Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Bermudez	Analyst:	Gail Hall	Bill Number:	AB 666
Related Bills:	See Legislative History	Telephone:	845-6111	Introduced Date:	February 17, 2005
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Dividend Deduction For Repatriated Dividends If Invested In California Property, Plant or Equipment

SUMMARY

This bill would allow a deduction for certain income received from foreign corporations.

PURPOSE OF THE BILL

Author's staff has indicated that the purpose of this bill is to encourage taxpayers to invest in California property, plant, and equipment.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2005.

POSITION

Pending.

ANALYSIS

FEDERAL LAW

Generally, income from a foreign subsidiary's operations conducted in a foreign country is excluded from federal taxable income. The foreign earnings are not included in federal taxable income until paid to the U.S. parent in the form of a dividend, in other words, repatriated. U.S. corporations receive no dividends-received deduction for dividends paid out of foreign earnings by foreign subsidiaries.

The federal American Jobs Creation Act (AJCA) of 2004 provides an 85% dividends-received deduction for repatriated cash dividends paid by a 10% or more owned foreign subsidiary to a U.S. parent corporation. The 85% deduction applies to the first taxable year beginning on or after October 22, 2004. Alternatively, the provision could be applied to the last taxable year beginning prior to October 22, 2004.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR		
_______ N	_______ OUA	_______ PENDING		

The deduction is available only for dividends that exceed the average level of dividends paid to the U.S. parent in three of the last five taxable years prior to the deduction. The U.S. parent company is not required to trace or segregate cash received from the repatriated dividends, but must demonstrate an amount equal to the repatriated dividends was invested under the domestic reinvestment plan. The domestic reinvestment plan is prepared by the company and provides details on how the repatriated dividends are to be invested in the U.S. This plan is approved by the CEO or president and board of directors.

A corporation elects to take the 85% dividends-deduction by attaching an election form or statement to the tax return. Information must be reported to the IRS annually regarding investments made under the plan.

STATE LAW

As a result of the decision in *Farmer Bros. Co v. Franchise Tax Board* (2003) 108 Cal App 4th 976, California no longer allows a general dividends-received deduction. There are, however, three California statutes that determine the amount of dividends included in California income.

1. Dividends paid from the earnings and profits that were included in the combined report used to determine California tax are completely eliminated from California taxable income.[1]

2. If a taxpayer's California tax is determined pursuant to a water's-edge election[2], a 75% deduction is allowed for dividends-received from certain foreign country subsidiaries.[3]

3. AB 263, enacted in 2004, provides an 80-85% deduction to the extent dividends are received by an 80% or more owned subsidiary engaged in the insurance business (conducts activities of a nature that they would be subject to the gross premiums tax in lieu of the corporation tax)[4].

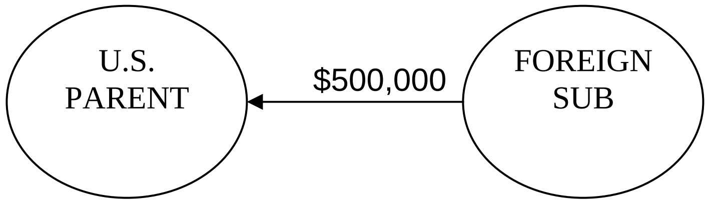
THIS BILL

This bill would allow a deduction equal to the federal dividends-received deduction for repatriated dividends paid by a foreign subsidiary to a U.S. parent if:

1. the dividend is invested in "qualified property" in California. "Qualified property" means tangible property used in a trade or business or held for the production of income.
2. the investment in "qualified property" is made within two years of the receipt of the dividend , and
3. the "qualified property" is not removed from California or disposed of within three years .

[1] R&TC Section 25106
[2] R&TC Section 25110
[3] R&TC Section 24411
[4] R&TC Section 24410

For example:



A U.S. parent corporation, located in California, receives a $500,000 dividend from a foreign subsidiary that qualifies for the federal dividends-received deduction. The parent invests $450,000 of the dividend in California equipment. This bill would allow a state deduction in the amount shown below:

Dividend Amount That Qualifies For Federal Deduction	$ 500,000
Allowable Federal Deduction Percentage	X 85%
Allowable Federal Dividends-Received Deduction	$ 425,000

This bill would allow a state deduction equal to $425,000. Even though the parent invested $450,000 in California, the amount of allowable state deduction is less than the amount of the deduction that is allowed for federal purposes.

If the U.S. parent takes this deduction on the California tax return:

1. no intercompany dividend elimination (R&TC section 25106) is allowed, and
2. no other dividend deduction is allowed (i.e., water's-edge dividend's-received deduction).

Under R&TC section 24425, expenses allocable to the dividend income may not be deducted on the California tax return if the dividend income they relate to is not included in taxable income.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would occur during the department's normal annual update.

BACKGROUND

Last year, Congress passed the AJCA of 2004 (H.R. 4520). One of the business incentive provisions of the bill allows an 85% deduction for certain income paid in the form of cash dividends from a foreign subsidiary to a domestic parent. Income earned from the trade or business of a foreign subsidiary is not included in federal taxable income until received by the U.S. parent in the form of a dividend. This provision was intended to encourage U.S. corporations to repatriate a significant amount of the business earnings that have been held overseas by foreign subsidiaries. Some have estimated the volume of earnings held abroad reaches $500 billion.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida – Foreign dividends repatriated to *Florida* are not included in taxable income.

Illinois – Foreign dividends repatriated to *Illinois* are included in taxable income. *Illinois* allows a 70% dividends-received deduction if the foreign corporation that paid the dividend is at least 10% owned.

Massachusetts – Foreign dividends repatriated to *Massachusetts* are included in taxable income. A dividends-received deduction equal to 95% is allowed if the taxpayer owns at least 15% of the voting stock of the corporation paying the dividend.

Michigan – Foreign dividends repatriated to *Michigan* are not included in taxable income.

Minnesota – Foreign dividends repatriated to *Minnesota* are included in taxable income. A corporation may take an 80% dividends-received deduction from dividends received from a corporation owned at least 20%, and 70% if owned less than 20%.

New York –Dividends received from foreign subsidiaries are fully deductible, but dividends received from foreign corporations other than subsidiaries, receive only a 50% dividend deduction.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 666 As Introduced 2/17/05 [$ In Millions]		
2005-06	2006-07	2007-08
-$10	-$1	No Impact

Revenue Discussion

The revenue impact of the bill would be determined by the amount of repatriated dividends invested in qualified property, as defined, in this state and the average tax rate of taxpayers making such investments.

There is a baseline revenue effect due to a provision in the AJCA of 2004 since corporations will be repatriating income to the U.S. Corporations that file on a water's-edge combined basis are required to report the income on their California tax returns (subject to a 75% foreign dividend deduction) and pay tax on that income. It is estimated that the baseline revenue effects to California are gains of $210 million and $15 million in 2004-05 and 2005-06, respectively, with no impact in 2006-07 and loss of $10 million in 2007-08.

This bill would increase the dividend deduction for water's-edge foreign corporations from 75 percent to 85 percent (a 10 percentage point increase in the deduction). This deduction would then be subtracted from dividend income and the remainder would be apportioned to California.

For this bill, it was estimated that corporations with repatriated dividends would invest about $15 billion in qualified California property in the two years following the repatriation. It was further estimated that about 60% of this investment would be made by corporations filing water's-edge combined reports. It was assumed that taxpayers would be able to exercise considerable latitude in showing that the investment was related to funds repatriated. As specified in the bill, this estimate incorporated investment made by corporations over two years. Multiplying the qualified investment by the additional 10 percent deduction percentage by the average apportionment factor for water's-edge corporations of 13.4 percent, we calculate a decrease in California net income for these corporations of about $120 million. Multiplying the $120 million by the 8.84% corporate tax rate yields the final revenue cost of $11 million. It is assumed that this revenue cost would be spread out over two years: $10 million in 2005/06, and $1 million in 2006/07.

Taking into account direct behavioral changes, but not indirect dynamic effects, we estimate that this bill would result in a $23 million increase in investment in qualified California property.

LEGAL IMPACT

This bill contains provisions that would target certain investment incentives to California. The U.S. Court of Appeals for the 6th Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738 that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. Ohio is seeking review by the U.S. Supreme Court. Although the outcome of this decision and its affects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

LEGISLATIVE STAFF CONTACT

Gail Hall	Brian Putler
Franchise Tax Board	Franchise Tax Board
845-6111	845-6333
gail.hall@ftb.ca.gov	brian.putler@ftb.ca.gov