CHAPTER OF CONTENTS:

6000 State Adjustments

6005 Amortization of Intangibles

6010 ADR Depreciation

6015 ACRS or MACRS Depreciation

6020 Depreciation - Foreign Corporations

6025 Depreciation Recapture

6032 Intercompany Dividends

6034 Dividends From Insurance Companies

6036 Dividend Gross-Ups, Subpart F Income, and IRC §1248 Dividends

6040 Capital Losses

6050 Charitable Contributions

6051 Qualified Research Contributions

6055 Donated Agricultural Products Transportation Credit

6057 Jobs/Zone Wage Tax

6065 Interest on Government Bonds

6070 Intercompany Profit In Inventory

6075 Foreign Inventory Adjustments

6080 Depletion

6085 Intangible Drilling and Development Costs

6086 Tertiary Injectant Expenses

6095 Sales of Subsidiaries

6100 Taxes Measured By Income or Profits

6000 STATE ADJUSTMENTS

Once you have verified federal net income, you will need to make state adjustments to revise federal income to the amount(s) allowable under California law. The most common state adjustments are discussed in this section. Because of differences in the way that taxpayers compute "net income before state adjustments", state adjustments may include virtually any kind of adjustment that the tax return preparer considers appropriate in order to arrive at California income. For example, net income before state adjustments will often reflect "pro-forma" Form 1120s that include unitary members that were not included in the consolidated return filed for federal purposes such as less than 80 percent owned subsidiaries. In other cases, net income before state adjustments will include only the income from entities that were actually included in the consolidated return as filed. The taxpayer will then make a state adjustment to include the income from unitary foreign subsidiaries and less-than-80 percent-owned subsidiaries. Both methods will result in the correct income. It is impossible to develop a checklist due to the various ways that income is reported. You will need to carefully analyze the state adjustments in conjunction with their analysis of the income base in order to fully understand what is being reported to California.

Not only should you thoroughly review all material state adjustments, also look out for state adjustments that the taxpayer failed to report. In order to identify potential adjustments, you will need to be familiar with the areas of the law in which federal/state differences exist.

6005 Amortization of Intangibles

For federal purposes, IRC § 197 entitles taxpayers to amortize certain intangible property over a 15-year period. Intangibles, which are eligible for this treatment, are defined in the statute and include such property as goodwill, going-concern value, patents, licenses, and covenants not to compete. Although this provision generally applies to property acquired after August 10, 1993, taxpayers may elect to have the provisions apply to property acquired after July 25, 1991 (Temporary Treas. Reg. § 1.197-1T; § 13261(a) and (g) of the Budget Reconciliation Act of 1993 (P.L. 103-66)). If eligible assets were acquired in years that have already been filed, then federal amended returns will be necessary in order to reflect IRC § 197 treatment from the date of the asset acquisition.

California has adopted IRC § 197 for taxable years beginning on or after January 1, 1994. See R&TC § 24355.5. Although California also applies these rules to property acquired after August 10, 1993 (and to property acquired between July 25, 1991 and August 10, 1993 if such treatment was elected for federal purposes), IRC § 197 treatment will not be allowed for any taxable year beginning before January 1, 1994. Therefore, taxpayers will be under the old rules for years prior to 1994, and will switch to IRC § 197 treatment beginning in 1994. See R&TC § 24355.5(c). (Under the pre-§ 197 rules, intangibles were only amortized if a limited useful life could be demonstrated with reasonable accuracy. No amortization or depreciation deduction was allowed with respect to goodwill (Treas. Reg. § 1.167(a)-3).)

Example

A calendar year taxpayer acquires goodwill of $10 million on January 1, 1993, and makes the retroactive election to amortize it over 15 years. For federal purposes, the goodwill will be amortized at a rate of $666,667 per year for 15 years, beginning in 1993 ($10 million / 15).

For California purposes, no amortization is allowed for 1993. At January 1, 1994, the goodwill still has a basis of $10 million, and has 14 years remaining out of the 15-year life. Therefore, beginning in 1994, the taxpayer will deduct $714,286 per year for 14 years ($10 million / 14).

In 1993, the taxpayer will have a positive state adjustment of $666,667. For each year from 1994 through 2008, the taxpayer will have a negative state adjustment of $47,619.

The federal/state differences are only timing differences. As with any other issue that only involves the timing of a deduction, use good judgment in deciding whether to make an adjustment.

6010 ADR DEPRECIATION

Congress adopted the ADR class life system to provide for a safe-harbor useful life. The ADR system assigns a class life (mid-range life) for each class of assets. Each class of assets (other than land improvements and buildings) is also given an asset depreciation range of 20 percent above or below the class life. Although for federal purposes a taxpayer could elect to use the lower or higher range life for depreciation purposes, California conforms only to the mid-range class life. (Rev. Proc. 83-35; R&TC § 24349(l).)

If a taxpayer uses the 20 percent lower range life for federal purposes, then a state adjustment is required to adjust depreciation to the amount allowable for California purposes. You should accept reasonable adjustments made by the taxpayer. If no adjustment has been made, and the amount of the adjustment would be material, then you should request the taxpayer re-compute depreciation using mid-range class lives. The taxpayer should also be allowed to re-compute additional depreciation for California if the 20 percent higher range life has been used.

If the taxpayer has used the 20 percent lower range, and will not re-compute depreciation for California purposes, you can approximate an adjustment to a mid-range life by:

- Disallowing 20 percent of the depreciation taken by class life in each year and
- Amortizing the 20 percent disallowance for each year over a period that is one-year less than the mid-range class life. The amortization should begin the year after the 20 percent disallowance.

Following is an example of this computation:

Asset Class	**Description**	**--- Depreciation Reported ---**		
		1st Year	**2nd Year**	**3rd Year**
0.11	Office Furniture	40,000	50,000	60,000
10.0	Mining Equipment	320,000	400,000	480,000
33.4	Assets used in the manufacture of steel	140,000	175,000	210,000

The asset depreciation range of classes 0.11 and 10.0 is 8, 10, and 12 years. The asset depreciation range of class 33.4 is 12, 15, and 18 years. The taxpayer has used the lower range lives.

The first step is to combine the depreciation of asset classes within the same range. Then, 20 percent of the depreciation is disallowed in each year and amortized over subsequent years.

Asset Class	**--- Depreciation Reported ---**

		1st Year	2nd Year	3rd Year
0.11		40,000	50,000	60,000
10.0		320,000	400,000	480,000
Total depreciation in asset range		360,000	450,000	540,000
		X 20%	X 20%	X 20%
Amount disallowed		72,000	90,000	108,000
Amortize over 9 yrs (mid-range - 1):				
	72,000 / 9		(8,000)	(8,000)
	90,000 / 9			(9,000)
Net adjustment to 10 year mid-range		72,000	82,000	91,000

Asset Class		----- Depreciation Reported ---		
		1st Year	2nd Year	3rd Year
33.4		140,00 0	175,000	210,000
		X 20%	X 20%	X 20%
Amount disallowed		28,000	35,000	42,000
Amortize over 14 yrs (mid-range-1):				
	28,000 / 14		(2,000)	(2,000)
	35,000 / 14			(2,500)
Net adjustment to 15 year mid-range		28,000	33,000	37,500
Total Adjustment (10 yr + 15 yr)		100,000	115,000	128,500

6015 ACRS OR MACRS DEPRECIATION

California has not adopted the federal depreciation methods known as Accelerated Cost Recovery System (ACRS) or Modified Accelerated Cost Recovery System (MACRS) for corporate taxation under Part 11 of the R&TC. If those systems are used for federal purposes, state adjustments are required to adjust depreciation to the amount allowable under California law.

For federal purposes, ACRS must be used to compute depreciation for most tangible depreciable property placed in service after 1980 and before 1987. Under ACRS, the cost of property is recovered over 3, 5, 10, 15, 18, or 19 years, depending on the type of property and the year it was placed in service. The amount of the depreciation deduction is determined through use of tables found in Proposed Treas. Reg. § 1.168-2.

Federal law requires the use of MACRS for most tangible depreciable property placed in service after December 31, 1986. MACRS extended the ACRS useful lives to 3, 5, 7, 10, 15, 20, 27.5, and 31.5 years. The amount of depreciation is determined using the applicable depreciation method, the applicable period and the applicable convention. Tables computing the deduction may be found in Rev. Proc. 87-57.

The specific rules for both ACRS and MACRS are complex. You should research them if additional information is necessary.

R&TC § 24349(b)(4) provides that, for California purposes, taxpayers may use any consistent method of depreciation as long the method does not result in more depreciation during the first 2/3 of the useful life than would result through use of the declining balance method. Under this test, ACRS or MACRS would be an allowable method for California for 3-year ACRS/MACRS property, which also has a 3-year mid-range ADR life. Most other classes of ACRS/MACRS property would not meet this test.

If the taxpayer has not made a state adjustment to place ACRS or MACRS on an acceptable state depreciation method, you should request the taxpayer to compute California depreciation. In determining whether the taxpayer's computation is reasonable, you should be aware that the use of the safe-harbor ADR mid-range class lives may only be elected on a timely filed return for the year that the assets are placed in service (CCR § 24349(l)(1)(C)). If no election was made, then the useful life is dependent upon the facts and circumstances. Facts that you should take into account may include the useful lives of assets for financial reporting purposes, and the taxpayer's asset replacement and disposition history.

Since depreciation allowable under generally accepted accounting principles is usually allowable for California as well, you may adjust federal ACRS or MACRS depreciation to reflect book depreciation if the taxpayer does not compute depreciation under an allowable California method.

There may be situations where book depreciation would not be acceptable. For example, if a corporation is acquired when the fair market value of its assets exceeds the book value, the acquiring corporation may step-up the asset values for book purposes, and accrue additional depreciation on the stepped-up amounts. This additional depreciation would not be deductible for California. See MATM 7110 for more information regarding this issue.

The adjustment to substitute book depreciation for federal depreciation may be made by reversing the taxpayer's M-1 adjustments, or M-3 if applicable, related to depreciation. Alternatively, you may review the taxpayer's AMT depreciation calculations to determine whether depreciation computed under the AMT methods can be accepted as a reasonable California depreciation deduction. See MATM 8520 for a summary of the AMT depreciation methods.

Corporate Partners and S Corporations:

A corporate partner's distributive share of partnership depreciation may reflect MACRS. Pursuant to R&TC §17858, enacted by Stats. 1989, c. 1352, Section 55.5; amended by Stats. 1992, c. 1295, Section 12 (SB 1684)

For purposes of part 11 (commencing with R&TC §23001) any election relating to the computation of depreciation shall be made by the partnership and each partner shall take into account his or her distributive share of the amount computed in accordance with that election.

Stats 1989, c. 1352 is declaratory of existing law and shall apply to taxable years beginning on or after January 1, 1987.

Therefore, for partnership taxable years beginning on or after January 1, 1987, a corporate partner is not required (or allowed) to re-compute its distributive share of partnership income where the partnership properly elected the MACRS method of depreciation.

Pursuant to R&TC § 23802(f)(1), S Corporations must compute depreciation in accordance with the rules set forth in the California Personal Income Tax Law. These rules include use of the MACRS method.

6020 DEPRECIATION – FOREIGN CORPORATIONS

Depreciation laws in foreign countries may vary considerably from those of California. In addition to allowing different methods of depreciation, some countries may allow depreciation to be computed on a basis other than historical cost (i.e. market value). You should review depreciation deductions of foreign operations in a combined report for reasonableness. Regulation § 25106.5-10 provides that the profit and loss statements of foreign branches and corporations must be adjusted to conform to California tax accounting standards, and this includes California law with respect to depreciation. In accordance with CCR § 25106.5-10(b)(3)(C), no such adjustments are required unless they are material in nature.

U.S. parents are required to report depreciation of foreign branches and affiliates on a U.S. accounting basis for purposes of financial statements prepared in accordance with generally accepted accounting principles, and also for purposes of Federal Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations). In the case of foreign parents, the notes to the foreign financial statements may disclose information regarding the method of depreciation used.

The assets of foreign corporations in a combined group may be depreciated using any method of depreciation otherwise acceptable for California, including accelerated depreciation. In accordance with the normal rules for depreciation, accelerated depreciation methods will generally only be allowed when such methods are used for California purposes from the date that the depreciable asset is acquired. When an existing foreign corporation becomes a member of the combined group, its depreciation has not generally been computed for California purposes in the past. Therefore, the new member may opt to use accelerated methods for existing assets as well as for newly acquired assets. The amount of accelerated depreciation on existing assets must be computed *as if* the accelerated method had been used from the time that the assets were acquired. Alternatively, if the taxpayer does not want to recompute prior years and elects to apply accelerated methods only to current year additions, it may do so. When combining a foreign corporation for the first time, offer the taxpayer (in writing) an opportunity to elect an acceptable California accelerated depreciation method.

Occasionally, taxpayers will try to convert their foreign depreciation to an allowable California method through use of estimates or ratios (such as the ratio of foreign assets to domestic assets). You should not allow it unless you determine them to be reasonable approximations of the actual depreciation allowances.

6025 DEPRECIATION RECAPTURE

California conformed to the federal depreciation recapture provisions for taxable years beginning on or after January 1, 1987. See R&TC § 24990. Prior to 1987, California had not adopted depreciation recapture rules. In many cases, characterization of income as ordinary recapture income rather than as capital gain will not have a tax effect. In certain situations, this can be a material issue. The situations that have been identified are as follows:

- Limitation on capital losses. For taxable years beginning on or after January 1, 1990, taxpayers may only deduct capital losses to the extent that they have capital gains. See MATM 6040. Gain from the sale of a capital asset that has been characterized, as ordinary depreciation recapture income will not free up capital losses.

- Liquidations falling under the transitional relief rules: Pursuant to P.L. 99-514, § 633(c)(1), liquidations and stock acquisitions qualifying under IRC §§ 336 - §§ 338 were generally nontaxable if they were subject to a binding contract entered into on or prior to August 1, 1986, and if the liquidation or acquisition was completed by January 1, 1988. In addition, P.L. 99-514, § 633(d) extended the transitional relief to January 1, 1989 for certain small corporations. Pursuant to IRC § 1245(a)(1) and IRC §1250(a)(1) (to which California generally conforms), the recapture provisions override these non-recognition provisions. Therefore, recapture income is recognized with respect to transactions in taxable years beginning on or after January 1, 1987, which would otherwise be nontaxable under the transitional rules.

Although the recapture income is reported for both state and federal purposes, you should be alert to the fact that the amount of recapture income will seldom be the same due to state and federal depreciation differences. Since federal depreciation methods are generally more accelerated than state methods, the recapture amount will usually be higher for federal purposes. For cases in which depreciation recapture will produce a tax effect, you should request the taxpayer's workpapers computing the recapture adjustment to verify that their calculation is correct for state purposes.

6032 INTERCOMPANY DIVIDENDS

Pursuant to R&TC § 25106 intercompany dividends paid out of earnings from the combined unitary business are eliminated from the income of the recipient corporation. This section addresses the computations of the R&TC § 25106 elimination. For a discussion of issues related to deemed inter-company dividends (IRC § 1248 dividends) arising from the sale of a subsidiary, see MATM 6036.

When reviewing inter-company dividend eliminations, you should verify that the distributions were paid from unitary business earnings. To the extent that the distributions exceed the earnings and profits of the payor, or to the extent that they are paid from pre-affiliation or non-business earnings, such distributions are not eliminated under R&TC § 25106 (See Willamette Industries, Inc. v Franchise Tax Board (1995), 33 Cal.App.4th 1242). You must also keep in mind that adjustments to the taxpayer's method of filing may affect the dividends eligible for elimination. For example, if a subsidiary is determined to be non-unitary and is de-combined at audit, dividends received from that subsidiary may not be eliminated under R&TC § 25106.

A distribution by a corporation to its shareholders is a dividend to the extent that it is paid out of current earnings and profits, then from accumulated earnings and profits in the reverse order of accumulation. For years prior to 1991, R&TC § 24495 defined the term "dividend." Effective for taxable years beginning on or after January 1, 1991, R&TC § 24451 conformed to the IRC § 316 definition. Earnings and profits can vary tremendously from net income for state purposes, particularly since earnings and profits are decreased by federal and state income taxes. Even though a dividend may not exceed the net income of the payer corporation, it may exceed the earnings and profits. It is also important to note that earnings and profits are calculated on a separate company basis. Therefore, although a subsidiary that incurs losses on a separate basis may be apportioned a large share of the combined business income of the unitary group, its earnings and profits will still reflect losses. (See Appeal of Young's Market Company, 86-SBE-198, November 19, 1986.) A detailed discussion of how to compute earnings and profits is in MATM 10000.

Example - Distribution exceeding earnings & profits

Corporation P and unitary subsidiary S filed a combined report for the year in which S was formed. S's net income computed on a separate basis was $10,000. Its apportioned share of the unitary business income was $50,000. S paid income taxes of $4,000. S distributed $9,000 to its parent during the taxable year. Although S's net income exceeded the amount of the distribution, S's earnings and profits were only $6,000 ($10,000 income - $4,000 taxes). Therefore, only $6,000 of the distribution is considered a dividend subject to elimination under R&TC § 25106. The remaining $3,000 will first be applied to reduce the parent's basis in the stock of S; and once the basis is reduced to zero, any remaining amount will be treated as gain from the sale or exchange of property (such gain is not subject to R&TC § 25106 elimination). See MATM 5260 for more detail concerning treatment of intercompany distributions in excess of earnings and profits and stock basis.

Once you determine that the distribution is a dividend, take this concept one step further and determine whether the dividends were "paid out of the income of the unitary business."

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 subject to a deduction 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.

Since dividends are paid out of earnings and profits and not out of income, this statutory wording should be interpreted to mean that the dividends must be paid out of the earnings and profits that correlate with the unitary business income (Rosemary Properties, Inc. v. McColgan, 29 Cal2d 677). To the extent that the dividends are paid from earnings attributable to non-business or pre-affiliation income, they may not be eliminated under R&TC § 25106.

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 subject to R&TC §25106 elimination.

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.

6034 DIVIDENDS FROM INSURANCE COMPANIES

R&TC § 24410 allows a "Dividends Received Deduction" of qualified dividends received from an insurer subsidiary. The deduction is allowed whether or not the insurer is engaged in business in California, if at the time of the payment, at least 80 percent of each of the class of stock of the insurer was owned by the corporation receiving the dividend. The amount of the deduction is:

- For taxable years beginning on or after January 1, 2004 and ending on or before January 1, 2008, an 80 percent deduction for qualified dividends;
- For taxable years beginning on or after January 1, 2008 the deduction is increased to 85 percent.

A portion of the dividend may not qualify if the insurer subsidiary paying the dividends is overcapitalized for the purposed of the dividends received deduction.

The total amount of funds available to an undertaking should be neither too much nor too low. An important question, therefore, is the question of capitalization of the company, i.e., the determination of the amount which the company should have at its disposal. The total amount of long-term funds available to the company, therefore, is the capitalization of the company.

A concern is said to be over-capitalized if its earnings are not sufficient to justify a fair return on the amount of share capital and debentures that have been issued. It is said to be over capitalized when the total of owned and borrowed capital exceeds its fixed and current assets; in other words, when it shows accumulated losses on the assets side of the balance sheet.

See MATM 3085 and MATM 5190 for additional issues concerning insurance companies.

6036 DIVIDEND GROSS-UPS, SUBPART F INCOME, AND IRC § 1248 DIVIDENDS

The Federal 1120 returns contain adjustments to dividend income reported on Schedule C that may not be applicable for state purposes. Some adjustments are:

- **Dividend Gross-Ups** - For federal purposes, dividends received from foreign affiliates are "grossed up" to include income taxes paid on the dividends to foreign countries. The taxpayer is then allowed to take a foreign tax credit for the grossed-up amount. California has no such provision and this income should be eliminated. You should review Schedule C of the Federal Form 1120, or Form 1118 (foreign tax credit form) to identify any dividend gross-ups.

Subpart F Income - For federal purposes, dividend income may include Subpart F income. In general, certain types of income earned by controlled foreign corporations (as defined in IRC §957) are taxed to the U.S. shareholder as a deemed dividend under Subpart F of the Internal Revenue Code (IRC § 951 - IRC § 964). To the extent that actual distributions are made out of earnings that have been previously taxed to the shareholder under Subpart F, the distributions are excluded from the recipient's income. You should review Schedule C, M-1 or M-3 and Federal Form 5471 to identify any Subpart F Income.

Example

A CFC has subpart F income of $8 in Year 1. The $8 is treated for federal purposes as deemed dividend income to the U.S. shareholder in Year 1. In Year 2, the CFC pays an actual dividend of $10. For federal purposes, the dividends are considered to be distributed first from previously taxed income (in contrast to the normal LIFO ordering rule for dividends). Therefore, $8 of the $10 dividend is considered paid from the previously taxed income, and $2 is paid from non-subpart F earnings. Only $2 of the distribution will be shown as a taxable dividend on the federal return for Year 2.

Since California does not conform to the Subpart F provisions, the income is not taxed for State purposes until it is actually repatriated to the U.S. shareholder. Therefore, state adjustments will be necessary (1) to eliminate the subpart F deemed dividend income, and (2) to include the actual dividend distributions in income when paid.

Example

Assume the same facts as in Example 1. For California purposes, the taxpayer should have made a state adjustment in Year 1 to reverse the $8 federal subpart F deemed dividend income. In Year 2, another state adjustment will be necessary to increase dividend income reported for federal purposes by $8. If the CFC is a member of the combined report, then the $10 dividend may be subject to elimination pursuant to R&TC § 25106. If the dividend was not paid out of unitary earnings and profits, then the dividend would be taxable for California purposes.

The presence of Subpart F income is usually shown on the federal Schedule C or Form 5471. In the year that the actual distributions are made however, the Schedule C will only identify the portion of the dividend that is taxable for federal purposes. There should be a Schedule M-1 adjustment for the difference between the actual distribution and the federal taxable amount, but occasionally there will be no M-1 adjustment, or the adjustment will be buried within another M-1 item. Consequently, the federal return is not a reliable source for verifying the amount of the actual distribution. If properly prepared, Schedule 5 of the Form 5471 should detail actual distributions and whether they are considered to be from previously taxed subpart F income. The best way for you to determine the actual amount of the dividends received is usually through the taxpayer's pre-consolidation books of account. See Chapters 2 and 11 of the Water's-Edge Manual for a more detailed explanation. It also provides examples of how to determine the amount of the actual distributions.

1248 Dividends

When a U.S. shareholder sells stock in a controlled foreign corporation in which they meet certain ownership requirements, the gain recognized on the sale may be considered a deemed dividend for federal purposes subject to certain earnings & profits limitations. Pursuant to R&TC § 24903 and R&TC § 24990, California conformed to this provision during a window period beginning with taxable years beginning on or after January 1, 1987. Our conformity was terminated by R&TC § 24990.7 for transactions occurring after August 20, 1990, in taxable years beginning on or after January 1, 1990. Therefore, for sales of stock reported on the installment method, payments received during the window period would be subject to IRC § 1248 treatment even though the actual sale took place prior to January 1, 1987.

During the window period, the deemed dividends may be subject to a R&TC § 25106 elimination if the foreign subsidiary was a member of the combined report (MATM 6032). Transactions occurring before and after the window period are treated as gains on the sale of stock for California purposes. Adjustments may be necessary to reflect the correct amount of gain based upon the California cost basis of the stock. See MATM 6095 for a discussion of these adjustments and other issues related to sales of subsidiaries.

If a member of the combined report has a recently acquired foreign subsidiary, and if the acquisition date was outside the window period, you should review the taxpayer's pre-consolidation books or ledger summaries to look for subsequent distributions made by the foreign corporation to its new owners. If the stock sale was treated as a deemed distribution for federal purposes, a portion of the foreign corporation's earnings and profits will be considered to be "previously taxed." Actual distributions made to the new owner in subsequent years will not be subject to federal tax to the extent that they are paid from the previously taxed earnings and profits (even though the E&P was previously taxed to the seller, not the buyer!) Consequently, foreign dividends identified on the new owner's federal Schedule C or Form 5471 may be understated or omitted altogether. The book/federal tax difference may be disclosed on the Schedule M-1, but is not always apparent. For California purposes, the earnings and profits are not considered to be previously taxed so the dividends may be taxable. Furthermore, since the E&P was incurred prior to acquisition by the new owners, it will not be subject to R&TC § 25106 intercompany elimination (although a foreign dividend deduction may apply if the new owner has elected water's-edge).

A review of Schedule C of the Federal Form 1120 may identify whether any of these items are included in federal dividend income. The Schedules M-1 and Form 5471 should also indicate the existence of dividend gross-ups and Subpart F income. You will then need to determine whether appropriate state adjustments have been made.

6040 CAPITAL LOSSES

Prior to 1990, California did not conform to the federal limitation on capital losses. For federal purposes, capital losses can only be deducted to the extent of capital gains. Any capital losses that are not deductible in the year of the loss may first be carried back three years, and to the extent not fully utilized in the three-year carryback, the capital losses may be carried forward five years. See IRC § 1211 - 1212. In the year in which a capital loss was incurred, the taxpayer would therefore have a negative state adjustment for the amount of the loss that was not allowed for federal purposes. Positive state adjustments would be made in the years in which the taxpayer utilized the federal capital loss carry-backs and carryovers.

Effective for taxable years beginning on or after January 1, 1990, R&TC § 24990 states that IRC § 1201 - IRC § 1296 are applicable law for determining capital gains and losses. Included in these sections are the provisions relating to the federal capital loss limitation. For California purposes, unused capital losses may only be carried forward; no carry-backs are allowed. See R&TC § 24990.5.

Although California now conforms to the capital loss limitation, federal/state differences will still arise. Federal/state basis differences will affect both the amount of capital loss and the amount of capital gain to which the capital loss deduction will be limited. For example, assume a taxpayer has a $35,000 capital loss for both federal and state purposes. For federal purposes, the taxpayer has a $40,000 capital gain, and may therefore deduct the entire capital loss. Due to basis differences, the gain is only $30,000 for California. The loss will be limited to $30,000, and the taxpayer will have a $5,000 capital loss carryover for California.

If material gain or loss transactions are reported on the Federal Schedule D or Form 4797, you should review the federal and state computations to ensure that appropriate federal/state basis differences were taken into account. Review the amount of any capital loss carryover to verify that it properly reflects the California amount.

Also, included in these law sections to which California now conforms are the federal procedures for netting gains and losses in order to determine the capital loss limitation. Capital losses are deductible only to the extent of capital gains, and any excess losses may be carried over and applied against capital gains in each of the five succeeding taxable years.

On July 13, 1999 CCR § 25106.5 went final. Regulation § 25106.5-2 provides for the intrastate apportionment of business gains or losses from the sale or exchange of capital assets, IRC § 1231 property and involuntary conversions prior to the netting provisions. Those gain/loss items are then netted at the entity level after interstate apportionment with non-business gains or losses. The PASS Schedules may assist in this calculation. The regulation is retroactive.

6050 CHARITABLE CONTRIBUTIONS

Contributions deductible for state and federal purposes may differ significantly. When reviewing the contributions deduction made by business entities for state purposes, you should be aware of the following:

The federal limitation on the deduction for contributions by corporations is generally 10 percent of taxable income, although members of a consolidated return are limited to 5 percent of adjusted consolidated taxable income. The California limitation for corporations is also 10 percent for years beginning on or after 1/1/96 (5 percent for taxable years prior to 1/1/96), and applies on a combined basis. See R&TC §24358. In addition, California further adjusts the contribution deduction to take into account the effect of non-business items on the income limitation. This is termed the "contributions adjustment". See MATM 4070. The contributions adjustment is calculated on Schedule R-6 of the Form 100. Rather than separately compute (1) the general 10 percent income limitation as a state adjustment, and (2) the contributions adjustment on Schedule R-6, taxpayers will often use the Schedule R-6 to reflect the overall adjustments. By analyzing the Schedule R-6 computation, as well as what has ultimately been deducted on the California return (federal deduction ± state adjustments ± contributions adjustment), you can determine whether the bottom line result is correct.

In addition, there are differences in the adjustments to income that are required for purposes of computing the limitation. For federal purposes, taxable income is adjusted for net operating loss deductions and other special deductions not applicable to California. For California, adjustments are made to net income to add back certain special deductions and an S Corporation's deductions for built-in gains and passive investment income.

Federal law allows for a five-year carryover of excess contributions for corporations. For taxable years beginning on or after 1/1/96, R&TC § 24358(c) is applicable and provides that IRC § 170(d)(2), relating to carryovers of excess contributions, shall apply with respect to excess contributions made during these taxable years. For taxable years prior to 1/1/96, California had no carryover.

California generally limits the contribution of appreciated property to the corporation's basis in the property. See R&TC § 24357.1. See MATM 6051 below for an exception with respect to qualified research contributions.

R&TC § 24359 states that a charitable contribution means a contribution or gift to or for the use of a qualified recipient that was created or organized in the United States or in any possession thereof. In computing combined unitary income, however, it is the Department's policy to allow contributions made by non-US corporations to a non-US charitable organization provided that the foreign jurisdiction has not ruled that such beneficiary is not a qualified charitable organization.

R&TC § 24425 provides for the disallowance of expenses incurred to earn income that is not included in the measure of tax. The most common type of income that is not included in the measure of tax is deductible dividend income. Because the dividend income is not being taxed, R&TC § 24425 provides that the expenses incurred to earn the dividends should not be deducted. Expenses relating indirectly to this type of income may include charitable contributions, interest expense, officer's compensation, office rent and overhead, etc. If material, a portion of these expenses should be allocated to the deductible dividends. The methodology used to allocate the expenses will vary depending upon the facts and circumstances, so you will have to select an allocation method that is reasonable for the taxpayer's specific situation. For example, charitable contributions generally relate indirectly to all of a taxpayer's income. Therefore, it would be reasonable to allocate the contributions to deductible dividends based on the ratio of deductible dividends over the taxpayer's total receipts (the SBE and courts have supported this approach). However, if the taxpayer suggests a different allocation method, be sure to evaluate that method to determine whether it is reasonable. If the primary position you are taking is that the dividends should not be deductible in the first place, you should still develop whether material expenses attributable to that dividend income should be disallowed as an alternative position.

Certain other differences exist with respect to the rules for certain types of contributions. If a contribution is material, you should verify whether California conforms to the specific rules pertaining to that contribution.

A review of the Schedule M-1, or M-3 if applicable, should reveal whether the federal contribution deduction includes carryover amounts or contributions of appreciated property.

6051 QUALIFIED RESEARCH CONTRIBUTIONS

California is in basic conformity with IRC §170(e) dealing with charitable contributions of ordinary income and capital gain property.

Many computer companies donate systems to colleges and avail themselves of IRC 170(e)(4). If they meet all of the requirements, they are entitled to increase their deduction by 50 percent of the difference between the fair market value and cost limited, to twice the basis of the property.

The principle requirements under R&TC §24357.8 are as follows:

- California limits the timing of the deduction to contributions made on or after July1,1983 and on or before December 31,1993 R&TC §24357.8(b)(7)
- The contribution must be of tangible personal property as described in paragraph (1) of IRC § 1221 -- generally property included in the inventory of the donor.
- The contributed property must be scientific equipment or apparatus; and substantially all of the use by the donee must be for research or experimentation or for research training in physical, applied, or biological sciences, or for instructional purposes. Use of the property for instructional purposes does not qualify for federal purposes.
- The property must be contributed within two years after construction. California does not have the federal requirement that the taxpayer must construct the property.
- The donee must be an institution of higher education in California. Unlike federal, California does not include tax-exempt scientific organizations as eligible donees.
- The donee must be the original user of the property.
- The college or university cannot transfer the property for money, other property or services.
- A written statement must be obtained from the donee representing that the use and disposition of the property will be in accordance with R&TC § 24357.8.

If you determine that a federal contribution deduction was made under this provision, and the deduction was made outside of the allowable period for California, then adjustments should be made to limit the contribution deduction to the cost basis of the contributed property.

If the contribution was made within the allowable period, verify that deductions for qualified research contributions do not include contributions to non-California donees. If such contributions are noted, make an adjustment to limit the deduction to the cost basis of the contributed property.

If the contribution to California institutions is material, review the required donee statements for compliance with R&TC § 24357.8. The taxpayer's method of establishing the fair market value of the property should also be reviewed for reasonableness.

6055 DONATED AGRICULTURAL PRODUCTS TRANSPORTATION CREDIT

For taxable years beginning on or after January 1, 1996, taxpayers may claim a credit for eligible transportation costs paid or incurred in connection with the transportation of any donated agricultural products donated to nonprofit charitable organization. The credit is 50 percent of the eligible costs. There is not a comparable federal credit. Only taxpayers engaged in the business of processing, distributing or selling agricultural products may claim the credit. The credit cannot reduce the alternative minimum tax or the tentative minimum tax.

To receive the credit the taxpayer must obtain a certificate issued by the nonprofit organization. This certificate must be made available to us upon request.

See R&TC § 23608 and 23036.2 for additional information.

Corporations can assign credits to other members of the combined group for tax years beginning on or after July 1, 2008. However, an assigned credit may only be applied against the tax of the eligible assignee in a tax year beginning on or after January 2, 2010. See R&TC § 23663 for additional information.

6057 JOBS/ZONE WAGE TAX

California law provides a credit for wages paid to qualified individuals in Local Agency Military Base Recovery Areas (R&TC section 23646). If any of these credits are claimed, the deduction for wages paid to such individuals must be reduced by the amount of the credit generated in that taxable year. Since there are no comparable credits in Federal law, you should verify a state adjustment has been made. For further details regarding economic development area tax incentives, refer to the Economic Development Areas Manual (EDAM).

6065 INTEREST ON GOVERNMENT BONDS

For California Franchise Tax purposes, pursuant to R&TC 24272, gross income includes all interest received from federal, state, municipal or other bonds.

The U.S. Constitution prohibits a direct tax on interest income from U.S. obligations. This interest is not taxable for California Income Tax purposes (chapter 3). The constitutional prohibition does not apply to the California Franchise Tax (chapter 2). This is because this tax is not considered a direct tax. It is based on income and is actually a tax on the privilege of doing business. Since U.S. government interest is taxable for federal purposes, no state adjustment for such interest should be necessary for taxpayers subject to the franchise tax. You will need to reverse any state adjustments made by the taxpayer to back out the interest income.

Interest on state and municipal obligations is generally not taxable for federal purposes. Such interest is only exempt for California Income Tax purposes if the obligations are on California or its political subdivisions. Interest on obligations of other states and foreign countries are subject to the California Income Tax. All state and municipal interest is subject to the franchise tax. Schedule M-3, if applicable, will disclose whether the taxpayer has exempt interest for federal purposes. If such interest exists, you should verify that state adjustments have been made to add back the interest to the extent necessary for franchise or income tax purposes.

6070 INTERCOMPANY PROFIT IN INVENTORY

The intercompany transaction regulations reflected in CCR § 25106.5-1 are for intercompany transactions that occur (regardless of the taxable year involved) on or after January 1, 2001. If a transaction occurred prior to January 1, 2001, the rules in place before that date may affect the determination of income in a later year. For example, if an intercompany transaction income was eliminated and the basis of the asset was transferred to the purchaser, the transferred basis of the asset will have an effect on the determination of taxable income when the asset is sold in a later year.

Our prior practices regarding intercompany profit in inventory are reflected below.

Intercompany profit in inventory occurs when sales of products are made between members of a combined group. Profit from intercompany sales is generally not recognized until the goods are sold to an outside party. Therefore, to the extent that goods that had been subject to an intercompany sale remain in the inventory of the unitary purchaser, the profits from the intercompany transaction should not be recognized.

The department's policy, as set forth in Publication 1061*, Guidelines for Corporations Filing a Combined Report*, is that the intercompany profit in inventory should be eliminated from combined income (MATM 5260). Correspondingly, the profit in inventory should also be eliminated from the beginning and ending inventories for purposes of computing cost of goods sold, as well as for property factor purposes. (See MATM 7173 for property factor adjustments). The income adjustment for any one year will be the difference between the intercompany profit in the beginning inventory and the ending inventory of each affiliate which has intercompany purchases. As a general rule, a negative adjustment to income will be necessary if inventories increase from year to year; while a positive adjustment will result if inventories decrease. Examples of both cases are as follows:

	Increasing Inventory	Decreasing Inventory
Profit in Inventory - 01/01/xx	$ 100	$ 100
Profit in Inventory - 12/31/xx	<u>150</u>	<u>50</u>
Adjustment to Eliminate Intercompany Profit in Inventory	(50)	50

If the taxpayer has made an adjustment for intercompany profits in inventory, you should review to ensure that the amount is reasonable, that the taxpayer is applying the adjustment consistently from year to year, and that the factors have also been adjusted.

Under GAAP, intercompany profits in inventory are eliminated for book purposes. A reconciliation of Schedule M-3 if applicable, book income to the financial statements (MATM 5130) should identify whether the book elimination adjustments have been picked up for federal purposes. If the Schedules M-3 reveals that the federal intercompany profits in inventory differ from the book amounts, then you should determine whether a state adjustment is necessary.

For federal purposes, intercompany profits on sales of products are deferred rather than eliminated. (See MATM 5260 for a discussion of the federal deferral rules.) Neither method recognizes intercompany income in the year of the sale. The primary difference between elimination and basis transfer, and deferral are:

Elimination and basis transfer – This method provides for:

- The elimination of intercompany income
- The buyer takes the related seller's basis in the product
- The gain is effectively recognized only when the product is ultimately sold to a third party.

Deferral – Under this method:

- The gains and losses from intercompany transactions are not truly eliminated, but merely deferred.
- The buying member's basis in the property is the consideration paid for the product.
- The seller's gain is put into a deferred status (unless the taxpayer elects not to defer), and is eventually recognize when a "restoration" event occurs. (Refer to MATM 5260.)

This distinction may create a federal/state difference when a restoration event other than a third party sale occurs. For federal purposes, the deferred intercompany profits would be restored into income, but no gain would be recognized for California. Federal/state differences may also occur when the taxpayer has intercompany profits in inventory with respect to entities that are not included in the consolidated Form 1120 (e.g. foreign entities).

Material issues may be created when inventory balances at the date of a water's-edge election include inventory purchased intercompany between foreign and domestic entities.

6075 FOREIGN INVENTORY ADJUSTMENTS

Pursuant to R&TC § 24701, California generally conforms to the federal rules for inventory valuations and methods (IRC § 471 and IRC § 472). In accordance with those rules, inventories are valued at either (1) cost or (2) lower of cost or market. For an inventory accounting method to be accepted under IRC §471, it must conform as nearly as possible to the best accounting practice in the trade, and it must clearly reflect income. Some of the inventory methods allowed for tax purposes are described in Treas. Reg. § 1.471-5 through Treas. Reg. § 1.471-11, and Treas. Reg. § 1.472-1 (LIFO).

Both California and federal law allow the use of the Last-in First-out (LIFO) inventory method. California generally conforms to the IRC § 472(c) requirement that the LIFO method will only be allowed for tax purposes if it is also used for financial statement purposes. Because LIFO is not an acceptable method in many foreign countries, California will allow the use of LIFO for foreign operations even though the foreign inventories are computed on a FIFO basis for financial statement purposes. (CCR § 25106.5-10(b)(3)(B)(2).)

Normally, the election to use LIFO must be made on the original return or on an amended return filed within 12 months of the filing date of the original return. This applies to foreign as well as domestic entities in the combined report. In cases where foreign corporations are combined for the first time at audit, the taxpayer will be allowed to retroactively elect to use LIFO for valuation of the foreign corporation's inventory starting with the first year of combination.

Example

Audit combined the taxpayer on a worldwide basis for 1980 - 1989. All years are in litigation, appeals or protest. In 1996, the taxpayer now agrees that they are unitary on a worldwide basis. The taxpayer will be allowed to elect to use LIFO for inventory valuation starting in 1980.

Example

Assume the facts as in Example 1, except the taxpayer was previously audited for 1977 - 1979, and did not dispute the worldwide combination for those years. The years were closed without the use of LIFO inventory valuation. The taxpayer cannot use the LIFO method on a retroactive basis for any year. If the due date for the current year return has not passed, the taxpayer can elect to use LIFO for that year.

To verify the acceptability of the foreign inventory method, you should:

Determine the base of valuation for foreign inventories (e.g., cost, lower of cost or market, or another method). For some countries, the inventory balances themselves may not be adjusted to account for market fluctuations, but such fluctuations may be charged to reserve accounts. The financial statements will usually identify the inventory valuation used, and whether any reserves are used. Publications, which describe the accounting practices of the foreign parent's country, may also help to determine how inventory was valued -- see Exhibit J. If the valuation is not acceptable for California purposes and the difference is material, then you should propose adjustments to beginning/ending inventories and to the property factor. (See CCR §25106.5-10 and MATM 5145 for criteria to consider before requiring a foreign corporation to conform its method of accounting to a California method.)

Determine the inventory method used to account for foreign inventories (e.g., FIFO, LIFO, etc.). The financial statements will usually identify the inventory methods used, and publications, which describe the accounting practices of the foreign parent's country, may provide additional information regarding those methods. If the inventory method is acceptable for California purposes, then the issue does not need to be pursued further. However, if the foreign corporations are being combined for the first time and the taxpayer wishes to elect an inventory method specifically for California worldwide reporting purposes, they should be given the opportunity to do so.

If the taxpayer wishes to convert to a LIFO inventory method for foreign inventories, verify that the LIFO adjustments are correct. In the past, the department required taxpayers to submit a CPA certification to support their LIFO values. This is no longer required, although you may still accept such a certification as one way for the taxpayer to meet its burden of proof regarding the LIFO valuations.

Rules for use of the LIFO method are provided in Treas. Reg. § 1.472. Although LIFO can be calculated based upon the quantity and cost of specific goods (e.g., unit method), most taxpayers use the "dollar-value" method:

For each pool of inventory, the cost for each item in the pool at the beginning of the first LIFO year will be aggregated to derive the base-year costs. The beginning inventory costs used for financial reporting purposes should generally be used. Because LIFO inventories are required to be stated at cost rather than at lower of cost or market, any previous write-downs of base-year inventory must be added back into income ratably over three years. (IRC § 472(d).)

For each LIFO year, the value of each pool of ending inventory must be determined using the cost that the inventory would have had in the base-year. The computational approaches available to restate ending inventory at base-year costs include the double-extension method, the index method, and the link-chain method. These methods are explained in Treas. Reg. § 1.472-8.

The beginning and ending inventories (expressed in base-year costs) are compared. If the value has increased over the year, then the amount of the increase is multiplied by the ratio of current costs over base year costs to arrive at the value of the current year LIFO layer. If the value has decreased, then prior year LIFO layers are accordingly decreased (liquidated).

Once inventory balances have been determined under the LIFO method, cost of goods sold must be recalculated. If financial statement net income was used as the base for California net income, the state adjustment should reflect the difference between cost of goods sold calculated for book and California tax purposes.

As discussed in CCR § 25106.5-10 and MATM 5145, the department must consider the cost of compliance and materiality of the issue. For example, if a subsidiary operates solely within one foreign country and has a similar line of products, it may be reasonable to take a "short-cut" by treating all inventory in that country as one LIFO pool. On the other hand, the information needed to make LIFO computations maybe available in the ordinary course of the taxpayer's business. Therefore, estimations should not be accepted unless you are comfortable that the estimate is a reasonable approximation of the actual numbers. For example, it is never reasonable to accept foreign LIFO valuations based on the ratio of domestic tax inventory to domestic book inventory.

When the inventory method used for California is different from the method used for book purposes, verify that the correct inventory valuation has been included in the property factor. Book/tax differences may be revealed during the property factor reconciliation discussed in MATM 7110.

6080 DEPLETION

For taxable years beginning on or after January 1, 1993, California has conformed to IRC §611 through 638, relating to the deduction for depletion of natural resources (R&TC § 24831). Currently, California conforms generally conforms to the IRC as of 2015. However, R&TC § 24831.6, relating to temporary suspension of the 100 percent taxable income limit with respect to marginal production of oil and natural gas does not apply in California. (IRC § 613A(c)(6)(H)). As a result, the percentage depletion deduction is restricted to 100 percent of the net income derived from the oil or gas well property, which is further not exceeded to 65 percent of the taxable income.

Percentage depletion allowance is a preference item for AMT purposes to the extent that it exceeds the basis of the property at year end (see MATM 8530).

Oil, Gas & Geothermal Wells

Under the federal law to which California conforms, percentage depletion is allowed for the following:

- Regulated Natural gas

- Natural gas sold under a fixed contract
- Certain geothermal deposits
- Certain independent producers and royalty owners subject to a 65 percent of taxable income limitation.

For taxable years beginning on or after January 1, 1993, California follows the federal provisions for percentage depletion.

6085 INTANGIBLE DRILLING AND DEVELOPMENT COSTS

The California and federal laws are similar.

IRC section 263(c) allows taxpayers the option to currently expense intangible drilling costs (IDCs) for oil, gas and geothermal wells located within the United States. R&TC § 24423 is substantially the same as IRC § 263(c), but only applies to oil and gas wells. Therefore, California has no provision that would allow IDCs related to geothermal wells to be currently expensed.

For years beginning on or after January 1, 1987, neither Federal nor California permit expensing of IDC's relating to costs paid or incurred with respect to an oil, gas, or geothermal well located outside the United States.

Intangible drilling costs may be an item of tax preference for alternative minimum tax purposes. See MATM 8530 for more details.

Property Factor Issues

Although not a state adjustment, there are property factor issues that are unique to IDC that deserve mention in this section. As a general rule, items, which are expensed for tax purposes, are not includable in the property factor. IDCs are capitalized for book purposes, but are usually expensed for tax purposes. Prior to 1990, you should ensure that IDCs have been excluded from the property factor if they have been expensed on the return. For taxable years beginning on or after January 1, 1990 however, CCR §25130(a)(1) was revised to include IDCs in the property factor regardless of whether they have been expensed or capitalized. The property factor inclusion is not limited to IDCs incurred after January 1, 1990, but applies to all IDCs that are still capitalized on the taxpayer's books, even though they may have been expensed for tax purposes in a prior year. See MATM 7795 for more details.

6086 TERTIARY INJECTANT EXPENSES

A "tertiary recovery method" means any method that is described in Section 212.78(c)(1) through (9) of the June 1979 Energy Regulations, 10 CFT 212.78 (1979). Very broadly, this entails injecting hydrocarbon gas into an oil or gas well to increase pressure for recovery. For federal purposes, tertiary injectant expenses are deductible in the year that the injections were made (IRC § 193 § 263(a)(1)(F)). California does not conform to the federal treatment. R&TC § 24422 adopts similar language as IRC § 263, except for § 263(a)(1)(F). In addition, California does not have a similar provision as IRC § 193. For California and financial reporting purposes, if tertiary costs enhance the recovery process, they are capitalized and amortized over the life of the reserve. If the tertiary costs do not enhance the recovery process, they will be expensed.

An examination of the federal Schedule M-3 if applicable, should identify if tertiary costs have been capitalized for books but expensed for federal tax purposes. If so, then state adjustments will be required to reverse the deduction in the year of the injection and to allow amortization in subsequent years.

6095 SALES OF SUBSIDIARIES

Since California law is significantly different from federal law with respect to investments in subsidiaries, material issues may be found in this area.

When a parent and subsidiary are members of a consolidated group, the parent's basis in the subsidiary's stock is treated as an investment account for federal purposes. Accordingly, it is increased by the net income of the subsidiary, and decreased by net losses and distributions out of earnings and profits (Treas. Reg. § 1.1502-32(b)). To the extent that the negative adjustments would otherwise reduce the parent's basis in its stock below zero, an "excess loss account" is established. When the subsidiary is sold, gain or loss on the disposition of the stock is computed using the parent's basis net of any investment adjustments. The balance of any excess loss account is recaptured into the parent's income (Treas. Reg. § 1.1502-19). California has no similar provisions. For state purposes, gain or loss on the sale of the stock of a combined subsidiary is computed using the parent's original cost basis, net of any distributions that constituted returns of capital. Because of this difference, the sale of a consolidated subsidiary will almost always result in a state adjustment.

Federal/state basis differences may also occur with respect to stock in foreign subsidiaries. For federal purposes, certain income of controlled foreign corporations (CFCs) is treated as a deemed dividend to the U.S. shareholder. Such income is termed "subpart F" income. The U.S. shareholder's basis in the CFC stock is increased by the amount of subpart F income that has been included in the gross income of the U.S. shareholder, and is reduced by the amounts that have been distributed out of previously taxed subpart F income. (IRC § 961, see MATM 6036.) Since California does not conform to these rules, gain or loss from the sale of a foreign subsidiary is again computed using the cost basis of the stock.

For federal purposes, the gain on the sale of stock in a CFC may also be deemed dividend income to the U.S. shareholder (IRC § 1248). California conformed to this provision during a window period from taxable years beginning on or after January 1, 1987 to transactions occurring on or before August 20, 1990 in taxable years beginning on or after January 1, 1990. Outside of that window period, IRC section 1248 gains on the sale of stock are not deemed as dividends for California purposes, and are not subject to the treatment of any California dividend received provisions such as R&TC sections 25106 and 24411 (see MATM 6036).

Reviewing Schedules D and M-3, if applicable, of the Form 1120 may identify stock transactions. Annual reports and SEC Form 10-Ks may also identify dispositions of subsidiaries. When a subsidiary has been disposed of during the audit period you should determine how the disposition was reported for state purposes. To ensure that original cost was used, the taxpayer's basis computations should be reviewed.

6100 Taxes Measured By Income or Profits

Pursuant to R&TC § 24345 no deduction is allowed for taxes on, or according to, or measured by income or profits paid or accrued within the taxable year. Since state, local and foreign income taxes are generally deductible for federal purposes, you should analyze the deduction for taxes to insure that all taxes measured by income have been added back for state purposes.

For purposes of R&TC § 24345, the term "income" refers to gross income, but the deduction prohibition also includes taxes with a statutory base measured by net income. You must distinguish whether the taxable base is composed, under the statutory formula, of gross income or items which are not gross income, because a tax whose base is measured by items which are not income, such as gross receipts, is deductible. Taxes are characterized on an overall general review of the imposition statute, and whether it is possible for the taxable base to include an item which is not income, and not on a case by case basis pertaining to a particular taxpayer. Taxes are characterized under California taxation principles, not the characterization label which a taxing jurisdiction provides its tax. Gross receipts is a term generally used to describe gross proceeds including a return of capital (cost of goods sold). In order to arrive at gross income, gross receipts are reduced by cost of goods sold. You must make the determination of whether a tax is on or according to or measured by income by looking at the components and items of deduction of the specific tax's taxable base. Certain taxes which are limited to particular types of receipts, such as rents or income received for the performance of services, do not impose a tax on a tax base which could contain a return of capital element. In these cases, gross receipts are the same as gross income, and the tax on that base will be considered to be a non-deductible income tax. For further guidance in determining whether a tax is based on income, see Franchise Tax Board Legal Ruling 2017-01 (Feb. 22, 2017); Appeal of Huntington Alloys, Inc. 84-SBE 129, September 12, 1984; Appeal of Charles and Mary Haubiel 73-SBE-004 I., May 15, 1974; *Beamer v. Franchise Tax Board*, (1977) 19 Cal.3d 467, 475; *MCA Inc. v. FTB* (1981) 115 Cal.App.3d 185.

Michigan Single Business Tax

The state of Michigan imposes a tax known as the Single Business Tax (MSBT). For purposes of computing the MSBT's tax base, employee compensation is added back to federal gross income. Since a labor component is generally included in cost of goods sold, adding back the compensation will result in an element of cost of goods sold being included in the tax base. The State Board of Equalization has ruled that if the tax base could include any element of return of capital, then the tax is measured by something other than gross income, and is therefore deductible. See Appeal of Kelly Services, Inc and Subsidiary Corporations, 97-SBE-10, May 8, 1997 and Appeal of Dayton Hudson Corporation, 94-SBE-003, February 3, 1994. The relevant inquiry was whether Michigan's MSBT "recipe" (ie, what is potentially includible in the taxable base) could add back or include a labor/compensation component, or some other non-income item.

In the Appeal of Kelly Services, Inc., 97-SBE-10, May 8, 1997, the State Board of Equalization concluded that the deductibility of the MSBT for California franchise or income tax purposes makes no distinction between activities of a particular taxpayer. The State Board of Equalization found that the MSBT is deductible as provided by R&TC § 24345(b), regardless of the specific components of the MSBT base of the taxpayer claiming the deduction.

Although not specifically addressed in the Dayton Hudson appeal, the MSBT computation also includes a depreciation add-back. To the extent that the depreciation would be a component of cost of goods sold under the IRC § 263A standards, it appears that the same rationale to allow the deduction of the MSBT would also apply.

Alternative Taxes

Some states have an alternative tax system under which a tax is calculated under two different bases (i.e., net income and net worth), and the larger or smaller of the two taxes is assessed. In such cases, you must determine if the taxpayer could ultimately only be subject to one tax for the taxable year (with the result that the tax is not a "multi-faceted" tax), and if any taxpayer subject to the tax, regardless of which base was used, could have had a base which was not solely composed, based on, or measured by income, with the result that the tax is deductible. See Appeal of Kelly Services, Inc., 97-SBE-10, May 8, 1997. A review of the other state's tax return will assist you to identify the base methodology used to calculate the tax.

Foreign Taxes

Because of the difficulties involved with determining the nature of some foreign taxes, rules specifically for foreign taxes have been set forth in CCR § 24345-7. The regulation contains a presumption that foreign taxes are income taxes. The burden of proof rests upon the taxpayer to establish that a particular foreign tax was not based on net income. Some countries impose a "dual capacity tax," which is defined as a tax, which is all or in part an income tax, but which is also for receipt of a specific economic benefit. In order to deduct any portion of a dual capacity tax, the taxpayer must prove that the portion of the tax is not an income tax. Once the taxpayer has established that it has paid a dual capacity tax, then it must determine the amount of such tax by either facts and circumstances or application of the safe harbor formula. See MATM 7795 for detailed guidelines on this matter.

Audit Techniques

Annual reports of U.S. companies disclose the amount of income taxes paid. If the taxpayer has classified taxes as income taxes for book purposes, they should generally be added back (any deduction for such taxes should be denied) as a state adjustment.

If there is a material difference between the amounts considered income taxes in the financial statements and the amounts added back into income, you should make a thorough analysis of the taxes deducted on the return and the tax provision in the financial statement footnotes. Following are some sources of information regarding amounts of foreign and domestic taxes:

Supporting detail to Form 100 or 1120:

- Cost of Goods Sold
- Taxes
- Other Deductions
- Schedule M-3 if applicable

- Federal Form 5471 (Information Return of U.S. Persons with Respect to Foreign Corporations) Federal Form 1118 (Computation of Foreign Tax Credit - Corporations).

Federal Form 1118 will provide you with information regarding foreign taxes taken as a credit, but it is not necessarily determinative as to whether a tax is an income tax. A tax that qualifies for the foreign tax credit is generally a tax measured by income. This is assuming that the taxpayer filed its Federal Form 1118 correctly. On the other hand, the fact that a tax is not reported on Federal Form 1118 does not indicate that the tax is not measured by income, because taxpayers may elect to deduct foreign income taxes for federal purposes rather than take a credit.

Once you have identified the taxes paid to particular jurisdictions, you may find information regarding the nature of the taxes imposed by the various jurisdictions on the internet or in large public libraries. A review of the tax returns filed with the other jurisdictions will also help you in identifying the nature of the tax and the statutory composition of the tax base.

Rev. 8/19