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CHAPTER 13... FOREIGN DIVIDEND DEDUCTION

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13.1 INTRODUCTION

Revenue and Taxation Code (RTC) §24411 allows taxpayers, which have elected to compute their income on a water's-edge basis, a deduction with respect to certain qualifying dividends.

In a worldwide combined report setting, any dividend that flows from a subsidiary to a parent, where both are included in the combined report, is eliminated as an intercompany dividend, pursuant to RTC §25106. In a water's-edge combined report setting, a United States (US) parent corporation must generally report as income any dividend received from its foreign subsidiary that is excluded from the water's-edge combined report. If the US parent receives a dividend, since its foreign subsidiary is excluded from the water's-edge group, the dividend would not be eliminated as an intercompany dividend. In addition, no apportionment factors corresponding to the subsidiary would be included in the apportionment formula.

A foreign parent corporation, on the other hand, generally may exclude all of its foreign source income. Although it may receive dividends from subsidiaries not included in the water's-edge combined report, the income would generally not be considered by California since the foreign parent corporation and the dividend payers are excluded from the water's-edge group.

Therefore, when the water's-edge legislation was being developed, US parent corporations argued that such dividends were "foreign source" income, and that their inclusion in the combined report effectively would tax the operations of their foreign subsidiaries. Therefore, RTC §24411 was intended to offer relief to domestic parent corporations for this perceived inequity.

For taxable years beginning before January 1, 1996, the Foreign Dividend Deduction computation rules required the calculation of base period amounts and foreign payroll factors to determine the amount of allowable deduction. The deduction started with 75 percent, and was then adjusted up or down dependent on certain factors (e.g., current year information, the base period amounts and the foreign payroll factor.) These somewhat complicated calculation rules have since been repealed. (Note dividends resulting from specified construction projects received a 100 percent deduction.)

In 1996, legislation (Senate Bill (SB) 38, Stats. 1996, Ch. 954) was enacted that simplified the computation of the RTC §24411 Foreign Dividend Deduction.

Effective for taxable years beginning on or after January 1, 1996, RTC §24411 allows a 75 percent deduction for qualifying dividends received. (Dividends resulting from specified construction projects continue to receive a 100 percent deduction.)

13.2 DEFINITIONS

a. Corporation
b. Qualifying Dividends
c. Factors Within The US
d. Water's-Edge Group
e. Specified Construction Project

a. Corporation

The term "corporation" applies to all corporations, other than corporations specifically exempted by the RTC or the California Constitution. (RTC §23038.) For taxable years beginning on or after January 1, 1998, the term "corporation" was amended and expanded to include banks. (Assembly Bill (AB) 1040, Ch 605, Stats. 1997.)

b. Qualifying Dividends

Per RTC §24411(a) and California Code of Regulations (CCR) §24411(b)(1)(A), current year qualifying dividends are those dividends received by any member of the **current year's** water's-edge group that are paid from a corporation (regardless of its place of incorporation) that has both:

1. An average property, payroll and sales factor within the US that is less than 20 percent.

2. More than 50 percent of its total voting stock owned, directly or indirectly, by the receiving water's-edge group at the time the dividend is received.

Qualifying dividends also include dividends that are classified as nonbusiness dividends, pursuant to RTC §25120. (See Chapter 13.3, section (b), of the Water's-Edge Manual.)

The dividend payor need not be unitary with the recipient of the dividend nor any other member of the water's-edge group. (CCR §24411(b)(1)(A).) There is no requirement that the dividend payor be a foreign corporation. (Item #1 above only limits US activity. It does not require that the dividend payor be incorporated in a foreign country.) A dividend paid by an excluded controlled US possessions corporation may be a qualifying dividend. It is unlikely, however, that dividends paid by other US corporations will qualify since the payor's average property, payroll and sales factors within the US must be less than 20 percent.

Note that RTC §24411 states that the dividend must be received from a corporation, as described in section a above. Thus, dividends can be received from a corporation or a bank, and qualify for the deduction. (CCR §24411(b)(1)(B).) However, **for taxable years beginning before January 1, 1998,** a dividend received from a bank could not be a qualifying dividend. (Off code language of SB 519 (Ch. 7, Stats. 1998), Section 45, states, "For purposes of the definition of 'qualifying dividends' in subdivision (a) of Section 24411 of the Revenue and Taxation Code, the term 'corporation' shall include banks only for taxable years beginning on or after January 1, 1998.")

In summary, the following requirements are necessary to qualify as an RTC §24411 qualifying dividend. The dividend payor:

- Must have less than 20 percent average of property, payroll and sales factors in the US. (RTC §24411(a)(1).)
- Must be owned over 50 percent by members of the water's-edge group. (RTC §24411(a)(2).)
- May or may not be incorporated in the US.
- May or may not be unitary with member receiving the dividend. (CCR §24411(b)(1)(A).)

Example 1:

Corporation A owns 100% of Corporation B, which owns 100% of Corporation C. Corporation C pays Corporation B dividends in 2002 of $120,000. The dividend is paid out of current earnings and profits (E&P). Corporations A, B and C are engaged in a unitary business. Corporations A and B file a combined report, making the water's-edge election effective January 1, 2002. Corporation C is incorporated outside of the US, does no business in the US, and was excluded from the water's-edge group since its average property, payroll and sales factor was below 20%. The dividends of $120,000 paid to Corporation B are qualifying dividends.

Example 2:

Further assume that Corporation C, in Example 1 above, owns 100% of Corporation D, which is also unitary with Corporations B and C. Corporation D is also incorporated outside of the US, and does no business in the US. The water's-edge election encompasses only Corporations A and B; Corporations C and D are properly excluded.

In 2003, the following distributions, all paid out current year E&P, are made:

- Corporation D pays dividends of $50,000 to Corporation C
- Corporation C pays dividends of $100,000 to Corporation B
- Corporation B pays dividends of $125,000 to Corporation A

The dividends paid to Corporation A from Corporation B are eliminated pursuant to RTC §25106, as intercompany dividends paid from unitary income. The dividends paid to Corporation B are considered qualifying dividends. Lastly, the dividends paid to Corporation C are not considered qualifying dividends since Corporation C is not a current member of the water's-edge group. (With Corporation C's proper exclusion, the $50,000 of dividends are not included in the water's-edge combined report.)

Summary of Example 2:

Unitary Business:	**Treatment:**
Domestic to Domestic: Dividends Paid: B to A - $125,000	Eliminated under RTC §25106
Foreign to Domestic (W/E in effect): Dividends Paid: C to B - $100,000	Qualified Dividend under RTC §24411
Foreign to Foreign (not included in W/E group): Dividends Paid: D to C - $50,000	Not considered, not qualifying

c. Factors Within The US

One of the requirements for a qualifying dividend is that the corporate payor must have less than 20 percent average of property, payroll and sales factors within the US. (RTC §24411(a)(1).) Property, payroll and sales are generally computed pursuant to the rules of each of the individual states. Each corporation will compute the percentage calculated for each factor under the rules of each of the individual states. (CCR §25110(d)(2)(B)(3).) See Chapter 2, Water's-Edge Manual for additional information on how to determine if an entity, either foreign or domestic, has 20 percent or more of its activity in the US.

d. Water's-Edge Group

The water's-edge group, for purposes of RTC §24411, is comprised of all corporations includible in the combined report, as determined pursuant to RTC §25110, for the applicable taxable year. This is relevant; a *current year* member of the water's-edge group must receive the dividend for that dividend to be considered for the Foreign Dividend Deduction.

e. Specified Construction Project

A "specified construction project" means an activity that meets both of these requirements:

- Is undertaken for any entity, including a governmental entity, which is not affiliated with the water's-edge group.
- The majority of the cost of performance of which is attributable to an addition to real property or to an alteration of land or any improvement thereto.

A specified construction project does not include the operation, rental, leasing, or depletion of real property, land or any improvements thereto. (RTC §24411(c); CCR §24411(d).)

13.3 FOREIGN DIVIDEND DEDUCTION

a. In General

For taxable years beginning on or after January 1, 1996, the RTC §24411 Foreign Dividend Deduction is:

1. 75 percent of qualifying dividends
2. 100 percent of qualifying dividends from specified construction projects

The Foreign Dividend Deduction is a deduction in the State Adjustment section of the California Corporation Franchise or Income Tax Return – Water's-Edge Filers, Form 100W. It is computed on California Schedule H (100W), Dividend Income Deduction – Water's-Edge Filers, Part II.

If dividends received by the current year members of the water's-edge group are considered qualifying dividends, RTC §24411(a) allows a 75 percent Foreign Dividend Deduction. The computation is performed on a group basis. Once you determine which dividends are qualifying dividends for the group, the computation of the Foreign Dividend Deduction is straightforward. The deduction is 75 percent of those total qualifying dividends.

Example 3:

> The taxpayer received $100,000 in qualifying dividends in 2002. The taxpayer is entitled to a RTC §24411 Foreign Dividend Deduction in the amount of $75,000 (75% of $100,000.)

A Foreign Dividend Deduction is also allowed in the amount of 100 percent for qualifying dividends derived from specified construction projects, the locations of which are not subject to the control of the taxpayer. (RTC §24411(c); CCR §24411(d)(1).) Dividends from specified construction projects are not common.

Note for **taxable years beginning before January 1, 1996,** the Foreign Dividend Deduction computation rules required the calculation of base period amounts and foreign payroll factors to determine the amount of allowable deduction. The deduction started with 75 percent, and was then adjusted up or down dependent on certain factors (e.g., current year information, the base period amounts and the foreign payroll factor.) These somewhat complicated calculation rules (with base period computations) have since been repealed. In 1996, legislation (Senate Bill (SB) 38, Stats. 1996, Ch. 954) was enacted that simplified the computation of the RTC §24411(a) Foreign Dividend Deduction.

Effective for taxable years beginning on or after January 1, 1996, RTC §24411(a) allows a 75 percent deduction for qualifying dividends received. (Dividends resulting from specified construction projects continue to receive a 100 percent deduction.)

Those dividends receiving the 75 percent Foreign Dividend Deduction are also referred to as partially deductible qualifying dividends. This should not be confused with a qualifying dividend received from a Controlled Foreign Corporation (CFC) that is partially included in (and partially excluded from) the water's-edge combined report.

The RTC §24411(a) Foreign Dividend Deduction should be reported as a deduction in the State Adjustment section of the California Corporation Franchise or Income Tax Return – Water's-Edge Filers, Form 100W, and appear on Schedule H (100W), Dividend Income Deduction – Water's-Edge Filers, Part II. If a RTC §24411 Foreign Dividend Deduction appears on the Schedule H (100W), but not shown on the "Foreign Dividend Deduction" line, the deduction may be in the State Adjustment section categorized under "other dividends," "other deductions" or some other description.

Any intercompany dividends received within the current year's water's-edge group are eliminated pursuant to RTC §25106 before computing the Foreign Dividend Deduction. Thus, the qualifying portion of the dividends paid by the excluded or partially included CFCs is usually the difference between the dividend included in the water's-edge combined report, less the intercompany portion.

Before computing a RTC §24411 deduction, consider:

- Reconciling total dividend income per the California Form 100W to the Schedule H (100W), to the federal Form 1120, Schedule C, and to books and records. Also consider previously taxed dividends that may have been excluded on the Schedule M-1 for federal purposes.
- Analyzing dividend income by summarizing the payors and payees, and the ownership structure of the payors and payees.
- Analyzing E&P layers and which distributions came from which layers.
- Determining the source (payor) of dividend distributions.
- Determining or verifying whether the distribution qualifies as a dividend, is an intercompany dividend, qualifies as a RTC §24411 dividend or other.

b. Business And Nonbusiness Dividends

When determining the Foreign Dividend Deduction, both business and nonbusiness dividends can qualify for the Foreign Dividend Deduction. (CCR §24411(b)(1)(A).) Once the total deduction is determined, the allowable business Foreign Dividend Deduction is determined by multiplying the total Foreign Dividend Deduction (business and nonbusiness) by the ratio of business qualifying dividends to total qualifying dividends. The remainder of the deduction is the nonbusiness Foreign Dividend Deduction.

Example 4:

> Corporation F had business qualifying dividends of $14,000 and nonbusiness qualifying dividends of $3,000. Corporation F computed its allowable RTC §24411(a) Foreign Dividend Deduction to be $12,750. The RTC §24411 business Foreign Dividend Deduction is $10,500 [$12,750 x ($14,000/$17,000)], while the RTC §24411 nonbusiness Foreign Dividend Deduction is $2,250 ($12,750 - $10,500.)

c. Distribution Classifications

CCR §24411(e) provides that for purposes of determining the application of RTC §§24402, 24410, 24411 and 25106, dividends are considered paid out of the current year's E&P, to the extent thereof, and from the most recently accumulated E&P by year thereafter. This layering position was challenged in *Fujitsu IT Holdings, Inc. v. Franchise Tax Board* (2004) 120 Cal.App.4th 459 *(Fujitsu.)* FTB continues to treat dividends as being paid first from the current year E&P until those earnings are exhausted, and then from the next succeeding prior year. See Technical Advise Memorandum 2005-1. In 2006, the State Board of Equalization sustained FTB's last-in, first-out layering position in the *Appeal of Apple Computer, Inc.*, 2006-SBE-002, November 20, 2006. This layering position is contrary to *Fujitsu*, but FTB has prepared proposed amendments to CCR §§24411 and 25106.5-1 to provide clarity with respect to this issue. Taxpayers that disagree with FTB's treatment of this distribution layering can protect their rights by filing a protest, appeal or claim for refund.

A RTC §24411(a) Foreign Dividend Deduction is not allowed with respect to a dividend for which a deduction was allowed under RTC §24410, RTC §24402, or which was eliminated under RTC §25106.

RTC §24410 was repealed and re-enacted to allow a "Dividends Received Deduction" of qualified dividends received from an insurer subsidiary. The deduction is allowed whether or not the insurer is engaged in business in California, if at the time of each payment at least 80 percent of each class of stock of the insurer was owned by the corporation receiving the dividend. For taxable years beginning on or after January 1, 2004, and before January 1, 2008, an 80 percent deduction is allowed for qualified dividends. For taxable years beginning on or after January 1, 2008, the deduction is increased to 85 percent.

See Chapter 11, Water's-Edge Manual, for a discussion of E&P, and the ordering of applicable code sections pertaining to dividend rules.

d. Intercompany Eliminations And Prorations

Dividends, paid out of earnings previously included in the combined unitary income, are eliminated 100 percent under RTC §25106. This elimination applies only to "intercompany dividends" that are paid out of apportionable business income that was included in a combined report of the dividend payor and payee. In determining whether a dividend is paid out of combined business income, dividends are deemed to be paid first out of current year E&P, and then out of prior year's accumulation in reverse order of accumulation. A thorough analysis of E&P is included in Chapter 11, Water's-Edge Manual. (Also see the *Appeal of Willamette Industries, Inc*., 89-SBE-008, March 2, 1989, *opinion on rehearing* 89-SBE-008-A, August 2, 1989.)

Intercompany dividends are eliminated 100 percent under RTC §25106, while the RTC §24411 Foreign Dividend Deduction is 75 percent. The benefit of the RTC §24411 Foreign Dividend Deduction may be reduced due to the Foreign Investment Interest Offset calculated under RTC §24344(c). Therefore, a misclassification as an intercompany dividend under RTC §25106, rather than a qualifying dividend under RTC §24411, can be significant. See Chapter 14, Water's-Edge Manual, for a detailed discussion of the RTC §24344(c) Foreign Investment Interest Offset provisions.

When a dividend is distributed from a pool of E&P of a year that is comprised of both included and excluded income, a proration is required. Dividends must be prorated between the included and excluded E&P from the same year (layer) for purposes of computing the deductions under RTC §§25106 and 24411. This would be the case when a CFC makes a dividend distribution out of the year it is partially included in a water's-edge combined report.

When a CFC owns another CFC, the result in the corporate structure is referred to as "multi-tiered CFCs." For a discussion of the treatment of a distribution from a lower-tiered CFC to a higher-tiered CFC, see Chapter 2, Water's-Edge Manual, Section 2.3.f Multi-Tiered CFCs And IRC §959(b).

e. Gross-Up of Foreign Taxes

IRC §78 provides that dividends received from foreign affiliates are "grossed-up" to include income taxes paid on the dividends to foreign countries. The taxpayer can then apply the grossed-up amount in computing its foreign tax credit for federal purposes. The RTC contains no comparable provisions to the IRC §78 gross-up or to the foreign tax credit provided by IRC §902. The amount of gross-up is a separately stated item in the federal Form 1120, Schedule C. Qualified dividends do not include IRC §78 amounts. (CCR §24411(b)(1)(C).)

For California purposes, the IRC §78 gross-up is excluded from the combined report. This item should appear as a deduction in the State Adjustment section of the California Corporation Franchise or Income Tax Return – Water's-Edge Filers, Form 100W. This IRC §78 gross-up amount should be excluded from the taxable income of the water's-edge group, and qualifying dividends.

f. IRC §1248

Pursuant to IRC §1248(a), the gains resulting from the sale of stock in a CFC is treated as a dividend to the extent of post-1962 E&P of that subsidiary, and any lower-tier foreign subsidiaries, attributable to that period, and to the extent of the shareholder's percentage of ownership of the sold foreign affiliate. Thus, for federal purposes, these gains, classified as deemed dividends, may allow the seller to claim an indirect foreign tax credit pursuant to IRC §902 for foreign taxes paid or accrued by the foreign affiliate on the earnings included as a dividend.

The RTC contains no comparable provision to IRC §1248. Thus, for California purposes, the transaction should be treated as a gain on the sale of stock. The transaction should not be treated as an intercompany dividend and eliminated pursuant to RTC §25106. The IRC §1248 amount should be excluded from qualifying dividends. (CCR §24411(b)(1)(C).)

g. Foreign Investment Interest Offset

Consideration should be given to the effect of a water's-edge election on the treatment of nonbusiness dividends, and in particular to the interplay with the interest offset provisions. RTC §24344(b) does not apply to dividends deducted pursuant to RTC §24411. (The US Supreme Court held RTC §24344(b) unconstitutional in *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000).) However, the Foreign Investment Interest Offset provisions of RTC §24344(c) continue to be valid and are applicable to foreign dividends deducted pursuant to RTC §24411. See Chapter 14, Water's-Edge Manual, for a detailed discussion of the RTC §24344(c) Foreign Investment Interest Offset provisions.

If current members of the water's-edge group are entitled to a RTC §24411 Foreign Dividend Deduction, then they may also have interest expense. The RTC §24411 Foreign Dividend Deduction must be computed and finalized before the RTC §24344(c) Foreign Investment Interest Offset can be computed.

h. S Corporations

S corporations are generally precluded, pursuant to RTC §23801(d), from being included in a combined report. However, an S corporation can make a water's-edge election. The S corporation would include 100 percent of their income on their tax return. In addition, an S corporation may own CFCs. However, under RTC §23801(d), the CFCs cannot file on a combined basis with the S corporation. If an S corporation receives dividends from a CFC, then the standard rules for dividend treatment for a water's-edge taxpayer applies. The dividends paid by the CFC to the S corporation parent can qualify, and would be included in the Foreign Dividend Deduction computation under RTC §24411. See Chapter 2, Water's-Edge Manual for a more detailed discussion of the effects of a water's-edge election on S corporations.