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Foreign Dividends in California: Apple Loses on Dividend Ordering. Now What?

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Last week, the California Court of Appeal in *Apple Inc. v. Franchise Tax Board* rejected Apple's claim for preferential ordering for dividends paid by foreign subsidiaries. The court did, however, conclude that Apple was entitled to deduct interest that the FTB had disallowed under the Foreign Investment Interest Offset rules. This alert summarizes the dividend ordering issue and discusses steps that taxpayers can take to mitigate its impact.

What happened?

Before 1989, Apple filed its California returns on a worldwide basis, so all earnings of its foreign subsidiaries were factored into the calculation of tax. Under California law,[1] a dividend paid out of those pre-1989 earnings is "previously taxed" and is eliminated. Beginning in 1989, Apple made a water's-edge election. During that year, only a small portion of the earnings of the foreign subsidiaries (i.e., the portion that was subpart F income) was included in the water's-edge return. So only a small portion of the foreign earnings generated in 1989 was taxed; the rest was untaxed.

During 1989, Apple repatriated foreign earnings by way of dividends. To determine whether the dividends were eliminated, Apple applied *Fujitsu's* preferential ordering approach.[2] Preferential ordering means that Apple treated the dividends as paid first from a pool of previously taxed earnings. The pool of previously taxed earnings was the subpart F income in 1989 and all of the world-wide earnings from years before 1989. Because, under the preferential ordering approach, Apple eliminated the dividends to the extent of the pool of previously taxed earnings, a substantial portion (if not all) of Apple's dividends were eliminated.

The FTB argued for a LIFO approach. Under LIFO, dividends are deemed paid first from current year's earnings until exhausted and then, from the most recent prior years' earnings on a year-by-year basis until each year's earnings are exhausted. Under the LIFO method, therefore, Apple had to take into account the untaxed earnings generated in 1989 before it got the benefit of the previously taxed earnings generated in years before 1989.

The court sided with the FTB. The Court of Appeal determined that *Fujitsu* only requires preferential ordering with respect to current year earnings. That is, under *Fujitsu*, Apple's dividend is deemed first paid out of the previously taxed earnings generated in 1989. After these *previously taxed* 1989 earnings were mathematically exhausted, the Court of Appeal then took into account the remaining *untaxed* earnings in 1989. Only after that point did the court consider the dividends to have been paid from previously taxed earnings for the world-wide years before 1989.

Now What?

We believe that the Court of Appeal got it wrong. *The Fujitsu* court stated that preferential ordering was necessary to permit the movement of earnings within a unitary group "without incident." Only preferential ordering accomplishes this in a manner that, as the *Fujitsu* court said, resolves the question in "favor of the taxpayer rather than the government." Perhaps the California Supreme Court will resolve the issue. Perhaps a different Court of Appeal will view the issue differently. Yet, despite the unfavorable result in *Apple*, there are several other considerations for a taxpayer whose tax is affected by dividends from foreign subsidiaries. They include the following:

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- Your foreign dividend may be non-business income. For example, dividends paid under the American Jobs Creation Act of 2004 (IRC § 965) are, by definition, extraordinary and therefore are more likely to qualify as non-business income than a typical dividend.[3] The strength of a non-business income case depends on how the repatriated dividends will be used under the taxpayer's investment plan.[4]

- Also, your foreign dividend might not be subject to tax because the dividend-paying foreign subsidiary may not be unitary with the water's-edge group. After all, foreign subsidiaries are more likely than domestic subsidiaries to have autonomy and management that is significantly independent of the domestic water's-edge group to make a persuasive unitary business case. In this vein, it is important to keep in mind that, even if foreign subsidiaries are engaged in a related business, they can be non-unitary if they are sufficiently independent.[5]

- If a dividend is included in the tax base (because only 75 percent is deducted), or if any portion of a taxpayer's interest deduction is disallowed because of the dividend, a taxpayer should argue that the property, payroll and sales of the dividend-paying foreign subsidiary must be included in the apportionment of the water's-edge group. After all, in order to include the dividend in income directly (by not allowing a full deduction) or indirectly (by disallowing a related interest expense[6]), the operations of the subsidiary that generated the earnings out of which the dividend was paid must be unitary with the dividend recipient's water's-edge group.[7] The unitary business principle and factor representation go hand-in-hand.[8] So some factor representation is essential, and factor representation for foreign subsidiaries is almost always beneficial. The State Board of Equalization agreed with Reed Smith attorneys in the case of *Argonaut* with regard to a similar factor-representation question.[9]

  Moreover, in our view, the impact of the foreign dividend may call for a special degree of factor representation. The foreign dividend is likely paid out of many years' worth of earnings generated by several years of activities. Yet, domestic income represents a single year's worth of earnings generated by a single year of activities. If the current year's factors of the foreign subsidiary are added to the current year's factors of the water's-edge group, then the foreign factors will be understated relative to the earnings contribution of the foreign subsidiary. Accordingly, in the case of a foreign dividend that is paid out of many years' earnings and profits, the factors of the foreign subsidiaries for the single, current year in which the dividend is paid should be amplified so that the relationship between the foreign factors and the foreign earnings is comparable to the relationship between the domestic factors and the domestic earnings

  For more information on the *Apple* case and other California tax issues, contact the authors of this Tax Alert or a member of Reed Smith's California Team. For more information on Reed Smith's California tax practice, visit www.reedsmith.com/catax.

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1. Cal. Rev. & Tax § 25106.
2. *Fujitsu IT Holdings, Inc. v. Franchise Tax Bd.*, 120 Cal. App. 4th 459 (Cal. Ct. App. 2004).
3. *See, e.g., Appeal of Consolidated Freightways*, 2000-SBE-001 (Cal. State Bd. of Equalization, Sept. 14, 2000).
4. Legal Ruling 2005-02 (Cal. Franchise Tax Bd., July 8, 2005).
5. *See, e.g., ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); F.W. *Woolworth Co. v. Taxation and Revenue Dep't of New Mexico,* 458 U.S. 354 (1982).
6. *See Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000) (if a state disallows a deduction because it cannot tax certain income, that disallowance is viewed---for purposes of applying constitutional limitations on state taxation---as if the income itself were being taxed).
7. *See Appeal of Argonaut Group, Inc.*, No. 287738 (Cal. State Bd. of Equalization, Jan. 23, 2009).

8. *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 458-461 (1980) (Stephens, J., dissenting) ("unless the sales, payroll, and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will inevitably cause ... income to be overstated").

9. *Argonaut Group*, No. 287738.