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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS

LP 08-03 (Revised After January 15, 2008, Interested Parties Meeting)

AMENDMENT 1

SECTION 1: Section 25110 of the Revenue and Taxation Code is amended to read:

25110. (a) Notwithstanding Section 25101, a qualified taxpayer, as defined in paragraph (2) of subdivision (b), that is subject to the tax imposed under this part, may elect to determine its income derived from or attributable to sources within this state pursuant to a water's-edge election in accordance with the provisions of this part, as modified by this article. A taxpayer, that makes a water's-edge election on or after January 1, 2006, shall take into account that portion of its own income and apportionment factors and the income and apportionment factors of its affiliated entities to the extent provided below:

(1) The entire income and apportionment factors of any of the following corporations:

(A) Domestic international sales corporations, as described in Sections 991 to 994, inclusive, of the Internal Revenue Code and foreign sales corporations as described in Sections 921 to 927, inclusive, of the Internal Revenue Code.

(B) Any corporation (other than a bank), regardless of the place where it is incorporated if the average of its property, payroll, and sales factors within the United States is 20 percent or more.

(C) Corporations that are incorporated in the United States, excluding corporations making an election pursuant to Sections 931 to 936, inclusive, of the Internal Revenue Code.

(D) Export trade corporations, as described in Sections 970 to 972, inclusive, of the Internal Revenue Code.

(2) ~~(A)~~ With respect to a corporation that is not described in subparagraphs (A), (B), (C), and (D) of paragraph (1), ~~as provided in either one or both of the following clauses:~~

~~(i)~~ The income and apportionment factors of that corporation to the extent of its income derived from or attributable to sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3) of subdivision (b). Income of that corporation derived from or attributable to sources within the United States as determined by federal income tax laws shall be limited to, and determined from, the books of account maintained by the corporation with respect to its activities conducted within the United States.

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~~_____ (ii) The income and apportionment factors of that corporation that is a "controlled foreign corporation," as defined in Section 957 of the Internal Revenue Code, to the extent determined by multiplying the income and apportionment factors of that corporation without application of this subparagraph by a fraction not to exceed one, the numerator of which is the "Subpart F income" of that corporation for that taxable year and the denominator of which is the "earnings and profits" of that corporation for that taxable year.~~

~~_____ (B) For purposes of this paragraph, both of the following apply:~~

~~_____ (i) "Subpart F income" means "Subpart F income" as defined in Section 952 of the Internal Revenue Code.~~

~~_____ (ii) "Earnings and profits" means "earnings and profits" as described in Section 964 of the Internal Revenue Code.~~

(3) The income and apportionment factors of the corporations described in this subdivision shall be taken into account only to the extent that they would have been taken into account had no election under this section been made.

~~_____ (4) The Franchise Tax Board shall prescribe regulations to coordinate implementation of subparagraph (A) of paragraph (2) to prevent multiple inclusion or exclusion of income and factors in situations where the same item of income is described in both clauses.~~

(b) For purposes of this article and Section 24411, all of the following definitions apply:

(1) An "affiliated corporation" means a corporation that is a member of a commonly controlled group as defined in Section 25105.

(2) A "qualified taxpayer" means a corporation that does both of the following:

(A) Files with the state tax return, on which the water's-edge election is made, a consent to the taking of depositions, at the time and place most reasonably convenient to all parties, from key domestic corporate individuals and to the acceptance of subpoenas duces tecum requiring reasonable production of documents to the Franchise Tax Board, as provided in Section 19504, by the State Board of Equalization, as provided in Section 5005 of Title 18 of the California Code of Regulations, or by the courts of this state, as provided in Chapter 2 (commencing with Section 1985) of Title 3 of Part 4 of, and Chapter 9 (commencing with Section 2025.010) of Title 4 of Part 4 of, the Code of Civil Procedure. The consent relates to issues of jurisdiction and service and does not waive any defenses that a taxpayer may otherwise have. The consent shall remain in effect as long as the water's-edge election is in effect, and shall be limited to providing that information

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necessary to review or adjust income or deductions in a manner authorized by Section 482, 861, Subpart F of Part III of Subchapter N, or similar provisions, of the Internal Revenue Code, together with the regulations adopted pursuant to those provisions, and for the conduct of an investigation with respect to any unitary business in which the taxpayer may be involved.

(B) Agrees that, for purposes of this article, dividends received by any corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) from either of the following are functionally related dividends and shall be presumed to be business income:

(i) A corporation of which more than 50 percent of the voting stock is owned, directly or indirectly, by members of the unitary group and which is engaged in the same general line of business.

(ii) Any corporation that is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or that sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business.

"Significant," as used in this subparagraph, means an amount of 15 percent or more of either input or output.

All other dividends shall be classified as business or nonbusiness income without regard to this subparagraph.

(3) The definitions and locations of property, payroll, and sales shall be determined under the laws and regulations that set forth the apportionment formulas used by the individual states to assign net income subject to taxes on, or measured by, net income in that state. If a state does not impose a tax on, or measured by, net income or does not have laws or regulations with respect to the assignment of property, payroll, and sales, the laws and regulations provided in Article 2 (commencing with Section 25120) shall apply.

Sales shall be considered to be made to a state only if the corporation making the sale may otherwise be subject to a tax on, or measured by, net income under the Constitution or laws of the United States, and shall not include sales made to a corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) in determining the amount of income of the taxpayer derived from or attributable to sources within this state.

(4) "The United States" means the 50 states of the United States and the District of Columbia.

(c) All references in this part to income determined pursuant to Section 25101 shall also mean income determined pursuant to this section.

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SEC. 2 Section 24411 of the Revenue and Taxation Code is amended to read:

24411. (a) For purposes of those taxpayers electing to compute income under Section 25110, to the extent not otherwise allowed as a deduction or eliminated from income:

(1) 100 percent of the qualifying dividends described in subdivision ~~(e)~~(d), and

(2) 27 percent of qualifying dividends described in Section 25117, and

(3) 75 percent of ~~other~~ qualifying dividends, other than those referred to in paragraphs (1) or (2). ~~to the extent not otherwise allowed as a deduction or eliminated from income.~~

(b) "Qualifying dividends" means those received by the water's-edge group from corporations if both of the following conditions are satisfied:

(1) The average of the property, payroll, and sales factors within the United States for the corporation is less than 20 percent.

(2) More than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned directly or indirectly by the water's-edge group.

~~(b)~~ (c) The water's-edge group consists of corporations whose income and apportionment factors are taken into account pursuant to Section 25110.

~~(e)~~ (d) Dividends derived from a construction project, the location of which is not subject to the taxpayer's control.

For purposes of this subdivision:

(1) "Construction project" means any activity which meets the following requirements:

(A) Is undertaken for any entity, including a governmental entity, which is not affiliated with the taxpayer.

(B) The majority of its cost of performance is attributable to an addition to real property or an alteration of land or any improvement thereto as those terms are utilized for purposes of this code.

"Construction project" does not include the operation, rental, leasing, or depletion of real property, land, or any improvement thereto.

(2) "Location of which is not subject to the taxpayer's control" means that the place at which the majority of the construction takes place results from the nature or character of the construction project and not as a result of the terms of the contract or agreement governing the construction project.

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SEC. 3. Section 25117 of the Revenue and Taxation Code is added to read:

25117. (a) Except as otherwise provided, income taken into account by all affiliated entities whose income and apportionment factors are determined pursuant to Section 25110 shall include income described in Subpart F of the Internal Revenue Code (commencing with Section 951). The income that is taken into account shall for all purposes be treated as a dividend actually paid, and be subject to any provision or limitation related to the treatment of dividends, including, but not limited to, Sections 24344, 24410, 24411, and 25106. The amount taken into account shall be treated as business or nonbusiness income (as defined in Section 25120), as the case may be.

(b) In the application of Subpart F of the Internal Revenue Code:

(1) Exclusions from gross income under Section 959 of the Internal Revenue Code, relating to previously taxed income, shall apply, including amounts related to income previously taxed under federal law in years prior to the water's edge election.

(2) Federal adjustments to stock basis made pursuant to Section 961 of the Internal Revenue Code, relating to adjustments to basis of stock in controlled foreign corporations and of other property, including adjustments made prior to the water's edge election, shall apply.

(3) The provisions of and any reference to Section 1248 of the Internal Revenue Code, relating to gain from certain sales or exchanges of stock in certain foreign corporations, shall not apply.

(4) Section 960 of the Internal Revenue Code, relating to special rules for foreign tax credit, shall not apply.

(5) Section 965 of the Internal Revenue Code, relating to temporary dividends received deduction, shall not apply.

(6) For purposes of this section, a federal election to exclude from Subpart F income the income described in Section 954(b)(4) of the Internal Revenue Code shall apply, including amounts related to income previously taxed under federal law in years prior to the water's edge election. No election under this subparagraph shall be allowed for state purposes unless a valid election was made for federal purposes.

(c) In the event that a water's-edge election is terminated, for taxable years thereafter, the following rules apply:

(1) Subpart F of the Internal Revenue Code shall not apply, except as provided in this subdivision.

(2) Section 959 of the Internal Revenue Code, relating to exclusion from gross income of previously taxed earnings and profits, shall apply, but only to the extent attributable to income that has been taken into account pursuant to subdivision (a) during the period of the water's edge election. **Section 24425 shall not apply to the exclusion from gross income of previously taxed earnings and profits discussed in this paragraph.**

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(3) Stock basis shall be determined as if this section did not apply, except that stock basis shall be--

(A) Increased by income taken into account pursuant to subdivision (a) during the period of the water's edge election, and

(B) Reduced by the following:

(i) That portion of amounts excluded from income under paragraph (2) of subdivision (b) that are attributable to income taken into account pursuant to subdivision (a) during the period of the water's edge election, and

(ii) Amounts described by paragraph (2) of subdivision (c) excluded from income after termination of the water's edge election.

(d)(1) Except as provided in paragraph (2) this section shall apply to taxable years beginning on or after January 1, 2008.

(2) In the event that two or more taxpayers subject to the same election under section 25110 have different taxable years, this section shall apply as of the first day of the first taxable year of those respective taxpayers that begins on or after January 1, 2008.

(e) If a distribution with respect to earnings and profits from a given year is eligible for treatment as previously taxed income and would, without regard to the effects of this section, be eligible for deduction, exclusion, or elimination under another section under this part if paid as a dividend, in no event shall combined effect of those sections and the rules relating to previously taxed income result in a deduction, exclusion, or elimination greater than the amount of the earnings and profits that apply to the distribution.

~~(e)~~(f) The Franchise Tax Board may prescribe regulations as may be necessary and appropriate to carry out the purposes of this Section.