Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Senate Rev & Tax Committee	Analyst:	Marion Mann DeJong	Bill Number:	SB 1061
Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	02/27/2003
		Attorney:	Patrick Kusiak	Sponsor:	Franchise Tax Board

SUBJECT: Water's-Edge Election Procedures/Definition of "Taxable Year" for Calendar or Fiscal Years Beginning on or after January 1, 2000/Claim of Right Deduction/Clarify Application of 2% Floor

SUMMARY

This Franchise Tax Board sponsored bill would:

1. Add a definition of the term "taxable year" for California franchise tax purposes that was inadvertently repealed for taxable years beginning on or after January 1, 2000.

2. Fundamentally reform the water's-edge election procedures to resolve problems that arise with elections made under the current contract rules. Under this bill, water's-edge elections would be made by statutory election rather than by contract.

This bill also would partially conform California law to the federal claim of right provisions (Revenue and Taxation Code Sections 17049 and 17076). Since these sections will be deleted from the bill, they will not be discussed in this analysis.

PURPOSE OF THE BILL

This bill is intended to clarify tax law and ease taxpayer compliance and administrative burdens regarding water's-edge elections.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2003.

POSITION

Support.

On November 26, 2002, the Franchise Tax Board voted to sponsor the two provisions discussed in this analysis.

Summary of Suggested Amendments

An amendment is provided to resolve a minor technical concern. See "Technical Considerations" under the "Water's-Edge Election Procedures." In addition, staff suggests that a phrase be used consistently. See "Technical Considerations" under "Taxable Year."

Board Position:			Department Director	Date
_____ S	_____ NA	_____ NP	Gerald H. Goldberg	03/27/03
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_____ N	_____ OUA	___X___ PENDING		

1. TAXABLE YEAR (Section 23041)

ANALYSIS

BACKGROUND

California tax law imposes a franchise tax for the privilege of doing business in California. For taxable years beginning prior to January 1, 2000, this tax was a "prepaid" tax, meaning the tax for the privilege of doing business in the current year (the *taxable* year) was measured by the amount of income earned during the prior year (*income* year). Thus, the "taxable year" was defined in Revenue and Taxation Code (R&TC) Section 23041 as the calendar year or fiscal year for which the tax is payable.

This "prepayment concept" was confusing and out of step with the manner in which other states imposed their franchise tax. As a result, in 2000, legislation was enacted that ended the "prepayment" concept, thereby making the current year, i.e., the "taxable year," the relevant concept for determining the period for which the franchise tax is due as well as the period during which the income was measured.

When the R&TC definition of "taxable year" was changed in 2000, the explicit definition that "taxable year" means the year for which the tax is payable was repealed. However, an explicit definition of "taxable year," which is also called the "privilege year," is significant to the theory of a franchise tax and should be included in the R&TC.

FEDERAL/STATE LAW

Federal law generally defines the term "taxable year" as:

- The taxpayer's annual accounting period, if it is a calendar year or a fiscal year,
- The calendar year, if the taxpayer has not been keeping books and records, or,
- The period for which the return is made, if a return is made for a period of less than 12 months.

Current R&TC Section 24631 defines "taxable year" the same as federal law. R&TC Section 23041 also contains a definition of "taxable year" (for years beginning before January 1, 2000) that states that "taxable year" means the year for which the tax is payable. In addition, taxpayers are required to have the same taxable year for state purposes as for federal purposes, unless they have received permission from Franchise Tax Board (FTB) to have a different taxable year.

THIS BILL

This provision of the bill would amend R&TC Sections 23041 to explicitly define "taxable year" as the year for which the franchise tax is payable.

IMPLEMENTATION CONSIDERATIONS

Since this provision of the bill clarifies the law, implementing it would not impact the department's programs and operations.

TECHNICAL CONSIDERATIONS

Section 23041 (page 4, lines 1 through 24 of the bill) is inconsistent in the use of the phrase "for purposes of." In some places the statute says "for *the* purposes of," in other places it says "for purposes of." To provide clarity, the phrase should be used consistently.

LEGISLATIVE HISTORY

AB 1843 (Ackerman, Stats. 2000, Ch. 862) eliminated the term and concept of "income year" from the Personal Income Tax Law, the Administration of Franchise and Income Tax Laws and Regulations, and the Corporation Tax Law.

SB 1185 (Senate Revenue and Taxation Committee, Stats. 2001, Ch. 543), a clean up bill for AB 1843, replaced the obsolete term "income year" with "taxable year."

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* define "taxable year" by reference to the Internal Revenue Code. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

This provision of the bill would not impact the department's costs.

ECONOMIC IMPACT

This provision of the bill has no identifiable state revenue impact.

ARGUMENTS/POLICY CONCERNS

Providing a definition of "taxable year" creates consistency within the R&TC provisions relating to the franchise tax. Clear definitions and internal consistency reduces the possibility of confusion and reduces complexity of the tax laws.

2. Water's-Edge Election Procedures (Sections 18405.1, 25111, 25113, and 25116)

ANALYSIS

BACKGROUND

Generally California law requires corporations that earn income from sources both within and without California to calculate their income using what is called the unitary method. Beginning in 1988 California allowed a corporation to elect to calculate its income on a "water's-edge" basis. Taxpayers make the election by entering into a contract with the Franchise Tax Board (FTB). The water's-edge legislation initially used a contract because it was necessary to justify imposition of the filing requirement of a domestic disclosure spreadsheet (DDS) and payment of the water's-edge election fee. However, the repeal of the DDS filing requirement and the fee in 1994 eliminated this justification for the contract.

Throughout the history of the water's-edge election, statutory and regulatory changes have been made in an attempt to provide relief for water's-edge election problems.

The previous solutions have focused on providing relief for taxpayers that failed to satisfy the stringent procedural requirements of the current election statute rather than reforming the entire manner in which water's-edge elections are made. Despite previous efforts, problems continue to occur for taxpayers and the department. The following is a brief history of the problems and attempts to resolve them.

Since many electors inadvertently failed to comply with the statutory requirements for making a water's-edge election, legislation (SB 1805, Green, Stats. 1994, Ch. 1243) was passed that added Section 18405 to the Revenue and Taxation Code (RTC). RTC Section 18405 provided a period for perfecting elections that were invalid because of unintentional noncompliance. This relief was limited to invalid elections made on the 1988 forms by taxpayers that subsequently requested relief within a specified period. However, election problems continued to occur.

RTC Section 18405 was subsequently amended (SB 887, Hughes, Stats. 1995, Ch. 490) to address the situation where an election was invalid because all but one member of the water's-edge group made the election. Only one water's-edge group perfected its election under this legislation.

In 1996 (SB 1870, Alquist), and again in 1997 (AB 1469, Ducheny and AB 1488, Pringle), additional taxpayer-specific legislation was introduced to allow perfection of certain invalid elections. In response to these bills, department staff recommended in 1997 that legislation be enacted to replace the current law contract requirement with a statutory election. However, such legislation was not pursued because the Franchise Tax Board Members and the business community preferred a regulatory solution at that time.

In 1998, California Code of Regulations (CCR), title 18, sections 25111 and 25111.1 were amended to provide that a water's-edge election is valid even if a taxpayer failed to comply with procedural or statutory requirements as long as there was substantial performance of the election requirements. A corporation is deemed to have substantially performed if its tax was computed consistent with a water's-edge election and other objective evidence demonstrates that the taxpayer intended to make the election. Generally, objective evidence is shown if the taxpayer attaches any completed water's-edge form to the original return or makes statements on the original return demonstrating the intent to elect.

These amendments cured many election problems but a substantial number of taxpayers have since been identified as having invalid elections that cannot be perfected under the regulations or present statutes. These problems arise from three general reasons:

1. The present statutory scheme applies contract law principles alongside tax law principles, which sometimes give incompatible results.
2. Water's-edge group members make inconsistent filings or corporate acquisitions result in unintended elections.
3. Filing and tracking notices of nonrenewal are burdensome both for the taxpayer and for FTB and can result in unintended consequences.

Consequently, department staff developed the legislative proposal contained in this bill.

FEDERAL/STATE LAW

Under current federal law, corporations organized in the U.S. are taxed on all their income, regardless of source, but are allowed a credit for any taxes paid to a foreign country on their foreign source income.

Foreign corporations engaged in a U.S. trade or business are taxed at regular U.S. graduated corporate income tax rates on income effectively connected with the conduct of that business in the U.S. This is known as effectively connected income, or ECI. Additionally, foreign corporations are taxed at a flat 30% rate (or lower rate if provided by treaty) on specified types of fixed, determinable, annual, or periodic income (usually investment income) from U.S. sources.

Under current California law, California source income for corporations that operate both within and without the state is determined on a worldwide basis using the unitary method of taxation. Under the unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of that income is then apportioned to California on the basis of relative levels of business activity in the state measured by property, payroll, and sales.

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine their income on a "water's-edge," or inside of the U.S. basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources. In exchange for filing on a water's-edge basis, the taxpayer agrees to:

- file on a water's-edge basis for seven years;
- treat certain dividends as California income; and
- ensure that methods of substantiating the information on the return will be available (i.e., depositions of key employees or officers, and requiring the reasonable production of documents).

The water's-edge election must be made *by contract* with FTB on the *original return* for the year and is effective only if *every taxpayer* that is a member of the water's-edge group and subject to California franchise or income tax makes the election.

An affiliated corporation that is either a member of the water's-edge group and subsequently becomes subject to tax or a non-electing taxpayer that is subsequently proved to be a member of the water's-edge group pursuant to an FTB audit determination, is deemed to have elected water's-edge treatment. If another corporation pursuant to a corporate reorganization acquires a water's-edge taxpayer, the water's-edge election will carry over and be binding upon the acquiring corporation.

Each water's-edge contract is for an initial term of seven years and is automatically renewed each year thereafter for an additional one-year period unless the taxpayer gives written notice of nonrenewal at least 90 days prior to the anniversary date.

The election will continue indefinitely if a taxpayer elects water's-edge treatment and does not file a notice of nonrenewal. If the taxpayer files a notice of nonrenewal, the election remains in effect for the balance of the period remaining on the original seven-year election or the last renewal of the election.

A taxpayer may terminate a water's-edge election prior to the end of the seven-year period if:

- the taxpayer is acquired, directly or indirectly, by a non-electing entity that alone or together with its affiliates included in a combined report is larger, in terms of equity capital, than the taxpayer, or
- the taxpayer receives permission from FTB to terminate its election.

A taxpayer seeking FTB permission to terminate an election must demonstrate that continuation of the water's-edge requirements would:

- result in a significant disadvantage to the taxpayer, and
- that such disadvantage is the result of an extraordinary or significant event that could not have been reasonably anticipated when the original election was made.

THIS BILL

This provision of the bill would fundamentally reform the water's-edge election procedures to replace the contract with a statutory election. In addition, this bill would make the following changes relating to water's-edge elections:

- Codify the "substantial performance" concept currently in the regulations to prevent taxpayers that inadvertently fail to satisfy a procedural aspect of the election from losing their water's-edge status. This would include inconsistent filings made by water's-edge group members.

- Reform the acquisition rules so that a water's-edge taxpayer would no longer automatically "taint" any non-electing affiliates with which it becomes unitary. Instead, when two or more taxpayers become unitary, the status of the larger taxpayer would prevail. This result is more likely to coincide with a taxpayer's expectations and would prevent a large combined reporting group from becoming unintentionally bound by a water's-edge election when it acquires a smaller water's-edge electing taxpayer.

- Eliminate the renewal/nonrenewal provisions. Instead, require a taxpayer that makes a water's-edge election to request and receive permission from FTB to terminate the election within the first seven taxable years. However, allow the taxpayer to elect to return to a worldwide basis for any taxable year after the taxpayer has filed on a water's-edge basis for at least seven years. Likewise, after electing to return to a worldwide basis, require the taxpayer to file on a worldwide basis for at least seven taxable years before making another water's-edge election. However, the taxpayer could request and receive permission from the FTB to make a water's-edge election prior to the end of that seven-year period.

- Give FTB the authority to perfect elections that are not valid under current law since the other provisions of this proposal would be prospective only.

- Preserve existing law related to water's-edge elections by clarifying that, unless otherwise specifically provided, for purposes of provisions of the Internal Revenue Code relevant to water's-edge elections, the term "Internal Revenue Code" means those provisions of Title 26 of the United States Code, as applicable for federal tax purposes for the taxable period. This would override the otherwise applicable meaning of a reference to the Internal Revenue Code (the Internal Revenue Code as of a specified date) ensuring that relevant federal changes to federal tax law applicable to water's-edge elections will be applicable in computing the income and deductions of the water's-edge group.

IMPLEMENTATION CONSIDERATIONS

This provision of the bill would improve the department's ability to administer laws relating to water's-edge elections. The provision could be implemented in the department's annual program updates. Water's-edge elections made for taxable years beginning prior to January 1, 2003, would be deemed to be made under the provisions of this bill. However, the term of the election would be determined under the prior law. Water's-edge elections made for taxable years beginning on or after January 1, 2003, would be made according to this bill.

TECHNICAL CONSIDERATIONS

Amendment 1 is provided to remove unnecessary language.

LEGISLATIVE HISTORY

AB 2741 (Alquist, 1999/2000), and SB 657 (Scott, Stats. 2002, Ch 34) contained provisions identical to this provision of the bill. AB 2741 was held in the Assembly Appropriations Committee. The water's-edge provisions were amended out of SB 657 prior to its enactment because of the minor revenue loss.

OTHER STATES' INFORMATION

Other states have variations on the rules for apportionment of income of the activities of multinational corporations conducted in foreign countries. No other state has a water's-edge election mechanism. Although *Idaho* and *Alaska* have water's-edge-like elections, they are different than California's water's-edge election.

FISCAL IMPACT

This provision of the bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

It is not anticipated that this provision would have any significant revenue impact. The revenue impact, if any, would be determined collectively by: the number of taxpayers with an invalid water's-edge election, the tax differential between water's-edge and worldwide combined reporting for these taxpayers, and the timing of when assessments would have been issued and their eventual collection under current law.

At one time, audit staff had identified 200 to 300 taxpayers with potentially invalid water's-edge elections. However, all of these cases for taxable years 1994-1996 either were not audit worthy or the taxpayers were actually filing worldwide. It is highly unlikely any of these cases are currently under audit.

ARGUMENTS/POLICY CONCERNS

The requirement that the election be made by contract between the taxpayer and FTB necessitates an analysis under both tax law and contract law (including the legal concepts of offer and acceptance and substantial compliance) to determine the validity of an election. The two bodies of law (tax, which generally requires strict statutory adherence, and contract, with its more generous application of inferences drawn from facts and circumstances) are neither compatible nor complementary. While the water's-edge legislation initially used a contract because it was necessary to justify imposition of the filing requirement of a domestic disclosure spreadsheet and payment of the water's-edge election fee, these items are no longer required and thus eliminate the justification for the contract. No other apparent policy reason exists for retaining the contract requirement. If the water's-edge election were simply a tax election like any other (e.g., S corporation and installment sales), only tax law would be considered in determining the validity of the election and the mechanics of the election would be simplified.

In addition, reforming the water's-edge election procedures would:

- eliminate inconsistent filings by water's-edge group members;
- reduce the potential for unintended elections when acquisitions occur;
- eliminate the administrative burdens of filing and tracking notices of nonrenewal, and
- remove unintended consequences of nonrenewal.

Finally, this bill would allow FTB to work more cooperatively with taxpayers in perfecting their water's-edge elections.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1061
As Introduced February 27, 2003

AMENDMENT 1

On page 9, modify lines 18 and 19, inclusive, as follows:

as of the date the nonelecting ~~taxpayers, and pursuant to a Franchise Tax Board audit determination, the~~ ~~nonelecting~~