumulated earnings and profits. H had earnings and profits of $100 in 2007. H paid to G a dividend of $50 in 2007.

Solution:

The dividend of $50 is derived entirely from E&P generated in the current year, 2007. (IRC §316(a).) Since H was not included in the combined report for 2007, any dividends paid out of its 2007 E&P do not qualify for elimination under R&TC §25106. Corporation G will report dividend income of $50 and the dividend is eligible for a deduction under R&TC §24411. The R&TC §24411 dividend deduction is discussed in Water's Edge Manual 13.

Example 2:

Same facts as in Example 1, except that Corporation H pays a dividend of $200 in 2007. The first $100 would not be eliminated pursuant to R&TC §25106. However, the second $100, attributed to 2006 and prior years' E&P would be eligible for elimination. Corporation G will report dividend income of $200. Of this dividend, $100 is eligible for elimination as an intercompany dividend pursuant to R&TC §25106, and the other $100 would qualify for a deduction pursuant to R&TC §24411.

2. Nonbusiness/Nonunitary Income – Worldwide and Water's-Edge

Example - Distribution paid out of non-unitary income

Corporation P acquired subsidiary S. They were found to be instantly unitary and filed a combined report for the year. S had E&P of $50,000 in that year and accumulated E&P of $100,000 from prior year. S distributed $75,000 to its parent P during the taxable year. Of the $75,000 paid, only $50,000 would be eligible for elimination pursuant to R&TC § 25106. This is the amount paid out of unitary earnings. Although there is E&P from prior years this is prior to the acquisition and not paid out of unitary earnings.

Example - Dividend paid out of non-business income

Corporation P owned 100 percent of the stock of unitary Subsidiary S. In the current year, S had net earnings and profits of $80,000 comprised of business earnings of $20,000 and earnings attributable to a non-business activity of $60,000. At year-end, S paid a dividend of $10,000 to P.

Since 25 percent of S's current year earnings were attributable to business activities ($20,000/$80,000), Corporation P would be able to eliminate $2,500 (25 percent of the dividend) under R&TC §25106. The remaining $7,500 of the dividend is business income to P because the S stock was a unitary business asset of P at the time that the dividend was paid (see MATM 4020), but it would not be eligible for elimination under R&TC §25106.

If the dividend had been paid out of earnings and profits accumulated in prior years, the same process would be applied to determine the portion of the earnings attributable to business activities in each prior year, starting with the most recent year and working backwards.

10140 Other Considerations

1. Dividends Received from CFCs – Actual or Deemed

For federal purposes, Subpart F income is includible in the income of a U.S. shareholder as dividend income. The dividend is deemed to have been distributed from the CFC to the U.S. shareholder, irrespective of whether the CFC actually distributes anything. (IRC §951.) The amount of Subpart F income appears as a separately stated item on Schedule C of the federal 1120. Such deemed dividends go into a "pocket" of E&P referred to as Previously Taxed Income (PTI). Under IRC §959, when a CFC makes an actual distribution, such dividends are considered to come first out of PTI (current and accumulated).

IRC §959 provides special ordering rules for maintaining the different "pockets" or history of earnings of the CFC. Under IRC §959, current and accumulated E&P are maintained in the IRC §956 pocket, the Subpart F pocket, and the "other" pocket. This is an exception to the general ordering rule of IRC §316. There are a number of reasons for this. The most important reason for maintaining IRC §959 pockets is to keep track of earnings previously reported as a deemed dividend by the U.S. shareholder(s). Subsequent cash distributions to the U.S. shareholder(s) reduce the IRC §956 pocket and Subpart F pocket until exhausted. Such amounts are considered drawn from previously taxed income and are not treated as dividends. These amounts will not be part of federal taxable income and should be reported on the federal Schedule M-1 (or Schedule M-3) and on federal Form 5471, Schedule J, "nontaxable" dividends distributions.

R&TC has no comparable provisions to IRC §951 through §971, except for references to IRC §952 (relating to Subpart F income definition) and IRC §964 (describing a CFC's E&P). The California "partial inclusion" rule of R&TC §25110(a)(2)(A)(ii) (formerly R&TC §25110(a)(6)) does not consider Subpart F income as a "deemed" dividend. We simply look to the ratio of Subpart F income to current year E&P to determine the amount of taxable income and factors subject to inclusion in the combined report.

For California tax purposes any Subpart F deemed dividend must be excluded from current year dividends. Conversely, any **actual** dividends paid out of PTI are included in California income, and may be eligible for elimination and deduction under R&TC §§ 25106, 24411, and 24410. This includes dividends paid from lower-tier CFCs to higher-tier CFCs. (For a discussion on the treatment of dividends from lower-tier CFCs, see Water's Edge Manual 13.) Similar to other dividends, in order to determine the R&TC §25106 elimination and the dividends deducted under R&TC §24411 of the **actual** dividends, the sources of such dividends from E&P will need to be determined (as discussed above).

Be aware that PTI distributions from partially included CFCs are a common area for potential audit adjustment. The taxable distributions from CFCs identified on the federal return DO NOT always represent the actual amount of distributions received by the U.S. shareholder.

Example 1 – Water's-edge

(CFC/Payor with Subpart F Income)

Corporation L filed a water's-edge election effective January 1, 2006. This allows L to exclude its foreign subsidiary, Corporation M, except for the fact that M is a CFC with Subpart F income. Corporation M has Subpart F income of $100 and total earnings of $150 in 2006. Based on the inclusion ratio as provided under R&TC §25110(a)(2)(A)(ii), $100 is attributable to income included in the combined report. In 2007, M has Subpart F income of $50 and total earnings of $100 of which $50 is attributable to income included in the combined report pursuant to R&TC §25110(a)(2)(A)(ii).

If Corporation M declares a $75 dividend in 2007:

For federal purposes, Corporation L reported Subpart F deemed dividends of $100 in 2006 and $50 in 2007. Therefore, the $75 cash distribution is considered a nontaxable PTI distribution ($50 from 2007 Subpart F earnings and $25 from 2006 Subpart F earnings). For California tax purposes, although the Subpart F income causes M to be partially included in L's water's-edge combined report, the Subpart F deemed dividends themselves were not taxed by California. Corporation L is, therefore, required to include the $75 actual dividend in its California income. This is generally done as a state adjustment on Form 100W. You will need to compute the portion of the dividend eligible for elimination (R&TC §25106) and deduction (R&TC §24411).

Fully excluded entities that have no current year Subpart F income may still have a current year actual distribution that is paid out of PTI from prior year Subpart F income. These can be difficult to spot, so you should always check for PTI issues if there are CFCs in the affiliated group. Schedule M-3, Part II, Lines 1-5 can help identify these distributions.

Example 2 – Water's-edge

(CFC/Payor with Subpart F income in prior tax year(s))

Corporation A, a U.S. corporation, elected to file on a water's-edge basis. It owns 100% of the stock of Corporation B, a CFC. In 2006, B derived $10,000 of Subpart F income. In 2007, B has no Subpart F income and made a distribution of $5,000 to A.

For federal purposes, A will include a $10,000 deemed Subpart F dividend in its gross income for 2006. A does not include the $5,000 actual distribution in its federal gross income for 2007. The distribution is considered to be previously taxed income (PTI) and is not includible in A's federal gross income for 2007 because the earnings have already been included in A's gross income for 2006. (IRC §959.)

On the 2006 federal return, A reports the $10,000 Subpart F deemed dividend from B on Schedule C. On the 2007 Form 1120, no dividend would be reported on Schedule C, but the $5,000 actual distribution should show up as a Schedule M-1 (or Schedule M-3) adjustment.

On the 2006 California return, A does not include the Subpart F income. In 2006, we only used the Subpart F to compute the inclusion ratio as provided under R&TC §§25110(a)(2)(A)(ii). On the 2007 Form 100W, A includes the actual distribution of $5,000 in its gross income, subject to elimination and deductions.

Dividends paid out of PTI are generally reported as a Schedule M-1 (or Schedule M-3) adjustment on the federal return. This is not always the case as taxpayers may report these dividends as a Schedule M-2 adjustment. Therefore, a thorough review of the Schedules M-1, M-3 and M-2 adjustments should be made in cases where there are CFCs in the affiliated group to make sure that the taxpayer properly included dividend income for California purposes. In addition, dividends reported as income on the California return should be reconciled to total "pre-elimination" dividends reported on the affiliated group's books and in the financial statements to identify possible PTI issues.

Subpart F income is discussed in more detail in Water's Edge Manual 2, section 3.

2. Offsetting/Restoration of Deficits

As discussed in section (10030) of this chapter, a deficit occurs when deductions exceed income (i.e., net loss) in computing E&P for any tax year. A loss sustained for a year before the current taxable year does not affect the E&P of the current taxable year. However, in determining accumulated E&P, a deficit/loss in a taxable year first reduces E&P accumulated after February 20, 1913 (Reg. § 1.312-6(d). A deficit in E&P for any taxable year must reduce the most recently accumulated earnings and profit for a prior year. (Rev. Rul. 74-550, 1974-2 C.B. 209.) If there are no accumulated E&P in an E&P account because of a deficit incurred in a prior year, such deficit must be restored before E&P can be accumulated in a subsequent year. (Rev. Rul. 74-550, 1974-2 C.B. 209; Treas. Reg. §1.243-4.)

For purposes of offsetting deficits with E&P generated and/or restoring deficits in calculating E&P available for distributions and the character of such deficits (or character of E&P that is being offset by the deficits), deficits generated should first be applied to E&P attributable to excluded income and then applied to E&P attributable to included/unitary income within a tax year. The reasoning/support behind such treatment is that in tax years where a CFC generates a deficit (net loss), such entities loss and factors are completely excluded from the California combined report, due to 0% inclusion ratio (Subpart F income/current E&P). As Subpart F income is limited to current E&P (IRC §952(c)), which would be $0, the taxpayer's numerator and denominator of the inclusion ratio would both equal $0.

As the deficits generated would not have been included in the combined report, such deficits should be applied first against earnings/income that was also excluded from the combined report. Any remaining E&P available for distribution from such tax year (i.e., E&P attributable to unitary income) should then be applied to the deficit. R&TC §24451 conforms to IRC §316(a) which provides that dividends should be paid first from current year earnings until exhausted and thereafter from the most recently accumulated E&P, exhaust each year's earnings in turn. Therefore, if the deficit exceeds the E&P attributable to excluded income, any E&P remaining for that year (E&P attributable to unitary income) must be applied to the deficit, until exhausted.

Use PASS schedule named "MSA-Water's Edge-Dividend Deductions per TAM 2011-02" when working on this issue.

10150 Maintenance of Books and Records

No statute of limitations pertains to the computation of E&P. The corporate taxpayer should construct and retain, permanently, records sufficient to compute E&P.

Dividends - IRC §6042(d) requires corporations to report information regarding the computation of E&P including a specific statement of accumulated E&P. (California conforms under R&TC §18631 and §18639.)

Depreciation - Treas. Reg. §1.312-15(d) requires that whenever different methods of depreciation are used for taxable income and E&P purposes, records must be maintained which show the depreciation taken for E&P purposes each year and which will allow computation of the adjusted basis of the property in each account using the depreciation taken for E&P purposes.

10160 Audit Tips

E&P plays a major part in determining:

- The amount of distributions that are treated as "dividend income" and the taxability of such dividends.
- How much income and apportionment factors of a CFC must be included in the water's-edge combined report. CCR §25110(d)(2)(E) describes this in detail.
- The ratio of interest expense assigned to foreign investment (See CCR §24344(c)).

In verifying E&P for the various issues, below are suggested audit actions to be completed, although such list is not all inclusive and such actions are dependent upon materiality.

1. Distributions – Determining E&P Distributed (Dividend Income) and Taxability of such Dividends.

- Verify:
    - Current and accumulated E&P available for distribution.
    - The reduction of E&P for all distributions of E&P to all shareholders (100%).
    - That accumulated E&P has properly been adjusted for IRS adjustments.
    - That deficits have been properly applied/restored.
    - The source of current and accumulated E&P available for distribution, E&P attributable to unitary income and excluded income.
    - That E&P being distributed is applied on a LIFO basis and that any E&P from such tax year(s) is first distributed with E&P attributable to unitary earnings.

- For fully or partially included CFCs, the above audit recommendations should also be applied in determining the includible net taxable income of the CFC, specifically the taxability of such distributions received. This is a common error experienced. Taxpayers often times incorrectly eliminate the entire dividend or do not properly reduce the dividend income for dividend eliminations and/or deductions available.
- Review Schedule M-3, Part II, Lines 1 through 5 for potential dividend issues related to foreign corporations
- Follow the rules provided in CCR §25106.5-10 in computing current and accumulated E&P of a foreign corporation. Both current and accumulated E&P should first be computed in the currency in which the books of account of the corporation/branch are regularly maintained. Once adjusted, the amounts should be translated in accordance with CCR §25106.5-10.
- Use the **audited income statement** for determining foreign E&P. Always request this document. Do not be content with any pro forma profit and loss statement done by the CFC for internal purposes.

For aid in computing the current and accumulated E&P, see PASS document. Exhibit 1. Also for aid in computing dividend eliminations under R&TC §25106 and deductions under R&TC §24411, see the excel document titled, "MSA – Water's Edge – Dividend Deduction TAM 2011-02," which is located in PASS. Exhibit 2.

2. Current E&P/Denominator of Inclusion Ratio (CCR §25110(d)(2)(E)) – Water's-Edge

- The calculation of the inclusion ratio, specifically E&P (denominator), takes into account **current E&P only**. If the CFC has a current deficit but positive accumulated E&P, none of the CFC's income and apportionment factors are included in the combined report.
- In computing current E&P of a foreign corporation for purposes of the CFCs inclusion ratio, follow the rules provided by IRC §964 and regulations there under.

As stated above, the best source for determining foreign E&P is the CFC's **audited income statement,** which you should always request. Do not be satisfied with any pro forma profit and loss statement done by the CFC for internal purposes.

For aid in computing the current and accumulated E&P, see PASS document. Exhibit 1.

3. Foreign Investment Interest Offset/E&P Included in the Equity Accounts – Water's-Edge

- Stock or other equity investment in an affiliated bank or corporation is taken into account at its adjusted federal basis, **plus (minus) any increases (deficits) in E&P**, but not below zero, accumulated during the period the stock was owned by an entity that is a member of the group which includes the taxpayer. (CCR §24344(c)(6)(B).) In computing such E&P, follow the rules provided by CCR §25106.5-10. If material, verify that the appropriate E&P is included in the numerator (unassigned foreign investment) and denominator (unassigned total assets). See Water's Edge Manual Chapter 14.

10170 Summary

E&P is an economic concept meant to reflect what a corporation will have available for distribution to stockholders as a dividend at any specific time without invading the capital contributed by its shareholders and creditors.

A correct computation of E&P is necessary to determine the tax treatment of corporate distributions (e.g., dividend, return of capital, or capital gain) for federal and California tax purposes. A distribution is a dividend only to the extent that it is paid out of E&P; if the distribution exceeds E&P, it reduces stock basis, and any excess distribution (beyond stock basis) is capital gain.

For federal tax purposes, among its other purposes, E&P also determines the amount of Subpart F income and foreign tax credits. For California tax purposes, a working knowledge of E&P is necessary to determine:

- The correct amount of dividend elimination and dividend-received deductions allowed under R&TC §§25106, 24410, and 24411

- The income and apportionment factors includible in a water's-edge combined report for CFCs with Subpart F income under R&TC §25110

- The interest expense that is attributable to the foreign investment under CCR §24344(c)

In calculating current E&P, begin with net income after state adjustments on a separate company basis. Adjustments, both positive and negative, are then made to net income.

Regarding distributions, the general rule is that distributions are paid from current year E&P first. If the distribution exceeds current year E&P, then it comes out of accumulated E&P on a last-in, first-out (LIFO) basis, starting with the most recent year.

Once you determine what portion of the dividends are paid from any given year's E&P, the next step is to determine the allocation of dividends paid out of earnings from the unitary business (thereby qualifying for elimination under R&TC §25106) and dividends paid out of earnings excluded from the combined unitary business (which dividend may be eligible for deductions under R&TC §24410 or §24411).

A dividend that is paid from E&P generated in years when the payor and payee were not unitary cannot be eliminated under R&TC §25106.

In computing the E&P of a CFC, use the CFC's audited financial statement. If these are not available, consider using the federal Form 5471. Be aware, however, that the information may not be as accurate as the information contained in audited financial statements.

10180 Exhibits/PASS Schedules

1. Computation of Current E&P

2. Computation of Dividends Eligible for R&TC §§25106 and 24411 – See PASS document titled, "MSA – Water's Edge- Dividend Deduction TAM 2011-02."

3. Adjustments Pre TRA 86 Rules

Rev. 8/19