State of California

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Legislative Change No. 04-37

Bill Number: AB 263 Author: Oropeza Chapter Number: 04-868

Laws Affecting Franchise Tax Board: Revenue and Taxation Code Sections 24410, 24425, 24465, and 24900 & Uncodified Provisions

Date Filed with the Secretary of the State: September 29, 2004

SUBJECT: Dividends Received Deduction (DRD)/Ceridian Issue

Assembly Bill 263 (Oropeza), made the following changes to California law:

Section 24410 of the Revenue and Taxation Code is repealed and re-enacted.

1. The act repealed and re-enacted Section 24410 to allow a taxpayer that owns 80% or more of a subsidiary engaged in an insurance business to an 80% DRD for qualified dividends received from that subsidiary. The deduction would be allowed regardless of whether the insurance company is engaged in business in California. The 80% deduction would apply to taxable years beginning on or after January 1, 2004, and would increase to 85% for taxable years beginning on or after January 1, 2008.

2. The act requires the dividends received that qualify for the DRD to be phased-out if the insurance company paying the dividend is overcapitalized. A phase-out ratio utilizing premiums and investment income is used to calculate the amount of overcapitalization. The capitalization ratio or percentage is calculated by dividing the five-year average of premiums earned by the five-year average of total income earned. The lower the percentage, meaning the greater investment income in relationship to premiums, the more the insurance company is overcapitalized. Total income is equal to premiums earned plus investment income. Premiums earned by a life insurance or financial guaranty insurance company are weighted at a higher amount. The capitalization percentage reduces dividends received that qualify for the DRD by the general parent corporation as follows:

   - If the capitalization percentage is equal to or greater than 60% (70% beginning in 2008), the dividends qualifying for the DRD are not reduced.
   - If the capitalization percentage is less than 60% (70% beginning in 2008) and greater than 10%, then the dividends qualifying for the DRD is ratably reduced for each percentage point by which the capitalization percentage falls below 60% (70% beginning in 2008). For example, if the capitalization percentage is 30%, the dividends qualifying for the DRD is reduced by 50%. The 30% is one half of the amount necessary (60%) not to be overcapitalized, therefore, one half of the dividends qualifying for the DRD is phased-out.
   - If the capitalization percentage is equal to or less than 10%, the dividends qualifying for the DRD are reduced to zero.

Bureau Director	Date
Jana Howard for Brian Putler	11/9/04

Premiums received from the insurance company's affiliates and the investment incomes earned on those premiums (i.e., premiums and income attributable to "captive" self insurance) are not included in the capitalization ratio computation. Additionally, the act provides that dividends received from an insurance company that is derived from profits on premiums received by the insurance company from related affiliates do not qualify for the DRD.

The act provides instructions and definitions needed to compute the capitalization ratio and would delegate to the Franchise Tax Board the authority to write regulations in narrowly identified situations.

3. For taxable years ending on or after December 1, 1997, and beginning before January 1, 2004, a taxpayer may elect to deduct 80% of dividends received from an insurance company subsidiary. The taxpayer must make the election on at least one return for the election period (1997 to 2003). The election must be made within 180 days of September 29. 2004, the enactment date, or no later than March 28, 2005. By making the election, the taxpayer would agree to all of the following:

    - To be subject to the DRD percentage and the phase-out of the qualified dividends received discussed in Item 2 above for all taxable years in the election period.
    - To report and remit any amounts due pursuant to the election for all open taxable years in the election period. This remittance must occur within 180 days of the effective date of the bill or by the due date of the return for taxable years where the return is due more than 180 days after the effective date of the bill.
    - No refund, credit, or offset may be allowed for a DRD in excess of the amounts allowed under the provision for the election period.

The election would be irrevocable once made and would apply only to taxable years during the election period for which the statute of limitations is open. Where the statute of limitations has closed for any particular year during that period, the election would apply if the final determination of tax has not been made for the taxable year because of a dispute related to the dividends received deduction or Section 24425 (expenses incurred in connection with income not included in the tax base under the Corporation Tax Law (CTL), as it relates to the DRD under Section 24410).

For purposes of determining taxable income for the taxable years during the election period only, Section 24425 would not apply to any expense related to Section 24410 dividends. Thus, taxpayers would not be required to reduce any expenses related to the Section 24410 dividends affected by the election.

<u>Section 24425 of the Revenue & Taxation Code is amended.</u>

For taxable years beginning on or after January 1, 2004, the act modifies Section 24425, which relates to expenses incurred in connection with income not included in the tax base under the CTL. The following interest or other expense paid to an affiliated insurance company would be disallowed as follows:

- Interest paid on indebtedness (except specified marketable debt instruments) the principal of which is attributable to a contribution of capital from a noninsurer member of the group.
- Interest paid within the last five years in connection with the acquisition of the insurance company.

- Interest paid multiplied by the disqualifying percentage, which is determined by subtracting the percentage of dividends that would have been qualified for the DRD under Item 2 above from 100%, whether or not a dividend is paid. In the example given above, the capitalization percentage was 30% and the dividends qualifying for the DRD is reduced by 50%. Therefore, 50% of all interest paid to an affiliated insurance company would be disallowed regardless of whether the insurance company paid a dividend in the year the expense was incurred.
- Interest paid multiplied by the greater of the ratio of:
  - Premiums received from affiliates divided by total premiums received.
  - Associated risk with insurance polices sold to affiliates divided by the associated risk with all insurance polices.
- Expenses attributable to property acquired by an insurance company from a non-insurance company affiliate where no gain was required to be recognized by the non-insurance company affiliate.
- Expenses attributable to property acquired by an insurance company with proceeds from a contribution of capital from a non-insurance company affiliate.

The bill provides that any interest or other expense described in one or more of the categories described above shall only be included once, and shall be included in that category that results in the highest disallowance amount.

<u>Section 24465 is added to the Revenue & Taxation Code.</u>

Except as specified, the act provides that if a taxpayer transfers appreciated property to an insurance company in an exchange described in specified provisions of the Internal Revenue Code, the insurance company shall not be treated as a corporation for purposes of determining whether gain from that transfer or exchange will be recognized. The effect of that rule would disable the effects of nonrecognition provisions dealing with various transactions involving general corporations and their insurance company subsidiaries, thus making the exchange a taxable event.

The specified provisions of the Internal Revenue Code are:

Section 332 – Complete Liquidations of Subsidiaries,
Section 351 – Transfer to Corporation Controlled by Transferor,
Section 354 – Exchanges of Stock and Securities in Certain Reorganizations,
Section 356 – Receipt of Additional Consideration, or
Section 361 – Nonrecognition of Gain or Loss to Corporations; Treatment of Distributions.

The act provides exceptions to the above general rule, but those exceptions do not apply if the transfer or exchange has the effect of removing the property from the CTL tax base. These rules effectively prevent low tax basis, high fair market value assets (appreciated property) of the non-insurance company affiliate from being transferred out of the CTL tax base to the gross premiums tax base where the gain on the property, if disposed of by an insurer, would not be subject to any tax. The exceptions provided are:

- Transfers due to certain statutory mergers using voting stock of the parent corporation.
- Transfers of stock for the purpose of filing a federal consolidated tax return, financial statements, or regulatory reporting.
- Transfers of stock for publicly owned stock of the general parent corporation.

An exception to the immediate recognition of gain rule by the non-insurance company affiliate would allow deferral if the insurance company uses the property in the active conduct of its trade or business. The gain will be deferred until property is no longer used in the insurance company's or a combined reporting affiliate's trade or business or the property is no longer owned by the insurance company or a combined reporting affiliate in the group. If the deferred gain was business income to the original transferor, then when restored, the business income is apportioned using the transferor's current year's apportionment percentage. The gain on certain types of property, including inventory, copyrights, and intangibles, would not be permitted to be deferred under these rules, and will be taxable in the year the transfer occurs. Under regulations, the Franchise Tax Board may prescribe reporting requirements for the deferral of gains under this provision on property transferred to an insurance company to ensure that gain is recognized when the appreciated asset leaves the trade or business of the specified members of the commonly-controlled group under the circumstances specified in the bill. The act also provides that if these reporting requirements are not met, then the Franchise Tax Board may require the gain deferred to be included in the income of the taxpayer in the year the reporting requirement was not met. The Franchise Tax Board may propose an assessment resulting from not meeting these reporting requirements for up to four years after the taxpayer again meets the reporting requirements (and discloses that the asset has left the group, or is no longer a part of the trade or business of the specified members of the group). In other words, if the taxpayer does not meet the reporting requirements, the Franchise Tax Board may issue an assessment at any time.

The act provides for additional narrower exceptions to the above and also narrowly expands the recognition of gains to which this provision applies. Numerous rules and definitions are also provided. The Franchise Tax Board may prescribe regulations appropriate to carry out the purpose of this provision, which is to prevent the removal of gain from the CTL tax base. Additionally, if the taxpayer demonstrates that a transfer of property does not result in removal of gain from the CTL tax base, the Franchise Tax Board may grant relief. The State Board of Equalization or a court may also grant relief from this provision, but only if the State Board of Equalization or court makes a specific finding that the transfer did not remove gain inherent in property from the CTL tax base.

Section 24900 is added to the Revenue & Taxation Code

The act provides that under certain conditions the Franchise Tax Board may include in the general parent corporation's gross income a deemed dividend (qualifying for the DRD under Item 1 above) from the parent's insurance companies, under rules that operate similarly to the deemed dividend rules under subpart F of the Internal Revenue Code. This applies if all insurance companies in an affiliated group have a capitalization percentage (discussed in Item 2 above) that is equal to or less than 10% (15% beginning in 2008) and a substantial purpose of the accumulation of earnings and profits of the insurance company was to avoid income tax of this or any other state. The deemed dividend amount would be equal to the pro rata share of all of the affiliated insurance companies' earnings and profits for the taxable year. The amount of the deemed dividend drawn from an insurer cannot exceed that specific insurance company's net income attributable to investment income (as defined) less the insurance company's premiums. Any amount included in the income of the general corporation in one year cannot again be considered in a following year.
If all insurance companies in an affiliated group constitute a "predominantly captive insurance group," this provision applies if the capitalization percentage (discussed in Item 2 above) is equal to or less than 40%. A "predominantly captive insurance group" means an affiliated group of insurance companies if either of the following ratios exceeds 50%:

- Unweighted premiums received from affiliates divided by total unweighted premiums received.
- Associated risk with insurance polices sold to affiliates divided by the associated risk with all insurance polices.

The act provides that the Franchise Tax Board may prescribe regulations relating to an affiliated group of insurance companies to describe conditions where accumulation of earnings and profits do not have the substantial purpose to avoid taxes on or measured by income.

The act also provides that if any part of this deemed dividend provision is found invalid, the invalidity shall not apply to any other provision in the bill or any severable portion of the provision.

The Act Made The Following Uncodified Legislative Declarations:

- The amendments to Section 24410 serve a public purpose and are necessary to provide for the equitable tax treatment of insurance company dividends in light of: (1) the *Ceridian* decision holding that Section 24410 violates the Commerce Clause of the United States Constitution, (2) that insurance company dividends do not qualify for a deduction under Section 24402 and are not eligible for elimination from income as provided for in Section 25106, and (3) that a number of corporations filed returns claiming deductions for all or part of the dividends they received from insurance subsidiaries because of uncertainty following the *Ceridian* decision.

- The amendments to Section 24410 serve a public purpose and are in furtherance of the public interest in avoiding the denial of a deduction for insurance company dividends. Denial of this deduction would have a detrimental effect upon the economy of California.

- The retroactive application of the amendments to Section 24410 serve a public purpose and promote sound tax policy by affording equitable tax relief to taxpayers that relied upon Section 24410 in expectation that they would be entitled to a deduction with respect to a portion of the dividends received from insurance companies.

- Section 24425 denies a deduction with respect to any amount otherwise allowable as a deduction that is allocable to a class of income that is not included in the measure of tax. The Franchise Tax Board contends and the State Board of Equalization has held that where a taxpayer claims a DRD for insurance company dividends, deductions for expenses associated with those dividends are disallowed under Section 24425. In contrast, the industry contends that Section 24425 does not apply under any circumstance.

- The amendment to Section 24410 that declares Section 24425 to be inapplicable to the dividends received deduction for tax years ending on or after December 1, 1997, and beginning before January 1, 2004, represents an integral part of the legislative resolution of the uncertainty created by the *Ceridian* decision, and accordingly furthers the same valid public purposes identified above.

- No inferences should be made with respect to the application of Section 24425 to the deductions allocable to dividends received deduction for taxable years ending before December 1, 1997, or beginning on or after January 1, 2004.

The Act Requires a Report

The Legislative Analyst, in consultation with the Department of Finance, Department of Insurance, and the Franchise Tax Board, must report to the Legislature by January 1, 2008, the following:

- State the impact of the deemed dividend provision (Section 24900) on the ability of taxpayers to use insurance companies to avoid state taxes. The report shall address whether the 15% capitalization percentage used beginning in 2008 should be decreased to 10%.

Compare the gross premiums taxes paid and the method of collection of the tax by insurance companies to taxes paid and collected under the CTL.

This act is effective September 29, 2004, and unless otherwise specified is operative for taxable years beginning on or after January 1, 2004.