Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author:	Calderon	Analyst:	Scott McFarlane	Bill Number:	AB 1561
Related Bills:	See Prior Analysis	Telephone:	845-6075	Amended Date:	June 23, 2008
		Attorney:	Patrick Kusiak	Sponsor:	Franchise Tax Board

SUBJECT: Conformity Act of 2008 / Controlled Foreign Corporations in Water's-Edge Returns

X DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended June 14, 2007.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced/amended ____________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ____________.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED JUNE 14, 2007, STILL APPLIES.

X OTHER – See comments below.

SUMMARY

This bill would do the following:

1. Change California's specified date of conformity to federal income tax law from January 1, 2005, to January 1, 2008, and thereby, in general, conform to the numerous changes made in federal income tax law during that three-year period; and
2. Simplify specific provisions of applicable law relating to water's-edge taxpayers.

SUMMARY OF AMENDMENTS

The bill as amended June 23, 2008, would:

- Conform to numerous 2007 changes in federal income tax law;
- Update the bill's operative date to apply to taxable years beginning on or after January 1, 2008;
- Make technical and clarifying changes suggested in the department's previous analysis; and
- Simplify specific provisions of applicable law relating to water's-edge taxpayers.

Board Position:			Legislative Director	Date
X S	NA	NP		
SA	O	NAR	Brian Putler	6/24/08
N	OUA	PENDING		

As a result of the amendments:

Conformity Provisions - A new revenue estimate is provided, and the "Federal/State Law," "This Bill," and "Other States' Information" sections have been revised and are provided below. Except for these revisions, the department's previous analysis of this provision included in the bill as amended June 14, 2007, still applies. The "Position," "Purpose of the Bill," and "Arguments/Policy Considerations" sections are restated for convenience.

Water's-Edge Provisions - A complete analysis is provided.

SUMMARY OF REVENUE ESTIMATES

Summary Revenue Estimates for AB 1561
Assumed Enactment After June 30, 2008
($ in Millions)

Conformity Provisions	2007-08	2008-09	2009-10	2010-11
Tax Revenue Totals		$12.25	-$2.15	-$10.35
Penalty and Interest Totals	$3.05	$8.65	$12.75	$18.75
Totals of Conformity Provisions	$3.05	$20.9	$10.6	$8.4
Water's-Edge Provisions				
Tax Revenue		<-$.5	<-$.5	<-$.5
Grand Totals - Tax Revenue *		$11.85	-$2.55	-$10.75
Grand Totals - Penalty and Interest *	$3.05	$8.65	$12.75	$18.75
Grand Total Revenue Estimate for AB 1561 *	**$3.05**	**$20.5**	**$10.2**	**$8.0**

*For purposes of adding totals, estimates of less than $150,000 are assumed to equal $50,000; less than $250,000 equal to $200,000; less than $500,000 equal to $400,000 and less than $750,000 equal to $600,000.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to conform to numerous changes in federal law to simplify the preparation of California income tax returns, and to simplify a complex area of the Corporation Tax Law that has been burdensome for taxpayers and department and resulted in taxpayer noncompliance.

POSITION

Conformity Provisions - On June 27, 2007, the Franchise Tax Board (FTB) voted 2-0 to support the conformity provisions in AB 1561 as amended on June 14, 2007, with the member from the Department of Finance (DOF) abstaining. The Board has not had an opportunity yet to take a position on the 2007 conformity provisions added by the June 23, 2008, amendments.

Water's-Edge Provisions - 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.

<u>PROVISION NO. 1: CONFORMITY ACT OF 2008</u>

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. This provision would be effective immediately, and unless otherwise specified, it would apply to taxable years beginning on or after January 1, 2008.

POSITION

Conformity Provisions - On June 27, 2007, the Franchise Tax Board (FTB) voted 2-0 to support the conformity provisions in AB 1561 as amended on June 14, 2007, with the representative from Department of Finance abstaining.

Water's-Edge Provisions - On March 6, 2008, the FTB voted 2-0 to sponsor the water's edge-provisions included in this bill (these provisions at the time of the vote included in AB 3078), with the member from the Department of Finance abstaining.

ANALYSIS

FEDERAL/STATE LAW

See FTB's annual reports titled "Summary of Federal Income Tax Changes – 2005," "Summary of Federal Income Tax Changes – 2006," and "Summary of Federal Income Tax Changes – 2007" for a detailed discussion of federal and state law.

THIS PROVISION

This provision would change the specified date from January 1, 2005, to January 1, 2008, for taxable years beginning on or after January 1, 2008. Changing the specified date automatically conforms state law to all changes from January 1, 2005, through December 31, 2007, to Internal Revenue Code (IRC) sections that have been previously incorporated by reference. Thus, California law would conform to most of the changes made to the federal income tax law during that three-year period.

This bill would also make numerous changes to specifically not conform to or modify certain items in the IRC. And, technical changes regarding cross references and deletion of unnecessary language that was used to conform to federal law changes subsequent to January 1, 2005, and prior to January 1, 2008, are being made by this bill.

The following tables list:

- The federal Act sections that impact provisions of the Personal Income Tax Law (PITL), Administration of Franchise and Income Tax Law (AFITL), and Corporation Tax Law (CTL);
- The beginning page number in FTB's annual report where that provision is discussed; and
- The change under this bill -- whether AB 1561 conforms or does not conform to that provision. (Note that conformity decisions that require modification are listed in the conform column.)

For certain federal provisions, California law automatically conforms to a federal law change and those provisions are not listed and not discussed in this analysis. Additionally, those federal provisions that are not applicable to the PITL, AFITL, and CTL are not listed and not discussed in this analysis.

2005 Conformity Decisions

These tables contain only items for which a conformity decision was necessary.

Table 2 – **Disaster Mitigation Payments Act (PL 109-7)**				
		FTB's 2005 Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
1	Proper Tax Treatment of Certain Disaster Mitigation Payments	**9**	**X**	

Table 3 – **ETIA of 2005 (PL 109-58)**				
		FTB's 2005 Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
1308	Electric Transmission Property Treated As 15-year Property	**38**	**PIT**	**CORP**
1309	Expansion of Amortization For Certain Atmospheric Pollution Control Facilities In Connection With Plants First Placed in Service after 1975	**40**	**X**	
1310	Modification to Special Rules For Nuclear Decommissioning Cost	**41**	**X**	
1323	Temporary Expensing for Equipment Used in Refining Liquids Fuels	**50**		**X**
1324	Pass Through to Owners of Deduction for Capital Costs Incurred By Small Refiner Cooperatives in Complying With EPA Sulfur Regulations	**54**		**X**
1325	Natural Gas Distribution Lines Treated As 15-Year Property	**57**	**PIT**	**CORP**
1326	Natural Gas Gathering Lines Treated As 7-Year Property	**59**	**PIT**	**CORP**
1328	Determination of Small Refiner Exception to Oil Depletion Deduction	**67**	**X**	
1329	Amortization of Geological and Geophysical Expenditures	**68**	**X**	
1331	Energy Efficient Commercial Buildings Deduction	**71**		**X**
1351	Expansion of Research Credit	**101**		**X**
1363	Modification of Recapture Rules for Amortizable Section 197 Intangibles	**107**	**X**	

Table 5 – **Conformity Revenue Estimates for GO Zone Act of 2005 (PL 109-135)**

		FTB's 2005 Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
101-F	Expensing for Certain Demolition and Clean-up Costs	**182**		**X**
101-O	Treatment of Public Utility Disaster Losses	**203**		**X**
303	Modification of Effective Date of Exception from Suspension Rules for Certain Listed and Reportable Transactions	**253**	**X**	
305	Disclosures of Certain Tax Return Information	**256**		**X**
401-423	Tax Technical Provisions	**261**	**X**	

2006 Conformity Decisions

These tables contain only items for which a conformity decision was necessary.

Table 1 – **TIPRA of 2005 (PL 109-222)**

		FTB's 2006 Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
Title II	**OTHER PROVISIONS**			
201	Clarification of Taxation of Certain Settlement Funds	**23**	**X**	
202	Modification of Active Business Definition under Section 355	**25**	**X**	
204	Capital Gains Treatment for Certain Self-Created Musical Works	**31**	**X**	
207	Amortization of Expenses Incurred in Creating or Acquiring Music or Music Copyrights	**38**	**X**	
209	Modification of Treatment of Loans to Qualified Continuing Care Facilities	**43**	**X**	
Title V	**REVENUE OFFSET PROVISIONS**			
501	Application of Earnings Stripping Rules to Partners Which are Corporations	**50**	**X**	

Act Section	Provisions		Conform	Not Conform
503	5-Year Amortization of Geological and Geophysical Expenditures for Certain Major Integrated Oil Companies	**53**	**X**	
507	Section 355 Not to Apply to Distributions Involving Disqualified Investment Companies	**65**	**X**	
510	Increase in Age of Minor Children Whose Unearned Income is Taxed as if Parent's Income	**75**	**X**	

Table 3 – **Clarification of Treatment of Self-Employment for Purposes of the Limitation on State Taxation of Retirement Income (PL 109-264)**				
		FTB's 2006 Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
1	Clarification of Treatment of Self-Employment for Purposes of the Limitation on State Taxation of Retirement Income	**101**	**X**	

Table 4 **– PPA of 2006 (PL 109-280)**				
		FTB's 2006 Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
Title I	**REFORM OF FUNDING FOR SELF-EMPLOYED DEFINED BENEFIT PENSION PLANS**			
112	Minimum Funding Standards; Funding Rules for Single-Employer Defined Benefit Pension Plans	**103**	**X**	
113	Benefit Limitations Under Single-Employer Plans	**125**	**X**	
Title II	**FUNDING RULES FOR MULTIEMPLOYER DEFINED BENEFIT PENSION PLANS**			
211	Funding Rules for Multiemployer Defined Benefit Plans	**143**	**X**	
212	Additional Funding Rules for Multiemployer Plans in Endangered or Critical Status	**151**	**X**	

Table 4 – **PPA of 2006 (PL 109-280)**				
		FTB's 2006 Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
221	Sunset of Additional Funding Rules	**177**	**X**	
Title VIII	**PENSION RELATED REVENUE PROVISIONS**			
Subtitle C	**Improvements in Portability, Distributions, and Contribution Rules**			
827	Penalty-Free Withdrawals from Retirement Plans for Individuals Called to Active Duty for at Least 179 Days	**290**	**X**	
828	Waiver of 10% Early Withdrawal Penalty Tax on Certain Distributions of Pension Plans for Public Safety Employees	**293**	**X**	
831	Allowance of Additional IRA Payments in Certain Bankruptcy Cases	**298**	**X**	
833	Inflation Indexing of Gross Income Limitations on Certain Retirement Savings Incentives	**301**	**X**	
Subtitle D	**Health and Medical Benefits**			
844	Treatment of Annuity and Life Insurance Contracts with a Long-Term Care Insurance Feature	**315**		**X**
Subtitle F	**Other Provisions**			
863	Treatment of Death Benefits from Corporate-Owned Life Insurance	**335**	**X**	
866	Exemption of Income from Leveraged Real Estate Held by Church Plans	**345**	**X**	
868	Gratuitous Transfer for Benefits of Employees	**348**	**X**	
Title XII	**PROVISIONS RELATING TO EXEMPT ORGANIZATIONS**			
Subtitle A	**Charitable Giving Incentives**			
1201	Tax-Free Distributions from Individual Retirement Plans for Charitable Purposes	**401**	**Expired**	
1202	Extension of Modification of Charitable Deduction for Contribution of Food Inventory	**410**	**Expired**	

Table 4 – **PPA of 2006 (PL 109-280)**				
		FTB's 2006 Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
1203	Basis Adjustment to Stock of S Corporation Contributing Property	**413**	**Expired**	
1204	Extension of Modification of Charitable Deduction for Contribution of Book Inventory	**415**	**Expired**	
1205	Modification of Tax Treatment of Certain Payments to Controlling Exempt Organizations	**417**	**Expired**	
1206	Encouragement of Contributions of Capital Gains Real Property Made for Conservation Purposes	**420**	**Expired**	
Subtitle B	**Reforming Exempt Organizations**			
Part 1	**General Reforms**			
1211	Reporting on Certain Acquisitions of Interests on Insurance Contracts in Which Certain Exempt Organizations Hold an Interest	**429**	**X**	
1213	Reform of Charitable Contributions of Certain Easements in Registered Historic Districts and Reduced Deduction for Portion of Qualified Conservation Contribution Attributable to Rehabilitation Credit	**437**	**X**	
1214	Charitable Contributions for Taxidermy Property	**443**	**X**	
1215	Recapture of Tax Benefit for Charitable Contributions of Exempt Use Property Not Used for an Exempt Use	**446**	**X**	
1216	Limitation of Deduction for Charitable Contributions of Clothing and Household Items	**451**	**X**	
1217	Modification of Recordkeeping Requirements for Certain Charitable Contributions	**455**	**X**	
1218	Contributions of Fractional Interests in Tangible Personal Property	**457**	**X**	
1219	Provisions Relating to Substantial and Gross Overstatements of Valuations	**460**	**X**	
1220	Additional Standards for Credit Counseling Organizations	**465**	**X**	

Table 4 – **PPA of 2006 (PL 109-280)**				
		FTB's 2006 Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
1222	Definition of Convention or Association of Churches	**479**	**X**	
1223	Notification Requirement for Entities Not Currently Required to File	**481**	**X**	
Part 2	**Improved Accountability of Donor Advised Funds**			
1231-1235	Excise Taxes Relating to Donor Advised Funds, Excess Benefit Transactions Involving Donor Advised Funds and Sponsoring Organizations, Excess Business Holdings of Donor Advised Funds, Returns of, and Application for Recognition by Sponsoring Organizations	**492**		**X**
Part 3	**Improved Accountability of Supporting Organizations**			
1241-1245	Requirements for Supporting Organizations, Excess Benefit Transactions Involving Supporting Organizations, Excess Business Holding of Supporting Organizations, Treatment of Amounts Paid to Supporting Organizations by Private Foundations, and Returns of Supporting Organizations	**510**		**X**

Table 5 – **TRHCA of 2006 (PL 109-432)**				
		FTB's Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
Division A	**Extension and Expansion of Certain Tax Relief Provisions and Other Tax Provisions**			
Title I	**EXTENSION AND MODIFICATION OF CERTAIN PROVISIONS**			
104	Extension and Modification of Research Credit	**538**		**X**
122B	Disclosure of Return Information Regarding Terrorist Activity	**577**		**X**
Title II	**ENERGY TAX PROVISIONS**			
204	Deduction for Energy Efficient Commercial	**589**		**X**

Table 5 – **TRHCA of 2006 (PL 109-432)**				
		FTB's Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
	Buildings			
209	Special Depreciation Allowance for Cellulosic Biomass Ethanol Plant Property	**597**		**X**
Title IV	**OTHER PROVISIONS**			
402	Credit for Prior Year Minimum Tax Liability Made Refundable After Period of Years	**616**		**X**
404	Partial Expensing for Advance Mine Safety Equipment	**620**		**X**
406	Whistleblower Reforms	**624**		**X**
407	Frivolous Tax Submissions	**626**	**X**	
409	Clarification of Taxation of Certain Settlement Funds Made Permanent – Effective in Taxable Year 2011.	**629**	**X**	
410	Modification of Active Business Definition Under Section 355 Made Permanent – Effective in Taxable Year 2011.	**630**	**X**	
412	Capital Gains Treatment for Certain Self-Created Musical Works Made Permanent	**635**	**X**	
417	Exclusion of Gain from Sale of Principal Residence by Certain Employees of the Intelligence Community	**648**	**X**	
418	Sale of Property by Judicial Officers	**650**	**X**	
419	Premiums for Mortgage Insurance	**651**	**X**	
424	Modification of Excise Tax on Unrelated Business Taxable Income of Charitable Remainder Trusts	**661**		**X**
425	Loans to Qualified Continuing Care Facilities Made Permanent – Effective in Taxable Year 2011	**662**	**X**	
426	Technical Corrections	**664**	**X**	

2007 Conformity Decisions

These tables contain only items for which a conformity decision was necessary.

Table 6 – **The Small Business Work Opportunity Act (SBWOTA) of 2007 (PL 110-28)**

		FTB's 2007 Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
8215	Family business tax simplification	**17**	**X**	
8233	Recapture of bad debt reserves	**32**	**X**	
8234	Treatment of sale of interest in a qualified subchapter S subsidiary	**33**	**X**	
8236	Permit interest deduction to an electing small business trust to acquire S corporation stock	**35**	**X**	
8241	Increase in age of minor children whose unearned income is taxed as if parents' income	**37**	**X**	
8242	Modify interest suspension under 6404(g) from 18 to 36 months	**39**	**X**	
8245	Increase in penalty for bad checks and money orders	**43**	**X**	
8246	Understatement of taxpayer liability by return preparers	**44**	**X**	
8247	Penalty for filing erroneous refund claims	**46**	**X**	

Table 7 - **Title XV of the Energy Independence and Security Act (EISA) of 2007(PL 110-140)**

		FTB's 2007 Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
1502	7-year amortization of geological and geophysical expenditures for major integrated oil companies	**59**	**X**	

Table 8 – **The Virginia Tech Victims and Family Assistance Act (PL 110-141)**				
		FTB's 2007 Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
1	Exclude from income payments from Hokie Spirit Memorial Fund	**63**	**X**	
2	Modify penalty for failure to file partnership returns	**64**		**X**

Table 9 **– The Mortgage Forgiveness Debt Relief Act (MFDRA) (PL 110-142)**				
		FTB's 2007 Annual Report Page No.	**Decision**	
Act Section	**Provisions**		**Conform**	**Not Conform**
1 - 2	Exclusion of discharge of principal residence indebtedness	**66**		Defer to AB 1918 or SB 1055
3	Extension of deduction for private mortgage insurance	**68**	**X**	
4	Change in tests to qualify as cooperative housing corporation	**70**	**X**	
5	Exclusion from income for benefits provided to volunteer EMS and firefighters	**71**	**X**	
6	Modify the prohibition against full-time students from qualifying for LIHTC unit	**74**	**X**	
7	Allow surviving spouse to exclude from gross income up to $500,000 of the gain from sale of principal residence if the sale occurs within 2 years of the death of the spouse	**76**	**X**	
8	Increase penalty for failure to file partnership returns	**77**	**X** (20% of federal penalty)	
9	Impose a penalty for failure to file S corporation returns	**79**	**X** (20% of federal penalty)	

Table 10 – **The Tax Technical Corrections Act of 2007 (PL 110-172)**				
		FTB's 2007 Annual Report Page No.	**Decision**	
			Conform	**Not Conform**
	The Tax Technical Correction Act of 2007 (TTCA)	**85**	**X**	

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. (*Florida* imposes corporate income tax, but does not does not impose personal income tax.)

Illinois, Michigan, and *New York* automatically conform each taxable year to the IRC. *Florida*, *Massachusetts* and *Minnesota* conform to the IRC as of a specified date, similar to California. Florida conforms to the IRC as amended through January 1, 2007. Massachusetts conforms to the IRC as amended through January 1, 2005. *Minnesota* conforms to the IRC as amended through February 13, 2008.

FISCAL IMPACT

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

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Based on data and assumptions discussed below, the revenue impact from this bill would be as shown in the following tables. Items that impact the measure of tax (tax revenue) are summed for each year, as are items that do not impact the measure of tax (penalties and interest). Total summaries of all three years are provided at the end. Note that penalty and interest provisions are identified by an asterisk (*).

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

2005 Conformity Revenue Tables

Table 2 – **Conformity Revenue Estimates for the Disaster Mitigation Payments Act (PL 109-7)** For Amounts Received or Dispositions Made Before, On, Or After April 15, 2005 Assumed Enactment After June 30, 2008 ($ in Millions)					
Act Section	**Provisions**	2007-08	2008-09	2009-10	2010-11
1	Proper Tax Treatment of Certain Disaster Mitigation Payments		0	0	0

Table 3 – **Conformity Revenue Estimate for the ETIA of 2005 (PL 109-58)** Assumed Enactment After June 30, 2008 ($ in Millions)					
Act Section	**Provisions**	2007-08	2008-09	2009-10	2010-11
1308	Electric Transmission Property Treated As 15-year Property		-<$0.15	-<$0.15	-<$0.25
1309	Expansion of Amortization For Atmospheric Pollution Control Facilities for Plants First Placed in Service after 1975		0	0	0
1310	Modification to Special Rules For Nuclear Decommissioning Cost		-$3.0	-$2.0	-$2.0
1325	Natural Gas Distribution Lines Treated As 15-Year Property		-<$0.25	-<$0.5	-$0.6
1326	Natural Gas Gathering Lines Treated As 7-Year Property		-<$0.15	-<$0.15	-<$0.15
1328	Determination of Small Refiner Exception to Oil Depletion Deduction		-<$0.5	-$1.0	-$1.0
1329	Amortization of Geological and Geophysical Expenditures	Included in Act Section 1502 of the EISA of 2007			
1363	Modification of Recapture Rules for Amortizable Section 197 Intangibles		<$0.15	<$0.15	<$0.15

Table 5 – **Conformity Revenue Estimate for GO Zone Act of 2005 (PL 109-135)** Assumed Enactment After June 30, 2008 ($ in Millions)					
Act Section	**Provisions**	2007-08	2008-09	2009-10	2010-11
303 *	Modification of Effective Date of Exception from Suspension Rules for Certain Listed and Reportable Transactions	$1.0	$0.75	$0.75	$0.75
401	Tax Technical Provisions		0	0	0

2005 Totals	2007-08	2008-09	2009-10	2010-11
2005 Tax Revenue Totals		-$3.65	-$3.45	-$3.8
2005 Penalty and Interest Totals	$1.0	$0.75	$0.75	$0.75
2005 Grand Totals	$1.0	-$2.9	-$2.7	-$3.05

2006 Conformity Revenue Tables

Table 1 – **Conformity Revenue Estimates for TIPRA of 2005 (PL 109-222)**
Assumed Enactment After June 30, 2008
($ in Millions)

Act Section	**Provisions**	2007-08	2008-09	2009-10	2010-11
Title II	**OTHER PROVISIONS**				
201	Clarification of Taxation of Certain Settlement Funds	Included in Act Section 409 of the TRHCA of 2006			
202	Modification of Active Business Definition under Section 355	Included in Act Section 410 of the TRHCA of 2006			
204	Capital Gains Treatment for Certain Self-Created Musical Works	Included in Act Section 412 of the TRHCA of 2006			
207	Amortization of Expenses Incurred in Creating or Acquiring Music or Music Copyrights		<$0.15	<$0.15	<$0.15
209	Modification of Treatment of Loans to Qualified Continuing Care Facilities	Included in Act Section 425 of the TRHCA of 2006			
Title V	**REVENUE OFFSET PROVISIONS**	2007-08	2008-09	2009-10	2010-11
501	Application of Earnings Stripping Rules to Partners Which are Corporations		0	0	0
503	5-Year Amortization of Geological and Geophysical Expenditures for Certain Major Integrated Oil Companies	Included in Act Section 1502 of the EISA of 2007			
507	Section 355 Not to Apply to Distributions Involving Disqualified Investment Companies		$1.0	<$0.5	<$0.5
510	Increase in Age of Minor Children Whose Unearned Income is Taxed as if Parent's Income		$8.0	$6.0	$6.0

Table 3 **– Conformity Revenue Estimates for Clarification of Treatment of Self-Employment for Purposes of the Limitation on State Taxation of Retirement Income (PL 109-264)**
Assumed Enactment After June 30, 2008
($ in Millions)

Act Section	**Provisions**	2007-08	2008-09	2009-10	2010-11
1	Clarification of Treatment of Self-Employment for Purposes of the Limitation on State Taxation of Retirement Income		baseline	baseline	baseline

Table 4 – **Conformity Revenue Estimates for PPA of 2006 (PL 109-280)**
Assumed Enactment After June 30, 2008
($ in Millions)

Act Section	Provisions	2007-08	2008-09	2009-10	2010-11
Title I	**REFORM OF FUNDING FOR SELF-EMPLOYED DEFINED BENEFIT PENSION PLANS**				
112	Minimum Funding Standards; Funding Rules for Single-Employer Defined Benefit Pension Plans		baseline	baseline	baseline
113	Benefit Limitations Under Single-Employer Plans		baseline	baseline	baseline
Title II	**FUNDING RULES FOR MULTIEMPLOYER DEFINED BENEFIT PENSION PLANS**				
211	Funding Rules for Multiemployer Defined Benefit Plans		baseline	baseline	baseline
212	Additional Funding Rules for Multiemployer Plans in Endangered or Critical Status		baseline	baseline	baseline
221	Sunset of Additional Funding Rules		baseline	baseline	baseline
Title VIII	**PENSION RELATED REVENUE PROVISIONS**				
Subtitle C	**Improvements in Portability, Distributions, and Contribution Rules**				
827	Penalty-Free Withdrawals from Retirement Plans for Individuals Called to Active Duty for at Least 179 Days		- < $0.15	- < $0.15	- < $0.15
828	Waiver of 10% Early Withdrawal Penalty Tax on Certain Distributions of Pension Plans for Public Safety Employees		- < $0.25	- < $0.25	- < $0.25
831	Allowance of Additional IRA Payments in Bankruptcy Cases		- < $0.25	- < $0.25	- < $0.15
833	Inflation Indexing of Gross Income Limitations on Certain Retirement Savings Incentives		-$1.0	-$1.0	-$2.0
Subtitle F	**Other Provisions**				
863	Treatment of Death Benefits from Corporate-Owned Life Insurance		< $0.15	< $0.15	< $0.15
866	Exemption of Income from Leveraged Real Estate Held by Church Plans		-< $0.15	-< $0.15	-< $0.15
868	Gratuitous Transfer for Benefits of Employees		< $0.15	< $0.15	< $0.15

Table 4 – **Conformity Revenue Estimates for PPA of 2006 (PL 109-280)**
(continued)

Title XII	**PROVISIONS RELATING TO EXEMPT ORGANIZATIONS**				
Subtitle A	**Charitable Giving Incentives**				
1201[1]	Tax-Free Distributions from Individual Retirement Plans for Charitable Purposes		baseline	baseline	baseline
1203[2]	Basis Adjustment to Stock of S Corporation Contributing Property		baseline	baseline	baseline
Subtitle B	**Reforming Exempt Organizations**				
Part 1	**General Reforms**				
1211	Reporting on Certain Acquisitions of Interests on Insurance Contracts in Which Certain Exempt Organizations Hold an Interest		baseline	baseline	baseline
1213	Reform of Charitable Contributions of Certain Easements in Registered Historic Districts and Reduced Deduction for Portion of Qualified Conservation Contribution Attributable to Rehabilitation Credit		< $0.25	< $0.25	<$0.25
1214	Charitable Contributions for Taxidermy Property		<$0.15	< $0.15	< $0.15
1215	Recapture of Tax Benefit for Charitable Contributions of Exempt Use Property Not Used for an Exempt Use		baseline	baseline	baseline
1216	Limitation of Deduction for Charitable Contributions of Clothing and Household Items		baseline	baseline	baseline
1217	Modification of Recordkeeping Requirements for Certain Charitable Contributions		baseline	baseline	baseline
1218	Contributions of Fractional Interests in Tangible Personal Property		<$0.25	<$0.25	<$0.25

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[1] 1201 - Although now expired for taxable years beginning on or after January 1, 2008, this federal provision results in ongoing baseline revenue losses for California. Ongoing baseline losses result from required minimum distributions (RMDs) in future years being reduced. In future years, RMD's are less than otherwise because the account value of an IRA is reduced due to direct contributions made to charities during the two-year window provided by the now expired federal provision.

[2] 1203 - Although now expired for taxable years beginning on or after January 1, 2008, this federal provision results in ongoing baseline revenue losses for California. The now-expired federal provision resulted in a basis adjustment of a lesser amount than under present law. Ongoing baseline losses result from less gain on subsequent S corporation stock sales due to a shareholder having a high basis in the stock.

Table 4 – **Conformity Revenue Estimates for PPA of 2006 (PL 109-280)**
(continued)

1219 *	Provisions Relating to Substantial and Gross Overstatements of Valuations		<$0.15	<$0.15	<$0.15
1220	Additional Standards for Credit Counseling Organizations		<$0.25	<$0.25	<$0.25
1222	Definition of Convention or Association of Churches		<$0.15	<$0.15	<$0.15
1223	Notification Requirement for Entities Not Currently Required to File		<$0.15	<$0.15	<$0.15

Table 5 - **Conformity Revenue Estimates for TRHCA of 2006 (PL 109-432)**
Assumed Enactment After June 30, 2008
($ in Millions)

Act Section	**Provisions**				
Title IV	**OTHER PROVISIONS**	2007-08	2008-09	2009-10	2010-11
407 *	Frivolous Tax Submissions		< $0.15	< $0.15	< $0.15
409	Clarification of Taxation of Certain Settlement Funds Made Permanent – Effective in Taxable Year 2011[3]		-<$0.5	-<$0.5	-<$0.5
410	Modification of Active Business Definition Under Section 355 Made Permanent – Effective in Taxable Year 2011[4]		-<$0.5	-<$0.5	-<$0.5
412	Capital Gains Treatment for Certain Self-Created Musical Works Made Permanent[5]		0	0	0
417	Exclusion of Gain from Sale of Principal Residence by Certain Employees of the Intelligence Community		-< $0.15	-< $0.15	-< $0.15
418	Sale of Property by Judicial Officers		-< $0.15	-< $0.15	-< $0.15
419	Premiums for Mortgage Insurance	Included in Act Section 3 of the MFDRA of 2007			
425	Loans to Qualified Continuing Care Facilities Made Permanent – Effective in Taxable Year 2011[6]		-< $0.15	-< $0.15	-< $0.15
426	Technical Corrections		0	0	0

2006 Totals	2007-08	2008-09	2009-10	2010-11
2006 Tax Revenue Totals		$7.05	$4.45	$3.60
2006 Penalty and Interest Totals		$0.10	$0.10	$0.10
2006 Grand Totals		$7.15	$4.55	$3.7

[3] Includes revenue from Act Section 201 of the TIPRA of 2005.
[4] Includes revenue from Act Section 202 of the TIPRA of 2005.
[5] Includes revenue from Act Section 204 of the TIPRA of 2005.
[6] Includes revenue from Act Section 209 of the TIPRA of 2005.

2007 Conformity Revenue Tables

Table 1 – **Conformity Revenue Estimates for Small Business and Work Opportunity Tax Act of 2007 (PL 110- 28)**
Assumed Enactment After June 30, 2008
($ in Millions)

Act Section	Provisions	2007-08	2008-09	2009-10	2010-11
8215	Family business tax simplification		baseline	baseline	baseline
8233	Recapture of bad debt reserves		$1.0	-$1.0	-$2.0
8234	Treatment of sale of interest in a qualified subchapter S subsidiary		-<$0.15	-<$0.15	-<$0.15
8236	Permit interest deduction to an electing small business trust to acquire S corporation stock		-<$0.15	-<$0.15	-<$0.15
8241	Increase in Age of Minor Children whose unearned income is taxed as if parents' income		$4.5	$4.5	$4.5
8242 *	Modify interest suspension under 6404(g) from 18 to 36 months	$2.0	$3.0	$4.0	$4.0
8245 *	Increase in penalty for bad checks and money orders		<$0.5	<$0.5	<$0.5
8246 *	Understatement of taxpayer liability by return preparers		<$0.5	$0.5	$0.5
8247 *	Penalty for filing erroneous refund claims	<$0.15	$1.0	$4.0	$10.0

Table 2 **- Energy Independence and Security Act (EISA) of 2007 (PL 110- 140)**
Assumed Enactment After June 30, 2008
($ in Millions)

		2007-08	2008-09	2009-10	2010-11
1502	7-year amortization of geological and geophysical expenditures for major integrated oil companies[7]		$14.0	$3.0	-$6.0

Table 3 - **Virginia Tech Victims and Family Assistance Act (PL 110-141)**
Assumed Enactment After June 30, 2008
($ in Millions)

Act Section	Provisions	2007-08	2008-09	2009-10	2010-11
1	Exclude from income payments from Hokie Spirit Memorial Fund		-<$0.15	-<$0.15	-<$0.15

[7] Includes revenue from Act Section 1329 of the ETIA of 2005, and Act Section 503 of the TIPRA of 2005.

Table 4 **- Mortgage Forgiveness Debt Relief Act of 2007 (PL 110-142)**
Assumed Enactment After June 30, 2008
($ in Millions)

Act Section	**Provisions**	2007-08	2008-09	2009-10	2010-11
3	Extension of deduction for private mortgage insurance		-$6.0	-$6.0	-$4.0
4	Change in tests to qualify as cooperative housing corporation		-<$0.15	-<$0.15	-<$0.15
5	Exclusion from income for benefits provided to volunteer EMS and firefighters		-$4.0	-$3.0	-$2.0
6	Modify the prohibition against full-time students from qualifying for LIHTC unit		-<$0.15	-<$0.15	-<$0.15
7	Allow surviving spouse to exclude from gross income up to $500,000 of the gain from sale of principal residence if the sale occurs within 2 years of the death of the spouse		-<$0.5	-<$0.5	-<$0.5
8 *	Increase penalty for failure to file partnership returns		$2.0	$2.0	$2.0
9 *	Impose a penalty for failure to file S corporation returns		$1.0	$1.0	$1.0

Table 5 **- Technical Corrections Act of 2007 (HR 4839, PL 172)**
Assumed Enactment After June 30, 2008
($ in Millions)

	No impact			

2007 Totals	2007-08	2008-09	2009-10	2010-11
2007 Tax Revenue Totals		$8.85	-$3.15	-$10.15
2007 Penalty and Interest Totals	$2.05	$7.8	$11.9	$17.9
2007 Grand Totals	$2.05	$16.65	$8.75	$7.75

2005, 2006, and 2007 Combined Totals	2007-08	2008-09	2009-10	2010-11
2005, 2006, 2007 Tax Revenue Totals		$12.25	-$2.15	-$10.35
2005, 2006, 2007 Penalty and Interest Totals	$3.05	$8.65	$12.75	$18.75
2005, 2006, 2007 Grand Totals	$3.05	$20.9	$10.6	$8.4

Note: For purposes of adding totals, estimates of less than $150,000 are assumed to equal $50,000; less than $250,000 equal to $200,000; less than $500,000 equal to $400,000 and less than $750,000 equal to $600,000.

*Penalty and interest provisions.

ARGUMENTS/POLICY CONCERNS

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer. With conformity, the taxpayer is required to know only one set of rules. Additionally, the taxpayer needs to maintain only one set of books.

Conformity also eases the burden of the Franchise Tax Board to administer the law by utilizing many federal forms, instructions, and regulations. In addition, whenever possible, the department uses federal information and audit results to verify that taxpayers pay the proper amount of tax. This eliminates the need for the taxpayer to submit the same information to both the IRS and the department.

PROVISION NO. 2: SIMPLIFY SPECIFIC STATUTORY PROVISIONS RELATING TO WATER'S-EDGE TAXPAYERS

EFFECTIVE/OPERATIVE DATE

This provision is specifically operative for taxable years beginning on or after January 1, 2008.

ANALYSIS

FEDERAL LAW

To understand this provision, 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:[8]
  - 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.[9]
- 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:[10]
  - 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."[11]
- 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.[12] (High Foreign Tax Rule).

[8] IRC section 1248.
[9] IRC section 961.
[10] IRC section 965.
[11] IRC section 960.
[12] IRC section 954(b)(4).

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.

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 income[13] and apportionment factors[14] 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 income[15] 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 Income[16]

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

[13] As reflected on the CFC’s current year books and records, adjusted to conform to California tax law.
[14] Property, payroll, and sales. Used to determine percentage used to assign business income to California.
[15] The numerator includes 100% of the CFC’s Subpart F income.
[16] 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.

2. CFC's Includable Nonbusiness[17] 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.

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.[18]

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.

[17] R&TC section 25120(d) defines nonbusiness income as all income other than business income.
[18] R&TC Section 25116.

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.

THIS PROVISION

This provision 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 provision 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 provision becomes operative would be considered previously taxed income for state tax purposes.
  - Federal adjustments to the CFC's stock basis before this provision 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.[19]
  - The temporary 85% dividend received deduction for dividends received from CFCs.[20]
  - The foreign tax credit.[21]

[19] IRC section 1248.
[20] IRC section 965.

- Add that the High Foreign Tax Rule election would be valid for state purposes only if a valid election was made for federal purposes.
- 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.

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 provision would not significantly impact the department's costs.

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[21] IRC section 960.

ECONOMIC IMPACT

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

Revenue Estimate

Estimated Revenue Impact of this Provision 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 provision.

Revenue Discussion

The revenue impact of the provision 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 provision. 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 provision: 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 provision is effective would be considered previously taxed income for state purposes, and (2) federal adjustments to the stock basis of a CFC before this provision 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	-$31.6
Net Impact for 2009	-$ 0.5

Although the net tax effect for the provision 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.

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

<u>U.S. Shareholder's Shares</u> Total Outstanding Shares	X	Subpart F Income of the CFC	=	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.

<u>California Treatment: Inclusion Ratio Example</u>

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 x $100,000).
- $25,000 of the CFC's nonbusiness income ($60,000/$120,000 x $50,000).
- $75,000 of property in the denominator of the property factor (($60,000/$120,000 x $150,000)
- $37,500 of payroll in the denominator of the payroll factor (($60,000/$120,000 x $75,000)
- $150,000 of sales in the denominator of the sales factor. ($60,000/$120,000 x $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
Mechanics of Provision 6

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	100	
Total E & P	$105	
Inclusion ratio: 10/100		10%

CFC1's Factors:

Property	$ 3,204
Payroll	$ 851
Sales	$17,000

Mechanics

	Proposed Law	**Current Law**
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 ($10 x 27%)	(3)	N/A
Amount of CFC1's Income Included For Water's-Edge Purposes	**$ 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 + $10)	(15)	N/A
Dividend Elimination: Section 25106		(10)
Dividend Deduction: Section 24411	(64)[22]	(67)[23]
Foreign Investment Interest Offset (Assume = 10% of Section 24411)	6	7
Amount of Dividend Income Included In US Parent's business income	**$ 27**	**$ 30**

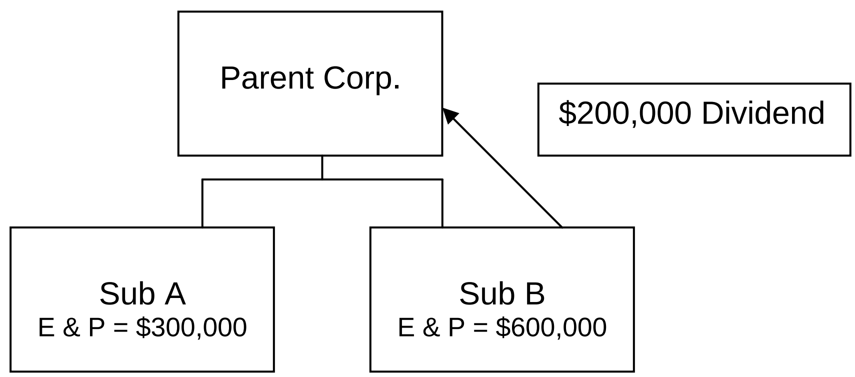
[22]($100 Dividend – $15) x 75% = $64.

[23] ($100 Dividend – $10 -- HOW COME IT'S $10 HERE, BUT $15 UNDER PROPOSAL? Under current law, beginning PTI would not be taken into account) x 75% = $67.

APPENDIX C
AB 1277

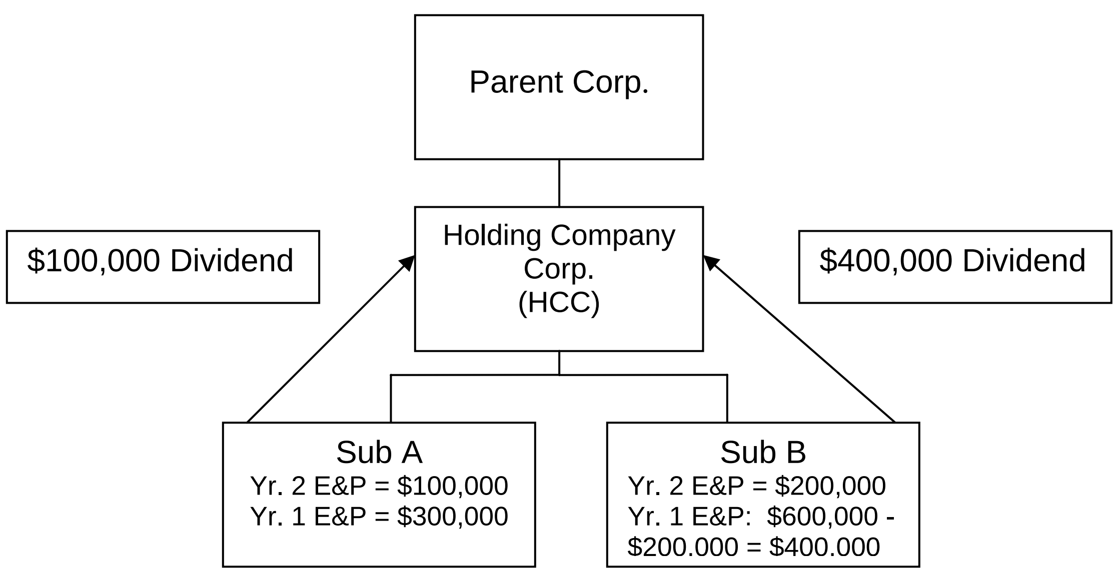
The Year 1 example below illustrates current law and the Year 2 example shows how the unintended inclusion of the same income twice may occur between members of a unitary business when a corporation is newly formed.

Current Law Example: Year 1



In Year 1, Parent Corp. and Subs A and B were members of a combined unitary business. Sub A had current year earnings and profits (E & P) of $300,000 and Sub B had E & P of $600,000. Sub B paid Parent Corp. a dividend equal to $200,000, and Parent Corp. eliminated the $200,000 dividend from taxable income because the dividends were paid out of earnings and profits when Parent Corp. and Sub B were members of a unitary business.

Newly Formed Corporation Example: Year 2



In Year 2, Parent Corp. forms a new subsidiary, HCC. Sub A pays HCC a $100,000 dividend and Sub B pays HCC a $400,000 dividend. The combined business income of Parent Corp, Sub A, and Sub B is included in a California combined unitary business. HCC may eliminate from income the $100,000 dividend received from Sub A because the dividend was paid from earnings and profits (year 2) when HCC and Sub A were members of a combined unitary business. HCC may eliminate from income only $200,000 of the $400,000 dividend received from Sub B because only $200,000 of the dividend was paid from earnings and profits accumulated when HCC and Sub B were members of a combined unitary business (year 2). The other $200,000 of dividend was paid from Sub B's earnings and profits from a year before HCC became a member of the combined unitary business (year 1).

The Year 2 example illustrates when the inclusion of the same income twice may occur if a dividend is paid to a newly formed corporation in the combined unitary business. The dividends distributed in year 2 from earnings and profits were already included in income for year 1, but would again be included in income in year 2 because the newly formed corporation HCC and Sub B were not members of the unitary business in year 1. If instead HCC was never created and the dividends had been paid directly to Parent Corp., Parent Corp. could have eliminated from income the dividends received from Sub B because Parent Corp. was a member of the unitary business in Year 1.