

Potential California Franchise Tax Impact of IRC §965

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On October 22, 2004, IRC §965 was signed into law as part of the “American Jobs Recovery Act of 2004.” It permits US corporations¹ an election, for their last tax year beginning before 10/22/04 or first tax year beginning during the one year period commencing on 10/22/04, to be taxed at a preferred federal effective tax rate of 5.25 percent upon remittance of their untaxed earnings from controlled foreign corporations (“CFCs”). It is generally accepted that most states will conform to IRC §965 and there will be no additional state tax consequences to a federally qualified repatriation.² California is the exception.

California has a unique taxation regime, in that it taxes corporations on their apportioned worldwide net income.³ Taxpayers, however, can elect to be taxed only on their apportioned domestic income by making a “water’s edge” election, subject to certain limitations. Intercompany dividends within the tax group, either worldwide or water’s edge, are eliminated from net income. Dividends from unitary members outside the water’s edge group, however, are not taxed by California until they are repatriated to the domestic group. At that time they are included in gross income.

California has not conformed to IRC §965. As a result, a corporation subject to California franchise tax that elects to repatriate income from its CFCs under §965 will be subject to California’s 8.84 percent corporate tax (10.84 percent for banks and financial corporations) on its additional apportioned net income. This will increase the corporation’s effective tax rate on those dividends above 5.25 percent and should be considered in any repatriation analysis.⁴

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¹ Such relief was heavily lobbied for by high-tech corporations in Silicon Valley, as they have substantial foreign sourced income. Other industries, such as pharmaceuticals, may also enjoy substantial benefit. Remaining industry groups, however, will receive little or no benefit from this provision.

² See, however, RIA Article No. ta-032005-0049, March 23, 2005, suggests that taxpayers pay particular attention to dividend-received deductions in Idaho, Louisiana, North Dakota and Texas.

³ California Revenue & Taxation Code §§24402, 25106.

⁴ In certain corporate structures, there could be double or multiple taxation, based upon the number of times the foreign dividend enters and leaves the domestic group before ultimately reaching the corporate group parent.