

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Chesbro Analyst: Norm Catelli Bill Number: SB 1869

Related Bills: _____ Telephone: 845-5117 Amended Date: April 23, 2002

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Conforming Income and Expense Rules for Foreign Activity To U.S. Rules for Certain Foreign Members of a Combined Group

SUMMARY

This bill would treat certain foreign activity income tax deductions as if they were incurred in the U.S.

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

The purpose of this bill is to provide clear statutory authority for FTB to allow corporations that are required to apportion their business income to California to treat items of business income and expense from a foreign country under the same rules as if these items were incurred within the U.S.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. Thus, it would be effective immediately, and apply to taxable years beginning on or after January 1, 2002. However, the provision specifically provides that it applies to all open tax years.

POSITION

Support.

On March 6, 2002, the Franchise Tax Board voted 2-0 to sponsor the language included in this bill.

ANALYSIS

FEDERAL/STATE LAW

Current federal law taxes a domestic corporation (corporations organized in the United States) on all its income, regardless of source. A domestic corporation may claim either a credit or a deduction for taxes paid to a foreign country on income earned from a foreign source so that the same income is not taxed by two nations.

Board Position:

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Department Director

Date

Gerald H. Goldberg

5/3/02

Current federal law taxes a foreign corporation (corporations organized outside of the United States) on U.S. source income realized from the active conduct of a trade or business within the U.S. The tax is imposed at graduated tax rates in the same manner as for a domestic corporation. Additionally, federal law imposes a flat 30% rate (or a lower rate if provided by treaty) on certain other specified types of income, usually investment and other types of passive (non-trade or business) income from U.S. sources. Federal law does not tax a foreign corporation's foreign source income.

Discriminatory treatment by a state that favors domestic commerce over foreign commerce is generally unconstitutional under the commerce clause of the U.S. Constitution, even if the discriminatory treatment has been adopted in conformity with federal statutes.

California tax law uses the "worldwide combined reporting" method, rather than the federal sourcing rules, to calculate the amount of a corporation's income that is taxable by California. The California combined reporting method treats business entities engaged in a single trade or business as a "unitary group." To calculate income, the worldwide business income and deductions of the unitary group are combined (treated as one entity). The amount of combined business income that is taxable by California is then calculated by the use of an apportionment formula. The apportionment formula consists of the following factors: a payroll factor, a property factor, and a sales factor times two. Each factor is a ratio of California activity to total activity worldwide. For example, the sales factor is the ratio of the unitary group's California sales to the unitary group's sales everywhere. Because the combined reporting method takes into account worldwide income, that method will often include income that would be characterized as foreign source income under the federal method.

This bill would resolve a problem related to charitable contribution deductions allowed to foreign corporations filing on a combined basis. The mechanics of the combined report may result in income of a foreign entity from the conduct of business activity in a foreign country being included in apportionable business income. However, California law only allows a charitable contribution deduction if the recipient is located in the United States. Since a foreign entity is most likely to make contributions to charitable organizations in their own country, a charitable contribution deduction would not be allowed against the foreign income includable in apportionable business income.

THIS BILL

This bill would allow certain foreign charitable contributions to be treated as if they had occurred in the U.S.

IMPLEMENTATION CONSIDERATIONS

Implementing this proposal would ease the administration of the tax law thereby assisting the department's programs and operations.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York laws use federal taxable income in the calculation of a corporation's state taxable income. The computation of federal taxable income does not contain the foreign income of a foreign corporation, so the laws of these states do not contain the problem this bill seeks to resolve.

The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

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

ECONOMIC IMPACT

As this proposal would codify existing departmental practice, it would not impact state income tax revenues.

LEGISLATIVE STAFF CONTACT

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