

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Migden Analyst: Gail Hall Bill Number: SB 663

Related Bills: See Legislative History Telephone: 845-6111 Introduced Date: February 22, 2005

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Clarify Coordination Of U.S.-Source Income & Subpart F Water's-Edge Partial Inclusion

SUMMARY

This bill would clarify specific provisions of the franchise tax law relating to water's edge taxpayers.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to clarify existing law, reduce taxpayer confusion, and eliminate unintended opportunities for tax avoidance.

EFFECTIVE/OPERATIVE DATE

If enacted in 2005, this bill would be effective January 1, 2006. The bill specifies that it would apply to taxable years beginning on or after January 1, 2005, with no inference for any taxable year beginning before January 1, 2005.

POSITION

Support

On December 2, 2003, the Franchise Tax Board voted 2-0, with the representative from the Department of Finance abstaining, to sponsor the provisions of this bill.

ANALYSIS

Current Federal Law

To understand this bill it is necessary to understand the general federal rules for taxing a U.S. corporation versus a foreign corporation. A U.S. corporation is taxed on all its income, regardless of source, and is allowed a credit for any taxes paid to a foreign country on its foreign-source income.

A U.S. corporation can operate in foreign countries directly through a "branch" or indirectly through its ownership in a foreign subsidiary. A foreign subsidiary owned more than 50% by U.S. shareholders is known as a controlled foreign corporation (CFC). Federal law taxes US-source income as well as "subpart F income" of a CFC. Subpart F income generally includes passive income such as dividends, interest, royalties, and rents. Subpart F income may also include shipping income, oil related income, insurance income, and income from certain sales of goods that are neither manufactured nor sold for use in the CFC's home country.

Board Position:

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Department Director

Date

Gerald H. Goldberg

4/13/05

A foreign corporation may derive income from sources within the U.S. This is referred to as U.S.-source income. Examples of U.S.-source income are:

1. income earned by a foreign corporation's sales office located in the U.S.,
2. royalties paid from a U.S. corporation to a foreign corporation, and
3. interest paid from a U.S. corporation to a foreign corporation.

A foreign corporation that is a CFC may have both U.S.-source income and subpart F income. In addition, some items of income can qualify both as U.S.-source and subpart F income (e.g., interest from U.S. Treasury Bonds). To the extent that a CFC has an item of income that is both U.S.-source and subpart F income, the income generally will be subject to both the U.S.-source rules and the subpart F income rules. The federal statutes coordinate the U.S.-source and subpart F income rules so that both sets of rules operate simultaneously and apply to a single corporation. The coordination of rules also assures that the same item of income is taxed only once.

Current State Law

If a taxpayer uses the worldwide unitary method to file its state taxes, its business income from both domestic and foreign operations is considered in the calculation of state tax. A share of that income is "apportioned" to California. The amount to be apportioned to California is determined on the basis of a formula. The formula measures relative levels of business activity in the state using the amounts of the taxpayer's property, payroll, and sales in California. These measures of activities are commonly called "factors." The factors from both domestic and foreign activities are included in the calculation of the apportionment formula.

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine their business income on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. Exceptions to this general rule are listed below.

The following affiliated foreign corporations, if unitary with an entity that is a water's-edge taxpayer, are includable in the water's-edge return. Revenue and Tax Code (R&TC) section 25110 lists these foreign affiliated corporations by paragraph number.

Paragraph

1. a domestic international sales corporation (DISC) and a foreign sales corporation (FSC),
2. a foreign incorporated entity, excluding banks, if the average of its property, payroll, and sales factors within the U.S. is 20% or more,
3. a U.S. entity,
4. a foreign corporation, if the average of its factors within the U.S. is 20% or less, but only to the extent of its U.S.-source income.
5. an export trade corporation, and
6. a corporation that is a CFC with subpart F income.

Generally, California conforms to the federal rules for U.S.-source income discussed in the "current federal law" section, above. California does not conform to the federal subpart F rules. Instead, the income and factors of a CFC are included in the water's-edge return based on a ratio. The ratio is the CFC's current year subpart F income for federal purposes to the CFC's earnings and profits. The includable portion of a CFC's income will be referred to as "subpart F income" for this analysis.

State law is silent on how the rules work when a corporation has both U.S.-source and subpart F income. In contrast, federal law does specify the rules, and both the U.S.-source income and subpart F income of a CFC is subject to federal taxation. The department has consistently included a CFC's U.S.-source and subpart F income in the water's-edge return.

BACKGROUND

This bill deals with two problems in current state law regarding the taxation of CFCs included in a water's-edge return.

Problem #1

Some taxpayers interpret state law to provide that if a CFC becomes a California taxpayer, it is no longer included under the rules for CFCs¹. The consequence of this interpretation is that the taxpayer includes only the CFC's U.S.-source income and factors in the water's-edge tax return and excludes the CFC's subpart F income.

Generally, CFCs are foreign subsidiaries and not California taxpayers. A CFC could become a California taxpayer by qualifying with the Secretary of State or by establishing minimal ties to California to create nexus.

The department interprets the statute to require any CFC with subpart F income to include its subpart F income in the water's-edge tax return regardless of whether it was a California taxpayer.²

Example: Problem #1

Generally, foreign corporations are excluded from the water's-edge group. Specific exceptions to general rule include:

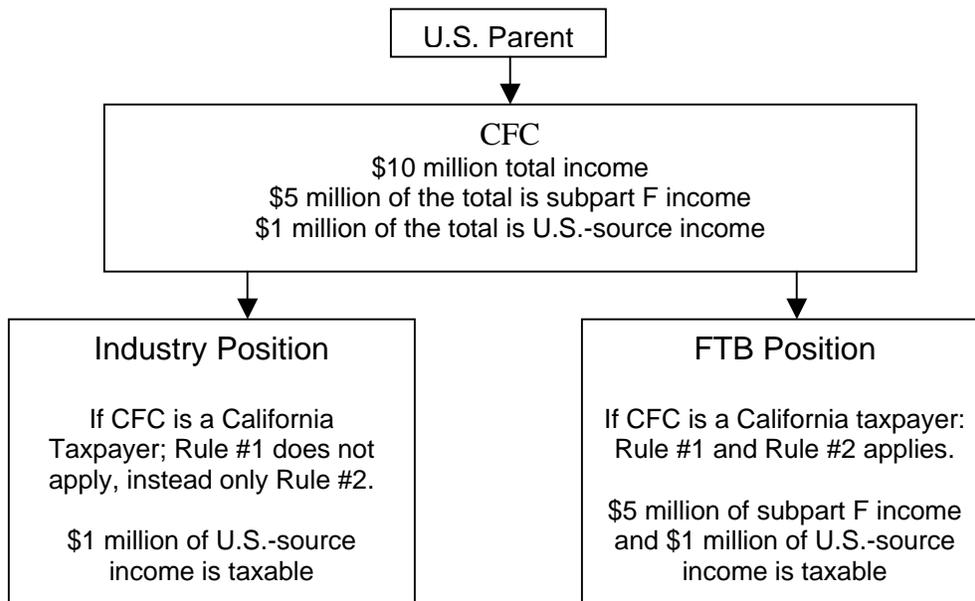
Rule #1 A CFC's income is included in water's-edge return based on the ratio of subpart F income/earning and profits.

Rule #2 A foreign corporation with less than 20% U.S. activities is included in water's-edge group but only to the extent of its U.S.-source income.

¹ R&TC Section 25110(a)(7)(B).

² It is department staff's opinion that the provisions of Section 25110(a)(6), which include "any" affiliated CFC, is broad enough to require inclusion of all CFCs in the combined report, regardless of whether they are California taxpayers. Further, the rules of statutory construction would favor the inclusion of CFCs because presumably the legislature would not create a law including CFCs in the water's-edge group that could be avoided simply by becoming a California taxpayer or generating a minimal amount of U.S.-source income.

Problem #1: If CFC is a California taxpayer which rule applies?



Problem #2

Taxpayers interpret state law to provide that if a CFC has both U.S.-source income and subpart F income, then only the CFC's U.S.-source income is subject to California tax. Taxpayer's take the position that the rules for CFCs and U.S-source income do not operate simultaneously.

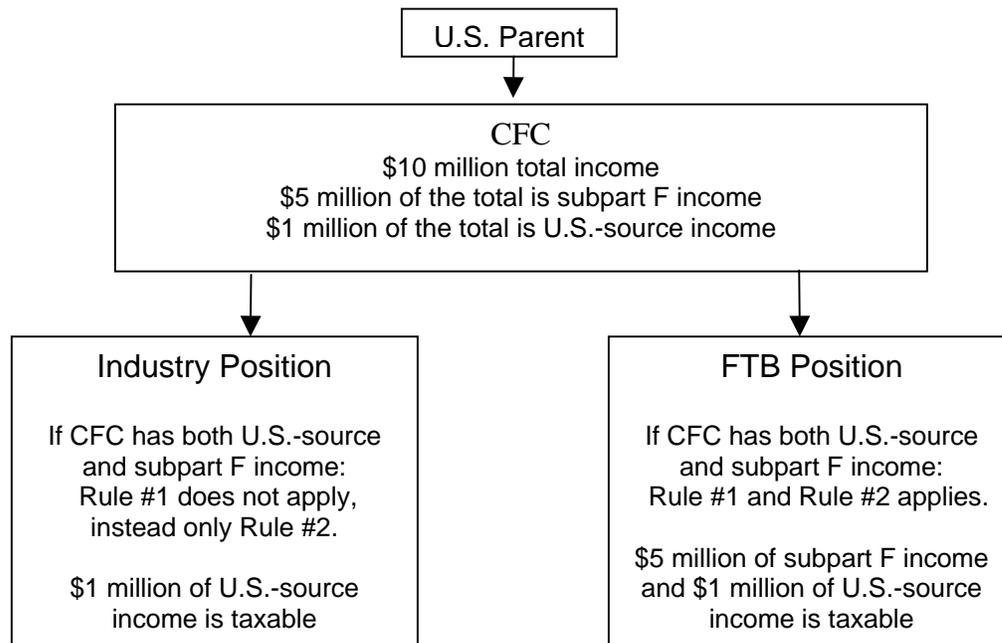
Example: Problem #2

Generally, foreign corporations are excluded from the water's-edge group. Specific exceptions to general rule include:

Rule #1 A CFC's income is included in water's-edge group based on a ratio of subpart F income/earning and profits.

Rule #2 A foreign corporation with less than 20% U.S. activities is included in water's-edge group but only to the extent of its U.S.-source income.

Problem #2: If CFC is not a California taxpayer but has both U.S.-source income and subpart F income, which rule applies?



THIS BILL

This bill would:

1. clarify that a CFC that is a California taxpayer cannot exclude its subpart F income from a water's-edge edge return;
2. clarify that a CFC that has U.S.-source income cannot exclude its subpart F income from a water's-edge return;
3. coordinate existing laws so that the U.S.-source income rules and the subpart F income rules would operate simultaneously and apply consistently to corporations regardless of whether they are California taxpayers; and
4. require the Franchise Tax Board (FTB) to issue regulations to resolve problems relating to potential double taxation of U.S.-source and subpart F income.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would occur during the department's normal annual update.

TECHNICAL CONSIDERATIONS

1. On page 4, line 11, after "in," "this" should be inserted.
2. On page 4, line 14, "if" should be stricken.

LEGISLATIVE HISTORY

SB 1571 (Alpert, 2003/2004) was nearly identical to this bill and passed out of the Senate but was held in Assembly policy committee.

AB 1469 (Ortiz, 1997/1998) was similar to this bill but was vetoed by Governor Wilson. The Governor stated that the water's-edge provision was added to the bill late in the legislative session with little or no policy debate, and it could have a negative effect on the California business community.

OTHER STATES' INFORMATION

Other states have variations on the rules for apportionment of income of the activities of multinational corporations conducted in foreign countries. However, no other state taxes on a water's-edge basis similar to California. Thus, it does not appear that these issues apply to other states.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

If this bill simply clarifies existing law, there would be no revenue impact. However, taxpayers assert that under their interpretation of existing law, they have been allowed since 1988 to create sufficient nexus to cause their CFCs to become California taxpayers and avoid including otherwise includible subpart F income. To date, relatively few taxpayers have been identified as asserting a nexus or other position for excluding subpart F income. The total revenue at risk is uncertain, perhaps a few million annually currently, but could reach \$50 million annually in the near future if the taxpayers' position is sustained. This projection is based on a prior examination by audit staff of corporations with prominent CFCs.

Revenue Discussion

Under the taxpayers' interpretation, the number of CFCs that establish ties in California sufficient to create nexus and any otherwise includible subpart F income and apportionment factors would determine the revenue impact of this bill. Removing CFC dividends from the calculation of the inclusion ratio (used to determine includable subpart F income) has been previously estimated, through an examination of tax returns, at \$25 million annually. Departmental staff estimates that this loss is roughly half of the loss attributed to excluding all subpart F income.

ARGUMENTS/POLICY CONCERNS

Department staff held a meeting with industry representatives in October 2003. Industry representatives did not express concerns with the issues addressed in this bill, but stated a preference for staff to develop a broader proposal, namely changing the conceptual approach from California's methods of taxing a CFC to one conforming to federal law that would treat subpart F income as a deemed dividend distribution. They also recommended that such an approach include a revenue neutral dividends received deduction.

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