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August 5, 2005
Chief Counsel Ruling CCR 2005-0005

Re: ****************

Dear ***************:

This Chief Counsel Ruling is issued in response to a request for a legal opinion authored by yourself, dated ************, in contemplation of the imminent acquisition of ****************** and its affiliates by the taxpayer. As such, it asks that the ruling expressly state that it is issued to ******************* and all of its affiliates at the time that the transactions described below will occur, including the acquired ****** entitites. In general, the request asks for an opinion on the taxability of certain dividends, some to be paid between members of the former ****** unitary group, and others to be paid by a member of the former ****** unitary group to a member of the ******* unitary group, and whether such dividends are properly eliminated under California Revenue and Taxation Code section 25106.[1] The Department concludes that, subject to audit verification of the factual representations made in the request for ruling and as more fully described below, some of the dividends to be paid will qualify for elimination under Section 25106 while others will not.

FACTS

As stated above, the genesis of this request for Chief Counsel Ruling is the imminent contemplated acquisition of ****************** by the taxpayer, ******************* and affiliates. As represented in the ruling request,[2] the taxpayer posits the following scenario:

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[1] Hereinafter all references to section numbers shall refer to the California Revenue and Taxation Code unless otherwise indicated.

[2] As represented in the request for Chief Counsel Ruling, the facts "have [been] simplified . . . to a certain degree in order to avoid distraction from the issues at hand; however, we have presented all relevant facts and represented them accurately."

A taxpayer (Corporation A) intends to acquire the stock of a parent corporation (Corporation B1) and its unitary subsidiary (Corporation B2). Corporations B1 and B2 have been unitary for their entire existence and, as of the date of acquisition, each has retained earnings and profits reflecting income of the unitary business (referred to in the ruling request as "pre-acquisition earnings and profits"). To effectuate the acquisition, Corporation A will create Merger Sub as its direct subsidiary, whereupon Corporation B1 will merge into Merger Sub, with Merger Sub surviving. Merger Sub will change its name to Corporation B1-New and will own all of the stock of Corporation B2.

For an unspecified period of time (referred to in the ruling request as "X"), Corporations B1-New and B2 will continue to operate, thereby increasing their earnings and profits (referred to in the ruling request as "pre-unitary earnings and profits"). Neither corporation will make any distribution of its earnings during this time. If Corporations B1-New and B2 are instantly unitary with Corporation A, X will equal zero and neither Corporation B1-New nor Corporation B2 will have any pre-unitary earnings and profits.

After Corporation A becomes unitary with Corporations B1-New and B2, whether as a result of instant unity or after the passage of time period X, Corporation B2 will distribute all of its pre-acquisition earnings and profits and all of its pre-unitary earnings and profits, if any, to Corporation B1-New. Later that day, Corporation B1-New will distribute a portion of the earnings and profits it will have received from Corporation B2 (not to exceed 5 percent of the fair market value of the net assets of Corporation B1) to Corporation A. Corporation B1-New will not distribute its own pre-acquisition earnings and profits or pre-unitary earnings and profits, if any, at this time.

As represented in the ruling request, all of the distributions will be properly characterized as giving rise to business income as defined in Section 25120(a). However, the request for ruling does not indicate whether the amounts of the dividends described above will exceed that portion of the current earnings and profits attributable to the ordinary business operations of the respective corporations.

RULINGS REQUESTED

1. A ruling is requested that would hold that the dividends paid by Corporation B2 to Corporation B1-New will be eliminated from the income of Corporation B1-New pursuant to Section 25106 (i.e., "paid out of the income of the unitary business").

2. A ruling is also requested that would hold that the dividends paid by Corporation B1-New to Corporation A will be eliminated from the income of Corporation A pursuant to Section 25106 (i.e., "paid out of the income of the unitary business").

3. A ruling is also requested that would hold that, in the future, if Corporation B1-New distributes its own pre-acquisition earnings and profits or pre-unitary earnings and profits (if any) to Corporation A, Corporation A will not be entitled to

eliminate such dividends from its income pursuant to Section 25106 (i.e., not "paid out of the income of the unitary business").

HOLDING

1. Dividends paid by Corporation B2 to Corporation B1-New out of the income of the unitary business will constitute "unitary income" within the meaning of Section 25106 for Corporation B1-New qualifying for elimination under Section 25106 (i.e., "paid out of the income of the unitary business").

2. Dividends paid by Corporation B1-New to Corporation A out of the income of the unitary business, comprising a portion of the earnings and profits it will have received from Corporation B2, will constitute "unitary income" within the meaning of Section 25106 for Corporation A qualifying for elimination under Section 25106 (i.e., "paid out of the income of the unitary business").

3. Should Corporation B1-New distribute its own pre-acquisition earnings and profits or pre-unitary earnings and profits (if any) to Corporation A in the future, Corporation A will not be entitled to eliminate such dividends from its income pursuant to Section 25106 (i.e., not "paid out of the income of the unitary business").

LAW AND ANALYSIS

Question 1:

Section 25106 provides:

> In any case in which the tax of a corporation is or has been determined under this chapter with reference to the income and apportionment factors of another corporation with which it is doing or has done a unitary business, all dividends paid by one to another of those corporations shall, to the extent those dividends are paid out of the income previously described of the unitary business, be eliminated from the income of the recipient and, except for purposes of applying Section 24345, shall not be taken into account under Section 24344 or in any other manner in determining the tax of any member of the unitary group.

To qualify for elimination under Section 25106, a dividend must be paid from "income" of a unitary business, and that "income" must have been determined by reference to the income and apportionment factors of both the dividend payor and the dividend recipient. (*Id*.; *Willamette Industries, Inc. v. Franchise Tax Bd*. (1995) 33 Cal.App.4th 1242.) However, Internal Revenue Code (IRC) section 316 (incorporated into the Revenue and Taxation Code by reference under Section 24451) defines a dividend as a distribution by a corporation out of its earnings and profits. This requires an analysis of both the concept of "earnings and profits" and the term "income" as it is used in Section 25106.

Although "earnings and profits" is not precisely defined by statute, the meaning of the term has generally evolved by administrative practice of the Internal Revenue Service, by regulations, case law, and as prescribed by adjustments required under IRC section 312[3] (see Bitker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, 6th Ed. ¶8.03[1]). In practice, earnings and profits are determined by using taxable income as a starting point, and by making a series of positive and negative adjustments thereto (*Id*., ¶8.03[2]). For the most part, by incorporation of IRC sections 312 and 316, California follows the federal adjustments to arrive at earnings and profits. However, California does not adopt the adjustments to earnings and profits prescribed by the federal consolidated return regulations adopted under IRC section 1501 (in a similar context, see *Appeal of Rapid American*, 96-SBE-19, Oct. 10, 1996, pet. for reh. den. 96-SBE-19A, May 8, 1997, in which the State Board of Equalization held that the consolidated return investment stock basis adjustments required under Treasury Regulation section 1.1502-32 do not apply for combined report purposes).

Under California law, for purposes of determining the amount of earnings and profits of a corporation, unitary attributes of a corporation are disregarded, and earnings and profits are determined on a separate entity basis (*Appeal of Young's Market Company*, 86-SBE-199, Nov. 19, 1986). This rule applies even if the amount of income apportioned to a taxpayer member of a unitary group under Chapter 17 of the Corporation Tax Law exceeds the separate entity earnings and profits of that member (see, generally, *Safeway Stores, Inc. v. Franchise Tax Bd.* (1970) 3 Cal.3d 745, in which the court authorized a special rule (often described as the "*Safeway* formula") in the application of Section 24402 to deal with that eventuality).

Under Section 24452, California incorporates IRC section 316. That section provides that every distribution is made out of earnings and profits, to the extent thereof, and from the most recently accumulated earnings and profits. Thus, earnings and profits are drawn first from current earnings and profits, and then from each year's layer of earnings and profits in reverse order of accumulation (i.e., on a last-in, first-out basis). This principle is a general rule of dividend distributions, and applies to all earnings and profits regardless of character or source. (See generally, Treas. Reg., § 1.316-2(b) and (c), which treat current earnings and profits as evenly earned throughout the year, without regard to the possibility that the specific date that an item of current earnings and profits is earned occurs after the date of a mid-year distribution in that current year.) If dividends are drawn from earnings and profits of a specific year, but are insufficient to consume all of the earnings and profits for that year, earnings and profits are drawn on a pro rata basis from all classes of earnings and profits earned during the year, without regard to the specific date on which an income item giving rise to earnings and profits

[3] Also incorporated by reference into the Revenue and Taxation Code by Section 24451.

was realized. (See *Safeway Stores,* 3 Cal.3d 745 at 753.) See also, Treas. Reg., § 1.245-1, subdivison (c)(4), which applies the last-in, first-out principle, and subdivison (d), Example (3), of that regulation, which illustrates application of the ratio principle, without regard to the specific date in a given year that an item of U.S. source income is earned.)

Thus, if a dividend is paid from a pool of earnings and profits that consists of earnings and profits from apportionable business income of a unitary group (eligible for Section 25106 treatment) and nonbusiness income (eligible, if at all, only for Section 24402 treatment[4]), the dividend is considered ratably drawn from each component of the pool, without regard to the specific date during the year when a given item of income was earned.

As described above, Section 25106 allows the "elimination" of a dividend paid out of certain unitary "income." Yet, the item entitled to relief under that section (i.e., a "dividend") is itself described by IRC section 316, which refers to an amount paid out of "earnings and profits." However, as noted above, the ordinary meaning of the terms "income" (i.e., "taxable income") and "earnings and profits" are not synonymous.

To reconcile the difference, it is instructive to look to the analogous application of a similar phrase contained in Section 24402. Under that section, dividends are deductible if "declared from income" that has been included in the measure of franchise tax (chapter 2), the alternative minimum tax (chapter 2.5), or the income tax (chapter 3). In the cases of *Burton E. Green Investment Co. v. McColgan* (1943) 60 Cal.App.2d 224, and *Rosemary Properties v. McColgan* (1947) 29 Cal.2d 677, because of the effects of percentage depletion, the dividend payor's earnings and profits were substantially larger than the amount of net income upon which the dividend payor actually paid tax. The taxpayer received a dividend larger than the amount of the payor's net income, but sought a dividend-received deduction under Section 8(h) of the Bank and Corporation Franchise Tax Act (a predecessor to Section 24402) for the entirety of its dividend.

The Franchise Tax Commissioner argued that the term "income" in that section meant something different than "earnings and profits." Because only a fraction of the income associated with the taxpayer's earnings and profits was subject to tax, the Commissioner argued that the taxpayer was entitled to a deduction only in the ratio of its net income subject to tax to its total earnings and profits. The court of appeal and the California Supreme Court, respectively, disagreed, holding that the term "income," as used in Section 8(h), did not mean "net income" subject to tax. Instead, in the words of the *Rosemary Properties* court, "any dividend paid from "earnings and profits"—an item of gross income entering, like the authorized deductions, *into the determination* of

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[4] Although the court in *Farmer Bros. Co. v. Franchise Tax Board* (2003) 108 Cal. App. 4th 976 held that Section 24402 violated the Commerce Clause of the United States Constitution by discriminating against corporations engaged in interstate commerce, that holding does not impact the principle of proration discussed here.

net income—would be a dividend paid out of income included in the measure of the tax." (*Rosemary Properties*, *supra*, at 682. Emphasis added.)

In Legal Ruling 376, August 5, 1974, a similar issue was presented with respect to a dividend that was deducted under Section 24402 in arriving at net income. The ruling held that the dividend was "income included in the measure of the tax" for purpose of Section 24402, despite the fact that the dividend was not an item of statutory "net income" to the dividend recipient, and "tax" is not literally imposed on such a dividend. Thus, the earnings and profits attributable to receipt of such a dividend was considered to be "income included in the measure of the tax" as the dividend is passed up a chain of ownership of corporations subject to California taxation (Legal Ruling 376, *supra*, questions one and two).

Thus, for example, if a dividend is paid from a lower-tier subsidiary to an intermediate-tier subsidiary, and then to a parent corporation (assuming that all of the corporations are California taxpayers and none of the above are members of a unitary group), the dividend paid by the middle-tier subsidiary, to the extent attributable to the income of the bottom-tier subsidiary, is eligible for a Section 24402 deduction, even though the middle tier subsidiary did not pay tax on that amount. The ruling relied on *Rosemary Properties, supra,* for that proposition ("It follows that dividends which are included in California gross income attributable to California sources is 'included in the measure of the taxes' of the recipient corporation even if such dividends are subsequently deducted under either Section 24402 or Section 24110.") Thus, the premise for this treatment, as in *Rosemary Properties*, *supra*, was that, although deductible, a dividend eligible for Section 24402 treatment was nevertheless "income" within the meaning of Section 24402 when "declared" as a dividend, on the basis that, had it chosen to do so, California could have subjected the dividend to taxation.

Thus, the meaning of "income" in the context of Section 24402 is broad enough to include all earnings and profits that the state had the right to tax as income from a California source, whether or not it chose to do so (see *Safeway Stores, Inc. v. Franchise Tax Bd.* (1970) 3 Cal.3d 745, 750-751, describing the deduction as relating to "all income, including earnings and profits, *attributable to California sources*…." (Emphasis in the original).)

The parallel phrasing in both Section 24402 and Section 25106 ("dividends . . . declared from income" and "dividends . . . paid out of . . . income," respectively) suggests that the term "income" in Section 25106 also means something other than statutory "net income" as defined in the Revenue and Taxation Code, and that, as in Section 24402, the term should be more broadly construed.

However, the scope of the term "income" in Section 24402 is not the same as in Section 25106. The latter section describes "income" that is taken into account by reference to "income and apportionment factors" of a unitary corporation. The description of the "income" as relating to the "apportionment factors" of another member of the unitary group indicates that "income" means both (1) business income, as defined by Section 25120(a), that is included in a combined report,[5] and (2) income *before* apportionment (i.e., "unitary business income from whatever source"). That is demonstrated by the phrase "income previously described of the unitary business," which indicates that the term "income" referred to the entire income of the unitary business as a whole.[6]

Nevertheless, if the term "income" in Section 25106 were construed as broadly as the court in *Rosemary Properties* construed the term in Section 24402 (i.e., income "entering . . . into the determination of" income subject to apportionment), that section would describe earnings and profits that California would have treated as combined report business income under Section 25120(a), without consideration as to whether the business "income" was otherwise beneficially treated. Thus, "income" would be eligible for elimination under Section 25106 even if the amount of business income included a deduction (like depletion) that exceeded cost basis, or income that was excluded from the computation of the income tax base, but would have been business income but for the exclusion (e.g., dividends deductible under Section 24411 that would constitute business income if subject to taxation).

A key portion of the analysis requires a determination as to whether "income" as described in Section 25106 includes earnings and profits attributable to dividends received from another corporation, where the dividends were themselves eliminated from the "income" of the dividend payor under Section 25106. In the absence of Section 25106, the court in *Safeway Stores v. Franchise Tax Board*, *supra*, clearly treated an intercompany dividend as an item of "gross income" within the meaning of the California equivalent of IRC section 61 (now incorporated by reference by Section 24271), even though the dividend was paid between members of a unitary group. Thus, if the Legislature had not enacted Section 25106, an intercompany dividend would clearly be "income." If the broad application of the term "income" utilized in the context of Section 24402 were to be analogously applied to Section 25106, that application would suggest that intercompany dividends that would constitute "income," but for the Section 25106 elimination, would be properly considered "income" in the hands of the recipient.

However, Legal Ruling 376, August 5, 1974, held that a dividend described by Section 25106 could not be considered as "income included in the measure of the tax" for purposes of Section 24402, thereby potentially preventing such a dividend from being

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[5] Because "income" includes only income taken into account by reference to income and apportionment factors of another unitary entity, and because the unitary business principle can only reach income subject to apportionment, the term "income" as described in Section 25106 can include only "business income" as defined in Section 25120(a). (See Cal. Code Regs., tit. 18, § 25120(a).)

[6] A similar use of the phrase "income and apportionment factors" occurs in Section 25110, which given the context in which it operates to exclude the income and apportionment factors of certain foreign entities from a combined report, clearly shows that the phrase refers to income that would have been combined report business income *before* apportionment, but for the effects of the water's edge election.

deducted under Section 24402. In so holding, the ruling cited a federal consolidated return case (*Oscar E. Baan* (1965) 45 T.C. 71, 93) for the proposition that the term "eliminated" is to be used in the sense of "nonrecognition." It further cited dictum in *Pacific Telephone and Telegraph v. Franchise Tax Board* (1972) 7 Cal.3d 544, 558, that stated "Section 25106 provides that intercompany dividends are not income. . . ." The ruling then stated that "[i]n any event it is clear that dividends eliminated from the income of the recipient are not required to be reported in California *gross income."* (Emphasis added.) The legal ruling then concluded, ". . . Section 25106 dividends are not included in the 'measure of the taxes' within the meaning of Section 24402 as construed by *Rosemary*."

The citations to *Oscar Baan* and *Pacific Telephone* for the proposition that Section 25106 dividends are not "recognized income" and not "gross income," and are therefore not "included in the measure of the taxes," indicates that the ruling was based on the premise that Section 25106 dividends are not "income" for purposes of Section 24402. Given the parallel construction of dividends paid "from income," this analysis could suggest that a Section 25106 dividend might likewise not be considered "income" for purposes of whether the elimination provisions of Section 25106 applied to a dividend paid by a middle-tier corporation to its parent.

Such a suggestion, of course, is contrary to that portion of the holding of the legal ruling that clearly held that a dividend passing through a chain of unitary entities that had always been unitary would at least retain Section 25106 character as the dividend passed from one unitary tier to another. From that holding, it could be concluded that such a dividend might be considered "income" for purposes of Section 25106, even though the dividend might not be considered "income" for purposes of Section 24402.

However, the theoretical underpinnings of Legal Ruling 376 may, in fact, have been flawed. The court in *Oscar Baan* did not deal with intercompany dividends. Rather, the issue in that case was whether intercompany transaction gain was properly considered "not recognized," for purposes of IRC section 355, because it was subsequently "eliminated" in a consolidated return (reflecting the consolidated return regulations in effect prior to 1966). The IRS argued that the "income" at issue in the case was "income" that was "recognized" under the Code for purposes of IRC section 355, despite later being eliminated in consolidated return income. The *Oscar Baan* court held that intercompany transaction income was "not recognized." The holding in *Oscar Baan* was rendered moot by a decision of the court of appeal, reversing the tax court, that held that the transaction did not qualify for IRC section 355 treatment for other reasons (*Comm'r v. Oscar Baan* (9th Cir. 1967) 382 Fd.2d 485).

Whatever the force and effect of the tax court's opinion in *Oscar Baan*, however, that case's holding was considerably narrowed by *Henry C. Beck Co. v. Comm'r* (1969) 52 T.C. 1, aff'd (5th Cir. 1970) 433 F.2d 309, in which the court held that intercompany transaction book income was properly considered earnings and profits with respect to a distribution from that company to its parent, despite the fact that the income from the intercompany sale was "eliminated" for purposes of computing income considered in a consolidated return.[7] Thus, even though "eliminated" intercompany gain might be characterized as "nonrecognized income" for purposes of IRC section 355, the court characterized the eliminated gain from an intercompany transaction as more of an "economic concept which the tax law has utilized 'to approximate a corporation's power to make distributions that are more than just a return of investment.'" (*Id*., at 6, quoting Albrecht, "Dividends and Earnings or Profits," 7 Tax L. Rev. 157, 183.) The eliminated intercompany income was nevertheless a "sum which [the intercompany seller], upon receipt, could distribute to its shareholders without impairing its investment." (*Henry C. Beck Co.,* 52 T.C. at 6.)

Thus, the fact that a dividend is "eliminated" from income does not mean that the dividend is not "income" for purposes of earnings and profits. As noted, a dividend is by definition a payment from earnings and profits, and is by definition an amount more than "just a return of [the shareholder's capital] investment." (*Id*., quoting Albrecht, "Dividends and Earnings or Profits," 7 Tax L. Rev. 157, 183.) To the extent a dividend is paid, the payor's earnings and profits are decreased (Treas. Reg., § 1.312-1), and the payee's earnings and profits are correspondingly increased. An item is "income" in the accounting sense of earnings and profits, even if the item is exempt from taxation (see Treas. Reg., § 1.312-6(b)).

The dictum in *Pacific Telephone*, *supra*, cited in Legal Ruling 376, is not particularly significant to the analysis, and should not have had any bearing on the legal ruling's outcome. In that opinion, the court was merely pointing out that Section 25106 both provided that intercompany transaction income was excluded from "income," and that the dividend was removed from the calculation of the interest offset provided by Section 24344(b). The casual observation of the court was merely descriptive of the immediate tax effect of Section 25106 (i.e., exclusion of formerly taxable dividends from the tax base), and not a substantive inquiry as to whether a dividend eliminated under Section 25106 was nevertheless "income" (either gross or net) for any other purpose, including the operation of Section 24402. Thus, the court was not really concerned about whether a dividend eliminated under Section 25106 was income in the first instance, and then eliminated, or whether the dividend was never income to begin with.

Thus, despite the ruling's reservation about characterizing a dividend "eliminated" from income under Section 25106 as "income" for purposes of Section 24402, that

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[7] The tax court, relying upon *Bangor & Aroostook Railroad Co.* (1951) 16 T.C. 578, *aff'd* (1st Cir. 1951) 193 F.2d 827, distinguished income resulting from an intercompany sale from nonrecognized income that represented merely a deferral of tax reflected in tax basis after a tax deferred exchange. In that case, income will eventually be recognized to the party to the exchange, making it appropriate to delay the effect on earnings and profits until the income is taken into account as taxable income at a later date. Conversely, in the case of an intercompany sale, the seller would never again recognize income from that intercompany transaction, because the "eliminated income" would be reflected in the basis of the intercompany purchaser, not the intercompany seller.

conclusion was unnecessary, and perhaps inappropriate. The ruling appeared to have been based on a concern that Section 25106 might be read as displacing the effects of Section 24402, thereby defeating the object of relieving multiple entity taxation as a dividend passed up a chain of unitary entities. However, as seen, the ruling need not have found a conflict between Section 24402 and Section 25106, but instead could have seen the sections operating simultaneously, giving effect to both, subject, of course, to the general rule proscribing a double deduction for the same item (see Treas. Reg., § 1.161-1). Accordingly, neither *Oscar Baan* nor *Pacific Telephone* affects the analysis that a dividend passing from one unitary entity to another is "paid from the income previously described of the unitary business."

The analysis that a dividend eligible for elimination under Section 25106 is nevertheless "income" is consistent with the Board of Equalization's opinion in *Appeal of CTI Holdings, Inc.* 96-SBE-004, Feb. 22, 1996. In that opinion, the Board held that a dividend eliminated under Section 25106 was properly considered "income" within the meaning Section 24345. That meant that a foreign tax paid on such dividend was properly considered to have been a tax "on or according to or measured by income or profits" for purposes of the latter section. The Board rejected the taxpayer's argument that *Pacific Telephone*, *supra*, stood as authority that such a dividend was not "income."

Note, however, that Section 25106 would not apply to earnings and profits earned by a member of the unitary group if that member is excluded from the combined reporting group as a result of a water's-edge election under Section 25110, et seq., notwithstanding that such income "would be" in a combined report, but for the water's edge election. Section 25106 is conditioned upon both the existence of a unitary relationship and having income *and apportionment factors* being taken into account with respect to both the payee and payor in the computation of tax under Chapter 17.[8]

[8] To be eligible for elimination under Section 25106, "tax" must have been determined under Chapter 17 with reference to the income and apportionment factors of a unitary member. This raises the question as to whether tax must actually have been imposed on an apportioned part of that income. If an actual tax were required to be paid on a specific income amount, then, for example, a dividend paid from earnings and profits attributable to items that had been excluded or deducted from income under such sections as Section 24384.5, Section 24402, Section 24404, Section 24406, Section 24410, or Section 24411, the dividend would not be eligible for elimination under Section 25106, even if it would have been apportionable business income in a unitary combined report, because "tax" was not paid on the business income excluded by those sections.

However, with respect to the operation of Section 24402 under *Rosemary Properties, supra,* at 682 (including items "entering, like the authorized deductions, *into the determination* of net income. . . ." (emphasis added), and Legal Ruling 376, a dividend is considered as having been paid from income subject to the "measure of the tax," even if no tax is actually paid with respect to that income, so long as California had the right to tax that income had it chosen to do so. By comparable analysis, "tax . . . determined under this chapter" refers to an amount that, if it were not exempted, would have been part of *the determination of* business income included in a combined report, and thus would have been apportionable to this state under Chapter 17. That construction is consistent with Legal Ruling 376, in that the ruling clearly contemplated that a dividend passing through tiers of unitary corporations would retain its character as paid out of "unitary income" even though the dividend received by the middle-tier

Because both income and factors are excluded from a combined report in a water's-edge election, that essential element in Section 25106 is not satisfied. The same analysis would apply to a partially included entity, such as a foreign entity with U.S. income and factors (Section 25110(a)(4)), and a controlled foreign corporation with subpart F income (Section 25110(a)(6)). To the extent that otherwise unitary income and associated factors are excluded from a combined report, Section 25106 is not satisfied, and a dividend from that "income" is not eligible for elimination.

Because the dividend to be received from Corporation B2 would have been apportionable business income to the B1—B2 group, but for the operation of Section 25106, the dividend should properly be considered paid from "income" determined by reference to the apportionment factors of the old B unitary group and thus will constitute "income previously described of the unitary business" when that amount is paid as a dividend to Corporation B1-New.[9] As such, the dividend will qualify for elimination from income pursuant to Section 25106.

Question 2:

As dividends pass up a chain of unitary entities, to be eligible for elimination under Section 25106 at each step, each dividend must then be considered "paid out of the income previously described of the unitary business." Corporation A was not unitary with Corporation B1 (the middle tier subsidiary) at the time that the earnings and profits of Corporation B2 (hereafter bottom-tier subsidiary) were accumulated. Accordingly, for the dividends paid to Corporation A to be eligible for elimination, those dividends must have been considered to have been paid from apportionable unitary income of the Corporation A—Corporation B1-New—Corporation B2 group during the combined report period during which the bottom-tier dividend was received by Corporation B1-New.[10] Thus, to be eligible for elimination, dividends from the bottom-tier subsidiary must be considered apportionable business income with respect to the Corporation A—Corporation B1-New—Corporation B2 group, notwithstanding the elimination of the dividends from Corporation B1-New's income.

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entity was itself eliminated under Section 25106, and thus would not itself be subjected to an actual imposition of "tax" in the application of chapter 17.

Thus, "tax . . . determined under this chapter" appears to relate to income subject to the application of the apportionment methodology of Chapter 17, and not to income actually subject to the imposition of tax.

[9] As represented in the request for ruling, the merger of Corporation B1 into Merger Sub (subsequently renamed Corporation B1-New) is governed by IRC section 381, as adopted in California by Section 24451. As such, the former Corporation B1's earnings and profits, as well as its past and present unitary relationship with Corporation B2, carry over to Corporation B1-New.

[10] As noted above, that is necessary because Section 25106 requires that the "income" from which the dividend was paid must be paid out of combined report business income that is determined with respect to the "income and apportionment factors" of both the dividend payor and the dividend payee.

As noted, intercompany dividends would be considered gross income under IRC section 61, adopted in California through Section 24271. With the enactment of UDITPA (as later interpreted by the *Appeal of Standard Oil of California*, 83-SBE-068, March 2, 1983, and *Times Mirror v. Franchise Tax Board* (1980) 102 Cal.App.3d 872), dividends and gains on the sale of stock are no longer treated as generally allocable to commercial domicile under the rule of *mobilia sequuntur personam* (*Southern Pacific Corp. v. McColgan* (1945) 68 Cal.App.2d 48). Presently, dividends are business income subject to apportionment if they arise from stock that satisfies the conditions of Section 25120(a) (Cal. Code Regs., tit. 18, § 25120(c)(4)) at the time the dividend is paid. Thus, if a dividend were to be paid between two presently unitary entities, but for the effects of Section 25106, the dividend would ordinarily be in the apportionable business income of a combined reporting group that consists of both the dividend payor and payee because the functional test of the statute would ordinarily be satisfied (see generally, *Hoechst Celanese v. Franchise Tax Bd.* (2001) 24 Cal. 4th 508). If that were the case, the tax of the parent member of the unitary group would have been determined by reference to the income and apportionment factors of the dividend payor, and the dividend would have been paid out of the income subject to apportionment.

As discussed above, Legal Ruling 376 construed Section 24402 to allow a dividend deductible under that section to be considered "income" eligible for another Section 24402 dividend when that dividend is paid to a higher-tier parent, notwithstanding that the dividend was deductible to the middle-tier recipient and was not again "taxed." The theory is that the dividend would have been taxed, but for operation of Section 24402, to the middle tier, and thus properly considered "gross income" under *Rosemary Properties, supra*. Given the similarity of the phrases "declared from income" and "paid out of the income," and the fact that dividends are not normally considered paid out of "net income," but are paid with respect to earnings and profits, the construction of the term "income" in Section 25106 can be reasonably construed more broadly than the term "net income" as defined by Section 24341. Thus, if an item would have been unitary business income subject to apportionment between members of a combined reporting group but for its exclusion, exemption, deduction, or "elimination" by statutory rule, that item should properly be considered unitary income for purposes of Section 25106. That is because, with respect to the dividend payor, a new pool of unitary earnings and profits has been created, from which the dividend to the parent is paid.

Because the dividend to be received from Corporation B1-New would have been apportionable business income to the Corporation A—Corporation B1-New—Corporation B2 group but for the operation of Section 25106, the dividend to be paid from Corporation B1-New to Corporation A should properly be considered paid from "income" determined by reference to the apportionment factors of all three corporations, and thus will constitute "income previously described of the unitary business" when that amount is paid as a dividend to Corporation A. As such, the dividend will qualify for elimination from income pursuant to Section 25106.[11]

Question 3:

As previously noted, Section 25106 excludes from a corporation's income intercompany dividends if the payor and recipient corporations were engaged in a unitary business, to the extent that the dividends are paid from the income of that unitary business. (*Willamette Industries, Inc. v. Franchise Tax Board* (1995) 33 Cal.App.4th 1242.) Conversely, dividends paid by one member of a unitary group to another out of pre-acquisition or pre-unitary earnings and profits do not qualify for elimination under Section 25106. Thus, should Corporation B1-New determine to distribute its own pre-acquisition and/or pre-unitary earnings and profits (if any) to Corporation A in the future, Corporation A will not be entitled to eliminate such dividends from its income pursuant to Section 25106 (i.e., not "paid out of the income of the unitary business").

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. All representations of fact, including representations of unitary relationships, are subject to verification by audit examination. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the Revenue and Taxation Code. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

[11] To be eliminated from income under 25106, of course, the dividends in question paid by Corporation B1-New must in fact be actually paid from earnings and profits previously accumulated by Corporation B2, and must be paid pursuant to the normal last in-first out ordering rules applicable to earnings and profits under IRC section 316 as incorporated by Section 24452. In addition, as discussed above, when dividends are drawn from earnings and profits of a specific year, but are insufficient to consume all of the earnings and profits for that year, the dividends cannot be designated as being paid from particular earnings and profits for that year but must be drawn on a pro rata basis from all classes of earnings and profits earned during the year, without regard to the specific date on which an income item giving rise to earnings and profits was realized.

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