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## Repatriating Cash Dividends in a State of Flux

By Mark A. Muntean • Robert W. Wood, P.C. • San Francisco

Generally, the Internal Revenue Code taxes U.S. shareholders of foreign corporations on the entire amount of dividends received from foreign corporations, but only to the extent a foreign corporation derives its earnings and profits from foreign source income. The federal tax law previously provided an incentive to leave undistributed foreign source earnings and profits in foreign corporations. As part of the American Jobs Creation Act of 2004 ("Jobs Act"), Congress enacted Code Sec. 965 to provide U.S. companies with a *temporary* incentive to repatriate any earnings held by foreign subsidiaries. [See Notice 2005-10, IRB 2005-6, 474.]

### It's Like a Sale

For one year, and one year only, Code Sec. 965 allows domestic companies to elect to deduct 85 percent of the dividends received from controlled foreign corporations (CFCs) if the domestic parent corporation meets certain requirements. For example, the Code Sec. 965 dividends must be cash dividends, and the corporation's shareholders must invest such cash dividends in the United States (hereafter referred to as "Code Sec. 965 cash dividends"). The Code Sec. 965 cash dividends need not be segregated or traced, and need not be applied to a permitted U.S. investment within a specific time. However, the domestic parent corporation must have a written plan for reinvesting the Code Sec. 965 cash dividend.

With the increasing importance of state taxes, you need to take applicable state conformity (or lack of conformity) into account. In California, Assembly Bill 115 (Klehs) has been moving through the legislature since May 2, 2005. This "omnibus" conformity bill would generally conform California's tax laws to the Internal Revenue Code ("the Code") as it read on January 1, 2005, subject to a number of

*(continued on page 2)*

#### ALSO IN THIS ISSUE

Norman Conquest? Insolvency Reorganizations and Net Value.....	4
To Deduct or Not to Deduct: The Cost of an IPO.....	7

exceptions. The bill would be effective for tax years beginning on or after January 1, 2005.

On the topic of repatriating Code Sec. 965 cash dividends, California corporations have had mixed emotions, since there was no guidance from the Governor's taxing authorities describing how the state planned to tax these dividends. Some commentators expected California corporations to repatriate as much as \$100 billion under the Code Sec. 965 temporary rules.

### Repatriation Shuffle

In response to these concerns, California issued Legal Ruling 2005-02 (July 8, 2005). Legal Ruling 2005-2 does not address the conformity issue. Instead, Legal Ruling 2005-02 addresses the business versus nonbusiness *characterization* of income earned in connection with cash dividends, while such dividends are held pending domestic reinvestment under

Code Sec. 965. The ruling is directed at the question whether income earned on Code Sec. 965 cash dividends after repatriation but before reinvestment under Code Sec. 965 is properly characterized as apportionable business income.


### Is Conformity a Plus or a Minus?

Most tax professionals (especially in high tax states like New York and California) think of conformity as a good thing. However, there are situations where this isn't so. Notwithstanding the fact that California has not conformed to Code Sec. 965, dividends may be eliminated or deducted from California net income under different provisions. [See California Revenue and Tax Code ("CR&TC") Sections 25106, 24410 and 24411.] In some cases, dividends paid by a foreign corporation are not taxed at the state level.

If California conforms to Code Sec. 965, 15 percent of any Code Sec. 965 cash dividend (that might otherwise not be taxed in California) would be taxed in the state. What's even worse, earlier this year a bill was introduced in the California legislature seeking to conform California tax law to Code Sec. 965 with a critical difference. Under the proposed bill, the Code Sec. 965 cash dividends would have to be reinvested in a California based business, California equipment or a California manufacturing plant, within two years of receipt. Investment in business operations outside the state would be subject to tax. Perhaps this is a clever embodiment of our Governor's "I'll be back" mantra. In any case, somehow this doesn't sound like an incentive.

### Confusion Characterizes Our Age

Code Sec. 965 does not address the characterization of dividends as business or nonbusiness income. Such characterization is only important for state tax purposes. [See CR&TC Section 25120 and Cal. Code Regs, Title 18, Section 25120(c)(4); *Appeal of Standard Oil Company of California*, 83-SBE-068 (Mar. 2, 1983).] However, the requirement under Code Sec. 965 that the Code Sec. 965 cash dividends be used in certain types of investments may affect the characterization of any possible income earned on the dividends, after such



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dividends are paid, but pending their use in a qualified investment under Code Sec. 965.

Whether income from the interim investment of dividends repatriated under Code Sec. 965 constitutes apportionable business income depends on the function that the repatriated funds serve in the taxpayer's unitary trade or business. According to the California State Board of Equalization ("SBE"), where 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 (income from the investment of liquid funds constitutes business income if the funds have been identified for future business needs).]

The SBE, incidentally, is California's top tax body, consisting of a five-member board that (among other things) makes decisions on tax disputes between taxpayers and the Franchise Tax Board ("FTB"). The latter is the California taxing agency that administers the state franchise and income taxes. Significantly, if the taxpayer wins at the SBE level, the FTB cannot appeal. Conversely, if the taxpayer loses at the SBE, the taxpayer can sue in state court for a trial *de novo*.

### So Who Cares?

If the income from the Code Sec. 965 cash dividends is earmarked for a nonbusiness or nonunitary line of business, two bad results could follow. First, the income would not be subject to state income tax apportionment. Apportionment generally results in a lower overall state tax burden for California-based corporations since, through apportionment, a part of the corporation's income is apportioned to other states with lower corporate income or franchise tax rates, or to a state with no corporate tax at all. Accordingly, without apportionment, all income would be taxed in California, at California's higher tax rates.

The second bad result is that if the domestic corporation's unitary business results in an operating loss for the tax year, the income from nonunitary or nonbusiness operations cannot offset the unitary loss. Therefore, the taxpayer would realize a net operating loss from its unitary business and pay tax on its nonunitary or nonbusiness income earned on the Code Sec. 965 cash dividends.

### The Return of Operational Integration

The California FTB has put us on notice that it will be examining taxpayers who receive Code Sec. 965 cash dividends for operational integration between the domestic parent corporation's unitary business and the reinvestment of the cash dividends. What this means is that the FTB will be satisfied if, on audit, they see an intercompany flow of value between the domestic corporation's main unitary business or operations and the reinvestment of the cash dividends.

In Legal Ruling 2005-02, the FTB provides an example of operational integration. In their example, a domestic parent corporation uses Code Sec. 965 cash dividends to hire and train workers for its U.S. operations. Such reinvestment would serve an operational function for the taxpayer's trade or business and would be unitary.

This would also constitute earmarking the cash dividend for a specific business use for apportionment purposes, as long as the U.S. corporation that receives the dividends has a written plan of reinvestment. 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, nonunitary line of business, or for a nonbusiness passive investment.

### Earmarking and Acquisitions

In all cases involving Code Sec. 965 cash dividends, "the earmarking" of the cash dividends referred to in Legal Ruling 2005-02 would be evidenced by the taxpayer-written plan for reinvestment as required under federal law. The FTB recommends that taxpayers document the earmarking of any amounts they need for specific business needs, even if they relate to planned expenditures outside the United States. Although the latter expenditures would not qualify as original dividends for the Code Sec. 965 deduction, they can be used to determine whether the earmarked funds produced apportionable business income.

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 Code Sec. 965 dividends. [*Appeal of DPF Inc.*, 80-SBE-113 (Oct. 28, 1980).] Financial stabilization through debt reduction could result in nonbusiness characterization.

The same analysis would apply to acquisitions using the proceeds of Code Sec. 965 cash dividends. The FTB will be looking to see if the acquired operations are business or nonbusiness. As long as the Code Sec. 965 cash dividends are earmarked for a specific business use of a unitary business, the earnings on their interim investment, pending implementation of the domestic reinvestment plan, would constitute business income. [*See In Appeal of Consolidated Freightways, Inc.*, *supra.*]

### **Some Benefit**

California businesses surely appreciate knowing what approach California will take in connection with Code Sec. 965 cash dividends and the income earned on such dividends. Despite the value of the heads up, though, this approach may not be all that beneficial. Where a corporation invests the dividend proceeds in its core business operations, there should be no worries in connection with a unitary business audit.

However, in the case of acquisitions or investments that expand a taxpayer's business beyond the boundaries of its traditional operations, expect challenges from California. The state is revenue-hungry. Legal Ruling 2005-02 could generate a number of unitary audits. It would be prudent to follow the FTB's advice of earmarking or documenting the use of the Code Sec. 965 cash dividends in a unitary business to attempt to avoid such issues.