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Accountants and Consultants

Subject:

State Tax Considerations Of One-Time Special Dividends Received

State Tax Alert

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Timing:

The American Jobs Creation Act (AJCA) was passed in October 2004. This Act enabled the creation of Internal Revenue Code Section 965 wherein U.S. shareholders may deduct 85 percent of the dividends received from a controlled foreign corporation (CFC). IRC Section 965(f) provides that the taxpayer may elect to apply this code section to either the taxpayer's last tax year that begins before October 22, 2004 or the taxpayer's first taxable year that begins during the one-year period beginning on October 22, 2004.

IRC Section 965:

The temporary dividends-received deduction is intended to bring economic stimulus into the United States. There are several requirements that must be met to qualify for the deduction.

First, the dividends must be invested by the U.S. shareholder in the United States pursuant to a domestic reinvestment plan that is approved by the taxpayer's senior management and the board of directors prior to the dividend payment.

Second, the plan must specify the use of the repatriated funds. Section 965 provides that in order to qualify such dividend in the United States (other than as payment for executive compensation), can include funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation.

Third, the maximum deduction is limited to \$500 million. However, the amount eligible for the Section 965 deduction is also limited by determining whether the dividend is considered extraordinary. The deduction is considered extraordinary if the dividend is greater than an annual average of dividends received during a base period of time.

State Tax Considerations:

Some states may choose not to adopt certain provisions of the AJCA. Similar to recent accelerated depreciation schedules allowed by Internal Revenue Code Section 168, some states decided not to abide by these rules in order to protect state tax revenue. As a result, states vary significantly on how they will adopt any changes to the Internal Revenue Code.

Some states will automatically adopt any change to Internal Revenue Code provisions. Other states will only adopt those provisions of the Internal Revenue Code as enacted during a specific point in time. In these states, the state legislature must adopt a more recent version of the Internal Revenue Code in order for the state to follow recent federal changes. A third group of states must have the legislature adopt specific code sections of the Internal Revenue Code in order for the state to utilize these provisions.

There are several state tax consequences of the dividend itself that should be separately examined:

1. Consideration should be given to states that may have their own dividend received deduction or exclusion rules for foreign source income that would protect taxpayers receiving extraordinary dividends from CFCs.
2. The state tax conformity to IRC Section 78 computations should be considered. These gross up computations should be reviewed even in those states that automatically conform to the IRC changes since the calculations may yield an unfavorable result. As a result, the IRC Section 965 deduction may not qualify for the IRC Section 78 gross up in all states.
3. Under the U.S. Supreme Court decision in Kraft a state may be required for constitutional reasons to allow a shareholder of a CFC a deduction because foreign dividends cannot be treated in a discriminatory manner. Further complicating the issue is the uncertainty regarding how the Kraft case applies in a unitary return state such as California.
4. The state expense disallowance rules also vary by state. Therefore, these rules should be reviewed to determine what expenses are attributed and allocable to the exempt dividend income and will not be deductible on the state return.
5. In those states that impose an alternative to a traditional state income tax such as Texas and Pennsylvania that impose a Capital/Franchise tax, Michigan's Single Business Tax, Washington's Business and Occupation Tax, and New Mexico's Gross Receipts Tax, special consideration should be given to the tax consequences of dividends.

Another important consideration from a state perspective is to look for significant state and local tax incentives and credits. It may be possible to obtain these tax incentives and credits at either the state or local levels.

Finally, the reinvestment of the dividend could have significant sales and use tax considerations. In many cases, completing the proper documentation to secure these tax benefits is essential to obtaining these benefits.

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