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MULTISTATE INCOME/FRANCHISE TAX

California OTA – Deducted foreign dividends includible in sales factor

Tax Alert

Overview

On July 27, 2023, the California Office of Tax Appeals ("OTA") issued its opinion in which it concluded that gross foreign dividend amounts attributable to foreign earnings and profits were includible in the California sales factor for the tax year ending June 30, 2018 ("2017 tax year"). In doing so, the OTA rejected the California Franchise Tax Board's ("FTB") long-standing position under FTB Legal Ruling 2006-01 ("LR 2006-01") that qualifying dividends deducted from the tax base under California Revenue and Taxation Code ("CRTC") section 24411 are not includible in the sales factor. On February 14, 2024, the OTA issued an opinion denying FTB's petition for rehearing.

This Tax Alert summarizes the decision and provides some taxpayer considerations.

Background

Taxpayer, an American multinational corporation, elected to file a water's-edge, combined, unitary California corporation franchise tax return for the 2017 tax year. During the year, the Taxpayer received repatriated dividends from its unitary controlled foreign corporations ("CFCs") outside the water's-edge group. The dividends qualified for the 75 percent dividends-received deduction ("DRD") pursuant to CRTC section 24411. On its original return, Taxpayer included only the net repatriated dividends (the 25 percent) in its sales factor denominator.

Subsequently, Taxpayer filed a claim for refund with the FTB, asserting that the gross amount of foreign dividends should be included in the sales factor. FTB denied the refund claim, which resulted in this appeal to the OTA.

Summary of OTA's analysis

The primary issue in the case was whether qualifying foreign dividends are includible in the sales factor measured by the actual "gross" dividends distributed by the CFCs to a member of the water's-edge group or whether that amount should be reduced by the 75 percent DRD which applies to compute net dividend income. The FTB, relying on LR 2006-01 and *Chase Brass and Copper Co., Inc. v. Franchise Tax Bd.* (1977) 70 Cal.App.3d 457 ("*Chase Brass*"), *inter alia*, contended that the 75 percent of dividends deducted is an "exclusion" from the income tax base apportioned under the Uniform Division of Income for Tax Purposes Act ("UDITPA"), and thus should be excluded from the sales factor.

The OTA disagreed, reasoning that:

- The plain language of the statutes establishes that "gross dividends are considered gross income or gross receipts, regardless of the qualifying dividend deduction." Specifically, CRTC section 25120(f)(2) defines "gross receipts" as including "the gross (rather than net) amounts realized and recognized," and CRTC section 24341 defines "net income" as "gross income" reduced by deductions, including the 75 percent DRD under CRTC section 24411. Therefore, "dividends enter gross receipts and gross income before the application of the deduction," unlike exclusions from income that are not included in gross income or gross receipts to begin with. Likewise, the 75 percent deduction for dividends does not result in an "exclusion" of gross income or gross receipts.
- Unlike CRTC section 25106 and the regulations thereunder, which expressly provide that eliminated intercompany dividends are excluded from the sales factor, CRTC section 24411 and its regulations do not contain similar language requiring exclusion. Rejecting FTB's argument that deducted dividends have a "similar economic reality" to eliminated dividends, the OTA pointed to this lack of exclusion language, as well as to the holding in *Fujitsu IT Holdings, Inc. v. Franchise Tax Bd.* (2004) 120 Cal.App.4th 459, where the court discussed the difference between the two statutory treatments for dividends. Specifically, CRTC section 25106 "'prevents dividends from subsidiaries from being taxed twice—once as earnings of the issuing subsidiary, and once as separate income to the unitary business from receipt of the dividend,'" while the "'dividends [that] are paid out of earnings and profits that have not been included on the combined report . . . is . . . eligible for the 75 percent dividends received deduction.'" Therefore, CRTC sections 24411 and 25106, while "'acting in conjunction,' each provide a 'different treatment of dividends.'"
- *Chase Brass* does not support FTB's position because that case involved intercompany transactions, while the present case involved qualifying dividends received from outside of the reporting group and are therefore deducted. The OTA rejected treating these dividends as intercompany transactions subject to elimination. Moreover, *Chase Brass* concerned former CRTC section 25101 that provided FTB discretion to use any "fairly calculated" apportionment formula, a "materially different statute" which preceded and was replaced by the current CRTC section 25101 requiring the use of UDITPA, and for this reason OTA was unpersuaded by FTB's reliance on the case.
- OTA was unpersuaded by FTB's reliance on *Great Western Finance v. Franchise Tax Bd.* (1971) 4 Cal.3d 1 because that case addressed CRTC section 24425, which precludes the deduction of certain items when they are attributable to income *not included* in the measure of tax, and the case here did not—instead, it was about whether qualifying dividends *deducted* pursuant to CRTC section 24411 are includible in the sales factor.
- FTB's reference to *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750—where the court examined the "economic reality" of the transaction to determine whether the gross or net amount from redemptions of marketable securities under former CRTC section

25120(e) should be treated as gross receipts—is inconsequential here because the court examined CRTC section 25120 before subdivision (f)(2) defining "gross receipts" was added, and is therefore distinguishable from the present case where subdivision (f)(2) was in effect and applicable. OTA noted that regardless, the court held that "gross" means the "whole amount received, which is consistent with the conclusion in this Opinion." Furthermore, the OTA, stated that "there is no basis to question the economic reality of the dividends as FTB contends," citing to *Appeal of CTI Holdings, Inc.*, (96-SBE-003) 1996 WL 248926, which held that "[b]efore income can be recognized, the taxpayer is required to realize an accession to wealth and have control thereof," citing to *Commissioner v. Glenshaw Glass* (1955) 348 U.S. 426. That is, the economic reality in the present case is the Taxpayer "received payments of dividends over which it had complete control, and realized economic gain and recognizable income equal to the gross amount received."

- The plain language and legislative history of CRTC section 25120 do not support FTB's contention that the list of exclusions (from gross receipts) under CRTC section 25120(f)(2)(A)-(L), including those items that are excluded because they do not add to the tax base, is non-exhaustive and evidences that a "matching principle" should be applied to also exclude deducted dividends from "gross receipts."
- The FTB's contention that the legislature endorsed LR 2006-01 when it enacted Senate Bill No. 2 in 2016 is not applicable to the present case because the legislature's statement was regarding former CRTC section 24330 related to an *exclusion* from income (and not a *deduction*). OTA also stated that FTB, in LR 2006-01, does not provide any legal authority establishing that deductions should be treated like exclusions and exemptions from income.
- With respect to deference to FTB's interpretation in LR 2006-01, the OTA explained that while the FTB has expertise and technical knowledge in the tax law, which weighs in favor of deference to FTB's interpretation, the OTA afforded less deference to the FTB's interpretation in LR 2006-01 because the ruling is not a formal regulation, and is an interpretation of a statute enacted by the legislature and not of FTB's own regulation. In addition, FTB's interpretation conflicts with well-established law and the plain language and legislative history of CRTC section 25120(f)(2). Therefore, citing to *Yamaha Corp. of America v. State Bd. Of Equalization* (1998) 19 Cal.4th 1, OTA explained that the weight provided to an agency's interpretation is "fundamentally situational." The OTA determined that it was appropriate under these circumstances to apply its own independent judgment, finding the FTB's interpretation unpersuasive.

(Notably, this was the second decision in which the OTA rejected LR 2006-01 and the FTB's analysis of *Chase Brass* as they relate to apportionment factor representation with respect to deducted income—see previously issued Tax Alert on the *Appeal of Southern Minnesota Beet Sugar Cooperative and Subsidiary (Minnesota Beet)*. Indeed, the OTA, in its February 2024 denial on petition for rehearing, concluded that the holding in the present case is consistent with *Minnesota Beet*, which was made precedential after the issuance of the July 2023 opinion in this appeal, but before the issuance of the February 2024 denial, in finding LR 2006-01 unpersuasive to the extent it treats the DRD at issue here as excluded from gross receipts.)

With respect to FTB's second position, the OTA also concluded that the gross repatriated dividends are not excluded from the sales factor as a "substantial and occasional" sale, pursuant to California Code of Regulations, title 18, ("Regulation") section 25137(c)(1)(A). The OTA explained that while the rule applies to a sale of fixed assets or "other property," including intangible assets (*e.g.*, patents or an affiliate's stock), there is no legal authority that supports FTB's contention that dividends are a sale of property under Regulation section 25137(c)(1)(A) which more narrowly defines sales for that purpose.

Finally, addressing FTB's third position, the OTA determined that the FTB had not met its burden to show by clear and convincing evidence that the standard apportionment formula did not fairly represent the extent of Taxpayer's business activities in California. As such, the OTA concluded that an alternative apportionment method under CRTC section 25137 was not necessary.

Considerations

Taxpayers filing a California tax return on a water's edge basis (*e.g.*, California Form 100W) that received dividends from qualifying foreign corporations, 75 percent of which were deducted from income under CRTC section 24411, should discuss with their tax advisors whether to file claims for refund within California's statute of limitations based on the grounds that 100 percent of such foreign dividends received are includible in the sales factor. Generally, California's statute of limitations for refunds is the later of four years from the date the California tax return is filed, four years from the original due date for the return, or one year from the date of the overpayment.

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