

Chapter 9 Foreign Dividend Deduction

Contents:

- 9.1 Introduction
- 9.2 Definitions
- 9.3 Foreign Dividend Deduction

9.1 Introduction

California generally incorporates, "except as otherwise provided," the provisions of the Internal Revenue Code (IRC) §§301-385, which relate to corporate distributions and adjustments. (Revenue and Taxation Code (R&TC) §24451.)

R&TC §24411 allows taxpayers, which have elected to compute their income on a water's-edge basis, a deduction with respect to certain qualifying foreign 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 R&TC §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 from an excluded foreign subsidiary, the dividend would not be eliminated as an intercompany dividend.

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 payors 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, R&TC §24411 was intended to offer relief to domestic parent corporations for this perceived inequity.

R&TC §24411 allows:

- 75 percent deduction for qualifying dividends received

- 100 percent deduction for qualifying dividends derived from construction projects

9.2 Definitions

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

a. Corporation

The term "corporation" applies to all corporations, other than corporations specifically exempted by the R&TC or the California Constitution. (R&TC §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 R&TC §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 R&TC §25120.

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.) 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.

In summary, the following requirements are necessary to qualify under R&TC §24411:

The dividend payor:

- Must have less than 20 percent average of property, payroll, and sales factors in the US. (R&TC §24411(a)(1).)
- Must be owned over 50 percent by members of the water's-edge group. (R&TC §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

Corp A owns 100% of Corp B. Corp B owns 100% of Foreign Corp C. Foreign Corp C pays Corp B dividends in 2009 of \$120,000. The dividend is paid out of current year earnings and profits (E&P). Corp A, B and C are engaged in a unitary business. Corp A and B file a water's-edge combined report excluding all income and apportionment factors of Foreign Corp C. Foreign Corp C does not have more than 20 percent average property, payroll, and sales factor within the United States. The \$120,000 dividends paid to Corp B are qualifying dividends.

Example 2

Assume Foreign Corp C, in Example 1 above, owns 100 percent of Foreign Corp D, which is also unitary with Corp A, B, and Foreign Corp C. Foreign Corp D does not have more than 20 percent average property, payroll, and sales factor in the United States. The water's-edge combined report includes Corp A and B; Foreign Corp C and D's income and apportionment factors are excluded.

In 2010, the following distributions, all paid out current year E&P, are made:

- Foreign Corp D pays dividends of \$50,000 to Foreign Corp C
- Foreign Corp C pays dividends of \$100,000 to Corp B
- Corp B pays dividends of \$125,000 to Corp A

The dividends paid to Corp A from Corp B are eliminated pursuant to R&TC §25106, as intercompany dividends paid from unitary income. The dividends paid to Corp B from Foreign Corp C are considered qualifying dividends. Lastly, the dividends paid to Foreign Corp C from Foreign Corp D are not considered qualifying dividends because Foreign Corp C is not a

current member of the water's-edge group. (Please note that, 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	Intercompany Elimination under R&TC §25106
Foreign to Domestic (W/E in effect): Dividends Paid: C to B - \$100,000	Qualifying Dividend under R&TC §24411
Foreign to Foreign (not included in W/E group): Dividends Paid: D to C - \$50,000	Not Included, not a qualifying dividend

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. (R&TC §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 WEM 2 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 R&TC §24411, means all banks, corporations or other entities whose income and apportionment factors are considered pursuant to R&TC §25110 in computing the income of the individual taxpayer for the current taxable year which is derived from or attributable to sources within this state. (CCR §24411(b)(3).)

e. Construction Project

The deduction in the amount of 100 percent is allowed for qualifying dividends derived from construction projects, the location of which are not subject to the control of the taxpayer. A "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 construction project does not include the operation, rental, leasing, or depletion of real property, land or any improvements thereto. (R&TC §24411(c); CCR §24411(d).)

9.3 Foreign Dividend Deduction

- a. In General
- b. Business and Nonbusiness Dividends
- c. Distribution Classifications
- d. Intercompany Eliminations and Prorations
- e. Gross-Up of Foreign Taxes
- f. IRC §1248
- g. Foreign Investment Interest Offset
- h. S Corporations

a. In General

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.

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. For most taxpayers, the deduction is 75 percent of those total qualifying dividends.

Example 3

The taxpayer received \$100,000 in qualifying dividends in 2012. The taxpayer is entitled to a R&TC §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 construction projects, the locations of which are not subject to the control of the taxpayer. (R&TC §24411(c); CCR §24411(d)(1).) Dividends from specified construction projects are not common.

The R&TC §24411(a) foreign dividend deduction is 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 appears on Schedule H (100W), Dividend Income Deduction – Water’s-Edge Filers, Part II. If a R&TC §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 R&TC §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 dividends included in the water's-edge combined report, less the intercompany portion.

Before computing a R&TC §24411 deduction:

- Reconcile 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 or Schedule M-3 for federal purposes.
- Analyze dividend income by summarizing the payors and payees, and the ownership structure of the payors and payees.
- Analyze E&P layers and which distributions came from which layers.
- Determine the source (payor) of dividend distributions.
- Determine or verify whether the distribution qualifies as a dividend, is an intercompany dividend, qualifies as a R&TC §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 R&TC §24411(a) foreign dividend deduction to be \$12,750. The R&TC §24411 business foreign dividend deduction is \$10,500 [$\$12,750 \times (\$14,000/\$17,000)$], while the R&TC §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 R&TC §§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. 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 Advice 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.

SBE agreed with the FTB's LIFO and proration approaches. SBE concluded, in pertinent parts:

...to the extent a CFC pays dividends from a year in which it is partially included in the water's-edge combined report, those dividends are deemed paid from included income and excluded income in the ratio that included and excluded income bear to total income.

Apple, Inc. filed suit for refund in San Francisco Superior Court after the SBE's decision in *Appeal of Apple*, supra. The Superior Court sided with FTB on the LIFO ordering issue. Apple's litigation ended in 2012 after the California Supreme Court denied petition for review. (*Apple, Inc. v. Franchise Tax Board* (2011) 132 Cal.Rptr.3d 401; petition for review denied, January 4, 2012.)

The Court of Appeal's decision in *Apple, Inc.* overrides the SBE's administrative decision.

FTB issued TAM 2011-02 on March 15, 2011. The TAM is in accordance with the Court's holding in *Apple, Inc. v. Franchise Tax Board*, supra. TAM 2011-02 provides the following guidance to audit staff in the ordering of dividend distributions:

- LIFO ordering – Continue to apply LIFO ordering rules to determine the order of year(s) from which the dividend distributions are made, starting with the current year, and after that year's earnings are depleted, moving to the next most recent year. (IRC §316(a).)
- Within each year's distribution – Treat dividends as paid 1st from:

- That year's unitary earnings which are eligible for elimination, until those earnings are depleted, and
- Then from earnings excluded from the combined report, which are eligible to deduction under other provisions of the R&TC, until that year's earnings are depleted

TAM 2011-02 replaced the #6 Conclusion of TAM-2005-1 only. The remaining conclusions on TAM 2005-1 remain valid.

See WEM 7 for a discussion of E&P, and the ordering of applicable code sections pertaining to dividend rules.

d. Intercompany Eliminations and Dividend Deductions

R&TC §25106 provides that intercompany dividends paid out of earnings from the combined unitary business are eliminated from the income of the recipient corporation. Once you determine that the distribution is indeed a dividend, the next step is to determine whether or not the dividends were "paid out of income of the unitary business." Since dividends are paid out of E&P and not out of income, this statutory language should be interpreted to mean that the dividends must be paid out of the E&P that correlate with the unitary business income. (*Rosemary Properties, Inc. v. McColgan*, 29 Cal2d 677.)

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 years' accumulation in reverse order of accumulation. (*Apple, Inc. v. Franchise Tax Board*, 132 Cal.Rptr.3d 401.) An analysis of E&P is included in WEM 7.

The benefit of a dividend received deduction under R&TC §24411 may be reduced due to the Foreign Investment Interest Offset calculated under R&TC §24344(c). Therefore, a misclassification as an intercompany dividend under R&TC §25106, rather than a qualifying dividend under R&TC §24411, can be significant. See WEM 10 for a detailed discussion of the R&TC §24344(c), Foreign Investment Interest Offset provisions.

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 WEM 2 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 dividends to foreign countries. The taxpayer can apply the grossed-up amount in computing its foreign tax credit for federal purposes. The R&TC 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 amount is excluded from taxable income and qualifying dividends. 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.

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 R&TC 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 R&TC §25106. The IRC §1248 amount should be excluded from qualifying dividends. (CCR §24411(b)(1)(C).)

g. Foreign Investment Interest Offset

R&TC §24344(c)(1) provides that interest expense allowable pursuant to IRC §163, which is incurred for purposes of foreign investment, may be offset against dividends deductible pursuant to R&TC §24411. See WEM 10 for a detailed discussion of foreign investment interest offset.

h. S Corporations

An S corporation may own CFCs. However, under R&TC §23801(d), the CFCs cannot file on a combined basis with the S corporation.

If an S corporation receives dividends from a CFC, 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 R&TC §24411. See WEM 2 for a more detailed discussion of the effects of a water's-edge election on S corporations.