

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Calderon Analyst: Gail Hall Bill Number: AB 1012
Related Bills: See Legislative History Telephone: 845-6111 Amended Date: August 22, 2008
Attorney: Patrick Kusiak Sponsor: Franchise Tax Board

SUBJECT: Controlled Foreign Corporations In Water's-Edge Combined Report

SUMMARY

This bill would simplify a complex area of "stand alone" state tax law for certain taxpayers by conforming to the federal tax law treatment for a controlled foreign corporation (CFC).

SUMMARY OF AMENDMENTS

The August 22, 2008, amendments removed the provisions relating to property tax exemption and added the provisions relating to CFCs.

PURPOSE OF THE BILL

The purpose of this Franchise Tax Board sponsored bill is to simplify the method used to report a water's-edge taxpayer's portion of its CFC's income by removing current law's "stand alone" inclusion ratio method and conforming to the federal Subpart F rules.

EFFECTIVE/OPERATIVE DATE

This bill is effective immediately and specifically operative for taxable years beginning on or after January 1, 2008.

POSITION

Support.

On March 6, 2008, the FTB voted 2-0 to sponsor the water's edge-provisions included in this bill, with the member from the DOF abstaining.

Board Position:

| | | |
|---------------------------------------|------------------------------|----------------------------------|
| <input checked="" type="checkbox"/> S | <input type="checkbox"/> NA | <input type="checkbox"/> NP |
| <input type="checkbox"/> SA | <input type="checkbox"/> O | <input type="checkbox"/> NAR |
| <input type="checkbox"/> N | <input type="checkbox"/> OUA | <input type="checkbox"/> PENDING |

Department Director

Date

Selvi Stanislaus

9/03/08

ANALYSIS

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. In general, a U.S. corporation is taxed on all its income, regardless of source, and is allowed a tax credit for any taxes paid to a foreign country on its foreign-source income. Foreign corporations are generally excluded from filing a federal tax return, except for income effectively connected with the conduct of that trade or business in the U.S. Deductions are allowed to net this income, and the net taxable income is taxed at the U.S. graduated tax rates. In addition, foreign corporations are taxed at a flat 30% rate (or a lower rate if provided by treaty) on specified types of fixed, determinable, annual, or periodic income, usually from investments, derived from U.S. sources. This is noneffectively connected income.

Subpart F of the Internal Revenue Code (IRC) (Sections 951-965), provides a comprehensive set of special rules for taxing certain U.S. shareholders of CFCs. In general, a CFC is defined as any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock, or more than 50 percent of the total value of the stock, is owned by U.S. shareholders. A U.S. shareholder includes a U.S. citizen or resident, domestic corporation or partnership, or an estate or trust, other than a foreign estate or trust, that owns 10 percent or more of a foreign corporation. The CFC provisions were originally enacted to combat perceived abuses where income that could be taxed by the U.S. was assigned to foreign subsidiaries located in "tax havens."

U.S. shareholders of a CFC must include in their gross income certain types of income and investments of the CFC that would otherwise be excluded from taxable income under general federal tax rules. Any income of a CFC that meets the definition of Subpart F income is treated as a deemed dividend received by the U.S. shareholder, regardless of whether the income was actually distributed to the shareholder. Subpart F income generally includes passive income such as dividends, interest, royalties, and rents.

Subpart F income may also include foreign personal holding company income, services income, 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. In addition, a U.S. shareholder must include in federal income the increase in earnings invested in U.S. property. A U.S. shareholder must treat its CFC's Subpart F income as if the Subpart F income was distributed to the U.S. shareholder in the form of a dividend and must report their pro rata share of the CFC's Subpart F income based on ownership as of the last day of the CFC's taxable year. The basic formula for determining a U.S. shareholder's pro-rata share of Subpart F income is illustrated in the attached Appendix A.

The amount of Subpart F income includable in a U.S. shareholder's gross income for any taxable year may not exceed the CFC's earning and profits for the taxable year. The CFC will compute its earnings and profits as if such corporation were a domestic corporation. The amounts reported in financial statements of the foreign companies must be recomputed to clearly reflect income based on U.S. tax accounting principles and methods. Dividends paid out of previously taxed earnings and profits are excluded from Subpart F income. This is referred to as previously taxed income.

Miscellaneous Federal Provisions Relating to CFCs.

- A U.S. shareholder may have dividend income on the sale or exchange of stock in a foreign corporation if at some time during the five years ending on the date of disposition both of the following conditions are met:¹
 - The U.S. shareholder owned at least a 10% voting interest in the corporation, and
 - The corporation was more than 50% controlled by U.S. persons.
- The U.S. shareholder's basis in the stock of its CFC is increased by the amount of Subpart F income and decreased by any distributions that have been paid out of previously taxed Subpart F income.²
- A temporary elective 85% dividends received deduction is allowed for cash dividends paid by CFCs to a U.S. corporate shareholder during either of the following two periods:³
 - The taxpayer's last tax year that begins before October 22, 2004, or
 - The taxpayer's first tax year that begins during the one-year period beginning on October 22, 2004.
- A credit for taxes imposed by foreign countries may be taken on the federal tax return and is referred to as the "foreign tax credit."⁴
- Foreign base company income and insurance income are excluded from Subpart F income, by election, if it is established that such income was subject to an effective tax rate imposed by a foreign country greater than 90% of the maximum federal corporate tax rate.⁵ (High Foreign Tax Rule).

STATE LAW

If a taxpayer uses the worldwide unitary method to file its state taxes, its unitary business income from both domestic and foreign operations is considered in the calculation of state tax. A share of that business income is "apportioned" to California. The amount to be apportioned to California is determined by 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. There are exceptions to this general rule as certain affiliated foreign corporations, if unitary with an entity that is a water's-edge taxpayer, are includable in the water's-edge combined report (group tax filing). One of these exceptions is an affiliated CFC with Subpart F income.

¹ IRC section 1248.

² IRC section 961.

³ IRC section 965.

⁴ IRC section 960.

⁵ IRC section 954(b)(4).

California conforms to the federal definitions of a CFC and U.S. shareholder, but does not conform to the federal Subpart F provisions discussed in the "Current Federal Law" section above. Instead, state law requires a CFC with Subpart F income to include a portion of its net income⁶ and apportionment factors⁷ in the water's-edge group tax filing based on an inclusion ratio. The inclusion ratio determines the amount of the CFC's income and apportionment factors included in the water's-edge group tax filing. The numerator of the inclusion ratio is the CFC's current year total Subpart F income⁸ and the denominator is the CFC's current year total earnings and profits. In addition, California does not include increases in earnings invested in U.S. property as Subpart F income.

The CFC's net business income, nonbusiness income, and apportionment factors that are included in the U.S. shareholder's water's-edge California income are calculated as follows:

1. CFC's Includable Business Income⁹

$$\frac{\text{CFC's Subpart F Income}}{\text{CFC's Earnings \& Profits}} \times \text{CFC's Business Net Income} = \text{CFC's Includable Business Income}$$

2. CFC's Includable Nonbusiness¹⁰ Income

$$\frac{\text{CFC's Subpart F Income}}{\text{CFC's Earnings \& Profits}} \times \text{CFC's Nonbusiness Net Income} = \text{CFC's Includable Nonbusiness Income}$$

3. CFC's Includable Apportionment Factors (Property, Payroll, and Sales that relate to Subpart F income)

$$\frac{\text{CFC's Subpart F Income}}{\text{CFC's Earnings \& Profits}} \times \text{CFC's Factors} = \text{CFC's Includable Apportionment Factors}$$

See Appendix A for an example of the inclusion ratio.

The inclusion ratio cannot fall below zero or exceed 100%. When the above calculations are determined for each CFC, then any CFC with an inclusion ratio between 1-100% is included in the water's-edge group tax filing as a subsidiary and included in the calculation of state taxable income.

The basis of a CFC's stock is determined by using the original cost basis, net of any returns or contributions of capital. No adjustment is made to increase basis in the stock with respect to Subpart F income included in the combined report or to reduce the basis to the extent dividends are declared.

⁶ As reflected on the CFC's current year books and records, adjusted to conform to California tax law.

⁷ Property, payroll, and sales. Used to determine percentage used to assign business income to California.

⁸ The numerator includes 100% of the CFC's Subpart F income.

⁹ Revenue and Taxation Code (R&TC) section 25120(a) defines business income as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

¹⁰ R&TC section 25120(d) defines nonbusiness income as all income other than business income.

If a dividend is declared, an elimination is allowed under Revenue and Taxation Code (R&TC) section 25106 to the extent the dividend is paid from earnings and profits, which were previously included in the combined report. In addition, any dividends remaining after elimination may qualify for a deduction under R&TC section 24411.

When a water's-edge provision refers to a provision of the IRC, this means the IRC in effect for federal purposes.¹¹

THIS BILL

This bill would simplify the method used to report a water's-edge taxpayer's portion of its CFC's income by conforming to the federal Subpart F rules for computing the amount of a CFC's income that is included in a shareholder's income. This bill would accomplish the following:

- Remove current law's "stand-alone" inclusion ratio method for computing the amount of a CFC's net income and apportionment factors that are included in the water's-edge group tax filing. CFC's would no longer be included in the water's-edge combined report, therefore, a CFC's apportionment factors would be excluded.
- Conform to the federal Subpart F provisions and provide that the amount of a CFC's Subpart F income would be included in a water's-edge taxpayer's income and treated as a "deemed dividend."
- Provide that a 27% dividend deduction would be allowed against the CFC's Subpart F income included in the water's-edge taxpayer's income.
- Add the following transitional rules for conforming to the federal Subpart F provisions:
 - Income previously taxed as Subpart F income before this bill becomes operative would be considered previously taxed income for state tax purposes.
 - Federal adjustments to the CFC's stock basis before this bill becomes operative would become the new stock basis for the CFC for state purposes.
- Specify that state law would not conform to the following rules relating to CFCs:
 - The gain from certain sales or exchanges of stock in certain foreign corporations.¹²
 - The temporary 85% dividend received deduction for dividends received from CFCs.¹³
 - The foreign tax credit.¹⁴
- Add that the High Foreign Tax Rule election would be valid for state purposes only if a valid election was made for federal purposes.

¹¹ R&TC Section 25116.

¹² IRC section 1248.

¹³ IRC section 965.

¹⁴ IRC section 960.

- Specify that if a water's-edge election is terminated, the Subpart F rules would no longer apply and only the previously taxed income and stock basis adjustments accumulated during the water's-edge election would be allowed.
- Prohibit the dividend deduction, exclusion, or elimination from exceeding the amount of earnings and profits that apply to the dividend distribution.
- Specify that R&TC section 24425 is inapplicable as it relates to previously taxed income and to the 27% dividend exclusion.
- Specify that the Franchise Tax Board may prescribe regulations as may be necessary and appropriate to carry out the provisions of this portion of the bill.

TECHNICAL CONSIDERATIONS

Under current state law, there are two versions of the same water's-edge code section (R&TC section 25110). One version relates to water's-edge elections made prior to January 1, 2006, and the other version relates to water's-edge elections made on or after January 1, 2006. This bill amended the CFC provisions in the version that applies to elections made on or after January 1, 2006, but failed to amend the version that applies to elections made prior to January 1, 2006. This issue is the result of a drafting error that would have no impact on the department's ability to implement this bill, but should be corrected when appropriate.

LEGISLATIVE HISTORY

AB 1561 (Calderon, 2007/2008) would change California's specified date of conformity to federal income tax law from January 1, 2005, to January 1, 2008. The provisions of this bill were amended into AB 1561 on June 23, 2008, amended out of AB 1561 on August 22, 2008, and amended into this bill on August 22, 2008.

PROGRAM BACKGROUND

Because of the complexity of the calculations involved in the state's current treatment of Subpart F income, department staff find low taxpayer compliance with the current statutory method. When calculating includable income for a CFC, many taxpayers use the federal "deemed Subpart F dividends" amount as reported on their federal return, rather than using the inclusion ratio to determine the amount of CFC income and factors to be included for California purposes.

Compliance with the law requires all unitary taxpayers to perform the recordkeeping and analysis for each of their CFCs, regardless of whether the result materially affects California tax or not. This requirement is particularly burdensome for taxpayers that do not have a large presence in California because the computations in the partial inclusion ratio are unique to California.

In addition, the CFC inclusion ratio rules are burdensome for the department to administer. Department auditors spend numerous hours recalculating incorrect methods used by taxpayers to include a CFC's income and factors in the water's-edge group tax filing often only to discover that the audit adjustments have minor tax effect. One reason for the minor tax effect is because the taxpayer included the federal Subpart F deemed dividend amount in income, which sometimes results in almost the same tax amount. In addition, any adjustments to the amount of a CFC's income and factors includable in a water's-edge taxpayer's income affects the calculation of the dividend elimination, foreign dividend deduction, foreign investment interest offset, and any deferred intercompany transactions.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. Research was performed to determine the method these states use to determine the amount of a CFC's income (loss) that is subject to tax.

Research found that none of these states use an inclusion ratio for calculating the amount of a CFC's income that is subject to tax.

- *Florida* uses federal taxable income as the starting point for computing *Florida* taxable income and requires Subpart F income to be excluded from *Florida* taxable income.
- *Illinois* adopts federal law and federal Subpart F income is subject to Illinois state tax.
- *Massachusetts* adopts federal tax law and follows the federal treatment of Subpart F income. *Massachusetts's* Supreme Court held that the amount of Subpart F income that is included in a corporation's federal gross income is treated as a dividend for *Massachusetts's* corporate income tax and a dividend deduction is allowed against such income.
- *Michigan*, effective January 1, 2008, includes dividends and royalties received from foreign operating entities, including Subpart F income, in the computation of taxable income.
- *Minnesota* includes Subpart F income in the computation of *Minnesota* taxable income with modifications.
- *New York's* starting point for computing a corporation's tax base is federal taxable income, which includes federal Subpart F income.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following net revenue impact.

Revenue Estimate

| Estimated Revenue Impact of this Bill Effective for Taxable Years BOA 1/1/08 Enactment Assumed After 6/30/08 | | |
|--|-------------|-------------|
| 2008-09 | 2009-10 | 2010-11 |
| <-\$500,000 | <-\$500,000 | <-\$500,000 |

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue impact of the bill would depend on the difference in amounts of net CFC income included in the water's-edge group tax filing under current state law (partial inclusion of subpart F income and unitary factors) versus federal law's provisions (Subpart F income treated as a deemed dividend).

The estimate was derived in the following steps:

1. Selected a statistically representative sample of water's-edge filers reporting CFC income or a foreign dividend deduction (Forms 100W–Water's Edge Filers or the 2004 taxable year);
2. Calculated the change in tax (increase or decrease) if each filer reported Subpart F income according to the bill. This was accomplished as follows:
 - Reversed the amount of CFC income reported on line 7a of Form 100W.
 - Added Subpart F income as reported on the federal Form 5471.
 - Excluded the amount of the CFC's property, payroll, and sales reported in the denominator of the apportionment factors.
 - Added the amount of the CFC's Subpart F income (100%) in the taxpayer's denominator of the sales factor.
3. Multiplied the calculated tax change for each corporation by its respective weight and summed the results: a revenue gain of \$21.4 million;
4. Assumed the approximate revenue offset for the taxpayer favorable transitional rules, interest offset, and intercompany transactions: a revenue loss of \$3 million;
5. Calculated a dividends-received deduction that would result in a roughly revenue neutral tax impact for the bill: 27% dividends deduction. The dividends-received deduction reduces the amount of CFC income and the amount included in the sales factor denominator.

Using data from 2004, conforming to the federal deemed dividend rules result in a revenue gain of \$21.4 million. This revenue gain would be reduced somewhat by proposed transition rules: (1) income previously taxed as Subpart F income before this bill is effective would be considered previously taxed income for state purposes, and (2) federal adjustments to the stock basis of a CFC before this bill is effective would become the new stock basis for the CFC for state purposes. For purposes of an estimate, it is assumed the revenue reduction is approximately \$3 million annually. This assumption is based on discussions with knowledgeable audit and legal department staff. This impact could drop in future years beyond those for which estimates are developed here. At the 2004 level, allowing a 27% dividends-received deduction for Subpart F would result in a net revenue loss.

For each component of the estimate, except for the \$3 million impact discussed in item 4 above, the tax effect is grown by the forecast in corporate profits as projected by the Department of Finance. The 2009 taxable year results are presented in the table below, as this is the first year that both calendar year and fiscal year filers would be represented.

| Estimated Revenue Effects Projected to the 2009 Taxable Year Level (\$ in Millions) | |
|---|----------------|
| Conformity with federal rules | +\$34.1 |
| Transitional rules | -\$ 3.0 |
| Dividend-received deduction | <u>-\$31.6</u> |
| Net Impact for 2009 | -\$ 0.5 |

Although the net tax effect for the bill is roughly revenue neutral, most corporations in the sample would experience a tax decrease. Specifically, 44% had a tax decrease, 25% a tax increase, and 31% had no tax impact.

LEGISLATIVE STAFF CONTACT

Legislative Analyst
Gail Hall
(916) 845-6111
gail.hall@ftb.ca.gov

Revenue Manager
Rebecca Schlusser
(916) 845-5986
rebecca.schlusser@ftb.ca.gov

Legislative Director
Brian Putler
(916) 845-6333
brian.putler@ftb.ca.gov

APPENDIX A

Federal Treatment: The Basic Formula For Determining A U.S. Shareholder's Pro-Rata Share Of Subpart F Income

$$\frac{\text{U.S. Shareholder's Shares}}{\text{Total Outstanding Shares}} \times \text{Subpart F Income of the CFC} = \text{Amount of Subpart F Income Treated As A Deemed Dividend}$$

For example:

Shareholder Y, a domestic corporation, owns 60 percent (60 shares/100 total shares outstanding) of a CFC. The CFC generated \$100,000 of subpart F income for the taxable year. Shareholder Y's pro rata share of the CFC's subpart F income is \$60,000 (60% x \$100,000). The \$60,000 is reported in Shareholder Y's federal tax return as a deemed dividend included in taxable income.

California Treatment: Inclusion Ratio Example

CFC, Inc. is a unitary foreign subsidiary with subpart F income of \$60,000 and current earnings and profits of \$120,000. CFC, Inc. has \$100,000 of net business income, \$50,000 of net nonbusiness income, property with an historic cost of \$150,000, payroll of \$75,000 and total sales everywhere of \$300,000. The following amounts from the CFC would be included in the water's-edge group tax filing:

- \$50,000 of the CFC's business income ($\$60,000/\$120,000 \times \$100,000$).
- \$25,000 of the CFC's nonbusiness income ($\$60,000/\$120,000 \times \$50,000$).
- \$75,000 of property in the denominator of the property factor ($(\$60,000/\$120,000 \times \$150,000)$)
- \$37,500 of payroll in the denominator of the payroll factor ($(\$60,000/\$120,000 \times \$75,000)$)
- \$150,000 of sales in the denominator of the sales factor. ($\$60,000/\$120,000 \times \$300,000$).

The inclusion ratio cannot fall below zero or exceed 100%. Once the above calculations are determined for each owned CFC, then any CFC with an inclusion ratio between 1-100% is included in the water's-edge combined report as a subsidiary and included in the calculation of state taxable income.

APPENDIX B
Illustration of Current Law and AB 1012

Facts:

US Corporation P owns 100% of CFC1. P files its California return on a water's-edge basis. Assume CFC1 has the following facts for the current year:

| | |
|-------------------------------------|------------|
| CFC1's Business Net Income | \$ 100 |
| Subpart F Income | \$ 10 |
| CFC 1's Earnings & Profits (E & P): | |
| Beginning of the year | \$ 5 |
| Current Year | <u>100</u> |
| Total E & P | \$105 |
| Inclusion ratio: 10/100 | 10% |
| <u>CFC1's Factors:</u> | |
| Property | \$ 3,204 |
| Payroll | \$ 851 |
| Sales | \$17,000 |

Mechanics

| | <u>Proposed Law</u> | <u>Current Law</u> |
|---|----------------------------|---------------------------|
| CFC1's Business Net Income | | |
| Times Inclusion Ratio | N/A | \$ 10 (10% x \$100) |
| Subpart F Income (treated as a dividend) | \$ 10 | N/A |
| 27% Dividend Deduction (\$10 x 27%) | <u>(3)</u> | <u>N/A</u> |
| Amount of CFC1's Income Included For Water's-Edge Purposes | \$ 7 | \$ 10 |

CFC1's Factors Included For CA Purposes:

| | | |
|----------|------|-----------------------|
| Property | None | \$ 32 (3,204 x 10%) |
| Payroll | None | \$ 9 (851 x 10%) |
| Sales | \$ 7 | \$ 170 (17,000 x 10%) |

Year 2: Actual \$100 Dividend Is Paid from CFC1 to US Parent Corporation P

| | | |
|--|---------------------|---------------------|
| Corporation P's Dividend Income | \$ 100 | \$ 100 |
| Dividend Exclusion: PTI (\$5 + \$10) | (15) | N/A |
| Dividend Elimination: Section 25106 | | (10) |
| Dividend Deduction: Section 24411 | (64) ¹⁵ | (67) ¹⁶ |
| Foreign Investment Interest Offset (Assume = 10% of Section 24411) | <u>6</u> | <u>7</u> |
| Amount of Dividend Income Included In US Parent's business income | \$ 27 | \$ 30 |

¹⁵(\$100 Dividend – \$15) x 75% = \$64.

¹⁶(\$100 Dividend – \$10) x 75% = \$67.