ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Speier	Analyst:	John Pavalasky	Bill Number:	SB 1067
Related Bills:	See Legislative History	Telephone:	845-4335	Amended Date:	April 24, 2003
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Corporation Taxes/Water's-edge Elections

SUMMARY

This bill would deny a water's-edge election to any corporation that, for tax purposes, has moved its headquarters' outside of the United States.

SUMMARY OF AMENDMENTS

The April 24, 2003, amendments completely replace the prior contents of the bill and insert the provisions discussed in this analysis.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to ensure that inverted domestic entities, i.e., former United States based corporations and partnerships that have converted themselves to foreign-country based corporations, pay their fair share of California taxes.

EFFECTIVE/OPERATIVE DATE

This bill provides that it would apply to water's-edge elections, including extensions, made on or after January 1, 2003, and does not affect any contracts in existence prior to that date.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is available to assist with amendments to resolve the implementation, technical, or policy concerns that arise as the bill moves through the legislative process.

ANALYSIS

FEDERAL/STATE LAW

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP	Gerald H. Goldberg	6/10/03
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_______ N	_______ OUA	___X___ PENDING		

Current Federal Law

Taxation of Domestic Corporations

Under current federal tax law, United States (domestic) corporations are taxed on their worldwide income. If a United States corporation has income from activities in foreign countries, then that country typically will tax the income sourced to that country. To the extent the United States would treat that income as arising from activities in foreign countries, it generally allows a credit for taxes against the corporation's federal income tax liability for the taxes paid to the foreign countries on such income.
A U.S. corporation, therefore, typically has income from its foreign operations taxed both here and in the foreign country in which that income was earned.

If a United States corporation conducts its business activities in a foreign country through subsidiaries, U.S. taxation of that foreign-earned income normally only happens when that income is received by the U.S. parent corporation in the form of a dividend paid by the foreign subsidiary. In order to combat tactics designed to convert what would normally be United States income to income reported by a foreign subsidiary, a series of complex anti-deferral rules (Subpart F of the Internal Revenue Code) were enacted to prevent the deferral of United States tax until the foreign subsidiary paid a dividend to the U.S. parent corporation. A foreign tax credit is allowed by the United States at the time dividends are paid, or deemed paid, by a foreign subsidiary to the United States parent. If a dividend is never paid, or deemed to be paid, to the United States parent by a foreign subsidiary the income of the foreign entity is never subject to United States tax.

For example, Group A (a U.S.-based multinational group) produces goods and/or services in the U.S. and abroad, and a foreign-based multinational group (Group B) produces exactly the same things, in the same amounts, for the same prices, in the same places as Group A.

In many cases, Group B will incur a lower United States tax bill, and in many cases a lower overall tax bill than Group A (the U.S-based group). This occurs first because all of the income of Group A will ultimately be subject to United States tax, while only the United States source income of Group B will be subject to United States tax. Second, it occurs because of tax rate differentials between the United States and some foreign countries.

These federal tax disadvantages have caused some U.S.-based multinational corporations with foreign-earned income to reincorporate and relocate their domiciles abroad. This transformation is accomplished by reincorporating in an appropriate foreign location, such as Bermuda or the Cayman Islands, typically by having a firm’s foreign subsidiary exchange its shares for those of the American parent company. Individual shareholders, who previously owned shares of the American parent company, will then own shares of the foreign (parent) company, which in turn owns the shares of the American company. These transformations are known as corporate inversions.

Taxation of Foreign Corporations

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is "effectively connected" with the conduct of a trade or business in the United States. Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a "permanent establishment" in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30% rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

Earnings Stripping

If structured properly, a corporate inversion can be used to reduce a company's taxes on domestically earned income (commonly called earnings stripping). This may be accomplished in several ways. In some inversion transactions the U.S. company issues debt to its foreign parent company in exchange for additional equity in the foreign company. The domestic firm can then deduct from its taxable income the interest expenses associated with the debt. However, since the U.S. corporation owns equity in the foreign company, the overall value of the domestic company does not change.

Another method of reducing a company's tax burden is to transfer ownership of intangible assets to the new foreign parent company. These assets continue to produce income in the United States, but that income is attributed to the foreign parent company that owns the intangible asset and faces a lower tax rate.

Current California Law

Worldwide Combined Reporting

Under current California law, California source income for unitary businesses 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. Where the business is incorporated (i.e., foreign or domestic) generally does not have a material effect on the California tax liability of the business under worldwide combined reporting.

Water’s-Edge Election

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. Under a water's-edge election, all the income of United States incorporated entities and a portion of the income of foreign incorporated entities doing business in the United States is included in the combined report, which is then apportioned geographically by use of the three-factor formula. Generally unitary foreign affiliates are excluded 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).

Thus, the income assigned to foreign corporations is generally not included within the water's-edge combined report.

Water's-Edge Contract

The water's-edge election must be made *by contract* with the Franchise Tax Board (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.

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.

<u>THIS BILL</u>

This bill would prohibit any foreign incorporated entity that is treated as an "inverted domestic corporation," as defined, from making a water's-edge election if the inversion was completed on or after January 1, 2003. Thus, if any one corporation that is a taxpayer within a combined group of corporations is treated as an "inverted domestic corporation," none of the members of the same unitary group may make a water's-edge election.

This bill would also require the FTB to prescribe legislative regulations to treat warrants, options, contracts to acquire stock, convertible debt instruments, and other similar interests as stock and to treat certain stock as not being stock.

<u>IMPLEMENTATION CONSIDERATIONS</u>

The bill prohibits a combined group with a taxpayer-member from making a water's-edge election. However, if an inverted domestic corporation in a combined group is not a taxpayer, nothing prevents the taxpayer-members of the combined group from making a water's-edge election. As a result, the combined group is not tainted by a member that is an inverted domestic corporation, unless that member is also a taxpayer. This result appears to be incompatible with the author's intent. To resolve this concern, the author may wish to require that a corporation making a water's-edge election self-certify that there is no inverted domestic corporation within the combined group, whether or not that inverted corporation is a "taxpayer" for California purposes.

This bill uses terms that are undefined, i.e., "completes," "direct or indirect acquisition," "substantially all," "constituting a trade or business," and "substantial business activities in the foreign country." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of the water's-edge election.

TECHNICAL CONSIDERATIONS

1. On page 3, line 30, the term "a partnership" should be stricken and "one partnership" should instead be inserted.

2. On page 3, line 31, the term "franchise" should be stricken and "Franchise Tax Board" should instead be inserted.

LEGISLATIVE HISTORY

SB 640 (Burton, 2003/2004) is a companion bill that would prohibit the state from entering into any contract with a publicly traded foreign incorporated entity or its subsidiary if that business meets certain conditions that would make it an expatriate company (a domestic corporation or partnership that incorporated in a foreign jurisdiction in name only).

SB 1061 (Senate Rev & Tax Committee, 2003/2004) is a Franchise Tax Board sponsored bill that would fundamentally reform the water's-edge election procedures to resolve problems that arise with elections made under the current contract rules. Under SB 1061, water's-edge elections would be made by statutory election rather than by contract.

PROGRAM BACKGROUND

As stated in the Senate Judiciary Committee analysis of SB 640 (Burton, 2003/2004), a companion bill to SB 1067, extensive hearings on corporate inversions or expatriations were held last year in connection with the Homeland Security Act then being debated in Congress. The hearings centered on whether an American company should be allowed to take advantage of tax benefits when it reincorporates in a foreign jurisdiction where the corporate tax rates are lower.

The Acting Assistant Secretary for Tax Policy, U.S. Department of the Treasury, during congressional testimony defined a corporate inversion (also known as expatriation) as a "transaction through which the corporate structure of a U.S.-based multinational group is altered so that a new foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group."

During that testimony before Congress, the Assistant Secretary also stated that the restructuring steps involving movement of foreign subsidiaries are complex and are taxable. When all the transactions are complete, however, the foreign operations of the company will be outside of the U.S. taxing jurisdiction and the corporate structure may also provide opportunities to reduce the U.S. tax on U.S. operations. Thus, she stated, U.S.-based companies and their shareholders are making the decision to reincorporate outside the United States largely because of the tax savings available.

The problem is accentuated by the fact that many United States corporations have in fact gone global, with income and profits coming from business ventures around the world, and the taxation scheme of the United States Tax Code has encouraged many of them to be "creative" in seeking ways to minimize taxes.

Bermuda and the Cayman Islands have been identified as favorite tax havens for corporate expatriations, although there are others in Europe and Asia.

The Senate Judiciary Committee analysis of SB 640 (Burton, 2003/2004), stated that:

> Early last year, news about Stanley Works, for example, seeking to reincorporate in Bermuda to save some $30 million in U.S. taxes when it only paid $7 million in U.S. taxes on foreign income last year, led to the conclusion that three quarters of the anticipated tax savings would have come from U.S. profits. Amid the hue and cry, Stanley Works stayed as a Connecticut corporation. More recently, Ingersoll-Rand, formerly of New Jersey but now operating as a Bermuda corporation, is reported to have avoided $50 million in U.S. taxes alone in 2002, almost as much as its U.S. defense and homeland security federal contracts. Thus, the outcry to restructure the tax code to recapture these taxes, and to force domestic companies to stay in-country led to various measures proposed in Congress last year, though none was actually passed. Rep. Neal, in reintroducing his measure in Congress this year, stated that corporate expatriation is a $4 billion problem for the federal treasury.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, Montana, New York,* and *North Dakota.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

1. Florida begins the computation of the Florida tax base with federal taxable income. An adjustment is required where the membership of the Florida affiliated group included in the Florida consolidated return differs from the membership in the federal affiliated group included in the federal consolidated return. The federal taxable income for the Florida affiliated group must be computed by adjusting for the difference, if any, between the income of the Florida and federal affiliated groups, including all intercompany adjustments and eliminations required under federal law. In addition, the Florida tax base excludes the following:

- Income from sources outside of the United States.
- Subpart F income.
- Dividends received from certain foreign corporations by domestic corporations choosing to use the foreign tax credit for federal purposes.

Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the Florida affiliated group's tax base.

2. Illinois begins its computation of the Illinois unitary group's tax base with federal taxable income. Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the Illinois unitary group's tax base. In addition, Illinois excludes from the unitary group any corporation having 80% or more of its total business activity outside of the United States (the 80/20 rule).

3. Massachusetts allows corporations filing federal consolidated returns to elect to file a combined return in that state. Taxable income must be determined and apportioned separately for each affiliated corporation and then combined to arrive at the group's net income subject to tax.

Taxable income for Massachusetts purposes is the same as that defined under the federal Internal Revenue Code (IRC) as amended and in effect for the taxable year, modified by adding back the interest from bonds, notes, and evidences of indebtedness of any state (including Massachusetts). However, the dividends received deduction and the deduction for income or franchise taxes are not allowed in computing Massachusetts taxable income. Federal modifications to each corporation's separate taxable income, generally including the eliminations and deferrals listed in Treasury Reg. Sec. 1.1502, are not recognized by Massachusetts. The taxable income amount for each corporation must be adjusted to reverse any of those modifications.

Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the Massachusetts combined group's tax base since a foreign corporation cannot be included in a federal consolidated return.

4. Michigan does not recognize the unitary method of taxation. Only firms actually engaged in business activity in Michigan are subject to the Michigan single business tax (SBT). A foreign subsidiary or parent corporation with no Michigan business activity is not subject to SBT. Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the Michigan business income component of the SBT tax base.

One of the components of the SBT is business income (which equals taxable income as defined for federal tax purposes) and additions or subtractions to business income.

- Additions include depreciation, taxes based on income, net operating loss carryover or carryback and any dividend, interest, and certain royalty expenses taken on the federal return.
- Subtractions include dividend, interest, and certain royalty income reported on the federal return.

Firms doing business in Michigan and in other states apportion their tax base to Michigan using a formula based on their percentage of property, payroll, and sales in Michigan. Financial organizations and transportation companies use a single factor formula based on gross business and revenue miles, respectively.

5. Minnesota requires a unitary group to file a combined return. A combined return for Minnesota may only include domestic corporations excluding insurance companies and investment companies. Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the Minnesota tax base. Foreign corporations and investment companies that have nexus with Minnesota, even if they are part of a unitary group, must file separate tax returns. In addition, Minnesota excludes from the unitary group (and treats as a foreign corporation) any corporation having 80% or more of its total business activity outside of the United States (the 80/20 rule).

6. Montana enacted legislation that, starting in tax year 2004, changes the manner in which it taxes corporations electing to file under the "water's edge" method of income apportionment. That change requires that the corporation's return include the income and apportionment factors for any corporation that is in a unitary relationship with the filing corporation and that also is incorporated in a "tax haven." The "tax havens" are specified in the statute to include Andorra, Anguilla, Antigua and

Barbuda, Aruba, the Bahamas, Bahrain, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Turks and Caicos Islands, Dominica, Gibraltar, Grenada, Guernsey-Sark-Alderney, Isle of Man, Jersey, Liberia, Liechtenstein, Luxemburg, Maldives, Marshall Islands, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, Samoa, Seychelles, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Tonga, U.S. Virgin Islands, and Vanuatu.

7. The New York tax base equals federal taxable income modified for income and deduction items that New York treats differently. Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the New York tax base.

New York uses a three-factor formula to allocate business income. The factors include property, payroll (excluding general executive officers), and receipts, with the latter factor being double weighted. Taxpayers allocate investment income by a formula that reflects the New York presence of the issuers of the obligations generating the investment income. In addition, New York's tax base excludes subsidiary income items and does not allow deductions directly and indirectly attributable to subsidiary capital.

8. In 2003, North Dakota legislation (SB 2054 and HB 1471) was introduced that proposes a flat North Dakota corporate income tax rate of 6.84% and 6.73%, respectively. SB 2054 would reduce the rate to 9.9% for corporations making a water's-edge election, while HB 1471 would repeal the water's-edge election provisions. Currently, the corporate income tax rate ranges from 3% on the first $3,000 to 10.5% on all taxable income above $50,000.

FISCAL IMPACT

If the implementation and policy considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

The revenue effects of this proposal over the initial three-year period are projected to be as follows:

Fiscal Year Cash Flow Impact Enactment Assumed After 6/30/03 $ Millions						
	2003-4	**2004-5**	**2005-6**	**2006-10**	**2010-13**	**Total**
New	**+1**	**+2**	**+3**	**+22**	**+27**	**+55**
Existing	**0**	**0**	**0**	**0**	**0**	**0**
Total	**+1**	**+2**	**+3**	**+22**	**+71**	**+55**

This analysis does not take into account any change in employment, personal income, or gross state product that may result from this bill becoming law.

Revenue Discussion

For most corporations, relocating their headquarters will shield more income under the water's-edge method than under the worldwide formulary apportionment method. This proposal would prohibit corporations that meet certain criteria involving the movement of their headquarters out of the United States after January 1, 2003 from electing water's-edge.

A number of corporations have been identified that have already relocated their headquarters out of the United States. Analysis of their tax returns suggests that the revenue cost of these relocations is approximately $132 million over the next ten years. (This revenue will not be recouped since the bill applies only to corporations relocating after January 1, 2003). Assuming that new relocations occur at the same rate as during the last several years and that the tax effects are approximately the same for old and new relocators, the revenue raised by this bill will initially increase at a rate of about $1 million per year. Over 10 years the total revenue raised by this bill is projected to be $55 million ($55 million from new corporate inversions + $0 from existing corporate inversions).

LEGAL IMPACT

SB 1067 would not prevent a non-U.S. corporation that was originally organized in a non-U.S. jurisdiction from making a water's-edge election. This would be true even if more than 50% of the ownership interests of the non-U.S. corporation belong to shareholders who are U.S. citizens, residents, or entities. The bill would affect those corporations or partnerships that were organized in the United States or under the law of the United States or any of its states and that subsequently are "acquired" by a shell company in a foreign country.

Further, acquisitions and mergers involving foreign corporations and domestic corporations or partnerships that are not nominal (on paper only) but rather involve a substantial change in ownership (where less than 50% of the resulting ownership is vested in the owners of the acquired or merged domestic corporation or partnership) would be excluded from the label "inverted domestic corporation" under this bill.

ARGUMENTS/POLICY CONCERNS

To facilitate the implementation of this ban on making a water's-edge election by an "inverted domestic corporation," the author may wish to require that a corporation making a water's-edge election self-certify that it is not an ineligible corporation (i.e., not an inverted domestic corporation). In addition, the author may wish to require that a foreign incorporated entity self-certify in its water's-edge election that it is not treated as an inverted domestic corporation for purposes of Section 835 of the Homeland Security Act of 2002 (Public Law 107-296) as that section was used as the basis for the language contained in this bill.

Because the bill now operates in a mandatory manner by precluding a water's-edge election whenever an "inverted domestic corporation" is a member of a unitary business that wishes to elect water's-edge treatment, there are concerns whether it impermissibly interferes with foreign affairs-- an area reserved exclusively to the federal government by the United States Constitution.

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