State Income Tax Implications of the American Jobs Creation Act – Repatriation of Foreign Earnings

Jeffrey M. Vesely, Esq.
Pillsbury Winthrop Shaw Pittman LLP
P.O. Box 7880
San Francisco, CA 94120
(415) 983-1075
jeffrey.vesely@pillsburylaw.com

Kerne H. O. Matsubara, Esq.
Pillsbury Winthrop Shaw Pittman LLP
P.O. Box 7880
San Francisco, CA 94120
(415) 983-1233
kerne.matsubara@pillsburylaw.com

Annie H. Huang, Esq.
Pillsbury Winthrop Shaw Pittman LLP
P.O. Box 7880
San Francisco, CA 94120
(415) 983-1979
annie.huang@pillsburylaw.com

© Copyright 2005
Pillsbury Winthrop Shaw Pittman LLP
All Rights Reserved
STATE INCOME TAX IMPLICATIONS OF THE AMERICAN JOBS
CREATION ACT – REPATRIATION OF FOREIGN EARNINGS

I. Section 422 of the American Jobs Creation Act of 2004 (Public Law 108-357) (Act)

A. Temporary Dividends Received Deduction.
   1. Designed to stimulate economic growth.
   2. One-time 85 percent dividends received deduction for certain distributions from controlled foreign corporations (CFC).
      a. 5.25 percent effective federal income tax rate for the dividend.
   3. New Internal Revenue Code (IRC) Section 965 provides that taxpayers may elect to deduct 85 percent of the dividends received from a CFC either in their last year beginning before the enactment of the Act on October 22, 2004 (for calendar year taxpayers, their 2004 year) or their first tax year beginning after October 21, 2004.
   4. Deduction only applies to cash dividends.
      a. Amounts treated as dividends under IRC Sections 78, 367 or 1248 are not included.
   5. Limitations on the deduction.
      a. Dividends must be extraordinary.
         (1) Applies only to repatriations in excess of the taxpayer’s average repatriation level over three of the five most recent taxable years ending on or before June 30, 2003.
         (2) “Base-period average” is determined by disregarding highest-repatriation year and lowest-repatriation year.
         (3) United States shareholders that file a consolidated tax return are treated as one United States shareholder. All such shareholders are aggregated in determining the “base-period average,” as are all CFCs.
         (4) Deemed repatriations are included in the “base-period average.”
      b. Amount of dividends eligible for the deduction is limited to the greater of the following:
         (1) $500 million.
(2) Amount of earnings shown as permanently invested outside the United States on the taxpayer’s most recent financial statement as defined.

(3) If the applicable financial statement fails to show earnings permanently invested abroad, but does show a tax liability attributable to such earnings, the amount of the tax liability divided by 35 percent.

c. Dividends received must be invested in the United States under a domestic reinvestment plan previously approved by the taxpayer’s senior management.

(1) Permitted uses include, but are not limited to the following:

(a) Funding of worker hiring.

(b) Funding of worker training.

(c) Infrastructure.

(d) Research and development.

(e) Capital investment.

(f) Job retention.

(g) Job creation.

(2) Payment of executive compensation is not a permitted use.

6. Under the Act, expenses related to the portion of the dividend eligible for deduction are disallowed.

II. State Income/Franchise Tax Issues

A. Income Base Issues.

1. States which conform to IRC § 965.

   a. 85 percent dividends received deduction.

   b. Balance of dividends may be includible in income base.

   (1) Business/nonbusiness income issues.
c. What is the effect of other dividends received deduction statutes in these states?

d. Expense attribution under IRC § 965 will be applied.
    
    (1) What is the effect of other expense attribution statutes in these states?

2. Worldwide Combined Reporting States (California).

   a. If the payor is unitary with the payee and the earnings were generated in the unitary business, the dividend should be fully eliminated under California Revenue and Taxation Code (RTC) Section 25106.

   (1) Dividends from nonunitary earnings generally should be includible as nonbusiness income allocated to the commercial domicile of the payee.

   (a) In the past, the Franchise Tax Board (FTB) has taken the position that such dividends may be business income.

   (2) Can a dividends received deduction be taken under Farmer Brothers and RTC § 24402?

   (a) FTB current policy would not allow a deduction.

   b. If the payor is not unitary with the payee, the dividends will not be eliminated.

   (1) Will they be classified as business or nonbusiness income?

   (a) Note the permitted uses of the dividends.

   (b) Note the extraordinary distribution requirement under the Act.

3. Water’s Edge Combined Reporting States (California).

   a. If the payor is unitary with the payee and included in the water’s edge combined report, the dividend will be eliminated to the extent it is paid out of unitary earnings. (RTC § 25106)

   b. If the payor is outside the water’s edge group, a 75 percent dividends received deduction under RTC § 24411 should apply.
(1) Foreign investment interest offset under RTC § 24344 will be applied.

(2) Whether the balance of the dividend will be includible in net income will depend on its classification as business or nonbusiness income.

   a. Whether the dividend will be taxable depends on the following:
      (1) Does the payee have nexus with the taxing state?
      (2) Are there other applicable dividends received deduction statutes?
      (3) Is the dividend apportionable or allocable income?

B. Apportionment Formula Issues.

1. Sales Factor Treatment of Dividends.
   a. FTB Legal Ruling 2003-3.
      (1) Business income dividends are includible in the sales factor if the payee participates in the management and operations of the payor.
      (2) Where are the payee individuals located who participate in the management and operations of the payor?
         (a) The income-producing activity rules under Regulations 25137(c)(a)(C) and 25136 should be reviewed.
   b. FTB Proposed Amendments to Regulation 25106.5-1.
      (1) Deductible dividends includible in the sales factor while eliminated dividends are not to be included.
   c. Since the dividend is required to be “extraordinary” under IRC § 965, what is the effect of Regulation 25137(c)(1)(A)?

2. Factor Representation
   a. If the dividend is included in business income and constitutes a major portion of the unitary group’s business income, should a portion of the factors which generated the earnings from which
the dividend was paid be included in the apportionment formula?

III. Miscellaneous Issues

A. Does the domestic reinvestment requirement under IRC § 965 raise Commerce Clause issues?

B. Has the state conformed to new IRC § 965? Or has it decoupled? Or has it selectively conformed?

This material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matters.