# LEGISLATIVE PROPOSAL 08-03
# EXECUTIVE SUMMARY

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

- **Problem:** Calculating a CFC's income and apportionment factors for a California water's-edge taxpayer is extremely burdensome—time consuming and expensive—for the taxpayer and the department, resulting in frequent taxpayer misapplications of the law and the need for audit.

- **Proposed Solution:** Simplify the method used to report a water's-edge taxpayer's portion of its CFC's income by removing current law's "stand alone" inclusion ratio method and conforming to the federal Subpart F rules for computing the amount of a CFC's income that is included in a shareholder's income with some specific exceptions.

  This proposal would allow a 27% dividend deduction against the CFC's Subpart F income included in the water's-edge taxpayer's income.

- **Major Concerns/Issues:** None

- **Revenue:**

| Estimated Revenue Impact of LP 08-03<br>Effective for Taxable Years BOA 1/1/08<br><br>***Enactment Assumed After 6/30/08*** | | |
|---|---|---|
| 2008-09 | 2009-10 | 2010-11 |
| <-$500,000 | <-$500,000 | <-$500,000 |

## Title

Controlled Foreign Corporations In Water's-Edge Combined Report

## Introduction

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

## Current Federal Law

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

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

U.S. shareholders of a CFC must include in their gross income certain types of income and investments of the CFC that would otherwise be excluded from taxable income under general federal tax rules. Any income of a CFC that meets the definition of Subpart F income is treated as a deemed dividend received by the U.S. shareholder, regardless of whether the income was actually distributed to the shareholder. Subpart F income generally includes passive income such as dividends, interest, royalties, and rents. Subpart F income may also include foreign personal holding company income, services income, shipping income, oil related income, insurance income, and income from certain sales of goods that are neither manufactured nor sold for use in the CFC's home country. In addition, a U.S. shareholder must include in federal income the increase in earnings invested in U.S. property. A U.S. shareholder must treat its CFC's Subpart F income as if the Subpart F income was distributed to the U.S. shareholder in the form of a dividend and must report their pro rata share of the CFC's Subpart F income based on ownership as of the last day of the CFC's taxable year. The basic formula for determining a U.S. shareholder's pro rata share of Subpart F income is illustrated in the attached Appendix A.

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

Miscellaneous Federal Provisions Relating to CFCs.

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

## Current 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.

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[1] Internal Revenue Code (IRC) Section 1248.
[2] IRC section 961.
[3] IRC section 965.
[4] IRC section 960.
[5] IRC section 954(b)(4).

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[6] and apportionment factors[7] 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[8] 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[9]**

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

**2. CFC's Includable Nonbusiness[10] 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.

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[6] As reflected on the CFC's current year books and records, adjusted to conform to California tax law.
[7] Property, payroll, and sales. Used to determine percentage used to assign business income to California.
[8] The numerator includes 100% of the CFC's Subpart F income.
[9] Revenue and Taxation Code (R&TC) section 25120(a) defines business income as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

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

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.[11]

## Program History/Background

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

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

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

This proposal differs from prior years' LP 01-24 and LP 03-23 in that it conforms to the federal Subpart F provisions and allows dividend deductions to offset the Subpart F "deemed" dividend. Executive Management approved LP 01-24 in 2000 and LP 03-23 in 2002. Spidell Publishing and Cal-Tax raised concerns that the proposals lacked factor relief or a dividend-received deduction, resulting in FTB staff withdrawing LP 01-24 and contributing to LP 03-23's rejection by the three-member Franchise Tax Board. This proposal includes conformity to the federal Subpart F provisions and the allowance of a dividend deduction to neutralize the tax effect.

[11] R&TC Section 25116.

## Problem

Calculating a CFC's income and apportionment factors for a California water's-edge taxpayer is extremely burdensome—time consuming and expensive—for the taxpayer and the department, resulting in frequent taxpayer misapplications of the law and the need for audit.

## Proposed Solution

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 proposal 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. (Amendment 1)
- Conform to the federal Subpart F provisions and provide that the amount of a CFC's Subpart F income that would be included in a water's-edge taxpayer's income would be treated as a "deemed dividend" eligible for current state law's dividend exclusion and deductions relief[12]. (Amendment 3).
- 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. (Amendment 2).
- Add the following transitional rules for conforming to the federal Subpart F provisions: (Amendment 3)
  - Income previously taxed as Subpart F income before this proposal is effective would be considered previously taxed income for state tax purposes.
  - Federal adjustments to the CFC's stock basis before this proposal is effective 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: (Amendment 3)
  - The gain from certain sales or exchanges of stock in certain foreign corporations[13],
  - The temporary 85% dividend received deduction for dividends received from CFCs[14].
  - The foreign tax credit[15],
- 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. (Amendment 3).
- Add that the High Foreign Tax Rule election would be valid for state purposes only if a valid election was made for federal purposes.

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[12] Revenue and Taxation Code (R&TC) Section 24344, 24410, 24411, and 25106.
[13] Internal Revenue Code (IRC) Section 1248.
[14] IRC section 965.

[15] IRC section 960.

- Specify that the Franchise Tax Board may prescribe regulations as may be necessary and appropriate to carry out the provisions of this proposal. (Amendment 3)

## Effective/Operative Date of Solution

If this proposal were enacted as a tax levy during the 2008 legislative session, it would be effective upon enactment and operative for taxable years beginning on or after January 1, 2008. In the event that two or more water's-edge taxpayers have different taxable years, this proposal would apply as of the first day of the first taxable year that begins on or after January 1, 2008, of those respective taxpayers.

## Justification

This proposal would eliminate the complexities with using current state law's CFC partial inclusion rules for calculating how much of a CFC's income and factors to include in the taxable income of a water's-edge taxpayer and allow taxpayer's to use the federal Subpart F rules—an amount the taxpayers have already calculated for their federal tax return.

## Implementation

Implementing this proposal would require some changes to existing tax form instructions and publications, which could be accomplished during the normal annual update.

## Fiscal Impact

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

## Economic Impact

Tax Revenue Estimate

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

| Estimated Revenue Impact of LP 08-03<br>Effective for Taxable Years BOA 1/1/08<br>***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 proposal.

## Tax Revenue Discussion

The revenue impact of the proposal 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 (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 proposal;
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: a revenue loss of $3 million;
5. Calculated a dividends-received deduction that would result in a roughly revenue neutral tax impact for the proposal: 27% dividends deduction.

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 proposal is effective would be considered previously taxed income for state purposes, and (2) federal adjustments to the stock basis of a CFC before this proposal 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. Using data from 2004, taxpayers allowed a 27% dividends-received deduction for Subpart F income would result in a minor net revenue loss of less than $500,000 for the proposal.

For each component of the estimate, except for the impact for transition rules, 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 proposal is roughly revenue neutral, most corporations in the sample would experience a tax decrease.

## Other States

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 if these states conform to the federal Subpart F provisions.

*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 includes federal Subpart F income 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.

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.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS
LP 08-03

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) T~~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.

~~(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

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.

AMENDMENT 2

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 ~~(c)~~(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.

~~(c)~~(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.

AMENDMENT 3

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.

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

## APPENDIX A

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

| | | | | |
|---|---|---|---|---|
| U.S. Shareholder's Shares / 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.

**California Treatment: Inclusion Ratio Example**

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

- $50,000 of the CFC's business income ($60,000/$120,000 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.