Chapter 7 Earnings & Profits and Distributions

Contents:

a. 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,* (52 TC 1, (1969)), 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. (Revenue and Taxation Code (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. It states that "*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 LIFO basis.

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

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

- Dividend income includible in the water's-edge combined report.
- Dividend elimination and deductions – E&P is necessary to determine the correct amount of dividend elimination and dividend-received deductions allowed under R&TC §§25106, 24410, and 24411.
- Controlled Foreign Corporations (CFCs) – Current E&P is required to compute the inclusion ratio, which is used to determine the income and apportionment factors includible in a water's-edge combined report for unitary CFCs with Subpart F income pursuant to R&TC §25110(a)(2)(A)(ii).
- Foreign Investment Interest Offset – E&P is included in the computation of the unassigned foreign investment and total assets, which are components of the formula used to determine the interest expense that is attributable to foreign investments. (CCR §24344(c).)

In general, computing the E&P of a corporation included in the waters-edge combined report begins with net income after state adjustments (Form 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, E&P for federal tax purposes will be similar to E&P for California tax purposes. However, E&P for federal and California may differ due to differences in 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 calculations, see section d, of this chapter.

b. E&P to Be Determined on a Separate Company Basis

Under California law, for purposes of determining the amount of E&P of a corporation, unitary attributes of a corporation are disregarded. Income apportioned to a member of a unitary group by formula cannot form the basis for determining that corporation's E&P. For California tax purposes, E&P is determined on a separate company basis. (*Appeal of Young's Market Company*, 86-SBE-199, November 19, 1986.)

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

For federal income tax purposes, 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. However, a corporation that is a member of a consolidated group, must adjust its basis in stock of a subsidiary to account for increases and decreases in the E&P of the subsidiary. (Treasury Regulation (Treas. Reg.) §1.1502-33.)

Treas. Reg. §1.1502-33 requires "tiering adjustments" whereby the E&P of an upper tier corporation includes the E&P of lower tier subsidiaries. As California does not conform to this regulation, any "tiering adjustments" (e.g., E&P of lower tier subsidiaries) should be excluded in computing E&P for California tax purposes.

Remember, E&P is computed on a separate company basis using separate accounting and arms-length prices (as discussed in WEM 7, section g) for all intercompany transactions.

c. 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 purposes (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.

Current E&P represents the current economic income computed on an annual basis. Accumulated E&P represents the sum of each year's current E&P reduced by distributions.

1. Calculation of E&P

Current E&P begins with taxable income. (Revenue Procedure 75-17.) For California purposes, start with net income after state adjustments, determined on a separate company basis (see WEM 7, section d). Adjustments, both positive and negative, are then made to taxable income. As E&P represents the corporation's economic income, many adjustments are necessary to arrive at the corporation's E&P. The computation of E&P can be summarized as follows:

Current year's taxable income/loss
+ Exempt and nondeferred 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 or Loss, as Corrected**

  PLUS: Exempt and nondeferred 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 elimination and dividend received deduction (R&TC §§25106, 24410, 24402, 24411)
- Excess of percentage of depletion over cost depletion (caution: do not duplicate at time of sale)
- Net operating loss (NOL) deduction
- Capital loss carryforwards
- Cancellation of interest owing by accrual basis corporations previously deducted – no tax benefit due to IRC §111
- Charitable contribution carryforwards
- Excess depreciation over straight line

LESS: Items (expenses and losses) not deductible for tax and items of income accelerated for tax, but not E&P

- 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. Additional Adjustments to E&P, 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 WEM 7, section f)

3. Accounting Methods

In computing E&P, the method of accounting adopted in computing taxable income must 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 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.

4. When to Compute Current E&P

Current E&P is calculated at the end of the taxable year without regard to distributions made during the year. Once calculated, current E&P is pro ratably applied to distributions made during the taxable year. 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. Accumulated E&P

If distributions made during a tax year exceed current E&P, the second source of taxable dividends is accumulated E&P. Accumulated E&P consists of the aggregated E&P accumulated for each tax year 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
    - o Stock splits and stock dividends
    - o Refund of prior year federal income tax (accrual basis)
    - o Unauthorized reserves
    - o E&P of corporations liquidated or merged into taxpayer

  LESS: Corrections of prior years
    - o Additional federal tax on amended returns (accrual)
    - o Fraud penalty – prior years returns (accrual basis)

  = Corrected accumulated E&P – beginning of the year

  PLUS: Current year E&P less distributions

  EQUALS: Accumulated E&P – end of the year

Note: Excess distributions do not create a deficit balance of accumulated 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 pursuant to IRC §301(c).

d. Calculation of E&P for California Tax Purposes

The method of computing E&P is generally the same under California and federal law. California conforms to IRC §312 effective for years beginning on or after January 1, 1987. R&TC §24484 (effective 1/1/87 – 12/31/92, repealed as of 1/1/93); R&TC §24451 (effective 1/1/93 to date). The rules that applied prior to 1987, R&TC §§ 24484 – 24493, were identical to the provisions of IRC §312. (R&TC §23051.5.)

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). Although such adjustments may differ in amounts in computing E&P for federal and California tax purposes, the resulting E&P for federal and California tax purposes from these types of adjustments will generally be equal. Examples of such adjustments are discussed below:

- Dividends eliminated and deducted under R&TC §§25106, 24410, and 24411. Add back to E&P those deductions rather than the "dividends received deduction" added back for federal tax purposes provided that net income after state adjustments is used as the starting point. (IRC §312(f)(2).)

- 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.

- Intercompany transactions. During years for which a unitary group files a worldwide combined report, the taxpayer will eliminate from income, the profit from intercompany sales of inventory between members of the unitary group. The purchaser takes the related seller's tax basis in the inventory. For federal tax purposes, profit from intercompany sales of inventory between U.S. and foreign affiliates is currently recognized and the purchaser gets a "stepped-up" basis in the inventory (e.g. its purchase price). This difference in treatment gives rise to differences in California and federal *taxable income*, but has *no* effect on E&P. (See WEM Chapter 14 for a discussion of the effects of intercompany transactions on the computation of taxable income.)

  As discussed in WEM Chapter 7, section b, E&P is determined on a separate company basis. E&P is an economic concept intended to measure a corporation's capacity to make distributions which are more than just a return of investment. When a party to an intercompany transaction receives payments from its affiliate in excess of its costs, that amount is available for distribution to its shareholders regardless of whether the profit was eliminated from taxable income. There is no statute, regulation, or other authority which requires elimination of intercompany profits from E&P, and such amounts should not be eliminated for purposes of determining E&P for federal and California tax purposes. Support for this position is found in *Henry C. Beck Company v. Commissioner*, 433 F2d 309 (1970), aff'm 52 TC 1 (1969).

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:

- Different adjusted tax basis under California and federal law. Examples of different basis may be caused by difference in like-kind exchange elections (e.g., IRC §1031), difference in elections for treatment of sale of stock transactions (e.g., IRC §338(h)(10)).

- 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. See section e of this chapter for further discussion.

- Other differences in California and federal law, although minor. For example, translation gain or loss 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. See WEM Chapter 7, section f, for further discussion.

e. 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 value. (Rev. Rul. 1954-1, C.B. 114.)

- **Depreciation/Gain(Loss)** – Generally, in computing depreciation expense, the period and rate of recovery for E&P purposes often differs from depreciation expense computed for federal and California income/franchise tax purposes. 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 purposes 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, you should 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 purposes, it was depreciated using an accelerated method. The accumulated depreciation expense for federal income tax is $30,000. Accumulated depreciation using straight line 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 taking into account the loss 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 increases for the credits applied against the tax liability. If a corporation has excess credits for federal purposes 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 must be 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.

- **Consolidated Returns – "Tiering" Adjustments** - In general, each corporations 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, any "tiering adjustments" included in the corporation's federal E&P are ignored.

- **Consolidated Returns – Allocation of federal income tax liability** - Special rules are also available for determining how to allocate the group's federal tax liability for purposes of computing federal E&P. (See IRC §1552 and Rev. Ruling 73-605, 1973-2 C.B. 109.) California law has 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 must apply in computing California E&P.

- **Dividend and Dividend Received Deductions** - Dividend received deductions are added back to taxable income to compute E&P. Intercompany dividends and other tax free dividends received also increase E&P unless the distribution is a return of capital. (IRC §312(f).)

f. E&P of Foreign Corporations

1. E&P of Foreign Corporations – In General

The determination of E&P of foreign corporations is much the same as for U.S. based corporations. (IRC §964) The main exception to this rule is for corporations with US source income that is less than 20% of gross income from all sources (which includes the majority of the foreign corporations). For these corporations, adjustments for depreciation do not apply. (IRC §312(k)(4).) For E&P layers accumulated prior to 1986, the adjustments for LIFO inventory (IRC §312(n)(4) and the completed contract method of accounting (IRC §312(n)(6) also do not apply. For E&P layers accumulated prior to 1987, the adjustment for the installment method (IRC §312(n)(5) as well does not apply. (IRC §312(n)(8).)

Treas. Reg. §1.964-1(a) contains general rules for computing E&P of a foreign corporation, which are provided in the below section.

2. Calculation of Foreign Corporation's E&P

For federal purposes, several methods apply in computing E&P, each depending on the purpose of the computation. (IRC §§902, 951, 960, 964.) For California tax purposes, only one federal method (IRC §964) is relevant since the CFC partial inclusion ratio set forth in R&TC §25110(a)(2)(B)(ii) looks to E&P as defined in IRC §964.

For purposes of IRC §951 through §964 (Subpart F), Treas. Reg. §1.964-1(a) provides the general rules to be followed in computing E&P (or deficits in E&P) of a foreign corporation. That is, E&P is computed in the same manner as if the corporation were a domestic corporation. The corporation must:

i. 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).)

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

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

Treas. Reg. §1.964-1(a)(2) requires other adjustments in computing E&P of a foreign corporation. The above calculation of E&P shall be made in the foreign corporation's functional currency as determined under IRC §985. The functional currency means the dollar or in the case of a qualified business unit, the currency of the economic environment in which a significant part of such units activities are conducted and which is used by the unit in keeping its books and records. (Treas. Reg. §1.964-1(a)(2) and IRC §985(b)(1).) In addition, only material accounting (GAAP) and tax adjustments are required. Whether an adjustment is material depends on the facts and circumstances of the particular case. (Treas. Reg. §1.964-1(a)(2).)

Another adjustment relates to illegal bribes and kickbacks. 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) and Treas. Reg. §1.964-1(a)(2).)

The above computation shall be made in the foreign corporation's functional currency as determined under IRC §985. (Treas. Reg. §1.964-1(a)(2).) The functional currency means the dollar or in the case of a qualified business unit, the currency of the economic environment in which a significant part of such unit's activities are conducted and which are used by the unit in keeping its books and records. ((Treas. Reg. §1.964-1(a)(2) and IRC §985(b)(1).)

In the case of a foreign corporation with the functional currency other than the U.S. dollar, see IRC §§986(b) and 989(b), for rules regarding the time and manner of translating the distributions or inclusions of foreign corporation's earnings and profits into U.S. dollars. (Treas. Reg. §1.964-1(a)(3).) Also see WEM, Chapter 8.

A. Accounting Adjustments

Generally, 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, an auditor must adjust the statement by applying GAAP standards. Treas. Regulation §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, an adjustment should be made when an allocation of current income is made for 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 over or undervalued, 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** – Generally, reserves for income or expense equalization over more than one accounting period must be adjusted, even though permitted or required under foreign law. (Treas. Reg. §1.964-1(b)(1)(iv).)
- **Foreign Currency** – Transactions effected in a foreign currency other than the currency in which the books of the corporation are kept shall be translated in accordance with the rules set forth by IRC §988. (Treas. Reg. §1.964-1(b)(1)(v).) See WEM Chapter 8.

B. Tax Adjustments

Next, adjust the Profit and Loss 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 and 472 and regulations there under.
- **Depreciation –** Depreciation must be computed according to IRC §167, if less than 20 percent of gross income is from US source income.
- **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. An adjustment to E&P should be made for accruals in excess of payments, since such amounts do not meet the qualifications under IRC §404.

C. 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 if the distributions by the CFC's 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).)

3. Effect of Tax Reform Act Of 1986

The 1986 Tax Reform Act introduced Subpart J (IRC §§985 - 989), rules for foreign currency transactions. The rules were introduced largely to conform to U.S. GAAP rules under FASB 52. (See WEM 8.)

Prior to the 1986 Tax Reform Act and for income years beginning before January 1, 1987, after making the appropriate adjustments to the P&L statement, the statement had to be translated into U.S. dollars. The rules required translating amounts at the "appropriate exchange rate" for the particular period, which were generally determined by either a year end rate (for balance sheets), or an average of end of month rates for the taxable year (for income statement). In addition, unrealized exchange gains and losses on retained earnings had to be computed in determining the IRC §964 E&P limitation on subpart F income and as part of IRC §1248 gains.

With the advent of Subpart J, it was necessary to provide special rules for computing a foreign corporation's E&P. For taxable years beginning after December 31, 1986, a foreign corporation's E&P must be computed using the corporation's "functional currency," as described by IRC §985 and as discussed in more detail in WEM, Chapter 8. IRC §989 is the definitional section of Subpart J. IRC §989(b) provides the "appropriate exchange rate" to be used in specific circumstances:

- 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.
- In the case of any other qualified business unit of a taxpayer, the average exchange rate for the taxable year of such business unit.

Final regulations were published in the Federal Register on January 25, 1990. Treas. Reg. §1.964-1, applicable for tax year beginning after December 31, 1986, makes the cross reference to IRC §985 (regarding functional currency) and omits the old Treas. Reg. §§1.964-1, subsection (d) (providing specified translation rates for income statements and balance sheets into U.S. Dollars); subsection (e) (regarding the translation gain or loss); and subsection (f) (regarding an election to be treated as a domestic corporation).

4. E&P OF Includible CFCs for Purposes of CA Inclusion Ratio

For purposes of determining the percentage of a CFC's income and apportionment factors subject to inclusion in the water's-edge combined report, the current E&P of a CFC (denominator of inclusion ratio) is determined using IRC §964. (CCR §25110(d)(2)(E)(2).)

The IRC §964 rules apply only for purposes of determining the denominator of the CFC's inclusion ratio. For all other California tax purposes, the CFC's E&P is calculated in accordance with the regular California rules.

g. IRC Section 482 Adjustments

When adjustments are made under IRC §482 between a controlled corporation and its shareholder (the parent), the difference between the actual payment and the arms-length amount must be recharacterized as either a constructive dividend (*Sammons v. Commissioner*, 472 F.2nd (5th Cir. 1972); *Loftin & Woodard, Inc. v. United States*, 577 F.2nd 1206 (5th Cir. 1978)) or a capital contribution.

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

Example 1

A domestic parent (P) sells inventory to a foreign subsidiary (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.)

P 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

A domestic parent (P) buys inventory from a foreign subsidiary (FS) for $1,000 when the arms-length price is $800. P sells the inventory during the year.

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

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

Example 3

A foreign parent (FP) sells inventory to its domestic subsidiary (S) for $1,000 when the arms-length price is $800. S sells the inventory during the year.

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

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

A domestic parent (P) owns a domestic subsidiary (S) and a foreign subsidiary (FS). FS sells inventory to S for $1,000 when the arms-length price is $800. S sells the inventory during the year.

Impact on E&P from_an IRC §482 adjustment:

S increases its net income and E&P by $200. (Cost of goods sold is decreased to reflect the arms-length price.) S is deemed to have made a

$200 constructive dividend to P for the distribution in excess of the arms-length price. This dividend increases P's E&P by $200 and reduces S's E&P. P is deemed to have made a capital contribution to FS of $200.

NOTE: The constructive dividend in examples 3 and 4 may qualify for elimination or deductions under R&TC §25106 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 WEM 15 for a detailed discussion of Rev. Proc. 99-32.

Note: Even though a federal IRC §482 adjustment is a "wash" for California net income purposes 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.

h. 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; and
- 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 in the amount of the fair market value of the distributed property over its adjusted tax basis. E&P should be increased 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 – A corporation that sells property to a shareholder below its fair market value, has made 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.)

i. 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 regard to distributions during the year. Once calculated, current E&P is proratably 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 and .2.)

A distribution received is treated for tax purposes as follows:

1. The portion that does not exceed E&P (current and accumulated) is a dividend and is includible in gross income. (IRC §301(c)(1).)

- The portion that is not a dividend 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 has not conformed to such regulation. 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.

  Also, pursuant to IRC §961, a U.S. shareholder increases its basis in the stock of a CFC by subpart F income, and under IRC §959, reduces its basis for dividends it receives and excludes from taxable income. California has not conformed to IRC §961 or §959. See also MATM 6095.

- The portion of the distribution that exceeds the adjusted basis of the stock is capital gain from the sale or exchange of property. (IRC §301(c)(3)(A).)

Note: The distribution taxed as capital gain does not qualify for elimination or deductions under R&TC §§25106, 24410, or 24411.

Example 1

The Allen Corporation had accumulated E&P of $1,000 on January 1, 2016. For 2016, its current earnings and profits were $5,000. A distribution of $20,000 was made to its sole shareholder on December 31, 2016. 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 2016 is computed as follows:

Distribution	$20,000	
Amount taxable as dividend (E&P)	6,000	($5,000 + $1,000)
Return of capital	14,000	

After the distribution, the taxpayer's new tax basis in the stock is $6,000 ($20,000 - $14,000).

Example 2

Bacone Corporation is a calendar year cash-basis taxpayer. During 2015, Bacone Corporation:

- Distributed $18,000 to the shareholder on July 1. The adjusted tax basis of the shareholder's stock was $10,000.
- Received tax exempt income in the amount of $5,000.
- Had a federal income tax liability of $2,550. (The tax was paid in 2016).
- Had California net income after state adjustments of $20,000. (Federal Form 1120, line 28 was $15,000.)

For 2015, 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 2015.

Example 3

Based on of the facts Example 2 above and Bacone Corporation being an accrual basis corporation, the computations will be:

	FEDERAL	**CALIFORNIA**
Taxable income	$ 15,000	$ 20,000
Add: Tax Exempt interest	5,000	
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 2015 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 6/1/2015	$22,000
Cash distribution to Caldon on 12/31/2015	$26,000
Caldon's adjusted tax basis of Mighty's stock	$10,000

For 2015, Caldon Corporation's dividend, return of capital, and capital gain are:

Taxable Dividend =	$35,000	(Total E&P = $15,000 + $20,000)
Return of Capital =	$10,000	(Adj. Basis cannot be reduced below 0)
Capital Gain =	$3,000	(The excess distribution after reduction to 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 distrib. Over accumulated E&P	$13,000
Adj. Basis of Stock	$10,000
Excess of distrib. over basis of Stock	$3,000

j. Determining California Tax Treatment of Dividends Received – Source of Distributions

A distribution is only considered a dividend to the extent that it is paid out of E&P. (IRC §316(a).) Distributions exceeding E&P reduce stock basis, and any excess is treated as a capital gain. (See FTB Notice 97-2 regarding potential deferral of the capital gain from excess distributions.) 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 business income) for purposes of determining intercompany dividends subject to elimination (R&TC §25106) and the various dividend deductions provided by R&TC §§24410 and 24411.

1. Identify the Source (e.g., tax year(s)) of E&P Distributed - LIFO

IRC §316(a) provides that dividends 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's 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 CCR §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, come from accumulated E&P on a last-in, first-out (LIFO) basis, starting with the most recent year.

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

k. Dividend Received from Foreign Corporations Partially Included in a Water's-Edge Combined Report

When a member of a water's-edge group receives a dividend from a partially-included entity, it must determine what portion of the dividend will be eliminated under R&TC §25106 and what portion will be subject to the R&TC §24411 foreign dividend deduction:

- Intercompany dividend income is eliminated under R&TC §25106 to the extent that the dividend has been paid from E&P attributable to a combined report that includes both the payor and payee.

- 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).

The key to determining the proper dividend treatment is to identify how much of the dividend has been paid from E&P that has been included in the combined report. The general rule is that a dividend is paid out of current E&P first. If it exceeds current E&P, then it is paid from the most recently accumulated E&P. An additional breakdown is required 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. In that case, it is necessary to identify how much of the dividend came from E&P that was attributable to combined report income versus E&P attributable to excluded income.

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.*"

1. **Character of Dividend Distributions under Technical Advice Memorandum (TAM) 2005-01, March 7, 2005**

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 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) (at the time of the case 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 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 being 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 TYE 12/2015, 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 US 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 US parent eliminates $225 dividend from its gross income under R&TC §25106 using the proration approach. The computation is as follows:

$300 dividend paid from current E&P	x 75%	=	$225 dividend elimination

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

2. Character of Dividend Distributions under TAM 2011-02, March 15, 2011

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:
  - o That year's unitary earnings which are eligible for elimination under R&TC §25106, until those earnings are depleted; and
  - o 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:

> *2. <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 R&TC 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 R&TC 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 2015 E&P attributable to earnings included in the combined report 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 earnings excluded from the combined report. 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 will be $100 qualifying for a R&TC §24411 deduction.

Example 3

X, a US Corporation, owns 100 percent of CFC1, a controlled foreign corporation. CFC1's income and apportionment factors are partially included in X's 2015 and 2016 water's-edge combined report. During 2015 and 2016 CFC1 reported the following:

	2016	2015
Subpart F income	$8,000	$12,000
Current E&P	20,000	15,000
Cash dividend	30,000	-

Following the TAM 2011-02, in 2016, 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 US parent's gross income and would qualify for an R&TC §24411 foreign dividend deduction. The computation is as follows:

	Inclusion Ratio	Current E&P	Earning in W/E combined Report	Section 25106	Section 24411
2016	40%	$20,000	$8,000	$8,000	$12,000
2015	80%	15,000	12,000	10,000	-

CFC1's E&P available for future distributions from 2016 is zero ($0), and for 2015 is $5,000 ($2,000 E&P eligible for R&TC §25106 elimination plus $3,000 qualifying for a R&TC §24411 deduction.

3. Dividends Received from CFCs – Deemed (IRC §952) and Previously Taxed Dividends (IRC §959)

For federal purposes, Subpart F income is includible in the income of a U.S. shareholder as dividend income (IRC§951). The dividend is deemed to have been distributed from the CFC to the U.S. shareholder, irrespective of whether the CFC distributes anything. The amount of Subpart F income appears as a separately stated item on the 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). The theory is that since such dividends were already taxed in the year they were "deemed" Subpart F dividends, they cannot be taxed again in the year actually distributed. (IRC §959(a).) Dividends paid out of PTI are excluded from federal taxable income. (IRC §959(d).) The taxpayer should have a Schedule M-1 (or M-3) adjustment for these items reported on its books as income but not on its tax return. These "nontaxable" dividends distributions are also detailed on the federal Form 5471, Schedule J.

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 a "deemed" dividend. We simply look to the ratio of Subpart F income to 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 both current year dividends as well as qualifying base period dividends. Conversely, any **actual** dividends paid out of PTI are subject to inclusion in California income and are dividends for purposes of R&TC §24411 and §25106. 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 WEM Chapter 9.) 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).

PTI distributions from partially included CFCs are a common area for potential audit adjustment. Be aware of this. 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

(CFC/Payor with Subpart F Income)
Corporation L filed a water's-edge election effective January 1, 2014. This would allow L to exclude its subsidiary, Corporation M, except for the fact that M has subpart F income. Corporation M has total earnings of $150 in 2014 of which $100 is attributable to income included in the combined report pursuant to R&TC §25110(a)(2)(A)(ii) (CFC with subpart F income). In 2015 M has 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) (CFC with subpart F income).

If Corporation M declares a $75 dividend in 2015:

For federal purposes, Corporation L reported subpart F deemed dividends of $100 in 2014 and $50 in 2015. Therefore for federal tax purposes, the $75 distribution is considered a nontaxable PTI distribution ($50 from 2015 subpart F earnings and $25 from 2014 subpart F earnings). For California tax purposes, although the subpart F income will cause M to be partially included in L's combined report, the subpart F deemed dividends themselves are not taxed by California. A state adjustment is therefore required to include the $75 actual dividend in California income. 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.

Example 2

(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 2014, B derived $10,000 of subpart F income. In 2015, B 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 2014. A does not include the $5,000 actual distribution in its federal gross income for 2015. The distribution is considered to be previously taxed income (PTI) and is not includible in A's federal gross income for 2015 because the earnings have already been included in A's gross income for 2014, pursuant to subpart F.

On the 2014 federal return, A would report the $10,000 subpart F deemed dividend from B on Schedule C. No dividend would be reported on Schedule C of the 2015 federal 1120, but the $5,000 actual distribution should show up as a Schedule M-1 (or M-3) adjustment.

For California purposes, A would include the actual distribution of $5,000 in its gross income for 2015 subject to the applicable dividend elimination and deduction. The $10,000, which was recognized as income by A for federal purposes in tax year 2014, will not be reportable to California until it is distributed. (Although the Subpart F income will cause B to be partially included in A's combined report for 2014).

Dividends paid out of PTI are generally reported as a Schedule M-1 (or 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 WEM Chapter 2.

I. Dividends Paid from E&P Attributable to Excluded Income

Generally, dividends paid from E&P attributable to excluded income (e.g., nonbusiness income, income from an entity not included in the combined report such as foreign corporation or pre-affiliation) do not qualify for elimination under R&TC §25106. In order 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; *Rosemary Properties, Inc. v.* McColgan, 29 Cal2d 677.)

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 related E&P is not attributable to unitary business 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 subsidiary H were engaged in a unitary business for many years prior to G's 2015 water's-edge election, under which H was excluded from the water's-edge group. For 2014 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 2015. H paid to G a dividend of $50 in 2015.

Solution:

The dividend is charged entirely to 2015 E&P since that is the most recently accumulated. Thus the dividend does not qualify for elimination under R&TC

§25106. Corporation G will report dividend income of $50 and the dividend qualifies for a deduction under R&TC §24411. The R&TC §24411 dividend deduction is discussed in WEM Chapter 9.

Example 2

Same facts as in Example 1, except that Corporation H pays a dividend of $200 in 2015. The first $100 would not be eliminated pursuant to R&TC §25106. However, the second $100, attributed to 2014 and prior E&P would be eliminated. 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.

m. 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. Treas. Reg. §§1.964-3 and -4 require specific records that are to be provided by the U.S. shareholders relating to subpart F income of a CFC. The E&P, or deficit in E&P of any foreign corporation, are one of the items required in verifying the subpart F income. (Treas. Reg. §1.964-4(b)(4)(ii).)

Dividends - IRC §6042(d) requires corporations to report information regarding the computation of E&P including a specific statement of accumulated E&P. (California has conformed 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.

n. Audit Tips

E&P plays a major part in determining how much income and apportionment factors of a unitary CFC must be included in the water's-edge combined report. CCR §25110(d)(2)(E) describes this in detail.

Generally, the includible amount of income and apportionment factors of the unitary CFC is determined by multiplying the CFC's total income and factors by the ratio of its Subpart F income as defined in IRC §952 to total current E&P as defined in IRC §964. This calculation is covered in WEM Chapter 2, but a few items should be noted about E&P here:

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

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 distributions by the U.S. shareholder(s) then 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 M-3). You need to be aware of this, identify the distribution, and source the distribution to E&P using California rules. Only after this is done you can determine the tax effect of the distribution, and what dividend deduction rules apply. WEM Chapter 2 discusses the effect of IRC §959 to which California law does not conform.

Other issues to you should consider:

- What part of the distribution is a dividend, a return of capital, and/or capital gain? There can be material federal/California differences in the amounts of E&P and stock basis.
- Has the taxpayer correctly computed E&P for California tax purposes?
- Do any adjustments exist that will affect E&P?
- How much, if any, of the dividend is eliminated under R&TC §25106 and how much, if any, deductible under R&TC §24411?

o. 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 dividends and dividend-received deductions allowed under R&TC §§ 24410, 25106 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 determined 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 combined unitary business (thereby qualifying for elimination under R&TC §25106) and dividends paid out of earnings excluded from the combined unitary business (which dividend received deductions under R&TC §24402, §24410 or §24411 may apply).

A dividend that is paid from E&P generated in years when the payor and payee were not included in the same combined report cannot be eliminated under R&TC §25106. In computing the E&P of a CFC, you should 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.