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Repatriated Dividends—Think Different

By Christopher Karachale • Wood LLP • San Francisco

In 1989, Steve Jobs had departed Apple and was building computers and software at NeXT Computer. In 1989, Apple introduced the Macintosh Portable, Apple's first attempt to produce a portable, battery-powered Macintosh. And in 1989, Apple adopted a strategy to address its tax liability. Like so much else at Apple, this too was innovative, maybe as forward-thinking as the iPhone or iPad.

Sadly, Mr. Jobs is no longer with us. But even he would have been impressed with Apple's sleek reading of the California Revenue & Taxation Code's ("Rev. & Tax. Code") tax treatment of repatriated dividends. Combining functionality and aesthetics, Apple argued that Rev. & Tax. Code Section 25106 could effectively eliminate Apple's tax liability for repatriated earnings in 1989 and potentially for subsequent years.

Still litigating this issue more than 20 years after the tax year in question, Apple has thus far been unsuccessful in its arguments. But neither Rome nor Apple was built in a day. Besides, regardless of the end result, such innovative legal reasoning would surely have made Jobs proud.

Bits and Bytes

In *Apple, Inc. v. Franchise Tax Bd.*, 199 Cal. App. 4th 1 (Cal. App. 1st Dist. 2011), the California Court of Appeals examined Apple's treatment of dividend payments received from its foreign subsidiaries for purposes of its franchise tax liability. Apple owned 100 percent, directly or indirectly, of numerous foreign subsidiaries during the years leading up to and including the 1989 tax year. These subsidiaries were in Ireland, the United Kingdom, the Cayman Islands, Australia, Canada and elsewhere.

For California franchise tax purposes, Apple and its subsidiaries were viewed as a "unitary business enterprise." As a unitary business

ALSO IN THIS ISSUE

enterprise, California imposed the franchise tax on the corporation's net income derived from or attributable to sources within California. [Rev. & Tax. Code Section 25101.] However, because Apple and its subsidiaries functioned as a unitary business enterprise, the computer maker was allowed to make a "water's-edge election" to account for the income and apportionment factors of its affiliates. [Rev. & Tax. Code Section 25110.]

For federal tax purposes, generally U.S. corporations must include in income as a constructive dividend a portion of their share of controlled foreign companies' (CFCs) current income (Subpart F income). That is so even if no distribution from the subsidiary is made. Internal Revenue Code ("Code Sec.") 951 *et seq*. Under the water's-edge election, similar forced income inclusion is required for California state income purposes.

In particular, Rev. & Tax. Code Section 25110(a)(6) adds to the water's-edge group a portion of the income and apportionment factors of affiliates that are CFCs if all or part of their income is Subpart F income. In essence, a portion of the CFCs' income is forcibly included in the unitary business enterprise's California income.

In 1989, Apple filed its franchise tax return using water's-edge combined reporting and included in income its domestic income and a portion of the income from certain CFCs. At that time, Apple had previously undistributed foreign subsidiary earnings of $698,778,366. It had paid $30 million in California franchise tax on the accumulated earnings of its CFCs.

In 1989, Apple also decided to repatriate $86.6 million in dividends from its CFCs. Apple's slick and sleek argument involved the tax character of such dividend payments back to Apple from the subsidiaries.

The CPU of the Tax Argument

Since these dividends were Subpart F income from CFCs, Apple asserted that the dividend income could be repatriated without tax consequence. Apple's argument was that the CFC income had *already* been included in its unitary business income (because of the forced inclusions rules). Therefore, no additional tax was due on the repatriated dividends.

Why? Because under Rev. & Tax. Code Section 25106, all dividends paid by corporations of a unitary business (to the extent those dividends are paid out of the income of the unitary business) are eliminated from the income of the recipient. This argument seems simple enough. Apple pointed out that the CFC rules forced it to take into income the previous earnings of its foreign subsidiaries.

Therefore, taxing those earnings when repatriated as dividends would effectively amount to a double tax on the same earnings. Axiomatically, double tax sounds wrong. Of course, the debate was not so simple.

The California Franchise Tax Board (FTB) argued that Apple was repatriating both *current year* earnings and *prior accumulated* earnings as a dividend. The FTB took the position that a last in first out (LIFO) proration should be applied to determine the proper treatment of the repatriated dividends. Plainly the current-year earnings had not already been subject to tax under the CFC rules.

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Therefore, including such current earnings (as dividends) in income would not result in double taxation. The FTB conceded that if the dividends were subject to tax upon repatriation, Apple would be privy to a dividends received deduction under Rev. & Tax. Code Section 24402. However, this meant that the dividends were still includible in income, rather than *eliminated* from income under Rev. & Tax. Code Section 25106.

FTB Thinks Different Too

This distinction was important. In 1989, 100 percent of the dividends received could be deducted for California income purposes under Rev. & Tax. Code Sec. 24402. *Farmer Bros. Co. v. Franchise Tax Bd.*, 108 Cal. App. 4th 976 (Cal. App. 2d Dist. 2003). However, *subsequent* to 1989, only 75 percent of the dividends received could be deducted pursuant to Rev. & Tax. Code Section 24411. [*Abbott Laboratories v. Franchise Tax Bd.*, 175 Cal. App. 4th 1346 (Cal. App. 2d Dist. 2009).] This meant that Apple would win *either way* for the 1989 tax year.

Yet if the dividend income was not eliminated under Rev. & Tax. Code Section 25106 for subsequent years, Apple would be subject to the 75-percent limitation on deductibility. By the time it was before the California Appellate Court, Apple *knew* that it had won the 1989 issue. However, the tax treatment for the subsequent years was still in play.

In short, the issue was ordering, a type of iPod playlist. And it wasn't random. Should the dividends that Apple received from its foreign subsidiaries in the 1989 tax year be treated as paid *first* out of earnings already taxed *before* consideration of any other earnings (preferential ordering), or were they subject to LIFO ordering?

If preferential ordering were applied, all of the dividends in question would be deemed paid from previously taxed earnings and thus eliminated from Apple's income under Rev. & Tax. Code Section 25106. If LIFO ordering were applied, some of the subject dividends would be eliminated (as previously taxed) and the remainder of the dividends would be deductible under Rev. & Tax. Code Section 24402. However, for subsequent years with LIFO ordering, any dividends not eliminated would still be deductible, but the deduction would be limited under Rev. & Tax. Code Section 24411.

Apple's "Siri-ous" Argument

Apple argued that preferential ordering was appropriate based on case law and legislative intent. First, Apple argued that *Fujitsu IT Holdings, Inc. v. Franchise Tax Bd.*, 120 Cal. App. 4th 459 (Cal. App. 1st Dist. 2004) controlled. In *Fujitsu*, the court concluded that dividends paid by first-tier CFCs from current year earnings should be treated as paid first out of earnings eligible for elimination under Rev. & Tax. Code Section 25106, with any excess paid out of earnings eligible for partial deduction under Rev. & Tax. Code Section 24411. [*Fujitsu*, 120 Cal. App. 4th at 840.]

The *Fujitsu* court sensibly pointed out that where a unitary business enterprise includes a CFC, the CFC should be able to move amounts that have already been included in the combined income of the unitary group. Plainly, that should be without tax incident under such ordering rules. This reading of *Fujitsu* seemed to mesh almost perfectly with Apple's argument that preferential ordering was appropriate.

In addition, Apple pointed out that the whole legislative intent of Rev. & Tax. Code Section 25106 is to prevent dividends from subsidiaries from being taxed twice—once as earnings of the issuing subsidiary, and again as separate income to the unitary business from receipt of the dividend. Thus, Apple reasoned that its application of *Fujitsu* to its particular facts ensured that double taxation would be avoided and the California tax policy would be respected.

The FTB's Point and Click

Like an e-reader competitor, the FTB offered arguments for its own hardware. First, the FTB pointed out that in *Fujitsu*, the issue was only about the ordering of dividends *within* a current tax year, where some earnings were included in the unitary group's return and others were not. In contrast, Apple had both a surplus of current year earnings plus an undistributed pool of accumulated earnings from *prior* tax years. That made *Fujitsu* factually distinguishable.

More importantly, the FTB was able to point to statutory and regulatory language to justify LIFO ordering. Code Sec. 316(a)(2) defines a dividend as any distribution of property made by a corporation to its shareholders out of its earnings and profits *of the tax year*. Rev. & Tax. Code Section 24451 (previously Rev. & Tax. Code Section 24495) expressly incorporates all of Subchapter C, including Code Sec. 316(a)(2).

The FTB also pointed to California Code of Regulations Section 24411(e)(3) which provides that for purposes of Rev. & Tax. Code Section 25106, dividends are considered to be paid out of *current year's earnings and profits* to the extent thereof and from the most recently accumulated earnings and profits by year thereafter. Such statutory language appeared to significantly undermine Apple's arguments for the applicability of the *Fujitsu* holding. Apart from Code Sec. 316, the FTB was also able to dismiss certain statutory arguments raised by Apple.

Federal v. California

Apple asserted that Code Sec. 959(c) trumps Code Sec. 316(a)(2). Code Sec. 959(c) generally provides that distributions received from a foreign subsidiary are deemed to have been paid *first* from earnings and profits attributable to amounts previously included in taxable gross income and *then* to other earnings and profits. However, unlike Code Sec. 316, the Rev. & Tax. Code does not expressly adopt Code Sec. 959(c).

In addition, the federal tax rules for income from CFCs are different from the California framework. The Internal Revenue Code deems a constructive dividend paid in the year earned (and thereby taxable income to the parent company), whether or not any of the amounts are repatriated in that year. In contrast, the Rev. & Tax. Code Section 25106 focuses on dividends "paid," and takes intercompany dividends into account for tax purposes at the time that they are distributed.

Court's iReasoning

In the end, the California Appeals Court concluded that LIFO ordering as between tax years was more consistent with statutory and regulatory authority. The court pointed out that LIFO ordering prevents a corporation from declaring what year's earnings are being distributed. Perhaps that is no surprise.

If corporations like Apple were allowed to elect preferential order for their dividends between tax years, they might obtain a potentially indefinite tax avoidance by ignoring consideration of earnings attributable to untaxed excluded income until all included income had been exhausted. We want to think different, but not that different. And California surely needs the money.

Adam's Apple

Apple has already petitioned the California Supreme Court to hear this matter. Like its founder, Apple appears ready to fight until its tax arguments are perfectly designed. Despite the passage of time, Apple may finally obtain success at the highest court in California. Such an argument will inevitably be based on a highly literal reading of Rev. & Tax. Code Section 25106.

However, beautifully designed tax arguments—like beautifully designed computers—are not always successful. Sometimes they still break down. Given the policy issues inherent in questions of untaxed foreign earnings, Apple may wish it still had Steve Jobs around to help perfect one final argument.