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LEGAL RULING 2005-02

SUBJECT: BUSINESS OR NONBUSINESS CHARACTERIZATION OF INCOME EARNED WITH RESPECT TO CASH DIVIDENDS, PENDING THEIR DOMESTIC REINVESTMENT UNDER SECTION 965 OF THE INTERNAL REVENUE CODE

ISSUE

When is income that is earned on Internal Revenue Code (hereinafter "I.R.C.") section 965 cash dividends, pending the domestic reinvestment of those cash dividends under I.R.C. section 965, properly characterized as apportionable business income?

FACTS

Company A is a U.S. corporation that manufactures and sells widgets. A owns ten percent or more of Company B, a controlled foreign corporation¹. B issues dividends to Company A. According to A's written domestic reinvestment plan under I.R.C. section 965, A plans to use the dividend proceeds to acquire another company that manufactures widgets. After A receives the dividends from B, A places them in an investment account, pending acquisition of the target company.

BACKGROUND

In general, the I.R.C. taxes U.S. shareholders of foreign corporations on the entire amount of dividends received from foreign corporations, but only to the extent that the earnings and profits of the foreign corporations are derived from foreign source income. As a result, U.S. shareholders have had an incentive to have foreign source earnings and profits in such corporations remain undistributed.

On October 22, 2004, as part of the American Jobs Creation Act of 2004 (P.L. 108-357), Congress enacted I.R.C. section 965 to provide U.S. companies with a temporary incentive to repatriate to the United States any earnings held by foreign subsidiaries. (See I.R.S. Notice

¹ A controlled foreign corporation is a foreign corporation more than 50% of whose stock (by vote or value) is owned (directly or indirectly) by U.S. shareholders who each own (directly or indirectly) 10% or more of such corporation. (I.R.C. §§ 957(a) and 951(b).)

2005-10, 2005-6 I.R.B. 474.) I.R.C. section 965 provides that U.S. companies may elect, for one taxable year, to deduct 85 percent of the dividends they receive from controlled foreign corporations, but only if they meet certain requirements. Those requirements include that dividends be paid in cash, and that the U.S. shareholders must invest the proceeds from the dividends in the United States. The I.R.C. section 965 dividend proceeds do not need to be segregated or traced, and they do not need to be applied to a permitted U.S. investment within a specific time. However, I.R.C. section 965 places limitations on what constitutes a permitted investment within the United States, and the dividends must be invested pursuant to a domestic reinvestment plan approved by company management. This plan must be written and state in reasonable detail and specificity the amounts of the anticipated investments in the United States. (*Ibid.*)

The Internal Revenue Service has issued guidance on the types of investments within the U.S. that would qualify under I.R.C. section 965 for the 85-percent foreign dividends received deduction. Under those guidelines, the U.S. investments permitted by I.R.C. section 965 include:

- Hiring and training workers
- Infrastructure and capital investments
- Research and development
- Financial stabilization for the purposes of U.S. job retention or creation (this would include debt repayment and the funding of qualified benefit plan obligations)
- Certain acquisitions of business entities with U.S. assets
- Advertising and marketing
- Acquisition of rights to intangible property, such as patent rights.

Expenditures that are not permitted under I.R.C. section 965 include:

- Executive compensation
- Intercompany transactions
- Dividends and other shareholder distributions
- Stock redemptions
- Portfolio investments
- Debt instruments
- Tax payments

(I.R.S. Notice 2005-10, *supra.*)

California has not conformed to I.R.C. section 965. Dividends may, however, be eliminated or deducted from California net income under different provisions, including Revenue and Taxation Code (hereinafter "RTC") sections 25106, 24410 and 24411.

I.R.C. section 965 does not affect the characterization of dividends as business or nonbusiness income. That characterization is governed by RTC section 25120 and California

Code of Regulations, title 18, section 25120, subsection (c)(4). (See also *Appeal of Standard Oil Company of California*, 83-SBE-068, March 2, 1983.) However, the requirement under I.R.C. section 965 that the dividends be used in certain types of investments may affect the characterization of any possible income earned on the dividends after such dividends are paid, pending their use in a qualified investment under I.R.C. section 965.

LAW AND ANALYSIS

RTC section 25120, subdivision (a), provides:

"Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

This definition provides two alternate tests: the transactional test and the functional test. (*Hoechst Celanese Corp. v. Franchise Tax Board* (2001) 25 Cal.4th 508, 520.) The transactional test focuses on the transactions and activity generating the income and their relationship to the regular course of the taxpayer's trade or business. In contrast, the functional test focuses on "property" and its relationship to the taxpayer's regular trade or business operations. (*Hoechst Celanese, supra*, 25 Cal.4th at p. 521.) In other words, the functional test focuses on whether the property serves an operational function in the trade or business. (*Id.* at p. 539, citing *Allied-Signal, Inc. v. Director, Div. of Taxation* (1992) 504 U.S. 768, and also citing *Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159.)

Whether earnings from the interim investment of proceeds from dividends repatriated under I.R.C. section 965 constitute apportionable business income depends on the function that the funds repatriated serve in the taxpayer's unitary trade or business. As the California State Board of Equalization ("SBE") has explained, "[i]f the funds are earmarked for a unitary business use, business income may be generated." (*Appeal of Consolidated Freightways, Inc.*, 2000-SBE-001, Sept. 14, 2000. See also Legal Ruling 98-5, holding that income from the investment of liquid funds constitutes business income if the funds have been identified for a future business need.) By the same token, if the repatriated funds are earmarked for a nonbusiness function, or are earmarked for a line of business separate from the taxpayer's unitary trade or business, any income earned on those funds would not constitute business income apportionable to the unitary trade or business.

The investments permitted under I.R.C. section 965 may or may not serve an operational business function in a taxpayer's unitary trade or business. For example, hiring and training workers in the U.S to qualify under I.R.C. section 965 would serve an operational function for the trade or business, and constitute earmarking for a specific business use for apportionment purposes, as long as the U.S. corporation that receives the dividends is not using the funds to hire and train workers for a separate, non-unitary line of business, or to manage a nonbusiness investment. Likewise, earmarking funds for infrastructure and capital improvements to

enhance the unitary business would constitute earmarking for a specific business use only if the infrastructure and capital improvements at issue are not for a separate, non-unitary line of business, or for a nonbusiness passive investment.

In the case of earmarking for financial stabilization, the relevant consideration would be how that financial stabilization is to be accomplished. For example, if under the domestic reinvestment plan the financial stabilization is to be accomplished through debt repayment, the business/nonbusiness characterization of the earmarking depends on the business or nonbusiness character of the debt that is to be repaid with the I.R.C. section 965 dividends. (*Appeal of DPF Inc.*, 80-SBE-113, Oct. 28, 1980.) If the debt to be repaid under the domestic reinvestment plan was incurred solely to acquire a non-unitary or nonbusiness asset, then the debt repayment would not serve a business or operational function for the unitary business. Therefore, the income earned on the repatriated dividends would not be treated as business income under RTC section 25120.

With respect to the acquisition of business entities as permitted under I.R.C. section 965, the analysis as to whether the earnings on the funds pending investment are business or nonbusiness is similar. As long as the dividends are earmarked for a specific business use of the unitary business, the earnings on their interim investment, pending implementation of the domestic reinvestment plan, would constitute business income. In *Appeal of Consolidated Freightways, Inc.*, *supra*, the SBE held that the taxpayer's earnings on certain liquid funds constituted business income because the taxpayer, a freight transportation company, had earmarked the funds for a specific business use: the acquisition of another freight transportation company. That was consistent, the SBE explained, with its holding in an earlier case, *Appeal of Cullinet Software, Inc.*, 95-SBE-002, May 4, 1995, in which a software company had raised funds to acquire other software companies. (*Appeal of Consolidated Freightways, Inc.*, *supra*.) As a result, an I.R.C. section 965 "domestic reinvestment plan" will constitute evidence of a taxpayer's earmarking for California purposes. That is, if the plan specifies that the taxpayer intends to use the repatriated dividends to acquire a business entity in the same line of business as the taxpayer's unitary trade or business, the earnings on the interim investment of I.R.C. section 965 dividends will constitute apportionable business income to the unitary trade or business.²

HOLDING

I.R.C. section 965 affects the business characterization of income in California only to the extent that dividends are not immediately reinvested and generate income while waiting to be reinvested (e.g., if under the reinvestment plan the reinvestment would take some time). In that case, the earmarking of the I.R.C. section 965 dividends for a particular purpose would

² In general, taxpayers should document the earmarking of any amounts they need for specific business needs, even if they relate to planned expenditures outside the U.S. Although the latter expenditures would not qualify the original dividends for the I.R.C. section 965 deduction, they can be used to determine whether the earmarked funds produced apportionable business income.

control the characterization of income arising from those dividends. The earmarking would be evidenced by the plan of reinvestment.

Company A's domestic reinvestment plan specifies that A, a widget manufacturer and seller, intends to use its dividends from B to acquire another company in the widget manufacturing business. Therefore, any earnings from the interim investment of the I.R.C. section 965 dividends, pending A's acquisition of the target company, would constitute business income.

If A's domestic reinvestment plan did not specify whether A is planning to acquire a company in the same line of business, then the domestic reinvestment plan, without more, would not be sufficient evidence of earmarking for a finding that earnings from the interim investment of the dividends constituted apportionable business income.

DRAFTING INFORMATION

The principal author of this ruling is Andrea H. Chang of the Franchise Tax Board, Legal Department. For further information regarding this ruling, contact Ms. Chang at the Franchise Tax Board, Legal Department, P.O. Box 1720, Rancho Cordova, CA 95741-1720.