Subpart F Issues Under a California Water's-Edge Election

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The California water's-edge election has proved immensely popular with both foreign and domestic parent corporations potentially engaged in a worldwide unitary business. Many elections are made to reduce or minimize California franchise tax, while others are made to simplify or reduce the compliance burdens under California's worldwide combined reporting method. However, while credit is due to the California Franchise Tax Board (FTB) and the California Legislature for their efforts over the years to simplify the election, there remain many pitfalls, or traps for the unwary, regarding the consequences of making the election. The situation is further complicated by the fact that one taxpayer's pitfall may be another taxpayer's windfall — depending, for example, on whether the taxpayer is based in California versus elsewhere, is a foreign versus a domestic parent corporation, or has gains versus losses.

One procedural morass for many electing taxpayers has been the subpart F inclusion ratio rules where controlled foreign corporations are part of the unitary group. A recent California Court of Appeal decision, coupled with the FTB's later efforts to effectively nullify that decision, make these subpart F issues particularly complicated.

In *Fujitsu IT Holdings Inc. v. Franchise Tax Board* (2004), 120 Cal. App. 4th 459 (*Fujitsu*), the California First District Court of Appeal, in a published, precedential decision, considered two significant California franchise tax issues involving subpart F income in the context of a water's-edge election. These issues are whether dividends paid out of unitary income of lower-tier subsidiaries of a CFC that is partially included in a water's-edge group should be excluded from both the numerator and denominator of the recipient's water's-edge inclusion ratio, and the proper ordering rules for California's dividends received deductions in the context of those subpart F income calculations. (For the California Court of Appeal's decision in *Fujitsu*, see *Doc 2004-14091* or *2004 WTD 134-15*. Note that Fujitsu was known as Amdahl Corp. through the tax years at issue.)

These issues arise in part from the convergence of two California statutory provisions in the context of the inclusion ratio, which brings subpart F income of a CFC into the combined report under a California water's-edge election. The first provision is California Revenue and Taxation Code section 25106, which generally permits full elimination of unitary intercompany dividends. The second provision is California Revenue and Taxation Code section 24411, which provides that a corporation making a California water's-edge election generally may deduct 75 percent of its qualifying dividends received from another member of its water's-edge group.

This article discusses the two issues presented by *Fujitsu*[1] and the FTB's response to that decision.

The California Water's-Edge Election

Fujitsu is very much a California water's-edge election case. Accordingly, to understand *Fujitsu*, it is necessary to understand the basics of the California water's-edge election provisions.

California uses the worldwide method of unitary taxation, under which all of the worldwide activities (as measured by payroll, property, sales, and business income) of all of the members of a California taxpayer's worldwide "unitary business" are taken into account in determining the corporate income/franchise tax for that California taxpayer. In 1986

[1]This article discusses only the portions of *Fujitsu* that address two issues: computation of the inclusion ratio for subpart F income and the ordering of distributions. Readers should be aware that the opinion also addressed two other significant state income tax issues that are beyond the scope of this article. The first was the characterization of a refund under the United Kingdom's advance corporation tax for California tax purposes. The second was whether the dividend deduction under California Revenue and Taxation Code section 24411 discriminated against foreign commerce in violation of the U.S. Constitution.

the California Legislature first enacted a water's-edge election beginning in income year 1988, under which certain foreign operations of a taxpayer's worldwide unitary business were excluded from the tax base.[2] The election was accomplished through a contract with the FTB. The original election contract was for a term of 10 years.[3] The original election contract also required the taxpayer to pay an annual election fee to the FTB. The original election contract also required most taxpayers to periodically file with their California return a domestic disclosure spreadsheet (DDS), which described the state tax reporting methods of the taxpayer and its affiliates that were doing business in the United States. Finally, under the original 1986 water's-edge legislation, the FTB had the statutory authority to disregard a taxpayer's otherwise valid election if a taxpayer willfully failed to file the DDS or failed to furnish certain information that was requested at audit.

One taxpayer's pitfall may be another taxpayer's windfall — depending, for example, on whether the taxpayer is based in California versus elsewhere, is a foreign versus a domestic parent corporation, or has gains versus losses.

There have been many legislative changes over the years to the original 1986 water's-edge election provisions. The election fee requirement and the DDS requirement have both been repealed, and the election contract was changed to its current term of seven years. The FTB also lost its authority to disregard a water's-edge election. Many of these changes were made in 1993 as the result of legislative and political pressure in conjunction with the *Barclays Bank* litigation in the U.S. Supreme Court, in which Barclays argued (unsuccessfully) that the FTB's worldwide unitary method violated the U.S. Constitution.[4] Additional significant changes to the election were made as a result of California legislation in 2003.[5]

Under the basic provisions of the current California water's-edge election, there are six classifications of entities included in the water's-edge group under an election.[6] Four are wholly included and two are partially included. The four wholly included types of entities are:

- domestic international sales corporations and foreign sales corporations;
- corporations, other than banks, with 20 percent or more average apportionment factors within the United States, regardless of where incorporated;
- corporations incorporated in the United States, more than 50 percent of whose stock is owned or controlled directly or indirectly by the same interests, except for corporations making an election under section 936 of the U.S. IRC; and
- export trade corporations.

There are two partially included types of entities:

- Foreign incorporated banks and corporations not meeting any of the four tests above for full inclusion are included to the extent they have (1) income that is effectively connected income with a U.S. trade or business; or (2) U.S.-source income that is "business income" under California law, regardless of whether or not it is considered ECI for federal purposes.
- CFCs, as defined in section 957 of the IRC, that have subpart F income are included. Generally, the income and apportionment factor denominator amounts of such an entity are included based on the ratio of the total subpart F income of the entity for the year to its current year earnings and profits (that is, the inclusion ratio).

It was this CFC portion of the water's-edge grouping that was the subject of the *Fujitsu* case. The two issues in *Fujitsu* involving CFCs are the computation of the inclusion ratio and the ordering of distributions.

Computation of the Inclusion Ratio

The plaintiff and taxpayer in the case — originally Amdahl, which later became Fujitsu — was the parent company of a unitary group for California franchise tax purposes. As the parent company, it made a California water's-edge election and filed its California franchise tax returns accordingly for the years in issue. As part of its water's-edge group, the taxpayer was required to include in its water's-edge

[2]1986 Cal. Stat., Ch. 660. For a more complete discussion of the history of the original election, see Coffill, "A Kinder, Gentler 'Water's Edge' Election: California Wards Off Threats of U.K. Retaliation as Part of Comprehensive Business Incentive Tax Package," *Tax Notes Int'l*, Oct. 25, 1993, p. 1049.

[3]Under a 1988 amendment, the election period was then reduced to five years.

[4]For a more complete discussion of the 1993 changes to the election under SB 671, see Coffill, *supra* note 2.

[5]2003 Cal. Stats., Ch. 633. *See* FTB Notice 2004-2 (May 3, 2004), discussing implementation of the new water's-edge

(Footnote continued in next column.)

election statute. *See also* Coffill, "California's New Water's Edge Election Provisions," *State Tax Notes*, Dec. 8, 2003, p. 845, *2003 STT 236-6*, or *Doc 2003-25615*.

[6]Cal. Rev. & Tax Code section 25110(a).

combined report a portion of the subpart F income of its unitary CFCs. The first dispute between the FTB and the taxpayer arose as to whether or how dividends received by each of the taxpayer's first-tier CFCs (Amdahl Ireland, ANBV, and AIMS) from the corresponding second-tier subsidiaries (AOCC, Amdahl Lease, and Amdahl U.K.) should be taken into account in the determination of the CFC inclusion ratio of the first-tier subsidiary.

The inclusion ratio is set forth in Revenue and Taxation Code section 25110(a)(6) and provides in pertinent part:

> The income and apportionment factors of any affiliate to be included under this paragraph shall be determined by multiplying the income and apportionment factors of that affiliate without application of this paragraph by a fraction (not to exceed 1), the numerator of which is the "Subpart F income" of that corporation for that taxable year and the denominator of which is the "earnings and profits" of that corporation for that taxable year, as defined in Section 954 of the Internal Revenue Code.

The trial court found that the taxpayer, in its water's-edge combined report, could completely exclude from the inclusion ratio the dividends paid out of income already included in the combined income of the group. In other words, dividends paid out of included income of a lower-tier CFC could not be taken into account in the determination of the inclusion ratio of the first-tier CFC. The FTB disputed this finding by the trial court and appealed. Although the Court of Appeal did not agree with the trial court's reasoning, it did agree with the trial court's conclusion, and affirmed the decision in favor of the taxpayer.

The court of appeal set forth two "separate and distinct" reasons why the second-tier dividends at issue could not be included in the inclusion ratio.

The first reason involved California's adoption of the federal definition of subpart F income. The FTB argued that IRC section 959(b) excludes from gross income dividends received by foreign subsidiaries from lower-tier foreign subsidiaries to the extent they "are or have been" included in the gross income of a U.S. shareholder under subpart F. Under U.S. Treas. reg. 26 CFR section 4.954-2(b)(1)(i),[7] subpart F income excludes "distributions of previously taxed income" under IRC section 959(b). The FTB argued to the trial court that the fact the dividends would be excluded for *federal* purposes as a result of IRC section 959(b) does not mean they are excluded for *California* purposes from the subpart F amount used to compute the inclusion ratio under the California Revenue and Taxation Code. The trial court agreed with the FTB on this argument, holding that California did not adopt IRC section 959 when it adopted the federal definition of subpart F income in IRC section 952. However, the trial court ruled for the taxpayer on this issue under section 25106.

The court of appeal disagreed with the trial court's reasoning but agreed with its result to exclude such dividends. The court of appeal said: "It is clear that California has chosen to measure Subpart F income by incorporating the federal definition — a standard that implies California's willingness to follow the federal lead. . . . [W]e may assume California has adopted into its definition of Subpart F income the federal exclusions, including 'distributions of previously taxed income under' " IRC section 959(b).[8] Accordingly, the court of appeal found that the federal definition had been incorporated in California law without modification.

The second reason given by the court of appeal why the lower-tier dividends at issue could not be included in the inclusion ratio was simply because "section 25106 forbids it."[9] California Revenue and Taxation Code section 25106 provides generally that dividends paid by one member of a unitary business to another member of a unitary business shall, to the extent such dividends are paid out of the income of the unitary business, be eliminated from the income of the recipient and, with an exception not relevant here,[10] "*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*."[11] The court of appeal concluded: "The Legislature could hardly have chosen words with a clearer meaning. Simply put, section 25106 ensures that amounts included in the combined income of a unitary group can be moved (in the form of dividends) among members of the unitary group without tax consequence."[12] The court of appeal rejected the FTB's arguments to disregard what the court saw as the "clear statutory language of section 25106."[13]

Accordingly, the court of appeal held that the dividends paid out of the unitary income of a lower-tier subsidiary should be excluded from all the factors used in the subpart F computation of the

[7]Formerly 26 CFR section 1.954-2(b)(1)(i).

[8]*Fujitsu*, *supra*, 120 Cal. App. 4th at 477.

[9]*Id.*

[10]The exception is that under the current version of section 25106, those dividends can be taken into account "for purposes of applying Section 24345."

[11]Cal. Rev. & Tax. Code section 25016, emphasis added.

[12]*Fujitsu*, *supra*, 120 Cal. App. 4th at 477.

[13]*Id.*

amount included in the inclusion ratio under Revenue and Taxation Code section 25110(a)(6). That means all those dividends must be excluded from the numerator (that is, subpart F income), the denominator (that is, earnings and profits), and the amount to which the inclusion ratio is applied (that is, the income of the CFC). As the court of appeal stated: "[W]e are persuaded that is the only conclusion possible from the plain and unambiguous language of section 25106."[14]

Ordering of Distributions

The second question addressed by the court of appeal in *Fujitsu* was how dividends received by the unitary group from a CFC should be treated when part of the CFC's income is subpart F income — and thus included in the taxpayer's water's-edge combined report — and some is not.

The respective positions of the parties were clear. The FTB said the dividends should be *prorated* between earnings that have been included in the combined report and earnings that have been excluded from the combined report. The taxpayer argued that those dividends should be deemed paid *first* out of included income. The distinction between the two positions is an important one, because of the dividend received deduction under Revenue and Taxation Code section 24411. That section provides that 75 percent of dividends received by the water's-edge group that are not eliminated under section 25106 can be deducted when computing the taxable income of the taxpayer's water's-edge combined report. That ordering issue determines if the 100 percent dividend elimination deduction under section 25106 applies (that is, for earnings previously included in the California combined report) or if the 75 percent dividends received deduction under section 24411 applies.

The court of appeal noted that no statute, regulation, or other administrative pronouncement provided clear guidance on that ordering question. However, the court said that under well-established California case law, statutes are to be construed in favor of the taxpayer rather than the government. Under that principle, the court of appeal concluded that dividends paid by first-tier subsidiaries from current-year earnings and profits should be treated as paid (1) first out of earnings eligible for elimination under section 25106, with (2) any excess paid out of earnings eligible for partial deduction under section 24411.[15] The court said that in the case of a CFC that is *partially* included in the water's-edge unitary group, "the CFC will be able to move amounts that have been included in the combined income of the unitary group without tax incident *only* by adopting the ordering rule described above."[16] The effect of the court's holding on the ordering of dividend payments is that tax-preferred dividends (such as dividends eligible for elimination under section 25106) are considered to be distributed before other dividends.

FTB's Response

In response to the court of appeal's holding in *Fujitsu* on the ordering of dividends issue, the FTB staff prepared proposed amendments to California Code of Regulations, Title 18, sections 24411 and 25106.5-1. The proposed amendments would add provisions that address the ordering of dividends paid from earnings and profits that are, in part or in whole, eligible for deduction, exclusion, elimination, or are wholly taxable. The proposed amendment to reg. section 24411 states that it will apply the ordering rules of IRC section 316, which provides that a distribution of stock is to be considered first paid from current year's earnings and profits, and then from the most recently accumulated earnings and profits. The proposed amendments also provide that if a distribution from a given year's earnings and profits are not sufficient to exhaust the earnings and profits of that year, the distribution will be considered drawn from each class of potential dividend on a pro rata basis.[17] The FTB has said that the proposed regulatory amendments "clarif[y] the department's regulations that were considered in *Fujitsu*" and are "intended to address the court of appeals' misinterpretation of the regulations that are being amended."[18] The proposed amendments

[14] *Id*. at 479.

[15] *Id.* at 480.

[16] *Id.*

[17] The proposed amendments also make two "technical amendments," as described by the FTB, to reg. sections 25106.5-1 and 24411. First, the proposed amendments would "clarify" the definition of an intercompany transaction under reg. section 25106.5-1. The proposal would explain that the term includes distributions of stock between members of the same combined reporting group to the extent the distribution (1) is eliminated from income under Revenue and Taxation Code section 25106 because the payer and payee were members of the same unitary group; or (2) constitutes a distribution in excess of basis that results in a deferred intercompany stock account. Second, the proposed amendments would provide that the deduction available under Revenue and Taxation Code section 24411 is not available if such a deduction is allowable or eliminated under other California tax law provisions. (FTB Notice 2005-1, Explanation of the Discussion Draft, California Code of Regulations, Title 18, Sections 24411, 25016.5-1, Ordering of Dividends, p. 2; Staff Proposed Amendments to Regulation 25106.5-1 and 24411.)

[18] *See* FTB Notice 2005-1, Mar. 4, 2005, Explanation of the Discussion Draft, California Code of Regulations, Title 18, Sections 24411 and 25106.5, Ordering of Dividends, p. 1; *see*

(Footnote continued on next page.)

make no reference to a prospective-only application and thus, as drafted, would apply retroactively.[19]

Despite the FTB's rhetoric of "clarification" of a "misinterpretation," its proposed regulatory amendments seem to be in direct contradiction with the court of appeal's holding in *Fujitsu* regarding the ordering of dividends. The FTB staff justifies its dividends ordering rule in the proposed amendments by saying the court of appeal in *Fujitsu* reached its holding by relying on an example found in reg. section 25106.5-1(f)(2) (example 2) and concluding that this example was in conflict with reg. section 24411(e). The FTB contends reg. section 25106.5 "only applied to intercompany transactions occurring on or after January 1, 2001" and that because the regulation was not in effect for the years in controversy in the case, "it was not appropriate for the court to rely upon those regulations to find a conflict."[20] Aside from this inappropriate reliance, the FTB also said "the court appeared to have misconstrued the example upon which it relied."[21] Accordingly, FTB staff has recommended the above changes to reg. sections 24411 and 25106.5-1 based on the following reasoning:

> Because the *Fujitsu* court's holding was based on a misconstruction of a regulation, which by its terms was not applicable to the year in question and by its example didn't apply to the issue presented to the court, and because of the court's open disregard of a regulation which it acknowledged was on point, the court's holding appears to be in error.[22]

During a February 9, 2005, meeting of the three-member FTB, the FTB staff requested authorization to proceed immediately with the formal regulation process regarding the proposed amendments to reg. sections 25106.5-1 and 24411. The FTB refused to authorize the formal regulation process to begin and instead directed staff to conduct a public symposium to collect comments on the staff's discussion draft.

On March 4 the FTB issued FTB Notice 2005-1, which requested public comment and announced the symposium. The symposium was held on April 4 in Sacramento. As part of the symposium, substantive written comments were submitted in response to the FTB staff's discussion draft of the proposed changes to the regulations. Oral comments were also offered by a number of non-FTB attendees during the course of the symposium. The principal comments submitted as part of the symposium included the following:

- The court of appeal's decision was based on a statutory interpretation of Revenue and Taxation Code sections 24411 and 25106, and thus a regulatory amendment is inappropriate.
- The court of appeal did not misinterpret the FTB's regulations, but instead "harmonized" the statutes and the constitution.
- The court of appeal acknowledged that regulation 25106.5-1 was part of new regulations starting in 2001 even though the years in dispute were 1988-1992.
- The FTB's proposed ordering rule misapplies Internal Revenue Code section 316.
- The proposed amendments would require taxpayers to keep track of California earnings and profits pool, which causes an undue burden of making complex computations that are different from federal requirements.
- The proposed amendments do not provide retroactive relief that must be available from the *Fujitsu* opinion.[23]

The staff then prepared a report to the FTB on the symposium. According to that report, even though "many comments and suggestions were proffered . . . Staff [did] not believe any changes [were] required as a result of the comments."[24] Accordingly, during a June 15 meeting of the three-member board, FTB staff *again* requested authorization to proceed immediately with the formal regulation process regarding its proposed amendments to reg. sections 25106.5-1 and 24411. Again the FTB did not grant staff's request to proceed, and instead (1) decided to postpone a decision on the request until its next meeting; and (2) directed staff to provide a report to the FTB addressing the statutory construction portion of the *Fujitsu* opinion on the ordering-of-distributions issue.[25]

FTB Staff Report on Symposium on Proposed Amendments to Regulation Sections 24411 and 25106.5-1 (Ordering of Dividend Payments), Apr. 4, 2005, p. 1.

[19]Tax regulations are presumed to be retroactive in the absence of some indication to the contrary. (*See* Cal. Rev. & Tax. Code sections 19503; *see also Tenneco West, Inc. v. Franchise Tax Board* (1991), 234 Cal. App. 3d 1510, 1536.)

[20]FTB Request to Amend Regulations 24411 and 25106.5-1 Dividend Order Rules and the *Fujitsu* (*Amdahl*) Case, Feb. 9, 2005, p. 1.

[21]*Id.*

[22]*Id.* at 3.

[23]*See* Staff Report on Symposium on Proposed Amendments to Regulation Sections 24411 and 25106.5-1 (Ordering of Dividend Payments), Apr. 4, 2005, pp. 1-11.

[24]*Id*. at 1.

[25]*See* FTB board minutes, June 15, 2005, Meeting, Item 6; Draft Proposed Amendments to Regulations 24411 and 25106.6-1(f), Staff Report Regarding the Court's Decision in *Fujitsu IT Holdings Inc. v. Franchise Tax Board* (2004), 120 Cal. App. 4th 459, Sept. 7, 2005.

The next FTB meeting was held on September 7, at which time FTB staff presented the FTB with a four-page report regarding the ordering of distributions portion of the *Fujitsu* decision.[26] Regarding the role of statutory construction in the court of appeal's ordering-of-distributions discussion, FTB staff concluded in its report that it "may be open to question" and that "in staff's view the appellate court grounded its decision in its conclusion that there is an 'absence of any clear and controlling guidance.'"[27] Unlike prior meetings, the FTB staff did not ask the FTB to take any action at the September 7 meeting, instead recommending no action on the draft regulations in order to provide an opportunity for consideration of its new report by the board and the public.[28]

The FTB-proposed regulatory amendments seem to be in direct contradiction with the court of appeal's holding in Fujitsu regarding the ordering of dividends.

One may wonder what the FTB audit staff has been advised regarding how to proceed while discussion continues between the FTB staff, the FTB board, and the taxpayer community over the meaning of *Fujitsu*. The answer is that the FTB issued a technical advice memorandum (TAM2005-0001) on March 7 that was internally circulated to FTB auditors. The TAM presented the following question: "How should the audit and legal staffs implement the decision of the court of appeal in *Fujitsu* . . . pending consideration of proposed amendments to regulation sections 24411 and 25106.5-1?"[29] The May 7 TAM sets forth six "conclusions," five of which relate to the inclusion ratio and ordering-of-dividends issues:

> 2. Dividends described in IRC section 959(b) will be excluded from the numerator of the inclusion ratio of section 25110(a)(6) in determining the amount of income of a controlled foreign corporation that is included in the combined report.
>
> 3. Dividends described in section 25106 will be eliminated from the numerator of the inclusion ratio of section 25110(a)(6).
>
> 4. We will not eliminate amounts described in IRC section 959(b) or section 25106 from the denominator (earnings and profits) of the inclusion ratio of section 25110(a)(6).
>
> 5. Dividends will be eliminated from the apportionable income base pursuant to section 25106. No reduction in the apportionable income base will be made with respect to dividends described in IRC section 959(b).
>
> 6. 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. Taxpayers should be advised that this position is contrary to the decision of the court of appeal, but the department has prepared proposed amendments to the regulations to provide clarity with respect to this issue. Taxpayers that wish to obtain the treatment accorded by the court of appeal decision should take appropriate steps to preserve their right to such treatment.

The FTB believes items 2 and 3 above follow the decision in *Fujitsu*.[30] However, the FTB states that item 4 "is contrary to dicta in *Fujitsu* but should generally benefit taxpayers."[31] The FTB's position is that the discussion in *Fujitsu* regarding this issue is inconsistent with IRC section 964's definition of earnings and profits (as referenced by Revenue and Taxation Code section 25110(a)(6)) and is inconsistent with the concept of earnings and profits that are determined without regard to taxability. Nonetheless, the FTB says its (admittedly non-*Fujitsu*) treatment with regard to item 4 should generally benefit taxpayers because the larger the denominator of the inclusion ratio, the smaller the inclusion ratio.

Regarding item 5, the FTB states its position in the TAM "may also be inconsistent with what the court said in dicta in *Fujitsu*."[32] The FTB offers the following explanation for the treatment set forth in the TAM:

> Other than for purposes of the inclusion ratio of section 25110(a)(6), IRC section 959(b) does not describe a circumstance that exists under California law. Dividends, unless declared, are not in the California income base. Therefore,

[26]FTB Staff Report Regarding Statutory Construction in the "Ordering of Distributions" Portion of *Fujitsu IT Holdings v. Franchise Tax Board* and In a Written Comment Received After the June Board Meeting, Sept. 7, 2005.

[27]*Id.* at 2.

[28]Draft Proposed Amendments to Regulations 24411 and 25106.6-1(f), Staff Report Regarding the Court's Decision in *Fujitsu IT Holdings Inc. v. Franchise Tax Board* (2004), 120 Cal. App. 4th 459, Sept. 7, 2005.

[29]FTB TAM2005-0001, Mar. 7, 2005, p. 1.

[30]*Id.* at 2.

[31]*Id.*

[32]*Id.*

no deduction is required to prevent double taxation. Section 25106 provides the appropriate relief for the dividends paid from income previously considered in the combined report.

Item 6 of the TAM is the provision arguably most inconsistent with the court of appeal's holding in *Fujitsu*. The FTB states that this item arises "because of what we believe was a *misinterpretation* of our regulations by the *Fujitsu* court."[33] (Emphasis added.) The FTB states that the decision in *Fujitsu* clearly rejected the FTB's position that dividends are paid proportionally from each component of a year's earnings and profits. The FTB then states that the court's decision can also be "read as disregarding the requirement that dividends are to be treated as being paid from the most recent earnings and profits determined on an annual basis."[34] The FTB states that until there is a decision as to whether to adopt the proposed amendments to reg. sections 24411 and 25106.5-1, the FTB will continue to apply the regulations "as we believe they would have applied if properly interpreted by the court. That is, dividends are to be treated as paid proportionally from earnings and profits of the most current year."[35] However, to the FTB staff's credit, their position on this issue comes with a warning label. The TAM specifically provides that FTB staff must provide the following disclaimer when this treatment is imposed: "**Taxpayers should be notified of the court decision and that our treatment is inconsistent with that decision so they can protect their rights by filing a protest, appeal or claim for refund**."[36]

Conclusion

Fujitsu is a wonderful decision for (most) taxpayers. Unfortunately, and as is clear from the above discussion, to the extent that interpreting the decision rests in the hands of the FTB, the fate of *Fujitsu* is far from clear. To put it mildly, beginning with its attempt to have the opinion depublished[37] (and thus not citable precedent) and throughout the proposed regulation process, the FTB staff has been less than receptive to the holding of *Fujitsu* on the ordering issue and has been hard at work to limit or nullify that holding to the fullest possible extent. Indeed, the staff has not ruled out the possibility of a *retroactive* regulation, which would nullify *Fujitsu* for taxpayers with open year statutes even predating that decision. Clearly, this is still an evolving issue, and interested parties should carefully watch the FTB's continuing efforts to limit *Fujitsu*, perhaps by adoption of a formal regulation, and perhaps on a retroactive basis. Interested parties may also wish to follow the *Appeal of Apple Computer* case, which is pending before the California State Board of Equalization and involves this ordering-of-dividends issue. ◆

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] *Id.* (bold original).

[37] The FTB filed with the California Supreme Court both a petition for review and a request for depublication of the *Fujitsu* court of appeal decision. The California Supreme Court denied both the petition for review and the request for depublication. (*Fujitsu IT Holdings Inc. v. Franchise Tax Board,* Oct. 20, 2004.)