

Franchise Tax Board

**ANALYSIS OF ORIGINAL BILL**

Author: Block Analyst: Gail Hall Bill Number: AB 1178  
 Related Bills: See Legislative History Telephone: 845-6111 Introduced Date: February 27, 2009  
 Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Water's-Edge Election/Include Income Derived From Or Attributed To A Tax Haven

**SUMMARY**

This bill would require multinational corporations that elect to file tax returns based only on income earned inside the U.S., known as the water's-edge method, to include the income of related corporations in a tax haven country.

**PURPOSE OF THE BILL**

According to the author's office, the purpose of this bill is to close a known tax loophole used by corporations to shift income to foreign countries known as tax havens to avoid paying their fair share of tax.

**EFFECTIVE/OPERATIVE DATE**

As a tax levy, this bill would become effective immediately upon enactment and specifically apply for taxable years beginning on or after January 1, 2010.

**POSITION**

Pending.

**ANALYSIS**

Federal Law

In order to facilitate the review of this bill, it is necessary to understand the general federal rules for taxing an entity incorporated in the U.S. (U.S. corporation) and for taxing an entity incorporated in a foreign jurisdiction (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.

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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 U.S.-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.

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.

### State Law

Under the worldwide unitary method, a taxpayer that is part of a worldwide unitary business includes the business income from both domestic and foreign operations in the calculation of income subject to California 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. For taxable years beginning on or after January 1, 2011, certain apportioning trades or businesses may elect to utilize a single factor, 100% sales apportionment formula. Apportioning trades or businesses that derive more than 50% of their gross business receipts from conducting one or more qualified business activities<sup>1</sup> are specifically prohibited from electing the single factor, 100% sales apportionment formula.<sup>2</sup>

As an alternative to the worldwide unitary method, California law, beginning in 1988, 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. A water’s-edge election must be for an initial term of 84 months and remains in effect thereafter, year to year, until terminated by the taxpayer. If a taxpayer terminates its water’s-edge election, it is required to file on a worldwide basis for at least 84 months before making another water’s-edge election.

The entire income and apportionment factors of the following affiliated entities, if unitary with an entity that is a water’s-edge taxpayer, are includable in the water’s-edge return:

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. Corporation incorporated in the U.S., excluding a corporation within the possession of the U.S.<sup>3</sup>
4. An export trade corporation.

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<sup>1</sup> Agricultural, extractive, savings and loan, and banking or financial business.

<sup>2</sup> Revenue and Taxation Code (R&TC) section 25128.5.

<sup>3</sup> Corporations making an election under IRC section 936.

In addition, the following foreign corporations may have income and apportionment factors includable in a water's-edge return:

1. A foreign corporation, if the average of its apportionment factors within the U.S. are less than 20%, will include its income and apportionment factors in a water's-edge return to the extent of its U.S.-source income and its apportionment factors assignable to a location within the U.S.
2. A corporation that is a CFC with subpart F income. The income and apportionment 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 current earnings and profits.

### THIS BILL

This bill would amend the version of Revenue and Taxation Code (R&TC) section 25110 added by SB 663 (Migden, Stats. 2006, Ch. 22).

This bill would include in a water's-edge taxpayer's return the entire income and apportionment factors of any corporation that was doing business in or had income derived from or attributable to a tax haven.

The term "tax haven" would be defined by reference to 39 jurisdictions identified as tax havens by the Organization for Economic Cooperation and Development (OECD)<sup>4</sup> as of December, 2002.

This bill would allow a taxpayer to petition FTB to exclude the income and apportionment factors of a tax haven corporation from the water's-edge return if that corporation's activities in a tax haven jurisdiction constitute either a "substantial economic presence" or "significant economic activity."

In addition, this bill would provide the following:

- Authorize FTB to prescribe regulations necessary or appropriate to carry out the purposes of this bill, including regulations prescribing the extent to which activities in a tax haven jurisdiction are presumed to constitute "substantial economic presence" or "significant economic activity," and therefore, the related tax haven income and apportionment factors would be excluded from the water's-edge return.
- Require FTB to issue a notice identifying the jurisdictions that are considered tax havens.
- Require the Legislative Analyst in consultation with FTB to conduct a study regarding the jurisdictions identified by the OECD as tax havens and report to the Legislature no later than January 1, 2011, about whether the definition of the term "tax haven" should be revised.

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<sup>4</sup> OECD is an organization that brings together the governments of countries committed to democracy and the market economy from around the world to support economic growth, boost employment, raise living standards, maintain financial stability, assist countries with economic development, and contribute to growth in world trade.

## IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

1. The term "doing business in" as it applies to activities in a foreign country (including a tax haven) is undefined for California tax purposes and could result in disputes with taxpayers. The statute that defines "doing business" for purposes of imposing the corporate franchise tax was recently amended to provide bright line rules but those rules may be inconsistent with the author's intent with respect to activity in a tax haven. A broader or narrower definition than current law's definition of "doing business in" the state<sup>5</sup> may better serve the author's intent.
2. The terms "substantial economic presence" and "significant economic activity" are not defined. The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this provision. The author may consider providing definitions for these terms or regulatory authority could be expanded to explicitly authorize FTB to define these terms and to prescribe the presumptions and safe harbors.
3. The bill would allow a taxpayer to petition FTB to exclude the income and apportionment factors of a tax haven corporation from the water's-edge return if that corporation's activities in a tax haven jurisdiction constitute either a "substantial economic presence" or "significant economic activity." The author should consider adding that the petition would be in a form and manner determined by the FTB.
4. The term "tax haven" is defined in the bill by reference to 39 jurisdictions identified as tax havens by the Organization for OECD) as of December 2002. The author should consider listing the 39 tax haven countries specifically in the bill in a manner similar to Montana's current law because department staff was unable to confirm OECD's December 2002 list of tax havens on OECD's website.<sup>6</sup>
5. The bill requires the Legislative Analyst in consultation with FTB to conduct a study regarding the jurisdictions identified by OECD as tax havens and report to the Legislature no later than January 11, 2011, about whether the definition of "tax havens" should be revised. The author should consider requiring that this study be conducted every few years to ensure the list of tax havens is consistent with the OECD's current list of tax havens.

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<sup>5</sup> R&TC section 23101.

<sup>6</sup> <http://www.oecd.org>

## TECHNICAL CONSIDERATIONS

The department has identified the following technical concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

1. In SECTION 1 of the bill, the Legislative findings and declarations refer to enacting "this section" instead of referring to "this act." Amendment 1 is attached to correct this referencing error.
1. This bill adds an affiliated corporation to the list of entities whose entire income and apportionment factors are included in the water's-edge return, therefore, paragraph (2) on page 4 of the bill needs to be updated to include the added subparagraph. (See Amendment 2).

## **LEGISLATIVE HISTORY**

AB 34 (Ruskin, 2005/2006) was nearly identical to this bill and would have required taxpayers filing on a water's-edge basis to include the income and apportionment factors of affiliated corporations doing business in or having income derived from or attributable to a tax haven. AB 34 failed to pass out of the first house by the constitutional deadline.

SB 663 (Migden, Stats. 2006, Ch. 22) added a version of R&TC section 25110 that clarified specific provisions of the franchise tax law relating to water's-edge taxpayers. This bill applies to a taxpayer making a water's-edge election on or after January 1, 2006, and to those taxpayers that made a water's-edge election before January 1, 2006, but not until the expiration of the sever-year period during which a taxpayer may not terminate that election without the consent of the department.

## **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.

*Illinois, Michigan, and Minnesota* have adopted water's-edge provisions, but have no provisions that include the income and apportionment factors of affiliates doing business in tax havens in the water's-edge return. *Florida, Massachusetts, and New York* have no water's-edge and tax haven provisions.

Research found that *Alaska, Montana, and West Virginia* have tax haven provisions. The following is a brief summary of these provisions:

*Alaska's* water's-edge provisions provide that a water's-edge return must include a corporation that is incorporated in or that does business in a country that doesn't impose income tax, or that imposes income tax at a rate that is lower than 90% of the United States income tax rate on the corporation's income tax base in the United States if 50% or more of the corporation's sales, purchases, or payments of income or expenses, exclusive of payments for intangible property, are made directly or indirectly to one or more members of the unitary group filing included in the water's-edge return and "does not conduct significant economic activity" in the low tax country.

*Alaska* law provides that “does not conduct significant activity” means the corporation’s business is substantially limited to transactions that permit favorable tax treatment because of the corporation’s presence in the country that would not otherwise be available to other members of the water’s-edge combined group.

*Montana*’s water’s-edge provisions include a corporation that is in a unitary relationship with the taxpayer and that is incorporated in a tax haven, including Andorra, Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bahrain, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Turks and Caicos Islands, Dominica, Gibraltar, Grenada, Guernsey-Sark-Alderney, Isle of Man, Jersey, Liberia, Liechtenstein, Luxemburg, Maldives, Marshall Islands, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, Samoa, Seychelles, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Tonga, U.S. Virgin Islands, and Vanuatu.

*West Virginia*’s water’s-edge provisions allow the unitary business to include only U.S.-sourced income and income from tax haven countries or a jurisdiction that has no, or nominal, effective tax on the relevant income. “Tax haven” means a jurisdiction so identified as a “tax haven” as of the most recent list or compilation of jurisdictions issued, published or adopted by the OECD on or before June 6, 2008.

**FISCAL IMPACT**

This bill would allow a taxpayer to petition FTB to exclude the income and apportionment factors of a tax haven corporation from the water’s-edge return if that corporation’s activities in a tax haven jurisdiction constitute either a “substantial economic presence” or “significant economic activity.” As a result, the bill would impact the filing and the audit processes. The additional costs have not been determined at this time. As the bill continues to move through the legislative process, costs will be identified and an appropriation may be requested, if necessary.

**ECONOMIC IMPACT**

Revenue Estimate

Projected revenue gains for this bill are shown in the table below:

Fiscal Year Cash Flow Impact Enactment Assumed After 6/30/09 Operative For Tax Years BOA 1/1/10 (\$ in millions)		
2009-10	2010-11	2011-12
\$40	\$130	\$160

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

## Revenue Discussion

Using a sample of corporations that have elected to file using the water's-edge method for California tax purposes, it is estimated that corporations that elected to use the water's-edge method paid approximately \$3.1 billion in franchise/income taxes (taxes) for tax year 2006. This amount was grown using the corporate tax liability growth rate. For tax years 2010, 2011, and 2012, the total taxes paid by water's-edge filers are estimated at \$3.2 billion, \$3.3 billion, and \$3.3 billion, respectively.

In 2004, the state of Montana enacted a tax haven provision that is similar to this bill's provisions. From conversations with a revenue analyst in Montana's Department of Revenue, Montana's tax haven provision increased Montana's corporation tax revenue from water's-edge filers by approximately 5%.

This revenue estimate assumes California would experience the same percentage increase in revenue if AB 1178 were enacted. Applying the 5% increase to California's estimated tax revenues from water's-edge filers for tax years 2010, 2011, and 2012, the estimated revenue increases would be approximately \$158 million, \$164 million, and \$167 million annually. These amounts are converted to fiscal year estimates and shown in the table above.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 1178  
(As Introduced February 27, 2009)

AMENDMENT 1

On page 2, line 18, ~~strikeout~~ "section" and insert:

Act

AMENDMENT 2

On page 4, line 12, after "(C)," ~~strikeout~~ "and (D)" and  
insert:

(D), and (E)